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THE POLITICAL ECONOMY OF ENTREPRENEURSHIP*

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Abstract:
We outline a politico-economic growth system centered around the entrepreneur. The working of entrepreneurial function crucially depends on the existing institutional framework. We develop a typology of different types of entrepreneurship to further our understanding of the effect of institutional context on entrepreneurial activity. We also point to the necessity of viewing institutions as endogenously influenced by entrepreneurs. We use developments in modern history as a real-world context for evaluating our framework. Particular attention is given to the effects of enforcement of property rights and taxation, two of the most prominent institutions in the literature.

JEL Codes: H32; L5; L25; M13; O31; P14.

Keywords: Entrepreneurship; Industrial Policy; Innovation, Property Rights; Regulation; Self-employment; Tax Policy.

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1. Introduction

Entrepreneurship is normally associated with profit-driven business activities. Still, political aspects of entrepreneurship have been dealt with in several strands of research, including the entrepreneurship/small-business literature new institutional economics, and public choice theory. In this paper we develop a framework which unifies the political role of entrepreneurship as it appears in these three fields with the traditional economic role.

The focus on causal mechanisms from entrepreneurship to economic performance is the main strength of the entrepreneurship literature. In the influential article by Wennekers and Thurik (1999), the entrepreneur affects economic outcome by making decisions at the firm level. Similarly, Hébert and Link (1989, p. 47) propose a specific economic function of entrepreneurship: "making judgmental decisions that affect the location, form, and the use of goods, resources, or institutions". The presence of this function is asserted to be necessary for improved economic performance.

In the entrepreneurship literature it has long been recognized that institutions shape the context in which entrepreneurs act.[1] Moreover, the reference to institutions has recently become more explicit. But the causal link between institutions and entrepreneurs is often assumed to be unilateral. For instance, Boettke and Coyne (2003) address the question whether entrepreneurship is the cause or consequence of economic growth. Their answer is that entrepreneurship is the consequence, and institutions the cause. In our view, this conclusion overlooks the effects of entrepreneurship on politically determined institutions.

The public choice analysis of entrepreneurship is highly influenced by Baumol (1990) and Murphy, Shleifer and Vishny (1991). The basic points in these two papers are very similar. Agents are assumed to be heterogeneous with respect to talent for management (Murphy *et al.*) and entrepreneurial ability (Baumol). The most talented have the highest return from productive innovation and the management of firms. However, if other types of activities yield a higher return to talent/ability, then entrepreneurs will instead direct their efforts at these other activites. Relative returns are determined by the institutional context, i.e., the rules of the game.

The relationship between entrepreneurship and institutions as it is often treated both in public choice and the entrepreneurship literature can be captured by the metaphor of a watershed. Agents pour through this watershed and are channeled in different directions. Baumol (1990) and Murphy *et al.* (1991) add a public choice ingredient to the analysis. In their theories entrepreneurship is not only hampered or facilitated by institutions, it can take on radically different shapes. Entrepreneurship now also includes rent seeking activities,[2] and can therefore be unproductive or destructive. The main problem with this analysis pertains to the underlying watershed metaphor. Assuming that entrepreneurs respond passively to institutions is flawed.[3]

[1] When economists have analysed the question why people start firms and what determines the growth trajectories of new firms, institutions loom large as explanatory factors (see Parker, 2004, section 3.3).
[2] Here the term rent seeking refers to the way it is used by public choice scholar. Later in the paper it will be used in a different sense.
[3] The way institutions are treated in the public choice tradition more generally is more complex. For instance, Buchanan (1980, p. 14), writes: "Faced with a prospect of differentially unfavorable tax treatment by government, a person or a group may (1) engage in lobbying effort; (2) engage directly in politics to secure access to decision-making power, and/or (3) make plans to shift into or out of the affected activity."

New institutional economics offers a more dynamic account of institutions. Moreover, key texts, notably North (1990), feature the entrepreneur as an agent of institutional change. A common problem in this literature is that the concept of an entrepreneur becomes too vague to be useful. The notion gets increasingly broad as the entrepreneur is no longer primarily an agent with unique productive capacities, but rather an agent of change more generally.

We model the entrepreneur as the key agent in an economic system that includes political institutions. This is done by synthesizing elements from all three traditions above. To this end, the watershed metaphor is dropped, and a more nuanced view is adopted. It will still be true that institutions channel entrepreneurial talent in different directions. But some agents might, at the same time, find opportunities within the institutions themselves. Others may expend effort in avoiding, or finding the easiest way around obstacles raised by institutions. In this process, the entrepreneurs effectively, intentionally and unintentionally, change the institutional setup. Hence, the institutional setup becomes endogenous.

In the next section we outline our model of entrepreneurial activity. We begin by defining the concept of an entrepreneur and introduce a typology of different kinds of entrepreneurship. We also identify the key roles of the entrepreneur. In section 3 we consolidate our model by embedding the entrepreneur in a politico-economic system. We identify the key role of the entrepreneur in this system. We then discuss a more general way of analyzing entrepreneurial actions in terms of rent seeking. Section 5 uses examples from recent history to illustrate the workings of our model and section 6 provides detailed examples of two pertinent institutions. Section 7 concludes.

2. A Model of Entrepreneurial Choice

2.1 Entrepreneurial talent

We follow Baumol (1990) and Murphy *et al.* (1991) and define an entrepreneur according to a set of talents (both cognitive abilities and motives).[4] There is no consensus in the literature about the exact nature of these talents.[5] Entrepreneurial talent, in our model, makes an individual more perceptive and more dynamic. The entrepreneur is apt to recognize

[4] Murphy *et al.* (1991) focus on management talent, while Baumol (1990) stresses entrepreneurial talent. To simplify somewhat we will henceforth discuss entrepreneurial talent only, where talent is assumed to include both ability and motivation.

[5] Which are the typical entrepreneurial properties? In the literature there are several suggestions. Two major themes can be discerned, one refers to cognitive abilities and the other to motivation. The prototypical entrepreneur is someone who is alert to opportunities. Cognitively, this amounts to structuring abundant information efficiently to make judgment feasible. See, for instance, the survey by Chell, Haworth and Brearley (1991). It also involves a capacity to think imaginatively and in novel ways. Regarding motives, the longest standing characterization of the entrepreneur is the need to achieve and create (Weber, 2001[1905]; McClelland, 1961). Furthermore, the entrepreneur exhibits a willingness to take calculated (but not necessarily calculable) risks. For instance, Knight (1921) discusses uncertainty bearing as the main function of entrepreneurship. This implies a predisposition of willingness to take (incalculable) risks. For a survey of the empirical evidence on these motivational aspects, see Rausch and Frese (2000). These properties are consistent with historical accounts, most importantly the ones given by Schumpeter and Kirzner. Despite their reluctance to point out certain individual characteristics, they nevertheless carefully described the characteristics or traits that make someone apt to fulfil the entrepreneurial function. Regarding Kirzner it can be noted that, even though he gives priority to alertness, he admits that characteristics such as courage and self-confidence should also be recognized (Kirzner, 1999).

opportunities and quick to take action in response. These actions yield an expected return above the risk-adjusted market rate of return, i.e. an economic rent. We discuss the nature of these rents in more detail in section 4.

The starting point for our model is that entrepreneurship is simply the carrying out of these actions. While retaining a broad definition of the entrepreneur, we wish to emphasize the distinction between being an entrepreneur and engaging in entrepreneurial activity. The former is a necessary but not a sufficient condition for the latter. Entrepreneurial activity is the active response to perceived opportunity. Institutions may prevent entrepreneurs from engaging in such activity, for example by imposing a prohibitively high entry cost.[6]

Another important aspect of our definition concerns the relationship between self-employment and entrepreneurship. Self-employment and the start-up of new firms remains the prototypical form of entrepreneurship in much of the literature. By contrast, our definition precludes many forms of self-employment. Most importantly, self-employment due to a lack of other opportunities (often called necessity entrepreneurship) does not qualify as entrepreneurship. Another instance is when the government artificially increases the return to self-employment through subsidies. The new self-employed are unlikely to be entrepreneurs in the sense used here.

Finally, we do not maintain that the supply of entrepreneurial talent is exogenous. On the contrary, it is plausible that the supply of entrepreneurs varies over time, among other things depending on the institutional setup. We abstract from this additional complexity in our analysis. For simplicity, we take the supply of entrepreneurial talents as exogenous and focus our attention on the relationship between entrepreneurial talent, institutions, and entrepreneurial activity. We will refer to the latter as entrepreneurship.

2.2 Entrepreneurship – A Typology

Our two-dimensional typology distinguishes between productive, unproductive and predatory entrepreneurship, and in another dimension, evasive entrepreneurship. All four types of entrepreneurship are defined as activities, and not as outcomes. In this respect we depart from many other accounts, where various types of entrepreneurship are by definition linked to outcome in terms of social and economic implications (see 2.4). [7]

Our definition of productive entrepreneurship is closely tied to Schumpeter's (1934) discussion of new combinations. Schumpeter mentioned: (i) introduction of a new good (or a new quality of a good); (ii) introduction of a new method of production; (iii) opening of a new market; (iv) conquest of a new source of supply of raw-materials or half-manufactured goods; (v) carrying out of a new organizational form. More abstractly, we will summarize these points as new combinations of resources and technology on the market.[8] The new combinations of resources and technology give rise to short-term monopoly rents. The size of

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[6] Our implicit claim is that it would, in principle, be possible to identify an entrepreneur through an appropriately devised psychological test.

[7] See Coyne and Leeson (2004) for a typical exposition.

[8] Since entrepreneurial ctivity is a driver of endogenous technological change, it is partly endogenous in our model. If we define technology as total factor productivity then all Schumpeterian combinations are by definition new technologies. However, we do not want to preclude cases where new inventions and scientific research and applications are made by others than entrepreneurs. Such technological progress constitutes is exogenous in our system.

the rent is partly determined by institutions, a point that will be elaborated further as we proceed.

We define unproductive and predatory entrepreneurship in relation to the rents created by productive entrepreneurship. Unproductive and predatory activities are aimed at capturing the rents created by productive entrepreneurship.

If we abstract from institutions, the activities of unproductive and predatory entrepreneurs would constitute a purely negative effect on the return to productive entrepreneurship. However, we add to our definition of unproductive and predatory activities that these must be related to the institutional framework. Whereas productive entrepreneurship generates rents through the exchange of marketed goods and services, unproductive and predatory entrepreneurship are more directly dependent on the institutional framework. A law firm started to construct contracts to help other firms avoid restrictive labor market regulations is an example of unproductive entrepreneurship. This law firm captures part of the rent created by others, and its existence hinges on special institutional circumstances imposed by the regulation. As is evident from this example, apart from capturing part of the rent created by productive entrepreneurship, unproductive and predatory activities alter the conditions under which productive entrepreneurship is carried out. Thereby, they also change the amount of rent created, resulting in an ambiguous net outcome for productive entrepreneurship. The relationship between unproductive and productive entrepreneurship could be a mutually beneficial symbiosis as in the example with the law firm.

Predatory and unproductive entrepreneurship are distinguished from one another in that the former entails an attack on the productive entrepreneur. In other words, it involves a non-voluntary relation on behalf of the productive entrepreneur. Examples of predatory entrepreneurship include mafias and illegal syndicates. Even in well functioning economies one can think of examples such as fraudulence and systematic law suits against other businesses.

Unproductive entrepreneurship, on the other hand, entails a voluntary relation with the productive entrepreneur. Examples of this kind of entrepreneurship include lobbying, rents from various contractual forms which either substitute for deficient regulation or help other entrepreneurs circumvent overly restrictive regulation.

Institutions determine the relative return of these three kinds of entrepreneurial activity. However, it is of equal importance that institutions also affect the absolute returns by imposing costs on these activities. An entrepreneur must make a decision about abiding by, evading or violating existing institutions. Each activity involves a transaction cost and an information cost. If the entrepreneur chooses not to abide by the institutions, the transaction cost is lowered but a new cost in the form of a risk of sanctions is incurred.

Evasive entrepreneurship is defined as activities which have the purpose of circumventing the institutional framework without an explicit violation. By avoiding violations, the activities of evasive entrepreneurs reduce the risk of sanctions and hence the costs imposed by institutions. Unlike the other three kinds of entrepreneurship, evasive entrepreneurship is not an end in itself. Instead, it is a means to reach an end which resides in one of the other three categories. The definitions laid out are illustrated and exemplified in *Table 1*.

Table 1. A Typology of Different Kinds of Entrepreneurship

	ABIDE	EVADE	VIOLATE
PRODUCTIVE	Pursue a business opportunity within prevailing institutions	Sidestep regulation in order to expand a profitable business	
UNPRODUCTIVE	Create contracts to overcome institutional shortcomings	Organized bribery; Creation of a bureaucratic form where rents are earned on selling licenses or subsidized loans	
DESTRUCTIVE/ PREDATORY	Rogue States; Rivalry between warlords	Illegal syndicates; Mafia; Sophisticated fraud and economic crimes	

2.3 The Role of Entrepreneurship

Regarding the social and economic consequences, the types of entrepreneurial activities outlined above are admittedly highly suggestive. Still, we have explicitly denied any direct implications. This section explains our approach.

To see our point more clearly, let us return to Baumol (1990). He defines entrepreneurial activities as a quest for new Schumpeterian combinations. Whether an entrepreneurial activity is productive, unproductive or destructive is determined by what kind of resources and technologies that are combined. If the new combination creates a new technology for rent seeking (wealth redistribution) it is unproductive (or destructive). This, however, involves circular definitions, since by Baumol's definition rent seeking activities generate bad outcomes. Clearly, this definition precludes the separation of activity from outcome (Hindmoor, 1999), and therefore overlooks the possibility that the same activity can give rise to different outcomes in different institutional settings. This explains Baumol's amazement regarding Schumpeter's inclusion of a new monopoly among his examples of productive combinations. Schumpeter would probably have responded that whether a monopoly is socially wasteful depends on the circumstances – in our words, it depends on the prevailing institutions.[9]

Productive entrepreneurship increases an economy's ability to adapt and its innovativeness. Innovativeness refers to Schumpeter's (1934) entrepreneur who disturbs the existing

[9] We do not want to deny that an entrepreneurial activity could involve the combination of a new technology to facilitate bribery and other forms of corruption (in Baumol's words a rent seeking technology). This would probably have negative consequences in the sense that it withdraws entrepreneurial talent and effort from productive activities. This may also impose an obstacle and increase the cost of carrying out other productive activities. But it could also have the opposite effect and facilitate the pursuit of productive activities for others. The outcome in terms of social value of the new combination is ambiguous.

equilibrium, while the ability to adapt captures the essence of Kirzner's (1973, 1992) entrepreneur. Here, the entrepreneurial activities move the economy towards equilibrium.[10]

Normally, productive entrepreneurship can be expected to improve economic performance. Nevertheless, the relative importance also depends on the external environment. For instance, in times of rapid change, driven for example by a high rate of technological progress or new supply of resources, adaptability becomes more important.[11]

By dissipating rents, unproductive and predatory entrepreneurship are both potentially disturbers of productive entrepreneurship.. However, this is no inevitable outcome. For instance, introducing new contractual ways of avoiding overly restrictive regulations could have both positive and negative consequences for productive entrepreneurship.[12]

But what makes unproductive and predatory entrepreneurship entrepreneurial activities in the first place? Is this not a fallacious terminology? It is part of our theory that a set of talented individuals have the potential of becoming productive entrepreneurs. But if such opportunities are barred from exploitation, or if other kinds of activities are more profitable, these persons will engage in other activities. Obviously, we cannot cover all possible alternative activities. Therefore, all types of entrepreneurship we consider relate to rents. Even if entrepreneurs do not create rents, they can use their abilities to perceive potential and actual rents and try to capture them from others.

3. The Politico-Economic Role of the Entrepreneur

The next subsection introduces the politico-economic approach. We then discuss the basic building blocks of our model, closely following Acemoglu, Johnson and Robinson (2005). Their analysis is extended in the next two subsections by embedding our entrepreneur in a politico-economic system of production.

3.1 The Politico-Economic Approach

Economic institutions of particular importance for entrepreneurship include tax codes, social insurance systems, labor market legislation, competition policy, trade policies, capital market regulation, enforcement of contracts and law and order (Hall and Jones, 1999). Recent research also points to the economic significance of constitutions, for example through their implications for voting systems, degree of centralization, federalism, *et cetera* (Persson and Tabellini, 2004, 2006). These are all examples of political institutions.[13]

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[10] See Baumol (2005) and Yu (2001) for discussions of these two aspects and how they can be combined in the same system. See also Kirzner (1999) for a critical assessment of such merging.

[11] Our concept of adaptability is related to, and could be regarded as a subset of, North's (1990) adaptive efficiency.

[12] To the extent that unproductive, predatory and evasive entrepreneurship change the institutions there is an additional cumulative aspect. Benson (1984, 2002) argues that new rules and regulations have the side effect of creating opportunities to earn profits if the rules are circumvented. This, in turn, creates incentives to offer payments and bribes to government officials in exchange for beneficial treatment.

[13] For some purposes it is useful to distinguish between three types of institutional change: (i) effects on *policy measures within given institutions*, such as changes in interest rates or enforcement of a law or a regulatory measure; (ii) effects through *changes in formal institutions*, such as a tax reform or new environmental legislation; (iii) changes at the *constitutional level*: introduction of mass democracy, a new voting system, granting of autonomy to the central bank, *et cetera*. The third type pertains to political institutions, whereas the first two types of change affect economic institutions.

Institutions shape human action and interaction, and they are commonly referred to as the rules of the game that govern the conduct of economic activity and that shape "the social structure of payoffs."[14] We want to emphasize three features of a rule (or an institution). First, rules can be more or less formal. In a political economy context, it is arguably crucial that someone (or a group) institutes a rule with a certain intention in mind. In the majority of instances, this excludes informal rules such as norms, values or codes of conduct, which arise as a side-effect of other activities. For simplicity, we will restrict our analysis to formal rules.[15] Second, rules that actually affect individual behavior often take time to become established, and once established, take time to be destroyed. In this manner, institutions typically show a high degree of inertia. Third, a rule which is not enforced is likely to lose its practical relevance. Henceforth, when we talk about an institution, we refer to its actual implementation and enforcement.

For a long time, economists have explored potential bilateral causal effects between politics, institutions and economic performance.[16] However, the underlying mechanisms have proven difficult to analyze rigorously in a general equilibrium setting. The concepts and distinctions introduced in Acemoglu *et al*. (2005) are important steps towards a better understanding of these issues. In the next section, we present an outline of these concepts and distinctions.

3.2 Building Blocks

The general outline of the model proposed by Acemoglu *et al*. (2005) is shown in *Figure 1*. Two kinds of institutions are distinguished: economic and political. The structure of both political and economic institutions is determined by those with political power.

There are two types of political power: *de jure* and *de facto*. *De jure* political power originates from political institutions, whereas *de facto* power captures the possibility of wielding power without having to rely on political institutions. It is useful to think of *de facto* political power in terms of coups and upheavals. Although we consider less extreme instances, *de facto* power still requires the possession of resources. The significance of dividing political power into two distinct types is illustrated in Acemoglu and Robinson (2006), where some of the mechanisms in *Figure 1* are formally modeled. One result emerging from their analysis is so-called invariance; the effects on the elite of varying *de jure* circumstances can be offset by compensatory elite investments in *de facto* political power.

Economic outcomes are analyzed in two dimensions: economic performance and distribution. The first dimension refers to growth in resource stocks, national income and other common measures. The second covers the equality dimension, i.e., how resources are distributed in the population or among particular groups (e.g. ethnic, religious or gender) of the population. It is the distribution which in turn affects *de facto* political power. The assumption made is that in

[14] This concept is borrowed from Baumol (1990). Institutions have moved to the fore of mainstream explanations for economic performance, especially over the longer term; see, for example, North and Weingast (1989), Rodrik *et al.* (2004) and, in particular, Acemoglu *et al*. (2005).

[15] Hence, we do not explicitly deal with aspects such as social attitudes toward entrepreneurship as an individualistic venture (Hofstede, 2001). Schumpeter (1934) discussed how the entrepreneur broke away from old routines and how this required special powers in order to endure social resistance due to entrenched values.

[16] That policies emanating from the political sphere should influence economic outcomes is a key assumption in economics. Effects of economic performance on political institutions have proven more difficult to isolate. However, at the macro level, there are some recent studies identifying such effects (e.g. La Porta *et al.*,1999; Chong and Calderón, 2000).

a society with high inequality, a wealthy minority can have a large impact in the political sphere.

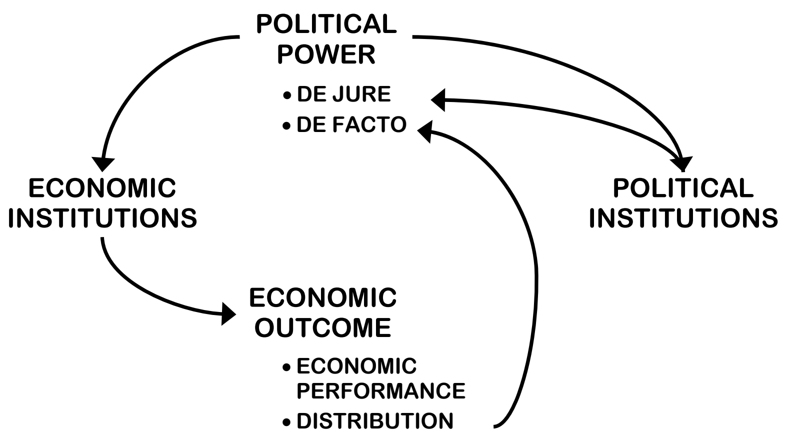

Figure 1. The Acemoglu *et al*. (2005) Growth System.

There are three noteworthy aspects of this model. First, it explicitly takes into account, and separates, economic and political institutions. This forces us to consider the distinction between institutions that have a direct effect on economic outcomes and those that work through a political process. Second, it proposes an explicit link between economic outcome and political power. This effect emanates from the economic outcome in terms of distribution. Not only are the *de facto* aspects of political power affected directly. There is also an indirect effect; in a long-term perspective, *de facto* power will leave its mark on political institutions and thereby be translated into *de jure* political power. Third, the explicit introduction of political institutions, and the related *de jure* political power, gives rise to inertia in the system. This is an important feature since without institutional inertia the political aspects of the model would merely mirror economic outcome.

The separation between political institutions, political power and economic institutions is more difficult to make in countries where the ruling elite has much discretionary power. Examples include developing countries where the ruling elite benefits from inappropriate institutions and thus contributes to preserving the *status quo* irrespective of welfare costs (North, 1981; Lundahl, 1997).[17]

But, well-functioning democracies also have political markets. Ever since Stigler (1971), it has been recognized that policy making is highly influenced by interest and lobbying groups. Moreover, in the opposite direction, politicians may extract rents by threatening to impose unfavorable regulation (McChesney, 1987). However, the crucial difference from developing countries is that in a mature democracy, economic interests cannot influence institutions directly.

[17] In such contexts it is often difficult to implement the requisite reforms, since the reforms themselves would undermine the political power of the ruling elite. One solution to this problem would be that the prospective winners of the reforms make binding commitments to compensate the ruling elite. All parties could potentially benefit from such an arrangement. However, without a third party to guarantee compliance, binding commitments would be difficult to enforce (Acemoglu *et al.*, 2005).

3.3 A Model with Entrepreneurs

The mechanism behind the link from economic institutions to economic outcome remains implicit in the Acemoglu *et al*. (2005) model. We close this gap by incorporating the entrepreneur and a production system, which is shown in *Figure 2*.

It is essential to our approach that entrepreneurial activity can only be evaluated within an institutional context. When viewed as a resource, the entrepreneur is qualitatively very different from capital and labor. There is no guarantee that a potential entrepreneur will actually devote his or her time and effort to productive use. In our model, it is the entrepreneur that directly shapes economic outcomes, which is why we have drawn the causal link to economic outcome from the entrepreneur only. Nonetheless, the characteristics of this link are inextricably related to the institutions. The subset of economic institutions denoted "pertinent institutions" consists of those institutions that we consider to be major determinants of the level and direction of entrepreneurial activity.

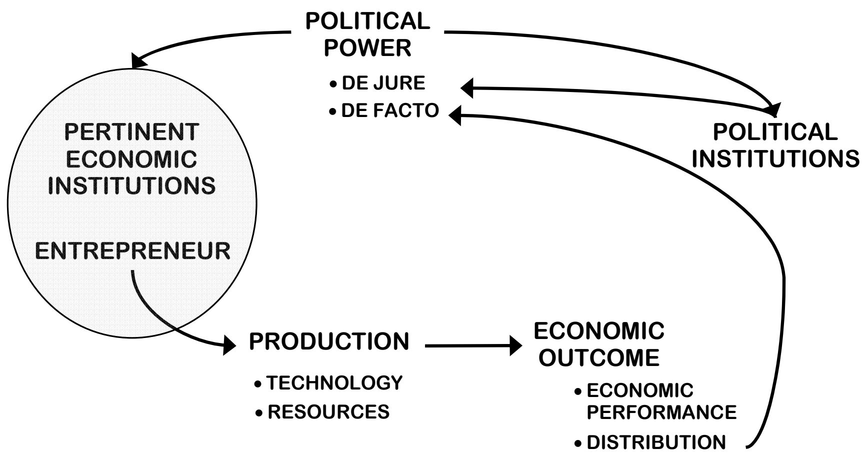

Figure 2. Introducing the Entrepreneur into the Growth System.

In *Figure 3*, we complete the model by making the different kinds of entrepreneurship explicit. The dynamics of the production system is captured by its ability to adapt to changing conditions and to renew itself through innovations.[18] Productive entrepreneurship is the vehicle of these capacities. Capital (both human and physical) and labor are the inputs in a more or less productive environment, which allows for greater or less dynamism. In the limit, when no entrepreneurship of any form takes place, this environment congeals, resulting in a static economy. But even for positive levels of entrepreneurship, the net effect of productive, unproductive and predatory entrepreneurship could be very modest.

[18] Myhrman (1989) discusses the key role of an economy's ability to adapt and in this context also stresses the importance of institutions.

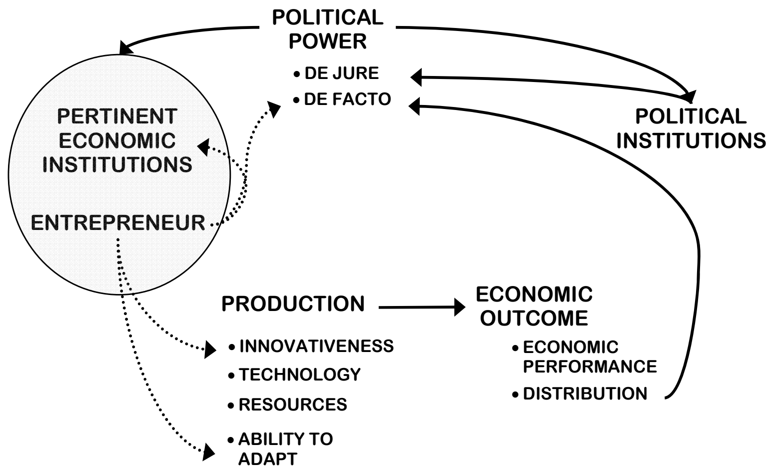

Figure 3. The Complete Growth System.

Predatory and unproductive entrepreneurship are illustrated with the same two links. One goes from the entrepreneur to *de facto* political power, and the other directly from the entrepreneur and back to the institutions. This separation is intended to illustrate the fact that some types of entrepreneurship require that the entrepreneur enters into the political decision making sphere, whereas other types are contained within the institutions.[19] The same two links also represent evasive entrepreneurship. However, these activities do not result in the establishment of an organization. They are undertaken in order to facilitate the pursuit of productive, unproductive or predatory entrepreneurship.

To the extent that unproductive and predatory entrepreneurship involve wielding *de facto* power, they need to be backed by resources. At the same time, as entrepreneurial undertakings they hold a potential for reaping economic rents. In this respect, there is a cumulative side to entrepreneurial wealth creation. This is true also for productive entrepreneurship.[20] Successful productive entrepreneurs subsequently become important in determining the *de facto* political power.

Critics of new institutional economics have pointed out that theorists such as North (1990), have difficulties in explaining how the rules or institutions themselves change (Hira and Hira, 2000). Our system is less susceptible to this criticism since it incorporates causal relations that affect the institutional framework. However, it could still be claimed that the system would eventually settle into a state of equilibrium, from which institutional change would be difficult to explain. It should therefore be emphasized that our system leaves several components largely unexplained, primarily new scientific knowledge, inventions and resource endowments. In our model, we simply take these as exogenous, but recognize that there is

[19] Note that, in *Figure 3*, there is no direct link from the entrepreneur to the political institutions. This is a deliberate delimitation of our study. Such a link would imply political entrepreneurship, where entrepreneurs enter directly into politics (e.g. Holcombe, 2002).

[20] It is well documented in the US that households where some member is engaged in entrepreneurial activities own a substantial share of total wealth and income (Gentry and Hubbard, 2000). There is also a positive significant correlation between entrepreneurship and socio-economic mobility (Quadrini, 1999). Moreover, since the effect on the position can be both positive and negative (Holtz-Eakin *et al.*, 2000) depending on the initial socio-economic position, entrepreneurship is arguably a powerful engine of social change and the formation of new interest groups.

much room for endogenizing them. Our system, which maps the primary causal relations with respect to entrepreneurship in a politico-economic theory, is in this sense embedded in a more complex dynamic (*cf*. Kim, 2005).

4. Entrepreneurship as Rent Seeking

We defined an entrepreneur as an individual endowed with the requisite talents to undertake activities yielding a rent exceeding the risk-adjusted market return. Hence, entrepreneurs are a kind of rent seekers. It should be obvious that the term rent seeking is not used in the constrained way usually applied in public choice to "describe behavior in institutional settings where individual efforts to maximize value generate social waste rather than social surplus" (Buchanan, 1980, p. 4).[21]

Our approach diverges from public choice, where rents usually are artificially created (e.g. Murphy *et al.*, 1993). The prototypical case of such a rent is a government taking advantage of its power to hand out monopoly rights. In Krueger (1974), the term rent seeking pertains to the effort of agents to obtain these rights. It is these efforts, and the resources expended on them, that is wasteful. In contrast, our focus is on the entrepreneurial creation (or discovery) of rents. Moreover, by separating the activity of rent seeking from the outcome in terms of social return (Hindmoor, 1999), we are able to use the concept more broadly. Consequently, our notion of rent seeking has no connotations of social waste.

4.1 Rents Due to Productive Entrepreneurship

Let us begin the discussion with productive entrepreneurship. In this regard, it is illuminating to consider the alternative definition of rent as return in excess of a resource owner's opportunity cost (Tollison, 1982). There are several means by which an entrepreneur could ascertain such superior employment of resources. In the broadest sense, these all involve the possession of some resource or technology which is unique or at least in very limited supply.

In the classical analysis by David Ricardo (1821), the scarce resource was fertile land. Obviously, this does not *per se* mean that the Ricardian rent seeker is an entrepreneur. What is of interest is how the agents perceive and realize a certain combination of resources on the market. If the land owner was able to perceive the superior fertility of a piece of land, and had the motivation to exert effort to secure the property rights of that land, that would make her/him a productive entrepreneur.

Entrepreneurs can ascertain the kind of unique resources needed to generate Ricardian rents in several ways. Obvious examples include the patenting of valuable innovations and copyright, but also skilful implementation of tacit knowledge that turn out not to be imitable and other entrepreneurial innovations that require a resource that potential competitors cannot obtain. Other examples are organizational advantage that cannot be imitated and locational advantage.

Most rents do not last forever, and the durability varies substantially. On this basis a distinction can be made between Ricardian and Marshallian rents, where the latter decays more rapidly. Marshallian rents pertain to activities which are easy to imitate and where the knowledge or skill is not embodied in a specific individual or organization. In such cases, the

[21] See also Lewin and Phelan (2002) and Alvarez (2005) for a discussion of entrepreneurial rents.

knowledge is easily transmitted at low cost and is expected to rapidly disseminate into the economy. Normally, imitating competitors enter the market, which increases the supply and lowers the price. According to calculations by Nordhaus (2004), entrepreneurs retain on average a mere two percent of the surplus generated by their activities.

4.2 Rents Due to Unproductive Entrepreneurship

It is important to recognize, before we proceed, that all examples of rents considered above could only materialize conditional on certain institutions. Innovations cannot be protected without a patent system, brand names cannot be built without copyright protection and so on.

In the sense that both unproductive and predatory entrepreneurship involves an attempt to reap the rents created by productive entrepreneurs, these two relate closely to the public choice notion of rent seeking. It has previously been stated that both unproductive and predatory entrepreneurship evolve in close relation to institutions. However, these actions are not necessarily wasteful in a suboptimal institutional setting (i.e. any real world institutions).

We will now illustrate this point with two examples. Consider a product where a chemical substance is used as input. There exists only one expert with specific knowledge and skills for safe use of the substance. Assume that the sale of the substance is only allowed under the supervision of the expert.

In the first case, consider a situation where the sale of the substance is prevented by environmental legislation. Moreover, assume that the cost of evading this legislation is sufficiently high to bar entrance for all potential producers. The expert has the option to invest resources to push trough a legislative change which would allow the substance and put him in a position with sole administrative rights. In our vocabulary, this could amount to either evasive or unproductive entrepreneurship. By using his/her sole possession of the resource, the expert could establish a monopoly position to earn rents. This would amount to productive entrepreneurship, which in a first stage involved evading the institutions. The expert could also continue to use his/her position as a gatekeeper and sell the substance to other producers. In this case we would say that the expert engages in unproductive entrepreneurship and reaps part of the rents earned by other producers.

In the second case, consider a situation in which the enforcement of the legislation is much weaker, and several entrepreneurs have managed to evade the legislation (e.g. bought the substance on the black market) and earn rents by producing the product. If the expert manages to establish him/her self as a sole administer of the substance, this could have several effects. First of all, evasive entrepreneurship would no longer be necessary. If the option to evade legislation is still open for the incumbent producers, we would expect the rent reaped by the expert to equal the difference in cost between evading and abiding by the legislation. If this option is not open, the expert could in principle acquire the complete rent. In both cases the expert would be engaged in unproductive entrepreneurship. Alternatively, he could drive the other producers out of the market and establish a production monopoly. Just as in the previous example we would call this productive entrepreneurship made possible through evasive entrepreneurship in a first stage.

Even though a complete welfare analysis is not feasible, one can still make some remarks on the economic outcome of these different cases. In the first case, resources were spent on changing the legislation, but this was compensated for by the new production possibilities.

Similarly, in all instances considered, in the second case there is at least a possibility that the initial cost of evasive entrepreneurship was large enough to motivate even the setting up of a monopoly. Our claim is not that these are first-best outcomes. Such outcomes would probably have involved a much more conducive legislation and many competing producers. However, in the example considered, just as in many other real world situations, the first-best institutions are not feasible (at least not in the short run).[22]

The situation is similar in many of the cases often taken as an example of unproductive (or rent seeking) entrepreneurship, such as lobbying and litigation. *Prima facie*, the vast majority of such activities are a waste of resources. However, when considered in the context of actual institutions, this is no longer evident. Most importantly, to the extent that such activities can substitute for or even change maladaptive institutions, their social value must be regarded in a different light. Our intention is not to deny that some unproductive (rent seeking) forms of entrepreneurship can have detrimental effects, but to propose a more nuanced view.

The distinction between unproductive and predatory entrepreneurship was made on the basis of the voluntariness of the productive entrepreneur. The prototypical case of predatory entrepreneurship is a mafia syndicate which manages to corrupt large parts of the legal bodies and thereby effectively undermines the protection of property for productive entrepreneurs. From this position the syndicate can siphon off large parts of the rents created by others.

5. Empirical Examples

In this section we use examples from recent history to illustrate our model. The first subsection discusses the role of institutions in channeling entrepreneurs in different directions. We then discuss to what extent entrepreneurs are able to affect institutions, in particular through mustering *de facto* political power. However, possible endogenous effects are strongly dependent on the quality of the political institutions, an issue which is explored in the third subsection.

5.1 The Allocation of Entrepreneurship

The move to a full-blown socialist regime after the Chinese Communist revolution in 1949 was a gradual process completed in 1956–57.[23] Step-by-step, private enterprise was circumscribed as more and more sectors were collectivized and government involvement in management was extended. In a first move from 1949 to 1952 private financial institutions were nationalized and private capital markets were shut down. The government began placing processing orders with private producers and took charge of large parts of the allocation of resources. Plans for production and sales had to be approved by officials.

Entrepreneurs were still allowed to operate on the market and respond to market signals, but the institutional reforms caused severe changes in the way entrepreneurs operated. Entrepreneurial activity became a contest for processing orders and escaping controls. At the same time, the system implied ample opportunities for officials in charge of processing orders and means of production to earn rents through corruption. The consequences for private firms and the economy as a whole were highly detrimental. In 1951, the government began to strike

[22] This argument is similar to Gerschenkron's (1962) idea of "appropriate institutions". For instance, in some phases of development, policies favoring large corporations could be growth conducive compared to an "incentive-neutral" policy (holding total taxation and redistribution constant).
[23] This is a brief summary of Chapter 4 on the role of the entrepreneur in China by Lu (1994).

at “the five evils”: bribery of government officials, tax evasion, theft of state property, cheating on government contracts, and theft of economic information for speculative purposes. The blame was largely directed towards the private sector, and resulted in an accelerated rate of collectivization and nationalization of resources.

The communist takeover radically changed the institutional setup in China. The new institutions drastically increased the cost of productive entrepreneurship. Entrepreneurs found themselves in a situation where they had to expend an increasing amount of effort on evasive activities. The new institutions also provided fertile soil for unproductive forms of entrepreneurship. It became possible to earn rents by competing for bureaucratic positions that functioned as gatekeepers for various forms of licenses and government contracts. These changes gave legitimacy to demands for further institutional reforms. Radical communist factions gained in political power as private enterprise was blamed for the malfunctioning quasi-socialistic economy. The increased power of these groups led to further changes in economic institutions.

Sweden, by contrast, maintained strong democratic institutions and a high level of protection of private property rights throughout the twentieth century. Nevertheless, socialist and collectivist ideologies had an impact on many of the institutions that were enforced and manifested in the welfare state. Although there was little move towards socialization of the private sector before the mid 1970s, policies were implemented that consistently eroded private wealth accumulation, private ownership of the business sector, and, ultimately, productive entrepreneurship. As shown by Henrekson and Jakobsson (2001) tax and industrial policies fuelled a development of the economy towards larger business entities, institutional rather than individual ownership and high debt-equity ratios. Taxation at the firm level was low for large, capital intensive and largely debt-financed firms, while it was high at the owners’ level (in real terms often exceeding 100 percent for individual owners). This created a large wedge between wealth accumulation at the corporate and individual levels benefiting large incumbent firms relative to new entrants and individual entrepreneurs.[24] The major incumbent owners managed to retain control despite this large wedge through a growing disparity between control rights and cash-flow rights. A number of devices were used to achieve this, the most important of which were dual-class shares and pyramiding with tax-favored closed-end investment funds as the prime control vehicle. It was not until the comprehensive tax reform in the early 1990s and the deregulation of credit markets that individual entrepreneurship and new firm formation could gain in importance and challenge incumbent firms and capital owners.

The institutional framework in Sweden seems to have precluded many opportunities for productive entrepreneurship, and sharply increased the cost of other. This hampered productive entrepreneurship, but what happened to the entrepreneurs? Clearly, they did not to any greater extent engage in activities with directly harmful social consequences. It is probably fair to say that the long-run effects of socialist institutions and ideology has had a stifling effect on the supply of entrepreneurial effort. However, one should not underestimate the extent to which entrepreneurial effort was exerted in circumventing and manipulating regulation, i.e. evasive and unproductive entrepreneurship.

[24] The actual effects of these policies on such variables as the size distribution of firms and employment and the industry distribution of production and employment are documented in Davis and Henrekson (1997).

5.2 Wielding de facto *Political Power*

The effect of entrepreneurial wealth accumulation is not clear-cut. In previous studies, the negative implications of wealth concentration are the most dramatic in models where business owners can form interests groups to persuade politicians to bar new entrants from the market (e.g. Do, 2004).[25] But many accounts are less pessimistic. For instance, Baumol (2002) describes how strong economic interests historically managed to strike bargains with the ruling elite by inducing them to relinquish some of their discretion over property rights. This, in turn, created incentives for productive entrepreneurship and sparked a cumulative process where institutions that favored secure property rights gradually replaced existing institutions characterized by arbitrary seizure of property by the ruler and other arbitrary decisions. We will here present three cases from recent history in order to nuance this issue further.

Post-Soviet Russia is, according to Åslund, Boone and Johnson (2002), locked in an "under-reform trap". The political dimension of this trap is evidenced by the continued political strength and influence of the former communist elite. Moreover, political influence from large firms in Russia is often related to the oligarchs (Guriev and Rachinsky, 2005). This group consists of people from the former Soviet nomenclature who, after the fall of the Soviet Union, seized power of the companies which they managed. A typical pattern in former socialist countries is that former party cadres take advantage of their pre-reform position and their social network.[26] However, other Russian oligarchs are relatively young entrepreneurs who amassed their wealth in the late 1980s. They took advantage of the huge arbitrage opportunities created by partial reforms and the co-existence of regulated and quasi-market prices during the Gorbachev era. Today, the oligarchs' far-reaching influence on the economy and the opportunities for entrepreneurs in general have resulted in, for example, the takeover of the Russian Union of Industrialists and Entrepreneurs. The prevalence of political influence of large firms at the local level, and the negative effect on entry of new firms is underscored by Slinko *et al.* (2005).[27] Other research has shown that in comparison to other more successful transition economies (e.g. Poland and Slovakia), Russian entrepreneurs face more corruption, higher official as well as unofficial start-up costs, higher tax rates, more bureaucracy and weaker protection of property rights. These weak property rights have severely impeded the willingness of firms to reinvest their profits (Johnson *et al.*, 2002).

What is of interest here is not primarily how currently weak protection of property rights circumscribes the set of productive opportunities and how it instead breeds unproductive and predatory entrepreneurship. It is rather how a powerful elite seems to have a large impact on the institutions. This elite partly consists of entrepreneurs who, during the transition phase,

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[25] Another possible mechanism that has been pursued in theoretical work is resistance to new innovations. Groups with vested interests try to influence economic institutions in order to prevent the introduction of new innovations (e.g. Mokyr, 1999). Since it is seldom costless to convert human and physical capital investment to suit new production technology some groups normally face (at least) a short-term loss in terms of unemployment or capital obsolescence. Such groups can potentially form a political alliance against change (Krusell and Ríos-Rull, 1996). Other potential losers are incumbent firms with monopoly power (Parente and Prescott, 1999).

[26] In a study from Hungary, using statistics on prior party position and post-reform engagement in entrepreneurship, Rona-Tas (1994) found that party cadres were more likely to own a non-corporate business, although the effect disappears when education is controlled for. However, the positive relationship between cadre membership and involvement in a corporate business is robust to the inclusion of education. The same author also hypothesizes that incomplete reforms keep cadres away from private enterprise, a hypothesis which could also be of some relevance for China after Deng Xiaoping.

[27] Slinko *et al.* (2005) find that firms that were *not* subject to preferential treatment (primarily tax breaks and subsidized loans) experienced slower growth in regions with a high degree of political capture. Moreover, a high degree of preferential treatment of large firms was found to have a negative effect on small firms. This result is interpreted as evidence that when large firms hold high political stakes they can prevent entry of new firms.

could earn exceptionally large rents. At least on the local level, this group now expends effort and resources in order to wield *de facto* political power.

Our next example deals with the Chinese minority in Indonesia. Although examples of Chinese influence can be found in many Southeast Asian countries, the case of Chinese dominance in Indonesia is striking. Chua (2003) describes how the historically strong position of Chinese entrepreneurs in Indonesia shaped the country's post-colonial history. Unlike socialist-inspired takeover of private property in many other countries during this period, the wave of nationalizations during President Sukarno's rule in the 1950s and 1960s was motivated more by ethnic conflicts than by a desire to eradicate private ownership. Economically influential minorities, in particular the Chinese, were targeted. As a result of nationalizations, the Indonesian economy was fraught with widespread corruption and poorly managed enterprises. When Suharto seized power in 1966, he endorsed economic liberalization and foreign investments. In so doing, he allied himself with the Chinese business community – which had retained much of its economic influence – and with Chinese entrepreneurs. During Suharto's autocratic rule, the Chinese minority enjoyed protection. Large corporations were treated preferentially and endowed with lucrative business opportunities, in a symbiosis that also enabled the ruling family to accumulate a massive fortune. When the Suharto regime fell in 1998, the Sino-Indonesian minority (about 3 percent of the population) controlled approximately 70 percent of the private sector. The collapse of the Suharto regime was followed by anti-Chinese violence and resulted in the break-up of Chinese conglomerates and redistribution of their wealth. Many formerly profitable companies subsequently experienced severe difficulties under their new management.

In contrast to the Russian case, the wealthy Chinese minority in Indonesia has not been able to uphold its political influence. During Suharto's regime the Chinese minority had a large influence on the institutions. To the extent that this influence prevented Indonesians from opportunities to earn economic rents, it was in fact, plausibly, an important reason why the Suharto regime was overthrown. The indigenous majority was able to muster enough *de facto* political power to overthrow the regime.

The Russian case obviously spans a much shorter time period than the Indonesian one. Nevertheless, the contrast between these two cases illustrates the importance of recognizing the ethnic dimension in the distribution of resources. Our next case is an example which underscores the time aspect. Even though the economic power of the oligarchs might seem overwhelming, many have pointed out that other countries, such as the US, Sweden and Japan, experienced similar trends during their early phases of development (Guriev and Rachinsky, 2005; Åslund, 2005). This is emphasized by Whitten (2002), who points out the similarities between the early twenty-first century Russian oligarchs and the early twentieth century US Robber Barons.

DeLong (1998) examines the enormous wealth accumulation of the Robber Barons. He also points out how "totally corrupt they *all* were – or, rather, if we allow them to defend themselves, how completely and totally corrupt was the system in which they were embedded". Great fortunes were accumulated in a process which involved bureaucrats and politicians at all levels. Despite popular and political awareness as of the late eighteenth century, it was not until after the Great Depression in the 1930s that the Barons lost their political and economic grip. Defenders of these tycoons often point out that they were also renowned philanthropists. A major beneficiary of their donations was the system of higher education; many of the leading universities in the US were founded by the Robber Barons.

One interpretation of this philanthropy is to see it as an act of enlightened self-interest rather than of pure altruism. Acs and Phillips (2002), argue that the Robber Barons helped creating institutions that would later enable those with motivation and abilities to realize their potential. Or, put differently, they created institutions where individuals could leverage their entrepreneurial talents.

In Russia, oligarchs continue to wield strong *de facto* power over economic institutions. Evidence suggests that the consequences for productive entrepreneurship seem thus far to be detrimental. However, as illustrated by the case of the US Robber Barons, the eventual outcome is probably strongly dependent on what happens to the oligarchs' fortunes. In the US, fortunes that were built largely as a result of strong influence in the political sphere, were later turned into institutions that created opportunities for productive entrepreneurship.

5.3 The Role of Political Institutions

In Iceland, the economy was stagnant until the beginning of the twentieth century. Despite the surrounding water, with some of the best fishing banks in the world, Iceland remained dependent on low productivity farming. Strong interests among the landowning elite supported legislation preventing the development of a fishing industry. The threat envisioned by the landowners was that it would erode their supply of workers if servants were allowed to freely engage in fishing. This supported a coalition among the elite to uphold institutions that largely kept the workforce employed in farming. But what kept the individual landowner from defecting from this alliance? If an entrepreneurial landowner had set up a large-scale fishing fleet he could have benefited from the sizeable European export market. The answer lies in Danish colonial rule (Eggertsson, 2005). It was in the interest of the Danish rule to keep Iceland isolated from other countries in order to protect its colonial territory. Consequently, entrepreneurial Icelanders were effectively cut off from most sources of funding and equipment as well as from export markets. Only after repeated famines, and faced with a starving population at the end of the nineteenth century, did the Danish Crown eventually change its policies to allow a fishing industry to develop.

This example serves to show the importance of political institutions, in this case the Danish Crown. The Icelandic experience shows an example where there seemed to be considerable scope for productive entrepreneurship. A coalition of landowners could have built a hugely profitable fishing industry. This would probably have removed the institutional barriers for further productive entrepreneurship. However, in this case the political power exercised by the Danish crown and its willingness to enforce the institutions was too strong and prevented such moves.

In our last example, we return once again to China. After the death of Mao in 1976, Deng Xiaoping rose to power in 1978 and initiated reforms that extended the scope of private enterprise. One example of the role of the entrepreneur in the ensuing transformation of Chinese institutions was the implementation of the practice of "contract-production-to-household", which allocated land to households on a long-term basis and allowed farmers to keep the profits. This practice was officially endorsed in 1983, but had already been widely adopted. The former laws which prohibited private profits from household farming had lost all practical relevance. Another example is the policy document enforced in 1981, according to which limited private enterprise was allowed, but with severe restrictions on, for instance, the maximum number of employees (two employees and five apprentices). However, these limitations did little to confine the size of private firms, many of which grew well beyond the size permitted. By the end of 1986, an official survey showed that a large number of firms had exceeded the stipulated limits. New institutional reforms in 1987–88 then granted these firms legitimate status. Lu (1994, p. 117) concludes that "the Chinese policy makers did not pre-design the boom of the private sector in the 1980s and the relating changes in institutions. In many cases, what happened was the official adaptation to reforms initiated by private entrepreneurs."

Daokui *et al.* (2006) coin the term "institutional entrepreneur" for someone who starts a business venture and, in that process, contributes to the destruction of prevailing institutions that are unfavorable to entrepreneurship. Apart from open advocacy of reforms and private persuasion of politicians, they mention two other strategies. A business owner can claim that he represents a special case and that exceptions should be made for him. Once one concession has been made, additional ones are easier to obtain, and numerous exceptions amount to a *de facto* change of institutions. The other strategy is to begin by circumventing regulations and, once a successful enterprise has been established, argue for an *ex post* justification.[28] As observed by Gilley (2002), Chinese politicians appointed at the local level increasingly have a background as been former (or current) entrepreneurs. Furthermore, Djankov *et al.* (2006) present evidence that Chinese entrepreneurs value political freedom significantly higher than non-entrepreneurs. These results suggest that entrepreneurs might be an important force also in bringing about change in the political institutions.

Although many of the institutions imposing restrictions on entrepreneurship were still in place, the political will to enforce such regulation weakened under Deng Xiaoping. The risk of sanctions, and hence the cost of evading the institutions, decreased significantly. Our example shows how this increased productive entrepreneurial activity. This was a cumulative process in which the costs of evading regulation fell to a level where the institutions had lost all practical relevance and where in the end they were formally abolished.

6. Examples of Pertinent Institutions

Our empirical examples illustrate that institutions are at the core of our system. In this section we focus on two key institutions and work out how they interact with other parts of our system.

The most fundamental economic institution is private property rights, including the existence of legal titles to hold property, and the protection thereof. A wider notion of property rights would also include taxation. Other institutions that are likely to affect entrepreneurship are the extent of publicly provided goods and services, social security, the institutions providing and supporting R&D, labor market regulation, competition policy and programs aimed at supporting nascent firms. In the following two subsections we analyze property rights and taxation in light of our model.

6.1 Property Rights

Secure property rights ensure that physical objects can be turned into capital, a transformation that requires judgment, imagination and innovation (de Soto, 2000). The entrepreneur is

[28] These kinds of "institutional entrepreneurship" have, according to the authors, changed the institutional environment in rapidly growing economies such as China, India and Vietnam.

instrumental in this process. The arrow in *Figure 4* indicates shifts in the composition of entrepreneurial activity following a weakening of property rights.

	ABIDE	EVADE	VIOLATE
PRODUCTIVE	Pursue a business opportunity within prevailing institutions	Sidestep labor market regulation in order to expand a profitable business	
UNPRODUCTIVE	Create contracts to overcome institutional shortcomings	Organized bribery; Creation of a bureaucratic form where rents are earned on selling licenses or subsidized loans	
DESTRUCTIVE/ PREDATORY	Rogue States; Rivalry between warlords	Illegal syndicates; Mafia; Sophisticated Fraud and economic crimes	

Figure 4. The Effect of Weakening Property Rights.

When the protection of property rights is eroded, a first effect is to reduce the rents pertaining to productive entrepreneurship. For instance, business owners will retain a smaller share of profits in their firms (Johnson *et al*., 2002). As argued by Claessens and Laeven (2003), physical capital is easier to protect than intangible assets and intellectual capital. They show that investment in R&D, relative to investments in tangible assets, is likely to be suboptimally low when property rights are weakly protected. In other words, weak property rights prevent productive entrepreneurship from reaching its full potential.

The second effect is that entrepreneurship takes new forms. First, opportunities to earn rents from unproductive entrepreneurship arise. This involves protective activities such as security firms and the like, which substitute for weak institutions. New forms of contract, to secure property, are other avenues to earn rents. Moreover, rents can be earned by legally transferring land titles or other resources among groups of the population. If the protection of property rights continues to fall, purely predatory forms of entrepreneurship, such as extortion, corruption or fraud, will eventually arise.

In a dynamic setting, it seems plausible that those who have gained from low institutional quality would subsequently want to protect their property.[29] Could *de facto* political forces work in the direction of better protection? Sonin (2003) shows that, in the event of a highly unequal distribution of wealth, the rich might actually prefer weak property rights protection since they can rely on private protection.

Following this informal reasoning, bad equilibria are not only feasible, but can also remain stable. Without a large exogenous shock, such equilibria could be difficult to dislodge. By

[29] Besley (1995) develops a theoretical argument as to why the quality of property rights may be endogenous, and finds some empirical support for this hypothesis. In his case, Ghanian farmers who have invested in their land may subsequently find it in their interest to push for better protection.

exogenous shock we refer mainly to changing factor prices or technological breakthroughs, which can rapidly change the balance of (economic) influence. A stable equilibrium with poor protection of property rights would be characterized by a low level of productive entrepreneurship and an uneven distribution of resources. Entrepreneurial talent would be spent on political struggles and predatory activities against existing businesses. Such an economy adjusts poorly to changes in the environment, and its rate of innovativeness is low. Consequently, the economy stagnates.[30]

In contrast, an equilibrium with strong protection of property rights is characterized by a high rate of productive entrepreneurship, and the economic system exhibits a high degree of innovativeness and ability to adapt. What are the possible threats to such a equilibrium? Given strong protection of property rights, entrepreneurs would find it more profitable to venture into business than to engage in unproductive activities. If the political institutions are strong, entrepreneurs would require the backing of considerable resources in order to wield *de facto* political power. The prospects for this depend on how resources are distributed. Under an even distribution, no group would find it worthwhile to muster the *de facto* political power needed to achieve a redistribution of resources in its favor. However, it is probably more realistic that, in equilibrium, there will always be some factions that try to bend the rules, and possibly reduce the protection of property rights, in their favor by wielding *de facto* political power.

6.2 Taxation

The effect of property rights protection on productive entrepreneurship seemed to be unequivocally positive. The verdict is somewhat less clear cut if we expand our definition our property rights to include freedom from confiscatory taxation.

	ABIDE	EVADE	VIOLATE
PRODUCTIVE	Pursue a business opportunity within prevailing institutions	Sidestep labor market regulation in order to expand a profitable business	
UNPRODUCTIVE	Create contracts to overcome institutional shortcomings	Organized bribery; Creation of a bureaucratic form where rents are earned on selling licenses or subsidized loans	
DESTRUCTIVE/ PREDATORY	Rogue States; Rivalry between warlords	Illegal syndicates; Mafia; Sophisticated Fraud and economic crimes	

Figure 5. The Effect of an Increasing Tax Rate.

[30] This description is consistent with, for instance, the literature on corruption (e.g. Murphy *et al.*, 1993 and Mauro, 1995).

Using our typology, we can distinguish two different effects of taxes. The most obvious effect is that the cost of abiding by regulations increases. Entrepreneurs respond to this by expending effort on tax evasion. In *Figure 5*, this is illustrated by the move of the arrow to the right. The other effect is that a higher tax level channels entrepreneurship into new forms. Opportunities for unproductive entrepreneurship arise, for instance, in services that offer instruments or transactions to circumvent the institutions, i.e. tax avoidance. This is illustrated as the vertical component of the arrow in *Figure 5*.

Since taxes often involve redistribution, some groups benefit from high taxes and some lose. Both of these groups may be willing to spend resources in order to increase their *de facto* political power. Even in societies with political institutions of high quality, there is some scope for entrepreneurs to exercise such power. However, the issue here is far more complicated since taxes can be levied on many different bases. Therefore, our ambition is just to identify a few factors that can contribute to sustaining a high-tax equilibrium.

If taxes entail redistribution from the rich to the poor, the median-voter theorem could, in a democratic context, be expected to roughly predict *de jure* political alliances (e.g. Alesina and Rodrik, 1994). This is to some extent mediated by the effect of *de facto* political power, which has been assumed to be concentrated to a rich stratum of the population. This implies a downward pressure on taxes. However, as shown by Roine (2006), political alliances can be formed in other ways if the very rich are offered some means of avoiding taxes. In the case where such instruments are allowed, the rich incumbent may prefer high tax rates and form a coalition with low-income groups.

A similar mechanism emanates from the fact that taxes affect large and incumbent businesses differently than newly started small businesses. In general, small firms tend to be more dependent on equity financing, whereas large and old firms can rely more on debt financing. Henrekson (2005) documents that, for Sweden, there has for a long time been a significant difference in effective tax rates on debt and equity. In our framework, this translates into a situation where resources are concentrated to few individuals with a high stake in large, incumbent firms. Such individuals have no reason to resist high taxes, as long as they can avoid them. They can even prefer high taxes, which tend to discourage new entrants, in order to protect their rents.

The effect of taxation on entrepreneurship is a core issue in the entrepreneurship literature. Therefore, we end this section by relating our framework to three of the most influential topics in the literature.

It has been argued that governments can provide insurance by taking part of the profits in good times and offsetting losses in bad times (Domar and Musgrave, 1944, Sinn, 1995, 1996). If individuals are risk averse, such insurance encourages the risk-taking central to all entrepreneurial activity. A number of arguments have been put forward to counter this proposition. For instance, it is not valid under progressive taxation and under most tax codes, losses can only be offset against future profits. Our framework allows us to pose another question: are those who, under the implicit insurance of a welfare state, start their own businesses really entrepreneurs? After all, according to our definition, an entrepreneur has to posses certain talents, and it is unclear whether such individuals really need risk reduction. It could well be that misdirected forms of insurance only serve to encourage new business ventures among those who are not entrepreneurs (de Meza and Webb, 1987; de Meza, 2002).

Second, it has proven difficult to empirically establish a negative relation between tax levels and the rate of self-employment.[31] If the success of an entrepreneur is assumed to be heavily dependent on his/her effort, then the theoretical prediction is that high marginal tax rates should have a negative effect on the level of entrepreneurial activity (Robson and Wren, 1999). However, the validity of the rate of self-employment as a measure of entrepreneurship is questionable. One possible explanation for the empirically observed pattern is that self-employment could be a means to avoid taxes. As argued by Feldstein and Slemrod (1980), self-employment can serve to shift from labor income taxed at a high marginal rate to corporate income taxed at a lower rate. Moreover, self-employment facilitates shifting activities to the black market (Watson, 1985; Young *et al.*, 1994). In some cases, avoiding taxes and shifting to the black market would be an example of evasive entrepreneurship.

A third issue concerns the rents that an entrepreneur could capture. Taxes on both capital gains and dividends affect the net rents available to the entrepreneur.[32] For new businesses, the time horizon between firm start-up and exit is often short. The close relationship between entrepreneurship and venture capital bears witness to the crucial role of equity that can be injected into new high-risk ventures and then compensated in a relatively early exit (Gompers and Lerner, 1999; Kortum and Lerner, 2000). But these are precisely the two properties that are penalized the most by high rates of capital taxation.

7. Conclusion

The effect that entrepreneurs wield upon institutions is an important issue, but remains largely neglected in economic research. From the public choice school we have learnt that politicians do not necessarily take decisions that are socially optimal. Likewise, entrepreneurs do not necessarily pursue the socially most profitable opportunities. Instead they choose how and to what extent they want to employ their entrepreneurial talent depending on the relevant incentive structure as determined by the pertinent institutions. In fact, entrepreneurial effort may even be expended in order to affect the institutional setup itself.

In a realistic politico-economic framework entrepreneurs should therefore be included as important agents of change. A main theoretical challenge consists in carving out a role for the entrepreneur which is not too broad, but at the same time does not neglect important aspects. To avoid confounding phenomena, we argue that it is crucial to retain and stress the entrepreneur as an agent involved in a productive process. In our model, entrepreneurs are characterized by an aptitude for recognizing and exploiting new economic opportunities. In doing so, it may be economically rational for productive entrepreneurs to try to evade or affect the institutional setup. Evasive activities inevitably distract entrepreneurial talent, which is a cost caused by inappropriate institutions. However, the same activities may cause institutional change.

[31] This holds for both cross-section studies (Long, 1982; Parker, 2003) and time-series analyses (Blau, 1987). Schuetze and Bruce (2004) find that the evidence is inconclusive. However, recent panel-data studies (Cullen and Gordon, 2002) and new time-series analyses (Bruce and Moshin, 2006) tend to find a weak negative relation.

[32] Due to the short time horizon, it cannot be maintained that retained earnings are a marginal source of funding and that investments should therefore be immune to dividend taxes (Auerbach, 2002). On the contrary, investments in new and small firms are impeded by these taxes, as can be observed in the positive correlation between the size distribution of firms and tax rates (Dietz, 2005).

It is also important to recognize that entrepreneurs are self-serving economic agents. They become entrepreneurs because they are endowed with the requisite cognitive and motivational talents. The use of these talents need not be aligned with the interests of society at large. Entrepreneurial activity can only be expected to be directed toward socially productive ends if the appropriate institutional framework is in place. Hence, a politico-economic theory of entrepreneurship must also consider alternative entrepreneurial activities. We have considered unproductive and predatory entrepreneurship as alternative forms of entrepreneurship. Our analysis underscores that institutions not only determine the allocation of entrepreneurial talent across activities, but entrepreneurial activity is in itself an additional source of institutional change.

The typology presented lays the foundation for including the entrepreneur in a politico-economic framework. We have consistently stressed that the outcome of the various types of entrepreneurial activities must be considered given the specific institutional setting. Our real world examples, and the application of our model to property rights and taxes, provide some intuition for such an analysis. However, our primary ambition has been to present definitions and concepts which are internally consistent and at the same time retain considerable flexibility.

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