

The Formal, the Informal & the Three Entrepreneurs

A Look at the Economic Role of Institutions

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what I would like to explain

1. institutions: *de facto/de jure* overlap
2. entrepreneurship: omnipresent but not sufficient
3. institutions drive entrepreneurship: what you get depends on which rules are followed
4. problem is constraining government in its possibility to renege

institutions: definition

- ◆ institutions? democracy? organizations?
- ◆ institutions are the rules and norms that individuals follow in their daily lives
- ◆ it is also the enforcement characteristics that allow the rules to exist
- ◆ analogy of sport: tennis



institutions: role

- ◆ provide guidance: shape actions and expectations
- ◆ allow for routines: cognitive short-cuts
- ◆ reduce uncertainty: what guides the actions of others
- ◆ stable and predictable

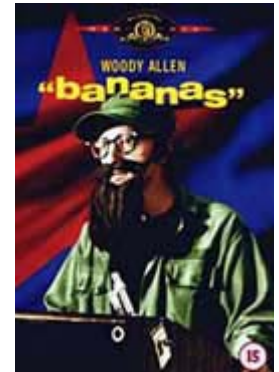
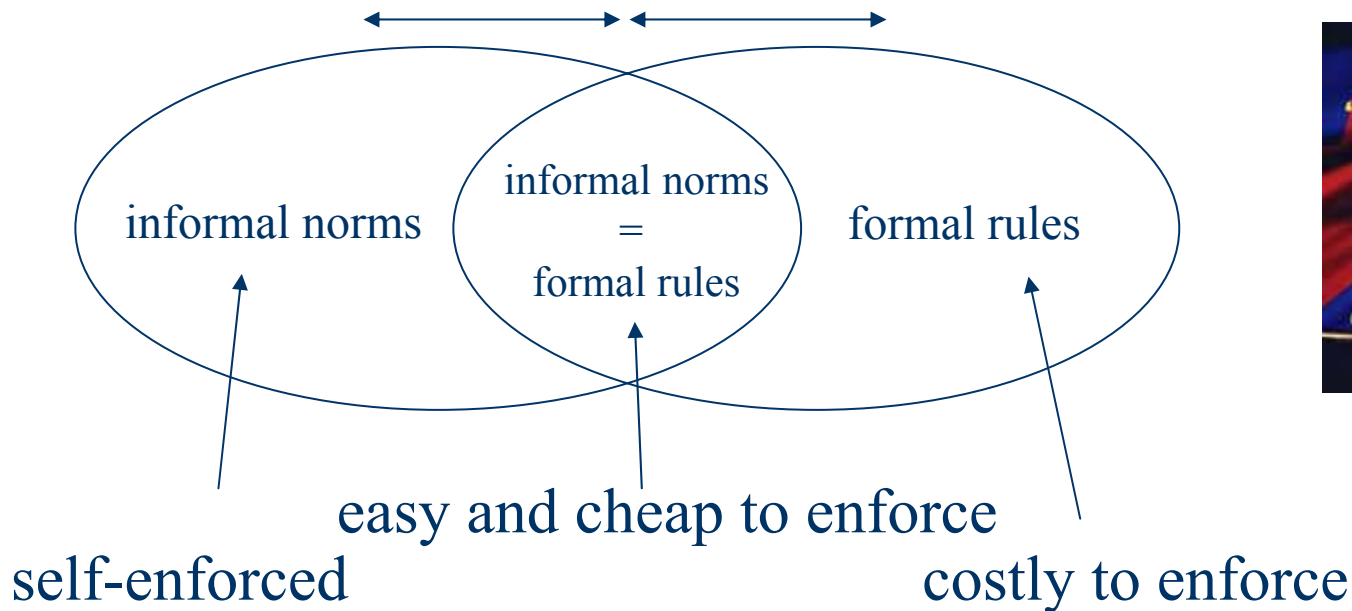
institutions: nature

- ◆ distinction at the core of the analysis:
 - formal rules – *de jure*: constitution, legislation
 - informal norms – *de facto*: implicit behavioral social codes accepted by most but written nowhere
- ◆ sport analogy: tennis again (ITF rules...)



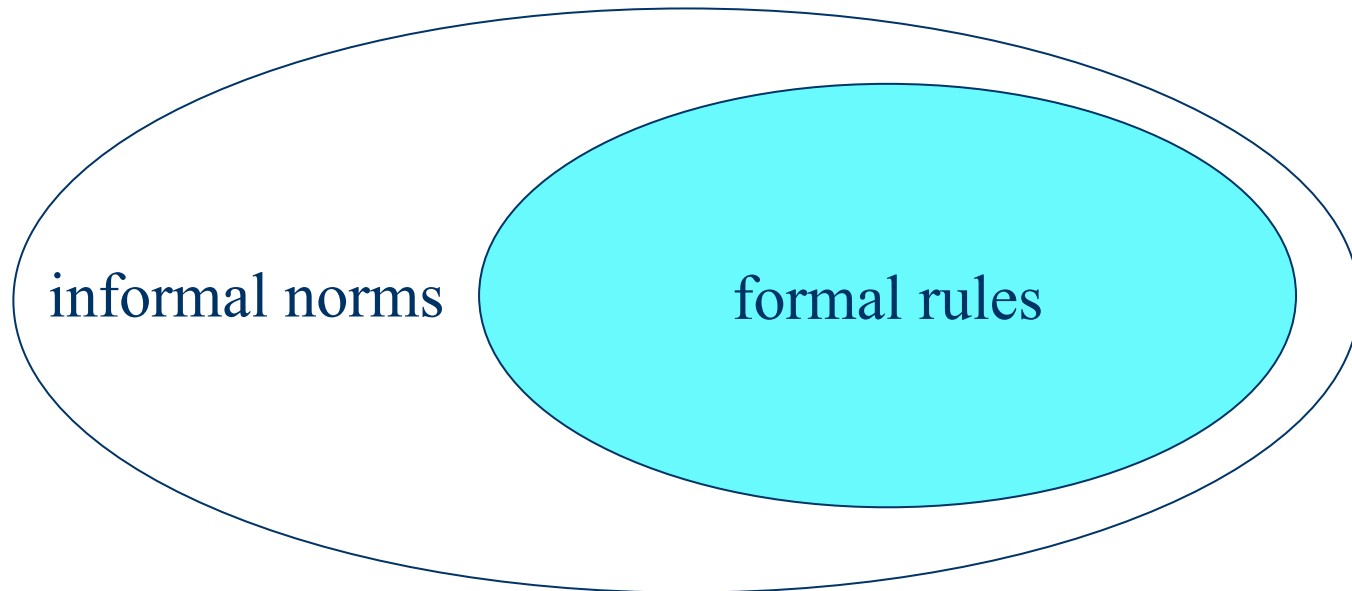
de jure/de facto: overlap?

- ◆ institutions only affect people if enforced
- ◆ formal and informal do not always overlap



best case scenario

- ◆ complete overlap: embeddedness



institutions: change & evolution

- ◆ *de facto*: culture, *tikanga*, civic capital, *mētis*...
 - evolves spontaneously but can also be influenced by *de jure* in the long run (difficult)
 - takes priority in the short run
- ◆ policy often disregards the *de facto* - “stickyness” problem

institutions: change & evolution

- ◆ dual problem:
 - bad *de jure* ignoring *de facto* (bad government)
 - bad *de facto* that cannot be influenced by *de jure* (sick society)

entrepreneurship

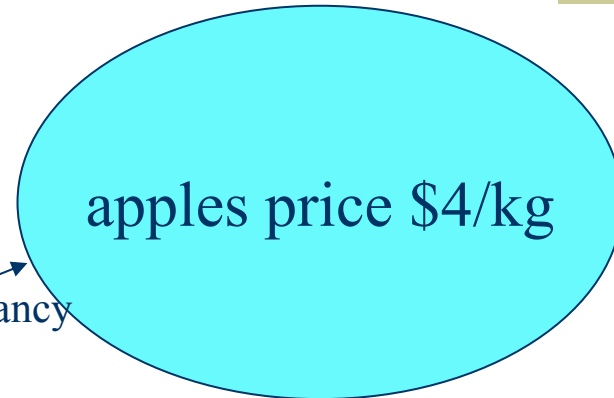
- ◆ entrepreneurship is about creation and discovery
- ◆ every individual is capable of it to some degree: entrepreneurship is omnipresent
- ◆ alertness to **profit** opportunities (arbitrage and innovation)



entrepreneurship



Market A



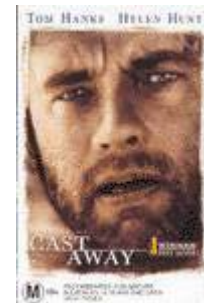
Market B

price discrepancy

- ◆ if transac. and capital costs: \$0.60/kg
- ◆ price discrepancy: \$0.40/kg
- ◆ cld buy in A sell in B for \$3.90/kg
- ◆ pure profit of \$0.30/kg

entrepreneurship

- ◆ the source of changes in knowledge (Crusoe)
- ◆ discovery \Rightarrow capital goods \Rightarrow capital accumulation \Rightarrow growth (prod^{ty} increase)
- ◆ entrepreneurship is necessary (to growth) but not sufficient (Crusoe is alone)



institutions & entrepreneurship

- ◆ no one can play tennis without rules
- ◆ entrepreneurship cannot exist without institutions
- ◆ whether growth occurs will depend on the *source* of profits
- ◆ *three* sources of profit => *three* types of entrepreneurs

the first entrepreneur



- ◆ genuine profit \Rightarrow productive entrepreneur
- ◆ productive: positive-sum games (gains from trade maximized)
- ◆ voluntary exchange based on fully defined property rights – good overlap

the second entrepreneur



- ◆ constrained profit \Rightarrow evasive entrepreneur
- ◆ evasive: positive-sum games (but gains from trade cannot be fully exploited)
- ◆ *de jure* reduces the gains from exchange, informal arrangements, costly to society – incomplete overlap

the third entrepreneur



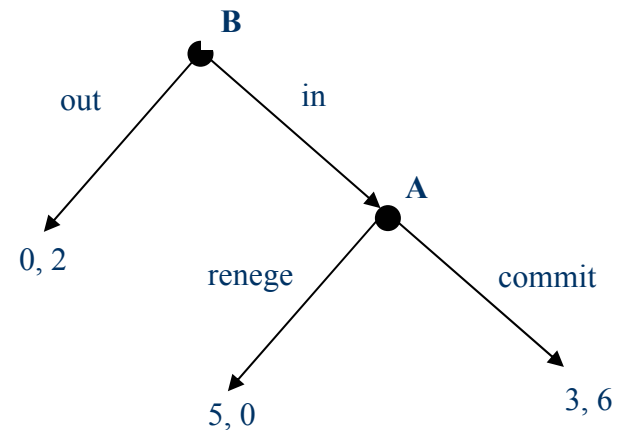
- ◆ stolen profit \Rightarrow destructive entrepreneur
- ◆ destructive: zero or negative-sum games (no gains from trade)
- ◆ *de jure* can be manipulated (rent-seeking) or favor public/private predation (expropriation, theft) – no overlap (and/or bad *de facto*)

the three entrepreneurs

	Productive entrepreneur	Evasive entrepreneur	Destructive entrepreneur
Profit	genuine	constrained	stolen
Gains from trade	positive & maximized	reduced but positive	zero or negative
<i>De jure/ de facto</i>	overlap, NRE, PR fully defined, accumulation	partial overlap, regulation, wasteful, slower growth	no overlap, rent seeking bad de facto, no growth

which entrepreneur do you get?

- ◆ source of profit depends on institutional structure
- ◆ market-preserving institutions
- ◆ ex-ante commitment and ex-post predation: tie the ruler's hands



Mercatus field work

- ◆ *Sustained Prosperity Project* at Mercatus: access local knowledge to understand the context of choice (NZ field study)
- ◆ anthropology and ethnography
- ◆ Austrian economics, NIE & public choice
- ◆ apply it to OECD countries

Mercatus field work

- ◆ Romania: rent-seeking in transition economy
- ◆ Philippines: micro-finance
- ◆ Botswana: the natural resource curse?



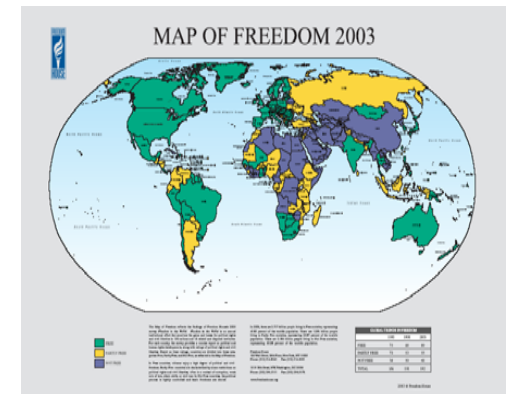
policy implications

- ◆ “do no harm” principle
- ◆ when designing policy: must know the *de facto*
- ◆ if *de facto* needs to be changed: must have v. good reasons
- ◆ property rights: always listen to the dogs barking...



policy implications

- ◆ avoid all forms of regulation that reduce (genuine) monetary **profit**
- ◆ constraining government: it all happens in the long run (Buchanan, Wilkinson)
- ◆ index of economic freedom



conclusion

- ◆ good policy understands *de jure/de facto* diff.
- ◆ prosperity depends on *productive* entrepreneurs
- ◆ productive entrep. depends on “genuine” **profit**
- ◆ “genuine” **profit** depends on institutions (rules)
- ◆ institutions count! not resources, distance...
- ◆ the #1 problem of political economy: the (secular) search for market-preserving institutions

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