1. Introduction

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Institutions matter. “Commerce, entrepreneurial capitalism takes more people out of poverty than aid; of course we know that,” stated Bono of U2 just after checking his internal compass and clearing the apparent irony of his own revelation, “Rock star preaches capitalism!” Bono nearly fell off the stage after making his proclamation. Economists for years have been trying with all their scholarly might to get the point across to other economists, politicians and the rest of the world. George Ayittey, Ghanaian economist and President of the Free Africa Foundation in Washington, D.C. apparently found a willing listener with a powerful voice in Bono.

This book is written in the hopes that you will revisit your own assumptions regarding what you take as given about institutions, market forces, political forces, and entrepreneurship. Not all institutions are good. Not all government policies are good. Not all market forces are free market forces. Not all entrepreneurship is productive. Corruption is not a product of capitalism. Good government is not a product of a benevolent dictator. We acknowledge the devil’s advocate and invite him to the conversation. Not all government policies are bad, and so on it goes. We unapologetically stand on the side of economic freedom. We suggest that not all companies are bad, and in fact we argue that most are not. Each of us uses hundreds, if not thousands, of privately produced products each day with almost no reason to complain of any of them. Proclaim the same for your choice of government monopolies, regulated utility companies, or managed care providers. We don’t think you can, not if you have a life outside of the ivory tower.

Take a fresh look at two understated and misunderstood forces responsible for creating hope and prosperity the world over: institutions and entrepreneurial capitalism. We argue that with sound institutions productive entrepreneurs will have a greater impact on society and our overall standard of living. Fewer and fewer children, and hopefully one day no children, will die each day from malnutrition and preventable diseases. More and more people all over the world should enjoy the
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freedom of choosing their own paths to prosperity, taking their shots at seemingly unrealizable dreams, and maybe enriching the lives of many others along the way.

Bono has it half right, but entrepreneurial capitalism will not be productive capitalism if the underlying institutional structures aren’t supportive. The formal rules (constitutions, laws, property rights) must create incentives for productive action, whereby society gets to enjoy more value from fewer resources. The informal rules (customs, taboos, etc.) likewise must support efficient, productive action. Before Douglass North’s seminal research on institutions and their historical development, the economic literature took the institutional setting for granted. Even the institutional economists took most of the formal and informal rules of the game for granted, focusing instead on how firms might optimally organize in the face of a given set of constraints, which may help the planner trying to determine profit-maximizing price and output, but as North noted, it doesn’t do much to explain the vast differences in economic performance across time and place.

Entrepreneurship is not a panacea where institutions do not support actions productive for society. Where corruption goes unchecked or property rights are weak, entrepreneurs will find, and always have found, ways to profit. The question for economic growth is how much that type of entrepreneurial behavior contributes value to society. William Baumol made this point very clearly. His research brought the entrepreneur back into the mainstream, while emphasizing the primary role of institutions and the rules of the game. The allocation of entrepreneurial activity will be more or less productive depending on the rules. According to Baumol, innovation and productive entrepreneurship help explain the power of the free market over all other forms of economic organization to generate economic growth and improve living standards. The more free the markets, the more likely entrepreneurs will engage in efficiency-enhancing, competitive behavior.

The stories told in the chapters of this book aim to clear the confusion surrounding institutions and the market process. Especially since the financial market collapse of 2008, defending pro-market reforms and capitalism has not been an easy task. It has never been an easy task. What are we not seeing? From an analytical perspective the problem likely lies in the complexity of our institutions and changes in the rules of the game over time. It is one thing to compare North Korea with the United States or Hong Kong to show differences in the institutional framework and apparent consequences for living conditions and prosperity. It is another task entirely to measure the full effect a new regulation or policy change will have on the competitiveness or growth trajectory of
a place. Analysis aside, it is an even greater challenge to overcome the media hype that sways public opinion. It would be hard to argue, for example, that the U.S. Supreme Court decision *Kelo v New London* doesn’t weaken property rights. But, local politicians trying to be heroes to their constituents can easily argue that some casualties are necessary to serve the greater good. Politicians have always been good at selling benefits while masking the greater long-term costs of their actions. People voting with their wallets are unlikely to calculate the cost of bad policy and organize against it.

Political entrepreneurs understand the democratic process. They understand voter behavior, and they know the key political decision-makers. They are expert at pushing their policy agendas into law. The challenge for economic growth is that not all policies are efficient. Each new, inefficient piece of regulation lobbyists successfully achieve erodes the competitive foundation. The stakes are high for the special interests, but so is the social cost of this unproductive entrepreneurial behavior. Economic analysis must identify the costs and benefits for each group affected by new policy, not just in the short-run, but in the long-run as well. Scholars have the opportunity and responsibility to educate. All individuals from political decision-makers to ordinary citizens should learn to recognize and consider the facts.

This book is divided into two parts. Part I is concerned with the theory and empirical analysis of the general effects economic institutions have on entrepreneurial behavior and living standards. Part II looks more specifically at particular institutional features or policy concerns. Collectively these chapters highlight the strengths and weaknesses of the research on institutions and economic growth. More importantly they may help us understand why policy recommendations are so often ignored. Words, and their meaning, matter. From economic freedom to entrepreneurship, each one of us develops a different mental image. As the popular press has adopted these terms both to oppose and uphold, they have taken on connotations completely distinct from their original intent.

In the second chapter, author Tomi Ovaska discusses institutions, entrepreneurship and economic growth. Societies’ standards of living and well-being are closely tied to the quality of institutions under which entrepreneurs conduct their everyday business. Ovaska discusses the theoretical connection between institutional quality, entrepreneurial activity, and economic growth and presents the main findings from previous literature. Finally, this research highlights the kinds of public policies that are conducive to an allocation of more productive entrepreneurial activity, economic growth and the consequence of better living standards.
Rachel Coyne more specifically examines economic freedom and its connection with productive entrepreneurship and economic growth in Chapter 3. A nation’s capacity for risk-taking and innovation is stifled without productive entrepreneurship, leading to economic stagnation and the loss of the competitive edge. Policies aimed at removing barriers to entrepreneurship, rather than proactive policies intended to subsidize it, will have the largest positive impact on productive entrepreneurship and economic growth. Coyne provides an extensive overview of the literature linking economic freedom, entrepreneurship, and economic growth and offers the economic theory and logic behind the expected positive empirical relationships between these three key variables.

In the next chapter, authors Noel Campbell, David Mitchell and Tammy Rogers conduct a thorough analysis of the different measures of entrepreneurship and institutions in order to remind scholars of the complexity of our measures of activity and institutions. Entrepreneurship is a vital component of economic development and growth, both internationally and intra-nationally. The type and amount of entrepreneurial activity depend on a society’s institutions. However, the literature uses different measures of entrepreneurship, different measures of institutions, in different models, with different estimators. It is unclear that the different approaches within the research literature are estimating the same relationship. The authors present a robustness check on the varied approaches and offer ideas to refine future empirical studies of entrepreneurship and institutions.

In Chapter 5, Bradley Hobbs and Mushfiq Swaleheen examine active and passive policies for their effect on encouraging entrepreneurial starts and catalyzing economic development. Is it nature, or is it nurture? Billions of dollars are spent each year by all levels of government across the United States on public efforts to drive entrepreneurship and economic development. Policy makers seem particularly convinced of the efficacy, not to say anything of the efficiency, of the use of public resources to support businesses willing to establish, relocate, or recommit themselves within a particular county, municipality, state or region. Typical offers include tax relief and indirect subsidies, though direct subsidies are not unheard of, all in an attempt to increase economic development, generate employment, and to expand the existing tax base. Examples include business incubator parks, industrial and biotechnology parks, transportation hubs, and the construction of sports facilities, among others. While location decisions may be influenced by the policies of economic development organizations, these decisions are multi-faceted and are ultimately made by the entrepreneur. Using a parsimonious model of entrepreneurial emergence in fifty U.S. states, as measured by
business startup activity, Hobbs and Swaleheen present empirical evidence that supports entrepreneurial action as the primary driver of the decision to start up. In short, their findings support nature over nurture, so what does that mean for public policy? Their suggestion will certainly stir the debate.

Greg Randolph presents an empirical investigation of institutions across the American states and differences in entrepreneurial productivity. Recent research has examined the relationship between institutional quality and entrepreneurial activity in light of Baumol’s (1990) theory of productive and unproductive entrepreneurship. Randolph reviews the recent literature regarding entrepreneurship and institutions and his own analysis presented here suggests that lower levels of government freedom result in greater interest group populations, while greater labor market freedom encourages firm births in states in the U.S. These results provide further evidence that institutions impact the decisions and productivity of entrepreneurs in society.

In Part II of the book we move into special cases of policies and their consequences. These chapters showcase selective policy considerations and suggest how policies and institutions in general often develop over time. In the first of these chapters, Geoffrey Turnbull, Rob Salvino and Michael Tasto discuss the evolution of eminent domain law and its intended impact on economic development in an examination across U.S. states. This controversial use of eminent domain for economic development has undergone intense scrutiny after the latest housing crisis and recession. Using a broad interpretation of the takings clause of the Fifth Amendment, local and state governments have increasingly justified the use of eminent domain in their efforts to provide jobs. Past studies have examined this use of eminent domain from the perspective of property rights and the scope and size of government. This chapter attempts to answer perhaps a more fundamental question. Do states that have liberal eminent domain actually enjoy greater economic growth? The authors analyze the growth in private sector employment, controlling for local competitive effects, and empirically test the data to see if this actually happens. Do states that give local governments more liberal eminent domain powers enjoy greater private sector employment growth? The empirical results do not support the employment growth motivation for eminent domain.

Chapter 8 provides an analysis of another institution as it has evolved in the United States, employer-provided healthcare. Author Rob Salvino examines this object of government policy and its impact on the decisions of individuals within firms, decisions which ultimately affect prosperity’s lifeblood – entrepreneurship and innovation. The chapter
highlights many of the undesirable outcomes of the public–private marketplace for healthcare in the United States. It argues that these outcomes are consistent with consequences of greater bureaucratic decision-making in otherwise localized, private decisions, and it suggests that more desirable outcomes for individuals and society in general would arise from less centralized decision-making and regulatory constraint in the structure of the healthcare market.

In the final chapter, Russell Sobel, Nabamita Dutta and Sanjukta Roy examine the following question. Does fiscal decentralization result in a better business climate? Previous literature generally finds greater fiscal decentralization associated with faster economic growth. A separate, but related, literature finds greater fiscal decentralization associated with improved government performance, and stronger constraints on the Leviathan behavior of governments. Because economic growth critically depends on the presence of good government policies and institutions, the likely but untested link between these two strands of literature is that greater decentralization probably improves growth because it results in government policies more conducive to productive entrepreneurship and business success. The authors test (and confirm) this hypothesis using a variety of business climate measures for the U.S. states.

Before moving on in the book, we hope you keep the following in mind. When our policies and institutions incentivize productive entrepreneurship, societies become richer. This benefits all on average, not just the rich, but the rest of us as well. If instead the most talented individuals spend their time and effort lobbying rather than competing in the marketplace, society produces less and borrows more from its future. Envision a world in which individuals are free to employ their entrepreneurial talents and productive entrepreneurial activity is both encouraged and rewarded. This world needs economic growth. Because incentives matter and scarcity is a fact of life, this world needs economic freedom: private ownership of resources and property, personal choice, voluntary exchange, and competition.

REFERENCE