# <u>**Institutions, Rent Seeking, and Entrepreneurs**</u>

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**Introduction**

Institutions throughout different countries have made the difference between prosperity and hardship. Having the right institutions in a country have aided in launching nations into great development and riches, but what institutions aide in making a country prosperous? Alesina and Giuliano, authors of a paper called “Culture and Institutions,” assert that culture and institutions interact and evolve with mutual feedback effects. In their paper as they define culture as customary beliefs and values that ethnic, religious, and social groups transmit from generation to generation, and they define institutions the same as Douglass North saying they are “the humanly devised constraints that structure human interactions. They are made up of formal constrains, informal constraints, and their enforcement characteristics” (Alesina and Giuliano, 901). Because beliefs and culture influence the constrains people place on human interaction, the formation of institutions and the formation of culture are informed by each other.  The structure of interactions between humans determines how prosperous institutions can be.

Institutions have contributed to making countries prosperous, with evidence from historically poor societies being equipped with the same technology as richer countries but not becoming developed or raising the standard of living.. Before the industrial revolution many of the main producers were on the same level of technology. Countries had roughly the same institutions and attitudes towards commerce, so when changes started shifting in favor of commerce and exchange there was a marked development in prosperity and standards of living. We have certain values and institutions in America that helped us develop faster than other countries such as protection of private property, stable money supply, and enforcement of contracts. These institutions that have a large impact on a country's prosperity have been studied and measured in depth in many countries and are measured in the Economic Freedom of the World Index.

So, some countries have prosperous institutions, and others do not, but what forms and transforms the institutions in a given country?

Because we always work from a position with institutions, it is hard to see how some institutions are formed, or how institutions change over time. Throughout the study of how institutions effect the prosperity of countries, some efforts have been made to change the institutions in undeveloped countries but have been largely unsuccessful. Institutions cannot be imposed on another country if they work against the beliefs, religions, and culture in that country. As was inferred from Alesina and Giuliano, culture and institutions interact and influence each other in such an entwined way that one cannot be easily studied independently of the other. Implanting an institution on one country because it worked in another country does not work normally; institutions are endogenous variables in a country. Institutional change must come from inside the country.

This institutional change can come from entrepreneurs who are able to change the adapt to institutions and transform them through competition and pursuing efficiency. Surveys of entrepreneurs and institutional change shows that competing entrepreneurs can shift the culture around trade and development.  A paper by Elert and Henrekson called Evasive Entrepreneurship suggests that entrepreneurs change institutions by circumventing obsolete institutions. evasive entrepreneurship is essentially profit driven business activity in the market aimed at circumventing the existing institutional framework by using innovations to exploit contradictions in that framework. Entrepreneurs can innovate through technology or organizations in order to evade the existing institutional framework. When their evasion is successful, entrepreneurs in the market can create a strong feedback loop to affect higher levels of institutions like the informal rules of the game and can overcome inertia to induce political reforms that can affect the institutional conditions for market actors and social welfare. Good and productive entrepreneurs can overcome bad institutions by innovating, but there is still an incentive for unproductive entrepreneurs to profit from these obsolete institutions. We see this primarily in rent-seeking. While he does not strictly define unproductive entrepreneurship, Baumol, in his paper called “Entrepreneurship: productive, unproductive, and destructive”, says that how the entrepreneur acts at a given time and place depends heavily on the rules of the game that happen to prevail. Unproductive entrepreneurship usually involves rent-seeking, enterprising use of the legal system, or tax evasion, and Baumol says that we can change the institutions to incentivize productive entrepreneurship. So, institutions can change through innovative market activity or unproductive entrepreneurship, but whether these changes stick depends on the level of institutions that are changed.

In his paper “Taking Stock and Looking Ahead,” Williamson considers four levels of social institutions. The first is embeddedness which includes informal institutions, customs, traditions, norms, and religion. The second level is institutional environment which includes formal rules of the game, property rights, the polity, judiciary, and bureaucracy. The third level is governance which is like the play of the game including contracting and aligning governance structures with transactions. The fourth level is resource allocation and employment which includes prices and quantities, and incentive alignment. Entrepreneurs can act within these levels to change institutions, and they can change them to the improvement or detriment of social welfare and economic freedom. Entrepreneurs will be further discussed in a later section, but right now it is important to note that there is a distinction between productive and unproductive entrepreneurship.

Moving on, institutions can be changed a number of ways, but this paper will look at how entrepreneurs circumvent obsolete institutions through special privilege and rent seeking. Rent seeking fits the framework in Williamsons 2000 paper for changing institutions because it changes the official rules of the game, is generally seen as unproductive, and circumvents institutions and has the potential to raise welfare by doing so. Because we do not start from ground zero, entrepreneurs have to produce given interventions and inefficient institutions. Entrepreneurs can raise or lower the welfare of the country by circumventing the existing institutions and adapting to interventions that make commerce difficult or inefficient. Economic institutions that contribute to a countries prosperity usually come from the institutional environment and the laws that entrepreneurs face in terms of property and exchange, so seeking priveliges or lobbying the government to change policies in their favor could be profitable for entrepreneurs. There will be more literature discussed in section III, but it is important to note that rent seeking can primarily change the institutions on the institutional environment level where the formal rules of the game are formed through legislation, trade policy, and tax structure.

Further, noting the literature on rent seeking and how it can transform institutions, I also want to look at how other kinds of entrepreneurship can shape institutions. For this, an example from Bill Gates will come in handy. Although rent seeking is an effective way to change economic institutions quickly, there are other ways to change the higher-level institutions. Bill Gates is a perfect example of this as he did not seek special privilege of government protected monopoly after his company was accused illegally maintaining a monopoly, but shifted to school reform. Bill Gates also provides an example of a kind of rent-seeking that differs from the method of unproductive entrepreneurs. He was a very successful entrepreneur in creating Microsoft. He quickly became very wealthy and very well known. Microsoft was then accused of illegally maintaining a monopoly in the PC market through legal and technical restrictions that it put on other manufacturers. Just by looking at this it would seem that Bills gates is a productive entrepreneur to lobby government so that he could most effectively sell his product and gain more profit. However, we do not see Bill Gates lobbying for less antitrust. Instead, we see him lobbying for more foreign aid, more spending on higher education, and funding vaccine and healthcare research.

## Prosperous Institutions

This section is to explain the institutions that helped countries grow prosperous. While there is much literature on institutions that help economic growth, there are two sources that stand out. One is by Rosenberg and Birdzell called *How The West Grew Rich* and the other is the Economic Freedom of the World index published by the Cato Institute. These help to explain the institutions in the West and throughout the world that encourage commerce and strengthen economic freedom.

In *How The West Grew Rich* by Rosenberg and Birdzell, the authors cite several institutions that changed in order to be more favorable to commerce (115). These institutions are important because they made exchanging and owning property easier so that people could accumulate more capital and goods in order to raise the standard of living. These institutions include legal enforcement of contracts and property claims, bills of exchange and banking, insurance, the substitution of taxes for confiscation and the recognition of property rights, economic association without kinship, double entry bookkeeping, development of religious and moral system suitable to commercial community, mercantilist partnership, and the divided European political structure and autonomous merchant class (Rosenberg and Birdzell 1986, 115).

Birdzell and Rosenberg consider briefly how these institutions came about, either through government reaction commercial expansion or through entrepreneurial innovation, but their contribution comes in explaining how these institutions helped grow trade early in commercial history. Starting with legal enforcement of contracts and property claims, the authors note that merchants and entrepreneurs needed to be able to depend on the legal system to provide predictable decisions for commercial cases. Systematic law added to an entrepreneur's ability to predict the behavior of others which reduced the risk of trading and investing with strangers. Next, bills of exchange made trading easier for merchants as markets developed buying and selling bills of exchange which supplied credit necessary for growing commerce (Rosenberg and Birdzell 1986, 117). These bills of exchange were a response to market demand that made it easier to invest and grow a business in a society that prohibited the payment of interest. Further, insurance developed in order to disburse the liability and burden of cost, so it was not quite as risky to undertake major voyages. Again, this institution developed because of a market demand for protection against loss of capital to an uncertain sea voyage. Another institution that guarded against uncertainty was the Magna Carta which established the right for people to own property without suffering from arbitrary confiscation by the state. These rights benefited merchants by allowing them to expand commerce because they could reliably hold property and it was no longer as risky to invest in capital. Next, association without kinship aided in economic growth because it allowed entrepreneurs to rely on non-family investors to help grow their enterprises that grew too large for a family enterprise. This is another institution brought about because of the entrepreneurial necessity for group loyalty, mutual trust, and mutual reliance among people who trekked out to sea, took on risky ventures. These associations also formed among small towns in the form of guilds (Rosenberg and Birdzell 1986, 126). This helped grow economies by further ensuring entrepreneurs of funds and reliable business partners. Now that entrepreneurs could do business without family, they needed a way to create an economic enterprise distinct from family. Thus, double entry bookkeeping arose as a way to distinguish the family affairs from business affairs by separating the assets and keeping separate records. This further lead to the development of a moral system suitable to commerce. Because it was more acceptable to do business apart from family, there was a more accepting attitude towards commerce that came about with the Protestant Reformation. This was a complicated relationship, however.  The Reformation was not directly related because some places that were still largely catholic grew economically, but the reformation provided a change in the moral system and the separation of religion and commerce. The change in moral systems and the shift out of family businesses also facilitated the growth of another institution of the mercantilist relationship with government. This partnership eventually led to the category of policies referred to as mercantilism which was favorable to trade and the merchant class. Finally, this all culminated into the ability to use Europe's political division as a source of growth. Rosenberg and Birdzell say "it seems certain that the development of capitalism in the West owed a good deal to the fragmentation of Europe into a multitude of states and principalities" (Rosenberg and Birdzell 1986, 136). Because each territory was too small to think of imperial wars and too afraid of competition from other states, economic growth was able to flourish while government intervention was limited. All of these institutions are cited to be growing factors in the west by many, and it is certainly seen today that these institutions aide in economic growth even after the West grew rich.

Another source that helps understand institutions that contribute to economic growth is the Economic Freedom of the World Index. The institutions as measured by the Cato institute in the Economic Freedom of the World index are in five major areas: size of government, legal system and property rights, sound money, freedom to trade internationally, and regulation of credit, labor, and business. There are 42 total variables that are measured on a scale of 1-10 and then averaged to derive the summary rating for each country. The Cato EFW Index shows that countries with greater economic freedom have higher income per-capita, higher life expectancy, lower infant mortality rate, lower poverty rates, and higher CPIA Gender Equality Rating.

In explaining why economic freedom is important, the authors in chapter 1 say "The cornerstones of economic freedom are personal choice, voluntary exchange, open markets, and clearly defined and enforced property rights. Individuals are economically free when they are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others" (EFW 2021, 1). Legal institutions that protect people and their property and enforce contracts fairly are required to allow people to trade freely without the worry that their property will be taken unwillingly or that they will be harmed in transacting with others. People must also have access to sound money in order to have stable prices and predictability which aides in trading with others without fear of being scammed or stolen from. These are the important factors that the Economic Freedom of the World Index cites are crucial for economic freedom and the ability for an economy to grow. Most importantly, economically free countries must have governments that refrain from restricting personal choice, voluntary exchange, and market entry. Taxes, government expenditures, and regulations all reduce economic freedom because it is the government acting on behalf of individuals in order to provide citizens with goods that they did not demonstrate preference for. Further, these government actions all involve some sort of coercion, so by definition are against freedom. Overall, the Economic Freedom of the World Index measures how closely a countries institutions compare with the ideal structure implied by the standard analysis of microeconomics.

The Economic Freedom of the World Index measures institutions that support economic development by protecting the individual's freedom to exchange voluntarily and own property. Entrepreneurs gain when these institutions are expanded, enforced, and adhered to because they make it easier to trade, accumulate capital, produce, and earn and keep profit. These institutions are considered the formal rules of the game, set by government rule usually, but they also include some informal institutions such as customs, traditions, and norms. Because theses institutions are formed by policy, entrepreneurs can attempt to form favorable institutions in order to make the country more economically free and favorable to commerce. Because these are formal rules of the game, it still takes time to change them, but it is possible to change them quickly without changing the underlying beliefs of the entire country. Changing the informal rules such as norms, beliefs, and underlying attitudes tends to take a lot longer, so it is a huge investment for entrepreneurs to undertake that many just do not have the time and resources for.

Because entrepreneurs can change institutions that effect trade and development by competing in a market, institutions that aide in economic development are important to understand. Institutions or policies that hamper free trade can come about if entrepreneurs care more about owning a larger share of the countries wealth rather than creating more wealth. However, institutions that appear in economically free countries as measured by the Economic Freedom of the World index typically end up with a less intrusive government. Less intrusive government allows competing entrepreneurs to have more influence over the institutions in a country, and can have a greater impact on whether a country is economically free or hampered.

## II. Institutional Change

In his essay "Institutions and the Performance of Economies Over Time" Douglass North says "Institutional change is a deliberate process shaped by the perceptions of the actors about the consequences of their actions" (North et al. 2005, 22). Institutions exist  to mitigate uncertainty as we have seen in institutions of economic freedom. The institutions that make a country the freest economically are the ones that provide some level of certainty in trade and exchange. Entrepreneurs must know what will happen, or at least have a prediction of what could happen, if they apply their means to achieve their ends. Moreover, these institutions are able to be shaped and worked towards if not possible to achieve through a process of change. North gives five propositions that describe the process of institutional change.

First is that institutions change through the continuous interaction between institutions and organizations in competition. Second is that competition forces organizations to invest in new skills and knowledge to survive which will shape perceptions about opportunities and hence choices that will incrementally alter institutions. Third is that the institutional framework provides the incentive structure that dictates the kinds of skills and knowledge perceived to have the maximum payoff. Fourth is that perceptions are derived from the mental constructs of the players. Finally, the economies of scope, complementarities, and network externalities of an institutional matrix make institutional change incremental and path dependent (North et al. 2005, 22).

These propositions make it clear that institutional change comes about through a competitive process. Entrepreneurs compete in the market process and change institutions incrementally by gaining knowledge and innovating in order to survive. This competition and ultimate innovations end up shaping the ideas that entrepreneurs have that they can then apply means to in order to achieve ends. The ideas that connect means and ends are connected through ideas that are shaped by the institutional framework. The choices that entrepreneurs make ultimately shape the institutions in a sort of feedback loop so that each time an entrepreneur acts they can shape an institution towards or away from economic freedom.

For North, competition is the key to institutional change. But for countries that do not have much competition fueling investment in skills and knowledge, institutions can be changed through a change in beliefs or by fomenting revolutions. Mary Shirley writes that New Institutional Economics has given much information in the way of specific processes of how institutions change. Shirley does say that institutions have been changed through revolutions and shocks, so they are not always incremental. Institutional change also occurs very slowly through a change in beliefs, although this is less frequent because it takes longer than the time frame most entrepreneurs allot for business ventures (Shirley and Menard 2005, 632).

These two authors gave two frameworks for how institutional change occurs, competition and revolution. These are incredibly helpful for understanding the current institutions and how to best transform them into economically freer ones. In order to understand how institutions change, however, it is important to have a good understanding of the economic actor operating in these institutions. Entrepreneurs have the greatest opportunity to transform institutions in a lasting way because they are the ones making decisions and transforming resources into consumer goods. If individuals see that entrepreneurs are thriving under certain institutions, they will benefit because a thriving entrepreneur usually means a higher standard of living for those who have a demand for what the entrepreneur sells them.

A paper by William Baumol called “Entrepreneurship: Productive, Unproductive, and Destructive” talks about how institutions can be changed to encourage entrepreneurs to be productive. This institutional change can be done through tax reform, deregulation, and more rational antitrust policies. These changes would happen through policy-makers so they might not stick as well as if the people actually affected by the institutions bring about the changes, as is the case with foreign aid and outsides trying to influence institutions in undeveloped countries as mentioned previously.

Baumols paper is useful, however, for how it distinguishes productive and unproductive entrepreneurs. Productive entrepreneurs in theory are able to maintain good institutions best because they would benefit the most from policies that go along with institutions that allow economic freedom. We know that entrepreneurs need private property in order to have the incentive to invest and produce. They must have equally enforced contracts so they can predictably deal with buyers and sellers and hired labor. We also know that entrepreneurs need a stable monetary environment so they can accurately calculate profit and loss and allocate goods accordingly. We also know that they need to rely on markets in order to actually produce and sell goods that they make. Entrepreneurs who are productive will work to keep these institutions because it will benefit them through profit incentives to do so. Productive entrepreneurs have incentive to protect economic freedom because they rely on them in order to produce and gain profit..

Unproductive entrepreneurs, on the other hand, will most likely work to damage these institutions because they do not benefit from them. Unproductive entrepreneurs will seek rents and lobby for policies that make it easy for them to earn a profit without producing or growing the pie. This means they will lobby against strong private property rights because it would benefit them if they could infringe on others property. They will not want even handed contract enforcement because they would likely benefit from having the ability to sway the contract in their favor. And they would not want low taxes because through their rent seeking and lobbying they would likely be net tax consumers instead of net tax payers. Being a net tax consumer means that this firm would benefit from higher taxes because they profit from government having more money. They would also benefit from not having a stable monetary environment because the only resource they are allocating is money and their own time and labor. They do not need to rely on profit and loss calculation in order to find the best method of rent seeking. The unproductive entrepreneur also does not rely on markets to allocate goods, instead he relies on government intervention and regulation in order to gain profit from his investments. The unproductive entrepreneur, therefore, actually harms the institutional environment and governance structures by working against economic freedom.

There is some disconnect between the two entrepreneurs. Productive entrepreneurs want to avoid being taxpayers while unproductive entrepreneurs want to become tax consumers. The productive entrepreneur wants to avoid paying taxes and comes as close as he can to this goal by lobbying for institutions that allow him to produce, sell, and keep what he earns. The unproductive entrepreneur wants to become a tax consumer and he does this by lobbying for special priveliges and regulations that make it easier to him to produce less, hamper competition, and still gain a profit without expending more of his own resources. This is why I argue that unproductive entrepreneurs are able to change institutions through interventive processes like rent seeking.

## **III. Rent Seeking to Change Institutions**

Gordon Tullock contributed a lot to the literature on rent seeking. In his book, rent seeking is a competitive process but it is inefficient because there are resources wasted in attaining the rent. It is not simply a wealth transfer because rent seekers expend resources in the process. He says "People are said to seek rents when they try to obtain benefits for themselves through the political arena. They typically do so by getting a subsidy for a good they produce or for being in a particular class of people, by getting a tariff on a good they produce, or by getting a special regulation that hampers their competitors." Tullock's insight was that expenditures on lobbying for privileges are costly and that these expenditures, therefore, dissipate some of the gains to the beneficiaries and cause inefficiency.

Tullock's comments on how entrepreneurs engaging in rent seeking seem to be wasting resources on lobbying contributes to the distinction between productive and unproductive entrepreneurs. These rent seekers are not really investing to produce something, they pour their resources into getting special priveliges and not producing goods. They want to hamper competition and gain monopoly privilege so that they do not have to compete as much and work as hard for their profit.

Roger Congleton says that "while institutions play a role in generating the kind and level of competition that will exist, transforming institutions is in itself a competitive game (Congelton 1980, 179). This is important because it means there can be entrepreneurial activity in attempting to transform institutions. Because there is competition, there has to be some form of efficiency in order to reduce costs or gain a greater rent

Robert Tollison's "An Economic Theory of  Rent Seeking" says there were three basic papers on rent-seeking from Tullock, Krueger, and Posner as well as a volume of papers published by Buchanan et al. Tollison says "Rent seeking embodies a social cost in terms of the foregone product of the resources employed in rent seeking" (74). There are resources poured into both obtaining the rent and into protecting it. These are resources that could be poured into other productive activities.

This is why Baumol refers to rent-seeking activity as unproductive entrepreneurship. Baumol suggests designing institutions in order to divert entrepreneurial efforts to more productive channels (Baumol 1990). Because entrepreneurship is like a good that can be allocated with the right incentives, institutions can be designed by policy makers to encourage entrepreneurs to join in productive efforts. While this is a good idea in theory, there is little incentive for policy makers to change the incentive when they also benefit from the rent seeking activity of unproductive entrepreneurs.

Normally we see that productive entrepreneurs are very knowledgeable about their industry, so when they lobby it is normally in favor for policies that benefit that industry. Then we see unproductive entrepreneurs and in real life they have to have some sort of business or industry that they lobby for in order to gain full benefits. It is not normally just an individual that gets rents from the government, it's normally a class of people, an industry, or another country. Rent seeking, then, works best if you actually produce something and lobby the government to hamper all other competition in that industry.

This seems to show that in reality we have productive and unproductive entrepreneurs looking almost identical because they both produce. The productive entrepreneur however recognizes that he can be most successful if he fills the most demand and so that is what he does and he becomes good at it. The unproductive entrepreneur however does not recognize that his role is to best fill a demand so that he can gain profit. instead, he takes his skills as an entrepreneur and applies them to lobbying the government to get benefits at the cost of others.

## **III. BILL GATES AS EXAMPLE OF UNPRODUCTIVE ENTREPRENEUR**

As a productive entrepreneur, Bill Gates started a technological giant that we know as Microsoft. In this venture, Gates revolutionized the technological world, and found clever ways to earn a profit on his products. He was a very successful entrepreneur in creating Microsoft because he created products and a new way of doing things that resulted in more wealth instead of fighting for a proverbial bigger piece of the existing pie. Microsoft was then accused of illegally maintaining a monopoly in the PC market through legal and technical restrictions that it put on other manufacturers.

If Gates wanted to continue creating wealth and being a productive entrepreneur, he would predictably lobby for less antitrust policies in order to remove any hampering of his business. However, we do not see Bill Gates lobbying for less antitrust. Instead we see him lobbying for more foreign aid, more spending on higher education, and funding vaccine and healthcare research. Completely changing his field of action, Gates transitioned to being a philanthropist, and an unproductive or even evasive entrepreneur in the policies that he advocates for.

Instead of even fighting for a larger portion of wealth for himself, Gates is seen attempting to change the institutions in foreign countries and his own country through foreign aide and education spending. As Gates says that government plays an important role in funding education and has lobbied for government to help lower the cost of college for students who graduate high school, he harms the institutions that lend to economic development by providing a larger role for government instead of entrepreneurs to impact the country. This kind of rent seeking is harmful because it does not build up institutions that lend toward economic freedom. Further, because of his recent funding of research on global health and vaccinations, Bill Gates has contributed to efforts that deteriorated our freedom to trade as we have seen the past few years.

## Conclusion

Institutional change happens mainly through entrepreneurial activity. Whether this change is towards or against economic freedom depends on whether the entrepreneur is productive or unproductive. Because there are incentives for both kinds of entrepreneurs it is difficult to parse out which is which in reality. Overall, the literature on rent seeking, New Institutional Economics, and entrepreneurs provides a helpful framework for understanding how institutions can be shaped in order to bring prosperity to a country.

Resources

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