

# *Journal des Economistes et des Etudes Humaines*

---

*Volume 14, Number 2*

2004

*Article 5*

NUMÉRO 2

---

## The Many Faces of the Market

Peter J. Boettke\*

Christopher J. Coyne†

Peter T. Leeson‡

\*

†

‡George Mason University

Copyright ©2004 by The Berkeley Electronic Press and IES-Europe. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher, bepress, which has been given certain exclusive rights by the author. *Journal des Economistes et des Etudes Humaines* is produced by The Berkeley Electronic Press (bepress). <http://www.bepress.com/jeeh>

# The Many Faces of the Market\*

Peter J. Boettke, Christopher J. Coyne, and Peter T. Leeson

## Abstract

While markets are all around us, not all markets are the same. Markets come in a variety of colors based on the legality of activities in the specific market. As such, there is no market economy per se, but instead various shades of markets. The different shades of markets that are evidenced in practice directly depend on the institutional environment that makes certain activities legal or illegal. Shifts in the institutional environment are a result of entrepreneurial activity over the rules of the game. The rules of the game and resulting shade of the market in turn impact entrepreneurs acting within those rules and hence economic development or the lack thereof.

L'économie de marché est en réalité une économie des marchés. La variété des marchés s'explique par la légalité des activités sur chacun d'entre eux. Ainsi il n'existe pas une économie de marché en soi, mais plutôt plusieurs formes de marché. Ces formes manifestes de marché sont fonction de l'environnement institutionnel qui rend certaines activités légales ou illégales. Les changements de l'environnement institutionnel sont le résultat de l'activité entrepreneuriale en dehors des règles du jeu. Les règles du jeu ainsi que la forme du marché qui leur est associée influencent à leur tour les actions entrepreneuriales et donc le développement économique.

**KEYWORDS:** Economic development, Institutions, Entrepreneurship

---

\*The authors would like to thank Nicholas Mercuro and Warren Samuels for useful comments and suggestion. The generous financial support of the Mercatus Center, the Earhart Foundation and the Oloffson Weaver Fellowship are acknowledged.

# THE MANY FACES OF THE MARKET\*

Peter J. Boettke, Christopher J. Coyne, and Peter T. Leeson<sup>o</sup>

## 1. Introduction

Markets are ubiquitous. No matter where one travels in the world, he observes exchange. Of course the nature of these transactions varies from place to place. It is clear though that markets of varying shapes and sizes pervade the lives of individuals in every country and culture. A market is said to exist if there are buyers and sellers for a good or service. However, as McMillan points out, decision-making autonomy is a key aspect of defining a market transaction<sup>1</sup>. Participants have the ability to voluntarily enter into the transaction and, given the parameters of the marketplace, have the ability to remove themselves from the transaction. The term “market economy” refers to the collection of individual markets.

Despite the omnipresence of markets, not all markets are the same. Both the formal and informal rules of the game, and the manner and effectiveness of the enforcement of those rules influence the nature of markets.<sup>2</sup> Institutions can be understood as the formal and informal rules governing human behavior, and the enforcement of these rules through the internalization of certain norms of behavior, the social pressure exerted on the individual by the group, or the power of third party enforcers who can use the blunt instrument of the threat of force on violators of the

\* The authors would like to thank Nicholas Mercuro and Warren Samuels for useful comments and suggestion. The generous financial support of the Mercatus Center, the Earhart Foundation and the Oloffson Weaver Fellowship are acknowledged.

<sup>o</sup> Department of Economics, George Mason University, MSN 3G4, Fairfax, VA 22030. Email: pboettke@gmu.edu; ccoyne1@gmu.edu; pleeson@gmu.edu.

<sup>1</sup> McMillan-2002, pp. 5-6.

<sup>2</sup> For the rest of this paper wherever the reader sees the phrase “rules of the game” they should have in their mind as the next clause “and their enforcement.” Rules that are not enforced by some mechanism are not effective rules in the sense in which we are using the term throughout this paper.

*Volume 14, numéro 2, Décembre 2004, pp. 71-86.*

rules. Certain institutions, such as a respect for private property, are necessary to underpin a well functioning market economy that yields widespread prosperity.<sup>3</sup> As we discuss below, the legal and political institutions influence the “color” of each market. The color of a market refers to its legality where fully legal markets are “bright” and fully illegal markets are “dark.” For instance, rules that make certain activities illegal will drive the market underground creating a “black market” for a particular good or service. Finally, the array of informal social norms and values will influence the color of markets as well. For instance, an ethos of acceptance and trust of strangers will broaden the extent of markets while interaction limited to a small group will necessarily limit the extent of markets.

In addition to influencing the color of the market, the rules of the game also impact entrepreneurs. As we will discuss, by shifting the relative payoffs of participating in certain color markets, the rules of the game influence the direction of entrepreneurial activities. Entrepreneurial activities can be directed toward a number of ends. Some of these ends are conducive to economic development while others lead to economic stagnation. Economic underdevelopment is not the result of lacking entrepreneurship. Rather, it is the result of institutions that make the payoff to unproductive activities higher than the payoff to productive activities. In short, the connection between the rules of the game and markets is a critical element of economic development.

Our core thesis is that while markets are all around us, not all markets are the same. Markets come in a variety of colors based on the legality of activities in the specific market. Shifts in the institutional environment are a result of entrepreneurial activity over the rules of the game. The rules of the game and resulting shade of the market in turn impact entrepreneurs acting within those rules and hence economic development or the lack thereof.<sup>4</sup>

<sup>3</sup> Throughout the paper we will use the terms “prosperity,” “economic development,” and “economic progress.” When we use these terms we have a specific definition and metric in mind. Economic development, progress and prosperity are defined as increases in real wealth and can be measured by changes in the level of real GDP per capita. Countries can be ranked from economically developed to economically underdeveloped based on their relative per capita GDP.

<sup>4</sup> Markets are in certain sense like weeds; they crop up wherever the opportunity arises and the attempt to stamp them out here means they grow over there. They are, in this sense, very robust. On the other hand, markets are also like hothouse orchards that are fragile and require care and cultivation. In this analogy, weeds are robust, but aesthetically unpleasant, whereas orchards are fragile, but aesthetically pleasing. It is our contention that while markets are omnipresent, the welfare properties we can attribute to any existing market are institutionally dependent. The crucial theoretical point here is that the differences between markets are not a consequence of behavioral assumptions (*e.g.*, profit-maximizing behavior, full-information, etc.) or structural state of affairs (*e.g.*, competitive or monopolistic), as taught in text-books, but are instead a consequence of the institutional framework within which any given market is embedded. Standard economic models usually assume the institutional framework, whereas modern political economy must seek to explore the evolution and operation of this framework if scientific progress and improvements in public policy are going to be made. See Rajan-2004.

This paper proceeds as follows. In Section 2 we discuss the various shades of the market. We then address how the formal and informal institutions and policies influence the shades of the market. Section 3 turns to a discussion of the entrepreneur. We explore how entrepreneurs contribute to the generation and evolution of markets. We also discuss how the institutions and policies underpinning markets direct entrepreneurial activity. Section 4 considers the role that economic freedom plays in fostering markets and entrepreneurial activity generating economic progress. Specific focus is placed on understanding the institutional conditions necessary for the adoption of policies conducive to economic freedom. Section 5 concludes.

## **2. Institutional Choice and the Color of Markets**

While markets are ubiquitous, not all markets are the same. Markets are shaped by and embedded in the political, legal and social environment<sup>5</sup>. This includes both the formal rules as well as the informal norms and mores that are present in a society. We can envision a spectrum of market colors ranging from bright legal markets, to dark illegal markets. The institutional and policy environment within which market participants must interact determines the color of a market. For instance, those engaged in black markets are not inherently villainous but rather are deemed so by the legal system. The “black market” is simply the market that has turned “black” because activity in that market has been criminalized — not necessarily because it is destructive (though it may be, for instance, the market for murder) or somehow inherently “bad.” Indeed, black markets can be effective in making individuals in society better off through mutually beneficial exchanges, as in the case of communist societies<sup>6</sup>.

Following Katsenlinboigen and Levine<sup>7</sup> who focused specifically on markets in the Soviet economy, we offer the following taxonomy to understand the various shades of the market. The color of the market is based on the ability of individual participants to control prices and what is deemed legal, semilegal or illegal by the state.

### **2.1. Legal Markets**

Red – In red markets government officials establish prices. Individual agents are able to freely enter into transactions for the goods or services in question, but they must do so at the price determined by central authorities.

Pink – Participants in pink market transactions have some freedom to alter prices.

<sup>5</sup> Pejovich-2003.

<sup>6</sup> Colombatto-2002, p. 66

<sup>7</sup> Katsenlinboigen/Levine-1977, pp. 62-65.

The seller is free to negotiate a price with the buyer but the price is subject to some official price control. In the case of a price floor, the agreed upon price cannot fall below the government determined price. In the case of a price ceiling, the price cannot be set above a maximum price set by government officials.

White – In white markets participants are free to set prices. White markets are often referred to as “above ground markets” and the collection of white markets is known as the formal sector of the private economy. White markets are recognized and enforced by formal legal and political policies and institutions.

## **2.2. Semilegal Markets**

Gray – Gray market transactions consist of both a legal and illegal component. The good or service is legal but gray markets are characterized by some illegal component as well. Doing work for pay that is not officially reported to the Internal Revenue Service is one example of a gray market. The extent of the grayness of the market will vary from case to case depending on the proportion of illegal activity that is undertaken.

## **2.3. Illegal Markets**

Black – Transactions in black markets are illegal and the subsequent penalty is criminal prosecution. Black markets encompass the sector of economic activity that is legally forbidden by legal and political policies and institutions. These activities are “black” because they are conducted “in the dark,” outside of the formal legal system. Examples of black markets include the prohibition period or the current drug trade in the United States. Often, the sum of black market activity is known as the “informal sector” or the “informal economy” given that this activity takes place outside of formal legal and political institutions.

It is important to note that not all markets contribute to positive-sum gains yielding widespread prosperity. For instance, the market for economic rents in the case of monopoly privilege may involve significant deadweight losses that destroy rather than contribute to prosperity. While this activity, and markets in general, may be legally recognized, this does not make it beneficial to economic progress. Likewise black markets, which are illegal, may yield positive-sum gains.

Returning to the taxonomy of market colors, we can view this spectrum in terms of how the legal institutions lead to the alignment or disconnect between *de jure* and *de facto* rules. In the case of legal markets, the *de jure* rules dovetail with the *de facto* realities. This degree of alignment will vary depending on the color of the legal market. In the case of white markets, *de jure* rules align completely with the *de facto* realities. At the opposite extreme, in the case of black markets, there is a strong disconnect between *de jure* rules and *de facto* realities. In general, as one moves from the legal end of the market spectrum toward the illegal end, this disconnect becomes larger.

One example of this misalignment is illustrated in Hernando de Soto's<sup>8</sup> comprehensive

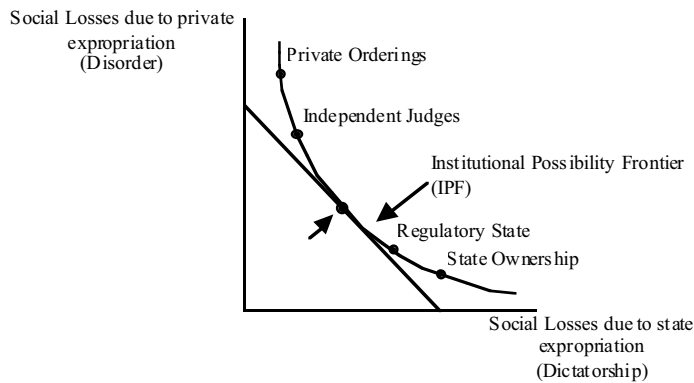
<sup>8</sup> Hernando de Soto-1989.

analysis of the plight of Peru. His analysis found an extensive and well functioning informal economy characterized by a drastic disconnect between the *de jure* rules and *de facto* realities. Due to the fact that the *de facto* realities were not recognized by the legal and political system, market participants were forced to undertake transactions outside the formal legal system.

As de Soto's study indicates, although extensive black market activity allows agents in Peru to engage in transactions prohibited by the *de jure* rules, there are large costs to operating in the underground economy. The range of choices of those in the informal sector, whether they are clients, suppliers or financiers, is severely limited. The costs involved in evading the formal system are significant. Property rights are not as strong as they could be because of a lack of formal recourse in the absence of an effective court system.<sup>9</sup> There is also a limitation on how much informal businesses can expand because they must remain small in order to avoid detection.<sup>10</sup> Utilizing certain credit instruments, physically expanding a business or hiring too many workers makes detection by authorities easier.

Given this, it is important to understand how the institutional environment influences can affect the color of markets. Djankov et al.<sup>11</sup> offer a useful way of illustrating the institutional possibilities facing society, which is depicted in Figure 1:

Figure 1: Institutional Possibilities<sup>12</sup>



<sup>9</sup> Formal contractual enforcement through a state court system, however, is not always necessary for exchange to flourish. See Leeson-2003, Leeson-2004 and Leeson/Stringham-2004.

<sup>10</sup> In addition to the issues associated with successfully avoiding detection by state officials, underground markets rely on either the mechanism of reputation, or the mechanism of third-party, extra-legal entities for enforcement. Reputation has limits as an enforcement mechanism relating to both the size of the group and the composition of the group under examination. To date the theoretical literature in economics seems to imply that only with small groups of homogenous agents can reputation serve to discipline deviant behavior.

<sup>11</sup> Djankov/al-2003.

<sup>12</sup> Figure 1 and the subsequent interpretation are taken from Djankov/ al.-2003.

In the hypothetical case illustrated in Figure 1, the two extremes are social disorder, including such things as general crime and the private subversion of public institutions, and dictatorship, involving expropriation and abuse by the state. The x-axis measures the hypothetical social losses from dictatorship and the y-axis measures social losses from social disorder. The negatively-sloped 45-degree line represents the constant social costs of dictatorship and disorder.<sup>13</sup> The Institutional Possibility Frontier (IPF) represents the various combinations of private and public institutions available to a society. Ideally, the institutional combination will serve to place constraints on both private and public predation and provide a suitable foundation for above ground, legal markets that lead to economic progress.

Movement along the hypothetical IPF represents the trade-off between private and public institutions. The IPF represents the amount of private disorder eliminated by a marginal increase in government control or, in other words, the amount of public expropriation eliminated by a marginal increase in private ordering. As a society moves down the IPF, the institutional context is one where the state has more powers to provide order but also to engage in more expropriation and predation. The far end of the lower tail would characterize a society with state ownership and involvement in all facets of social, economic and political organization. In contrast the top tail is characterized by the complete private ordering of a social and economic affairs. Private ordering would include such things as private litigation, self-regulating associations and high trust, reciprocal communities. The area between the two tails represents varying mixes of private and public orderings. A private industry that has some self-enforcing aspects through associations but also faces some government regulations would be an example of this latter case. Figure 1 illustrates four potential categories of private and public institutions ranging from private orderings to state ownership.

The location of the IPF depends on the level of civic capital present in a society. In societies with a higher level of civic capital (culture, factor endowments, physical environment, social capital, etc.), the IPF is closer to the origin. These societies are more able to achieve widespread social cooperation as compared to those societies with low levels of civic capital.

The point of its tangency with the IPF represents the efficient institutional choice. This slope of the IPF can change, shifting the point of tangency, as new forms of governance are introduced which change the relative prices of private governance as compared to public governance. For instance, a new form of private arbitration would lower the relative cost of private governance and flatten the IPF curve such that the point of tangency with the constant 45-degree social cost line is closer to the upper tail of the IPF curve.

To understand changes in the slope of the IPF curve, one can envision two types of entrepreneurship. The first is entrepreneurship over the rules of the game. This involves alertness to new forms of governance that change the relative price of private and public governance and change the slope of the IPF. The second type

<sup>13</sup> It is assumed that a unit of private disorder is as bad as a unit of public disorder.



is entrepreneurship within the rules of the game. This involves entrepreneurial activity within a given set of rules. The second type of entrepreneurship is the focus of Section 3.

Combining the taxonomy of market colors we discussed above with this rendering of the institutional options facing a society allows us to better understand the impact of different institutional combinations on the color of markets. The combination of public and private institutions directly influences the color of the market in question. In the context of the hypothetical situation illustrated in Figure 1, a situation with excessive state predation, characterized by the lower tail of the IPF, will not minimize social losses and will cause individuals to move underground and utilize black markets. This is illustrated by the case of the Soviet Union where the informal market played a major role in the everyday life and survival of citizens<sup>14</sup>.

The other extreme of the situation illustrated in Figure 1, the upper tail, is characterized by a lack of functional legal and political institutions. There will be no black markets in this situation because there will be no activities that are legally criminalized. In this hypothetical situation interaction in markets will be extremely limited given widespread predation. At the extreme, individuals will only produce what they can consume or will cease production altogether. As the institutional combination moves toward the point of tangency, the hypothetical combination of private and public institutions creates a market environment that hypothetically minimizes social losses.

From an economic standpoint, the aim of the trade-off between private and public institutions is achieving an environment conducive to markets resulting in positive-sum gains and widespread prosperity while minimizing social losses. Markets will still exist at the two extreme tails of hypothetical situation depicted in Figure 1. However, these markets will fail to effectively operate and support an advanced exchange economy or they will operate underground in the informal sector. Work on prohibited markets, such as alcohol and illicit drugs, by economists has demonstrated that the legal status affects not only the manner in which the prohibited commodity is produced, marketed and exchanged, but also the overall environment in which otherwise law-abiding citizens must interact<sup>15</sup>. It is the legal restrictions, not the commodity in question, that leads to increases in per unit potency, the corruption of public officials, and the culture of violence that serves to enforce the rules of the game under conditions of market prohibitions. As Milton and Rose Friedman put it:

Al Capone, Bugs Moran became notorious for their exploits — murder, extortion, hijacking, bootlegging. Who were their customers? Who bought this liquor they purveyed illegally? Respectable citizens who would never themselves have approved of, or engaged in, the activities that Al Capone and his fellow gangsters made infamous. They simply wanted a drink. In order

<sup>14</sup> Boettke-1993: pp. 46-72; Boettke/Coyne-2004.

<sup>15</sup> Miron/Zwiebel-1995; Thornton-1991.

to have a drink, they had to break the law. Prohibition didn't stop drinking. It did convert a lot of otherwise law-obedient citizens into lawbreakers. It did confer an aura of glamour and excitement to drinking that attracted many young persons. It did suppress many of the disciplinary forces of the market that ordinarily protect the consumer from shoddy, adulterated, and dangerous products. It did corrupt the minions of the law and create a decadent moral climate. It did *not* stop the consumption of alcohol.<sup>16</sup>

Government decrees do not stop the production and exchange of goods and services that people desire but do impact the manner in which these activities are conducted. It is precisely this manner of interaction that determines the welfare properties of the market under examination.<sup>17</sup>

### **3. Entrepreneurship: Productive, Unproductive and Evasive**

All too often, markets are discussed as though their character is predetermined and unalterable—as though the nature of their existence lies outside the institutional regime they operate in. Yet markets themselves are generated and evolve over time. We have already touched on the role that institutions play in influencing the evolution and operation of markets. Another key element in establishing and shaping both new and existing markets is the entrepreneur. As will become evident, entrepreneurs are the first-movers in the evolutionary process of shaping existing markets and creating new ones.

Entrepreneurship involves alertness to previously unrecognized profit opportunities<sup>18</sup>. It is critical to note that the existence of profit opportunities does not necessarily lead to economic growth. The institutional context creates payoffs to a set of activities which may possibly lead to economic growth, but which may also lead to economic stagnation. For instance, in underdeveloped countries it is often profitable to engage in corruption, crime and rent-seeking. But profit opportunities must be connected to positive-sum activities in order for entrepreneurial undertakings to produce economic progress.

We can tie the notion of entrepreneurship to the institutional possibilities facing a society, as illustrated in Figure 1. The relative prices of private and public

<sup>16</sup> Friedman/Friedman-1979, p. 216.

<sup>17</sup> The amount by which production is curtailed depends on two factors: 1. the price-elasticity of demand, and 2. the impact of regulation on the cost of production. Sufficiently elastic demand and regulation can cause production to be completely curtailed.

<sup>18</sup> Kirzner-1973.

enforcement directly influence the institutional environment and hence entrepreneurs. The institutional setting in which the entrepreneur acts is critical because it will direct his alertness to different kinds of profit opportunities with different kinds of social outcomes. In short, there is a link between the institutional possibilities frontier and the direction of entrepreneurial alertness.

For instance, the lower tail of the IPF in the situation depicted in Figure 1 illustrates an institutional environment with ineffective courts, insecure property rights and state predation. This results in the absence of markets that generate economic growth. Such institutional combinations will lead to widespread black market activity.<sup>19</sup> Entrepreneurs will redirect their activities from the formal economy and long-term investments. Instead, they will only be alert to opportunities in the underground economy. A large informal sector will in turn distort the development of markets necessary for an advanced exchange economy and economic development. Likewise, a society characterized by relatively high payoffs to rent-seeking and corruption will serve to direct entrepreneurial efforts toward those activities.

The underlying point is that entrepreneurs are alert to profit opportunities along the entire IPF. The issue then becomes whether these opportunities are tied to positive-sum situations in which the economy at large can benefit, or if they are tied to negative-sum or zero-sum situations in which a few benefit at the expense of society. The former is the essence of economic growth while the latter characterizes the plight of underdeveloped nations.

We therefore distinguish between the types of activities that entrepreneurs can undertake in the following way. Entrepreneurs can engage in *productive* activities resulting in economic growth or they can engage in *unproductive* and *evasive* activities resulting in economic stagnation or retrogression.<sup>20</sup>

Productive activities – arbitrage and innovation – constitute the very essence of economic growth and progress. When engaging in productive activities, the entrepreneur has a dual role. The first is in discovering previously unexploited profit opportunities. This pushes the economy from an economically (and technologically) inefficient point towards the economically (and technologically) efficient production point. The second role takes place via innovation. In this role of innovator, the entrepreneur shifts the entire production possibility frontier (PPF) outward<sup>21</sup>. This shift represents the very nature of economic growth – an increase in real output due to increases in real productivity. Proxies for the magnitude of productive activities would be business start-ups, foreign investment, foreign trade, the use of capital and financial markets, price differentials and measuring the per capita numbers of “productive” lines of work.

When undertaking productive activities, entrepreneurs drive economic growth

<sup>19</sup> For but one example of this, see Myrdal-1968 who discusses how corruption enabled primitive capital development in Asia.

<sup>20</sup> Baumol was the first to make the distinction between productive and unproductive entrepreneurship (Baumol-1990, Baumol-2002, pp.59-61).

<sup>21</sup> Kirzner-1985; Boettke/Coyne-2003.

through arbitrage and innovation. Further, productive entrepreneurial activities continually contribute to the development of new markets and their subsequent evolution as well as the evolution of existing markets. Through the discovery of some new good or service that is demanded by consumers, entrepreneurs create a market for that good or service. By discovering new means of production or interacting with buyers of already existing goods or services, entrepreneurs influence the composition of existing markets. eBay is one example of this latter point. Consisting of over 42 million registered members, eBay operates as an online flea market and has significantly lowered the transaction costs of bringing together buyers and sellers from around the world<sup>22</sup>. It has served to turn many local markets into one large global market.

In contrast, unproductive activities include crime, rent-seeking and the destruction of existing resources. In the case of unproductive entrepreneurship, it is possible that innovation is taking place, but these activities do not shift the PPF outward. For example, consider new techniques for engaging in rent-seeking. While they lead to increased profit for the entrepreneur undertaking the activity, they result in a larger deadweight loss for society as a whole.

To productive and unproductive entrepreneurship we can add a third category – evasive entrepreneurship. Evasive activities include the expenditure of resources and efforts in evading the legal system or in avoiding the unproductive activities of other agents. Tax evasion is one readily apparent example of evasive activities, as are efforts to avoid bribing corrupt officials. Proxies for the magnitude of unproductive and evasive activities would include the level of corruption, the size of the black markets, per capita number of rules and regulations passed in a specific period, tax evasion and per capita numbers of lines of work that assist in unproductive or evasive activities. For instance, Murphy et al.<sup>23</sup> look at the proportion of engineers to lawyers. They conclude that a high level of engineers has a positive impact on growth and a large number of lawyers have a negative effect because of a high level of rent-seeking.

Given these categories of entrepreneurial activities and the institutional framework illustrated in Figure 1, we can postulate a relationship between the two. The institutional combination that minimizes social losses (the point of tangency) will also serve to foster productive entrepreneurship. This productive activity will take place in markets formally recognized by the legal and political policies and institutions. As society moves away from the point of tangency, one can envision more and more unproductive and evasive entrepreneurial activities taking place. At the extremes we would expect a large amount of unproductive and evasive entrepreneurial activities and a large amount of social losses. Any productive activity will take place in informal markets to avoid the formal policies and

<sup>22</sup> McMillan-2002, p. 20.

<sup>23</sup> Murphy/al-1991.

institutions.<sup>24</sup>

Entrepreneurs are present in every country and every cultural setting. We observe different outcomes from entrepreneurial activities because markets and activities yielding the highest payoffs vary across societies. In countries with low growth, it is not that entrepreneurs are absent or are not acting, but rather that they are stymied by either a lack of functional markets and hence profit opportunities or the existence of profit opportunities yielding outcomes counter to economic progress. In other words, the profit opportunities in underdeveloped countries are tied to negative-sum or zero-sum activities. Put simply, one of the major reasons underdeveloped countries suffer from systemic poverty is because the incentives in those countries are aligned with rewards for predation by private and public actors as opposed to productive wealth creation.

#### **4. The Wealth of Nations: Achieving the Institutional Foundations for Economic Freedom**

The main theme of this paper is that the institutional environment influences the direction of entrepreneurial activity and hence economic prosperity or the lack thereof. In this section we focus on understanding the institutional and policy environment conducive to productive entrepreneurship. Given an understanding of the environment necessary for economic development, we place specific focus on how it can be achieved in the context of our framework developed above.

As we have seen, economic growth and development are a consequence of institutions and policies creating an environment where the markets that come into existence are ones that allow entrepreneurs to bet on ideas that pay off for society. When this is the case, the payoff to productive entrepreneurship will be high relative to the payoff to unproductive and evasive activities. While it is true that markets are ubiquitous, markets allowing for an advanced exchange economy require a certain institutional foundation.

This realization offers insight into why we observe an increasing world income gap and a lack of convergence between rich and poor countries. The answer lies in the

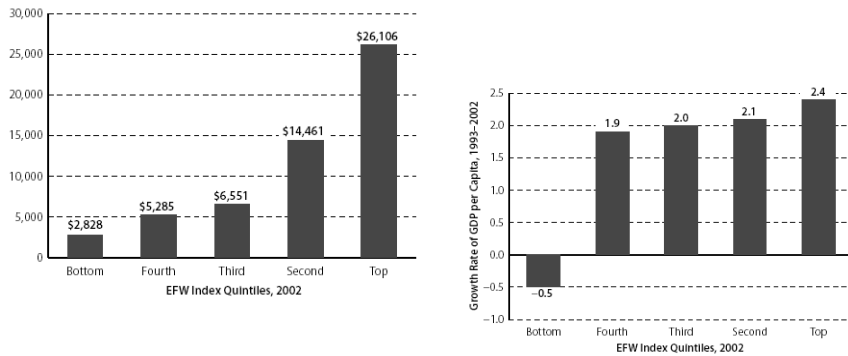
<sup>24</sup> All beneficial changes in Figure 1 require changes in the legal system that recognize productive activities. A potential issue arises in distinguishing between proposed legal changes that are productive and those that are unproductive (*i.e.*, pure rent-seeking). The fundamental issue here is one of the outcomes of the proposed change. If a legal change leads to an overall increase in social welfare-enhancing entrepreneurial activity, the legal change was productive. If a legal change does not do this, but instead benefits one group of entrepreneurs at the expense of others or benefits no entrepreneurs, the change is unproductive. Although this distinction makes sense conceptually, practically it may be difficult to determine whether or not some legal changes are productive or unproductive. A closely related element determining a legal change's productivity or lack thereof is the motivation behind the change. Again, while practically it is difficult to determine, we can at least conceptually envision two distinct categories of legal changes – those that are motivated by advancing productive entrepreneurship and those based on rent-seeking.

institutional combination (private and public) currently in place in underdeveloped countries. Unfortunately, over the last several decades, the development community has met with continued failure by focusing on foreign aid instead of the policy and institutional mix of underdeveloped countries<sup>25</sup>. It is only since the early 1990s that development economists have begun to focus on the role that both formal and informal institutions play in the development process.

One of the earliest to recognize the institutions and policies necessary for economic progress was Adam Smith. Writing in 1776, Smith indicated that, "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things"<sup>26</sup>. As research by Gwartney et al.<sup>27</sup>, Scully<sup>28</sup> and the Fraser Institute<sup>29</sup> indicates, Smith's claim was on target. This research has highlighted the role of economic freedom, manifested through well-defined property rights, a freely functioning price mechanism, a stable legal system, and trade liberalization in generating economic development.

When one compares those countries possessing economic freedom to those lacking these freedoms, the differences are staggering. Consider Figures 2 and 3, which show per capita income and economic growth for the Economic Freedom Index quintiles respectively.

*Figures 2 & 3: Per Capita Income, Economic Development and Economic Freedom<sup>30</sup>*



<sup>25</sup> Easterly-2001.

<sup>26</sup> Smith-1776, xliii.

<sup>27</sup> Gwartney/al.-1999.

<sup>28</sup> Scully-1988, Scully-1992.

<sup>29</sup> Fraser Institute-2004.

<sup>30</sup> Figures 2 & 3 are taken from Fraiser Institute, *Economic Freedom of the World 2004*, Chapter 1: 22. Available at: <http://www.freetheworld.com/2004/efw2004ch1.pdf> last accessed August 19, 2004.

The per capita income of those countries in the top quintile of economic freedom is more than nine times the per capita of those in the lowest quintile. Similar results hold for economic growth, as measured by changes in per-capita income, with those in the top quintile experiencing the greatest growth and those in the lowest quintile experiencing negative growth.

Indeed, on many margins those countries with economic freedoms outperform those lacking these freedoms. Countries with the greatest amount of economic freedom also provide the best opportunities for their citizens to live healthy and prosperous lives. Life expectancy in those countries in the top quintile is 75.9 years as compared to 53.7 years for those countries in the lowest quintile. Infant mortality falls drastically from 81.4 per 1,000 births for those countries in the bottom quintile to 9 per 1,000 births in those countries in the top quintile. With increasing economic freedom, literacy, human development and political freedoms increase while child labor and corruption fall as economic freedom increases<sup>31</sup>.

Given the importance of economic freedom for the achievement of productive entrepreneurship, and in turn measured economic prosperity, the major analytical question becomes how such an environment can be achieved in underdeveloped countries. Economists know what an economic miracle requires, but they know much less about how to go about implementing the conditions to create that miracle. The analysis put forth above offers insight into what the adoption of good policy entails.

Return to the institutional possibilities frontier illustrated in Figure 1. The critical point is that a given stock of civic capital – which determines the location of the IPF – and a given set of enforcement technologies – which determines the relative price of enforcement and hence the slope of the social loss line – constrains the set of policies that can be obtained. The logic here is straightforward. When the slope of the IPF curve changes such that the point of tangency with the constant social loss line is closer to the upper tail, the transaction costs associated with adopting policies conducive to economic freedom are relatively lower. Private means of facilitating social interaction and exchange will exist and intervention on the part of the state will not less necessary to support these the economic and social orders.

In contrast, if the slope of the IPF curve is such that the point of tangency with the social loss line is closer to the lower tail of the IPF (*i.e.*, state ownership), the transaction costs associated with adopting policies conducive to economic freedom are relatively high. Continual intervention and force will be required to facilitate social and economic interaction in the absence of private means of dealing with conflict.

To generalize the main implication, the lower the cost of relying on self-governance, relative to state governance, due to technological factors for detection and correction of opportunistic behavior by private individuals, the more likely it is that policies supporting economic freedom will be adopted. In other words, the achievement of a policy environment conducive to economic freedom requires a change in the slope of the IPF curve so that the point of tangency is closer to the upper tail where there is greater private ordering and thus greater social capital.<sup>32</sup> Only under these

<sup>31</sup> Fraser Institute 2004: pp. 23-6.

<sup>32</sup> The change in the slope of the IPF is due to changes in the relative price of enforcement.

circumstances is the adoption of policies that support economic freedom viable. This analysis has implications for the development community. It is not simply a matter of undeveloped countries adopting policies that provide economic freedom in developed parts of the world. Rather, it is a matter of ensuring that these countries have private means of governance that cause the slope of the IPF to change such that the point of tangency is closer to the IPF's upper tail. Only when adequate private governance mechanisms exist and thus sufficient civic capital is in place will freedom-oriented policy be generally less expensive to adopt than greater state control.

## **5. Conclusion**

No matter time nor place, markets are around us. This holds for all countries, large and small, rich and poor. Despite the fact that markets are all around us, not all markets are the same. The color of markets is influenced by the institutional and policy combination that make markets legal, semilegal or illegal. Not only do institutions and policies influence the legality of markets, they also affect the relative profitability of participating in certain markets.

Like markets, entrepreneurs are present in all cultural settings. But entrepreneurship is not synonymous with growth. If legal institutions make it more profitable to devote resources to unproductive or destructive activities, this is where entrepreneurial energies will go. In contrast, where wealth-creating activities are rewarded, productive entrepreneurship will flourish.

The most important lesson to take away from our analysis is simple. Economic prosperity requires an institutional environment that brightens the color of markets and by doing so attracts the attention of entrepreneurial innovation. Unfortunately, the ease with which this can be understood has not translated into enough real-world application of this insight. With the collapse of the Soviet Union, the importance of brightening markets has gained considerable ground, even if not conceived of along the lines discussed here. Nevertheless, many governments, particularly in underdeveloped nations, continue to pursue policies and promote institutional environments that darken markets and distort entrepreneurial effort. Although, as we alluded to above, there has been some recent interest within the development community, for instance, in creating institutional environments conducive to bright markets, not enough has been done to change the climate of perverse entrepreneurship. The institutional structures in many of these places have created. Further progress will require more substantial change.

As discussed in Section 2, this involves entrepreneurship over the rules of the game. This type of entrepreneurship entails alertness to new forms of governance that change the relative price of private and public governance. For the purposes of this section we treat this change as exogenous and focus instead on the analytical implications of a rotation in the social line for the achievement of specific policies.



## References

- Baumol, W. J. (1990)** "Entrepreneurship: Productive, Unproductive and Destructive", *The Journal of Political Economy*, Vol. 98, n°5, pp. 893-921.
- Baumol, W. J. (2002)** *The Free-Market Innovation Machine*, New Jersey: Princeton University Press.
- Boettke, P.J. (1993)** *Why Perestroika Failed: The Politics and Economics of Socialist Transformation*. New York: Routledge.
- Boettke, P.J. & Coyne, C.J. (2003)** "Entrepreneurship and Development: Cause or Consequence?", *Advances in Austrian Economics*, Vol. 6, pp. 67-88.
- Boettke, P.J. & Coyne, C.J. (2004)** "The Forgotten Contribution: Murray Rothbard on Socialism in Theory and Practice", *The Quarterly Journal of Austrian Economics*, Vol. 7, n°2, pp. 71-89.
- Colombato, E. (2002)** "Is There an Austrian Approach to Transition?", *The Review of Austrian Economics*, Vol. 15, n°1, pp. 61-74.
- Djankov, S., Glaeser, E., La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2003)** "The New Comparative Economics", *Journal of Comparative Economics*, Vol. 31, n°4, pp. 595-6151.
- de Soto, H. (1989)** *The Other Path*, New York: Basic Books.
- Easterly, W. (2001)** *The Elusive Quest for Growth*, Massachusetts: MIT Press.
- Fraiser Institute. (2004)** *Economic Freedom Index of the World 2004*. Available at: <http://www.freetheworld.com/release.html> last accessed August 19, 2004.
- Friedman, M. & Friedman, R. (1979)** *Free to Choose: A Personal Statement*, New York: Harcourt Brace Jovanovich
- Gwartney, J., Lawson, R. & Holcombe R. (1999)** "Economic Freedom and the Environment for Economic Growth", *Journal of Institutional and Theoretical Economics*, Vol. 155, pp. 643-663.
- Katsenelinboigen, A. & Levine, H.S. (1977)** "The Soviet Case", *American Economic Review*, Vol. 67 n°1, pp. 61-66.
- Kirzner, I.M. (1973)** *Competition & Entrepreneurship*, Chicago: University of Chicago Press.
- Kirzner, I.M. (1985)** *Discovery and the Capitalist Process*, Chicago: The University of Chicago Press.
- Leeson, P.T. (2003)** "Contracts without Government," *Journal of Private Enterprise*, Vol. 18 n°2, pp.33-39.
- Leeson, P.T. (2004)** "Cooperation and Conflict: Evidence on Self-Enforcing Arrangements and Heterogeneous Groups," *American Journal of Economics and Sociology*, forthcoming.
- Leeson, P.T. & Stringham, E. (2004)** "Is Government Inevitable?," *Independent Review*, forthcoming.
- McMillan, J. (2002)** *Reinventing the Bazaar*, New York: W.W. Norton & Company.

**Miron, J.A. & Zwiebel, J. (1995)** "The Economic Case against Drug Prohibition", *Journal of Economic Perspectives*, Vol. 9, n° 4, pp. 175-192.

**Murphy, K, Shleifer, A. & Vishny, R. (1991)** "The Allocation of Talent: Implications for Growth", *Quarterly Journal of Economics*, Vol. 106, n° 2, pp. 503-530.

**Myrdal, G. (1968)** *Asian Drama: An Inquiry into the Poverty of Nations*, New York, Twentieth Century Fund.

**Olson, M. (1996)** "Big Bills Left on the Sidewalk: Why Some Nations are Rich and Others are Poor", *Journal of Economic Perspectives*, Vol. 10, n° 2, pp. 3-24.

**Pejovich, P. (2003)** "Understanding the Transaction Costs of Transition: It's the Culture, Stupid", *Review of Austrian Economics*, Vol. 15, n° 4, pp. 347-361.

**Rajan, R. (2004)** "Assume Anarchy? Why An Orthodox Economic Model May Not Be the Best Guide for Policy", *Finance & Development* (September), pp. 56-57.

**Scully, G.W. (1988)** "The Institutional Framework and Economic Development", *Journal of Political Economy*, Vol. 96, pp. 652-62.

**Scully, G.W. (1992)** *Constitutional Environments and Economic Growth*, New Jersey:

Princeton University Press.

**Smith, A. (1776 [1991])** *The Wealth of Nations*, New York: Prometheus Books.

**Thorton, M. (1991)** *The Economics of Prohibition*, Salt Lake City: University of Utah Press