

Two-Tiered Entrepreneurship and Economic Development^{*}

Peter T. Leeson[†] Peter J. Boettke

George Mason University

Abstract

This paper argues that there are two tiers of entrepreneurship important for economic development. One is concerned with investments in productive technologies that improve productivity and better service consumer needs. The other is concerned with the creation of protective technologies that secure citizens' private property rights vis-à-vis one another. In the developing world where governments cannot or do not protect citizens against predation, "institutional entrepreneurs" devise private mechanisms of property protection, providing the security required for productive entrepreneurship to grow. However, private protection technologies can be a double-edged sword. While private protection technologies enable some investment and exchange by securing citizens' property where government does not, potential constraints on these technologies' effectiveness may simultaneously limit their ability to expand investment and exchange beyond modest levels.

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[†] Email: pleeson@gmu.edu. Address: Department of Economics, George Mason University, MSN 3G4, Fairfax, VA 22030.

1 Introduction

A growing body of research shows that the strength of the positive relationship between economic freedom and development stems largely from presence of “good” institutions in economically free countries and “poor” institutions in unfree ones.¹ Most fundamental to “good” institutions are those that protect private property rights (see, for instance, Acemoglu et al. 2001, 2002; Acemoglu and Johnson 2005). Property protection has two components: freedom from government expropriation, which requires rulers to refrain from confiscating citizens’ property, and protection against threats of private predation posed by other citizens. Where government is well-functioning the state provides this protection through institutions such as police, courts, and the law.

It is widely recognized that where property rights are secure entrepreneurship thrives. Property rights institutions create a stable, certain, and incentive-compatible business climate in which, free from the fear of public or private predation, individuals have the incentive to “place bets” on new ideas and the ability to bring these ideas to life (see, for instance, Brenner, 1994, pp. 51-83). Far less recognized is that where property rights are insecure, entrepreneurship also thrives but at a different, “higher tier” of economic activity.

Conventional discussions of entrepreneurship focus on entrepreneurship at a “lower tier” of economic activity—entrepreneurial activity within a given institutional framework. Building

¹ Political economists from Adam Smith to P.T. Bauer understood the fundamental role played by cultural and political institutions in economic development. As Smith (1776, xliii) put it, “little else is required to move from poverty to opulence but peace, easy taxes and the administration of justice.” In more recent times Bauer challenged the conventional wisdom in development economics that there was a “vicious cycle of poverty”—that poor countries cannot emerge from poverty because low per capita income cannot generate the savings and investment necessary to raise per capita income. Bauer pointed out that this view overlooked the reality that the currently rich countries were once poor and yet they somehow escaped this “vicious cycle.” Instead of looking for a solution in foreign aid, Bauer argued that small-scale domestic trade was the first step in the process of development. A major determinant of economic performance is the cultural and political institutions that either promote or discourage trading behavior. “The misery in Ethiopia, Sudan, and elsewhere in Africa is not the result of unfavorable weather, external causes, or population pressures. It is the result of enforced reversion to subsistence conditions under the impact of the breakdown of public security, suppression of private trade, or forced collectivization” (2000, p. 8).

on Baumol (1990), Boettke and Coyne (2003) and Coyne and Leeson (2004), for example, argue that entrepreneurship is omnipresent; its form is simply guided by the institutional context in which it operates, which shapes whether entrepreneurial activity is positive or negative sum. In this framework we tend to associate positive-sum entrepreneurial activity with recombining resources or seizing profit opportunities in the context of a well-functioning system of government-protected property rights, as described above. Further, we tend to associate negative-sum entrepreneurial activity with predation where there is no such system. This paper argues that there is a third possibility: entrepreneurial activity directed at creating private protection technologies that restrict predation in the absence of well-functioning government.

While existing research considers entrepreneurship within given “rules of the game,” our analysis considers entrepreneurship at a “higher tier” of economic activity—entrepreneurial activity over the rules of the game. We explore entrepreneurship directed at altering the institutional context within which other economic activity takes place. Accordingly, we argue there are two tiers of entrepreneurship important for economic development. The lower one, which we call the “productive tier,” is concerned with investments in productive technologies that improve productivity (innovation) and better service consumer needs (arbitrage). The higher one, which we call the “protective tier,” is concerned with the creation of protective technologies that secure citizens’ private property rights vis-à-vis one another (governance). In the developing world where governments cannot or do not protect citizens against private predation, “institutional entrepreneurs” devise private mechanisms of property protection, providing the security required for productive entrepreneurship to grow.² However, private protection

² Following North (1990), we define institutions as “rules of the game” and mechanisms of these rules’ enforcement. The protective technologies that entrepreneurial activity in the protective tier develops thus include private activities that define property rights (such as, for instance, the development of private legal rules) and private mechanisms of enforcing these rules (such as, for instance, private courts, multilateral punishment strategies, etc.).

technologies can be a double-edged sword. While private protection technologies enable some investment and exchange by securing citizens' property where government does not, potential constraints on these technologies' effectiveness may simultaneously limit their ability to expand investment and exchange beyond modest levels.

Most treatments of underdeveloped economies neglect the "protective tier" of entrepreneurship and in doing so overlook a critical component of economic activity in the developing world. Failure to appreciate this tier of entrepreneurship has also led researchers to underestimate the extent of entrepreneurial behavior in impoverished nations and to overestimate the importance of introducing public technologies of property protection. By highlighting this tier of entrepreneurship, its relationship to "productive-tier" entrepreneurial activity, and its positive and negative forces for progress, we hope to shed light on the connection between entrepreneurship, property protection, and economic development.

Our analysis is connected to the literature in both property rights economics and development economics. In the former literature Harold Demsetz's (1967) seminal paper on the emergence of property rights paved the way for subsequent discussions of endogenous property rights institutions. Later research by Anderson and Hill (2004), Benson (1989), Friedman (1979), Haddock (2002), Leeson (2007b, 2007c, 2008b, 2009), Libecap (2002), and Umbeck (1981) among others explores the emergence of self-enforcing property rights without the state. In the development economics literature Coyne (2006), Nenova (2004), Nenova and Harford (2004), Leeson (2007b), Powell et al. (2008), and others show that in weak and failed states production and exchange continue despite the absence of effective government-provided property protection. This paper bridges the gap between these two important streams of research by examining institutional entrepreneurship's role in facilitating property institutions' endogenous

emergence. Our analysis fills the lacuna between these literatures by adding a new dimension to the relationship between entrepreneurial activity and property rights. We show that entrepreneurship is not only a product of property rights, but that, critically, it is a producer of these rights as well.

2 Two Technologies of Development

2.1 Productive Technologies

Productive technologies are crucial to the process of economic development. These technologies refer to investment in activities that improve productivity and better service consumer needs. For economies to grow citizens must be willing and able to invest in capital and new technologies of production. Unless production exceeds what is necessary to sustain the producer there is no “surplus” for sale to others, no capacity for trade, and thus no economic development. Peter Bauer’s (1954, 1991, 2000) insightful work highlights that in much of the developing world these technologies take rudimentary forms unlike the modern machinery they are associated with in the developed world. This fact has led many development economists to mistakenly believe that productive technologies are not actively developed and employed in poor countries and to significantly underestimate the extent of developing nations’ investment. As Bauer (2001, p. 11) puts it, “These forms of investment, when made by small farmers, are generally omitted from official statistics and are still largely ignored in both the academic and the official development literature.”

Simple investments, such as the clearing of brush, terracing of land, and the planting of cash crops for sale, constitute important and sizable capital formation in developing, usually agricultural, economies. Indeed, “millions of poor producers in the Third World ha[ve] in the

aggregate made massive investments in” these forms (Bauer, 2000, p. 6). As part of these investments developing world producers have contributed to another economic activity crucial to development: trade. As Bauer notes, the large majority of agricultural producers in much of Africa, for instance, are also active small-scale traders. These “trader-entrepreneurs,” as he calls them, “are productive in both static and dynamic senses” (2000, p. 6). They entrepreneurially identify market demands, produce for their satisfaction, and engage in the process of connecting buyers with their supplies. Trader-entrepreneur activities do more than simply improve the allocation of existing resources. They habituate an outward-looking, market-oriented perspective crucial to an exchange- rather than subsistence-based economy. Trader-entrepreneurs’ production and exchange enterprises stimulate new contacts, such as those with individuals supplying input markets, disperse new ideas, communicate new methods of production, acquaint individuals with new products, encourage specialization, and initiate more complex forms of exchange, such as credit, which is often necessary for seasonal agricultural production.

This form of investment in productive technologies, however basic, constitutes the economic backbone of much of the developing world. Although at the individual level this activity is small-scale, as Bauer highlights, in aggregate it is indispensable to raising inhabitants’ living standards above subsistence. These production, investment, and trading activities constitute investments in productive technologies and occupy the “productive tier” of entrepreneurship that is significant for economic development.

2.2 Protective Technologies

Protective technologies refer to the methods of creating and enforcing individuals’ property rights. Where property is at risk, either from state predation or from predation by private

individuals, citizens have little incentive to invest in the productive technologies discussed above. The reason for this is straightforward. If citizens cannot reap the rewards of investment in production for exchange, they will not invest or produce beyond the level necessary to sustain themselves. Protective technology is therefore primary over productive technology in that the latter is impossible without the former.

There are two kinds of protective technologies: public institutions of government (public protection technologies) and private institutions of governance (private protection technologies).³ The former consists of institutional constraints on government predation, such as constitutions, separation of powers, judicial checks and balances, and federalism, as well as public institutions to deal with private misconduct, including state police, courts, and the law. The latter includes, but is not limited to, bilateral and multilateral punishment schemes, such as ostracism and boycott, reputation, bonds/hostages, social norms and customs, private law and courts, and private police protection. Virtually all societies use both kinds of protective technologies. However, developed economies tend to rely on public institutions of government to a much greater extent than undeveloped ones, and vice versa for private institutions of governance.

Djankov et al.'s (2003) important work, which presents a tradeoff between the social costs of public and private institutions of order, points to the reason we observe greater reliance on public protection technologies in rich countries and greater reliance on private protection technologies in poor ones. Their framework posits an "Institutional Possibility Frontier," which

³ In practice the distinction between "public" and "private" institutions is sometimes unclear. On the one hand, states, for example, result from the initiatives of private individuals. And on the other hand, some "private" institutions are created and run by "gangs" or other local strongmen who can and sometimes do, as we discuss below, engage in "taxing" activities that governments do. It is therefore more accurate to think about a spectrum along which various institutional arrangements fall with "pure" private arrangements at one end and "pure" public arrangements at the other. Still, when we observe the mafia, for example, we don't see a government. The distinction this suggests is the one captured by the classic definition of government: an agency with a territorial monopoly on the legitimate use of force. This definition also has some problems but the basic idea behind it is the one we have in mind when we distinguish between public and private arrangements.

reflects the tradeoff between private “disorder” created from relying on private institutions of governance on the one hand, and “dictatorship,” or the capacity for state predation created from relying on public institutions of government on the other. Efficient institutional organizations minimize the total social cost (disorder plus dictatorship) of alternative institutional arrangements.

Where government transparency is low, corruption of public officials is high, and institutional checks on rulers are weak, the social costs of relying more heavily on public institutions of protection increase relative to private institutions of protection. This leads to a situation in which greater reliance on private institutions is less costly and thus more efficient. Notably, in this environment, private protection technologies tend to be substitutes for public ones. State weakness or dysfunction means effective public protection is lacking. Since functional public protection technologies are largely absent they cannot complement private protection technologies. Instead, private protection technologies emerge to fill the vacuum created the absence of effective public ones.

Where there are strong checks preventing ruler predation and government is well-run the reverse is true. Here greater reliance on public institutions is less costly and more efficient. In this environment the private protection technologies that emerge tend to complement, rather than substitute for, public protection technologies, which are functional and highly effective. Thus in contrast to the case in which public institutions are weak, corrupt, and ineffective, where they are strong, transparent, and work well, private and public institutions tend to work in mutually supporting roles.

This reasoning suggests that which sector—public or private—has a comparative advantage in providing protection technologies depends on the features of the specific public vs.

private sector in question. Where government is transparent, highly functional, and effective, as it is in developed countries for instance, the state has a comparative advantage in the production of such technologies. However, where government is weak, corrupt, and dysfunctional, as it is in the developing world, the reverse tends to be true.

Djankov et al.'s (2003) argument has important implications for understanding differences in institutional arrangements across levels of development and is closely connected to James Buchanan's (1975) distinction between the productive, protective, and redistributive state. The productive and protective state is associated with "good" institutions of public government. In its productive and protective role the state provides public goods necessary for the maintenance of law and order, which enables the state to protect individuals' property rights. This in turn facilitates wealth-creation by encouraging investment in productive technologies.

The productive and protective state is paradoxical, however.⁴ Empowering government to perform these functions simultaneously empowers rulers to engage in predatory activities that destroy wealth. The result is what Buchanan calls the redistributive state. In this role government uses its power to benefit small classes of individuals, who in turn support the bestowing rulers, at the expense of society. Besides enabling rent-seeking behaviors, a government strong enough to act in the productive and protective functions of supporting property rights is also strong enough to turn its power against those individuals to expropriate their property.

The dilemma is thus how to empower government sufficiently to protect property but at the same time prevent it from using this power to destroy citizens' property claims, stifling investment in productive technologies, and with it, wealth creation. Constitutions and the sub-institutions they create, including a separation of powers, federalism, and judicial checks and

⁴ This paradox goes back to Madison who noted that if men were angels there would be no need for government and if rulers were angels there would be no need for constraints on political power. See Weingast (1995) for a discussion of how the ability to resolve this paradox is a crucial determinant in economic development.

balances, are supposed to overcome this dilemma. However, the empirical failure of state-made institutions in much of the developing world that has adopted written constitutions raises questions about their ability to enable the productive and protective state while limiting the redistributive one. The weakness of formal political constraints in this regard is further strengthened by evidence that suggests their presence does not promote economic growth (see, for instance, Glaeser et al., 2004).

Absent ruler commitment, written rules protecting private property and prohibiting government expropriation are as worthless as the paper they are written on (Boettke, 1993, pp. 88-105, 2001, pp. 191-265). Checks and balances aside, when governments desire, they may break these rules more or less at their whim. This is especially so in the developing world where in many cases citizens do not even expect that government will respect prohibitions on property expropriation established in written law. The recent introduction of a new constitution in the Democratic Republic of Congo, for example, has not prevented the Congolese government from proceeding with predatory business as usual. This reflects both the constitution's inability to check government's power in the Congo and citizens' rational expectations that this is the case.

Importantly, where governments go awry, as they have in much of the developing world, state power is not only transformed into a vehicle of expropriation. In many cases it also involves the breakdown of public protective technologies that are supposed to protect citizens' property claims vis-à-vis one another. These technologies include state police, courts, and the law itself. Thus, in the Congo again for example, government not only violates individuals' property rights as it pleases. It also fails to protect citizens' property rights from other citizens' private predation. This is the two-fold dire consequence of government in many developing countries.

Citizens must endure a government strong enough to prey on them but at the same time too weak or indifferent to protect them from others' predation (Leeson, 2007).

Individuals in countries where the redistributive state has overcome the productive and protective one have little recourse against the ubiquitous threat of public predation. When government sees the opportunity for expropriation and desires to seize upon it, citizens must "give way" to the stronger political authority. Only by hiding their wealth can they avoid state predation. This, of course, is largely responsible for the substantial underground economies of the developing world—unofficial economies that are in some cases larger than their official counterparts. Black markets generate an opportunity to improve living standards for individuals effectively barred from above-ground markets by corrupt governments' predation.

In the unofficial economy productive-tier entrepreneurship flourishes. Black markets open a back door for this entrepreneurship by recreating incentives to invest in productive technologies. However, a significant obstacle remains. Where do individuals derive the security of their property against private predation needed to invest in these technologies? The state cannot be resorted to. Production and trading activities on the black market are illegal and thus cannot be enforced in state courts. Legal, productive-tier entrepreneurial activities confront the same problem in the developing world. The weakness, corruption, and unreliability of public protection technologies for securing individuals' property against private predation precludes citizens from relying on government for this purpose.

This obstacle creates a profit opportunity for individuals who can devise institutions of private governance that protect others against the threat of private predation. "Institutional entrepreneurs" are the agents of these private protection technologies. Their innovations are substantial and vary considerably. In some developing regions of the world, such as Sub-Saharan

Africa, tribal units and larger kinship-based clans provide informal, unwritten rules of commercial activity and private “courts” for their enforcement. In other cases, where this is not possible, citizens rely on reputation mechanisms of bilateral and group-coordinated multilateral punishment to deal with dishonest conduct. Still elsewhere individuals rely on “hostages” or upfront investments—a form of bonding—to ensure good behavior where, for instance, they use credit. This entrepreneurship over rules of exchange and these rules’ enforcement is what we call “protective-tier” entrepreneurship.

Many of the private protection technologies citizens employ in developing countries are similar to those individuals employ elsewhere when public protection technologies are weak or absent. International trade is a good example of this. In the absence of formal international commercial law and courts of enforcement, private merchant-created law, called the *lex mercatoria*, governs international commercial contracts (see Benson, 1989; Leeson, 2008a). Private international arbitration associations rather than state courts overwhelmingly enforce merchant law.⁵ International commercial associations provide a way to keep tabs on the reputation of various international merchants, which helps ensure compliance. International traders also widely use letters of credit and bonds of various sorts. Thus protective-tier entrepreneurship is neither “backward” nor specific to developing countries. It emerges wherever there are gains from trade that would go unrealized in its absence. This is where public protection technologies cannot be readily relied upon, whether because of the absence of global government, as in the case of international trade, because of the absence of “good” government, as in the case in the developing world, or simply because of the relative costliness of relying on

⁵ Although several multinational treaties created in the latter part of the 20th century allow for state enforcement of private arbitral agreements, the world’s largest international arbitration association, the International Chamber of Commerce, estimates that 90 percent of its arbitral decisions are complied with voluntarily. For a discussion of this issue, see Leeson (2008a).

public protection technologies, as is the case with private domestic arbitration in developed countries, for example.

3 The Puzzle of Private Protection Technologies

Although private protection technologies, such as multilateral punishment, are able to partially secure individuals' property rights, enabling some investment in productive technologies, they have difficulty doing so fully.⁶ Bauer's argument about the proliferation of individually small-scale investments in productive technologies in developing countries has a protective technologies analog. According to Bauer, these individually small-scale investments point to the initial movement from a subsistence to an exchange economy and serve to "get the development ball rolling." Investment in production technologies does not grow miraculously or over night. It necessarily begins at low level and, from these small beginnings, hopefully expands. The same can be said with respect to private protection technologies. The relatively limited property security and exchange activity that reputation mechanisms can enable, for example, serve as the starting point for more developed private institutions of protection that can secure more individuals' property, making larger scale investments in production technologies and widespread exchange possible.

The difficulty of moving from small-scale investment in productive technologies that Bauer describes to large-scale investments lies in two factors. The first relates to the issue of government predation, which private protection technologies are at a loss to defend against. Social ostracism, for instance, an important mechanism for securing good conduct between private individuals in many underdeveloped countries, is of no use in defending against state

⁶ Of course, as we consider below, this is also true for public protection technologies, though for different reasons.

expropriation. This is what drives economic activity into the unofficial economy, as we discussed above. In his book, *The Other Path*, Hernando de Soto (1989) points out that this necessarily constrains economic activities' size in the informal sector. To avoid state detection, for example, trader-entrepreneurs must keep their activities below government's radar. This rules out, for instance, creating large-scale enterprises, which are easily discovered.

Second, the potentially limited property securing capacity of private protection technologies may be insufficient to create incentives to engage in wider-reaching production and exchange activities. Boycott of dishonest individuals, for example, may secure cooperation and create property certainty among a relatively small network of traders. In a moderately sized group each individual can know every other individual's history and cheaply communicate new information about this history to the rest of the community, enabling coordinated punishment of misconduct. However, as the population expands and becomes more diverse, it becomes more costly to communicate individuals' histories to others. Coordinated punishment becomes more difficult in this case, rendering boycott less effective at enabling widespread exchange. If, for instance, producers require credit to move a presently small-scale enterprise to the next level, creditors cannot rely on boycott alone to ensure repayment if potential debtors lie outside their close-knit social groups. Lenders will be less likely to make loans in this case, constraining productive-tier entrepreneurs' ability to expand their enterprises. Avner Greif's (2006) important work, for example, which considers the evolution of private protection technologies in pre-modern Europe, highlights the importance of such technologies in facilitating commerce but also the constraints they may face in term of the number and diversity of individuals they can encompass, limiting their effectiveness.

Private protection technologies may limit investment in production technologies in other ways as well. In the transition economies of Eastern Europe, for instance, where some governments do not effectively protect individuals' property against private predation, organized groups, such as the mafia, frequently perform this function. On the one hand these groups may be considered protective-tier entrepreneurs in that they protect individuals' property where the state does not. However, like government, these groups can and do turn their protection function into an expropriative one, extorting locals under the threat of force. This may be the most important drawback of private protection technologies. Thus, in some instances, private protection technologies may inhibit productive-tier entrepreneurship and economic development. These factors—the potentially more limited scope of private protection technologies and the possibility that institutional entrepreneurs may, upon developing these technologies, use them to prey on others—constitute the relative disadvantages of private, as opposed to well-functioning public, protection technologies.

While these relative disadvantages are very real one must also be careful to avoid comparing admittedly highly imperfect private protection technologies with idealized public ones. This comparison is inappropriate for at least two reasons. First, just as private protection technologies have their limitations, so do public ones, even where they are highly functional. For instance, the latter's inability to resolve property rights disputes between private parties quickly or cheaply in some cases is the reason certain private protection technologies have emerged even in countries with highly functional governments, such as the United States.

Second, and most important, it is inappropriate to compare imperfect private production technologies with idealized public ones because this is not the choice individuals—especially those in developing countries—ever face. Although the United States, for instance, may, through

government, supply vastly superior protection technologies to the private ones institutional entrepreneurs supply in, say, Zimbabwe, this is irrelevant for evaluating the comparative desirability of private vs. public protection technologies for Zimbabwe. The public protection technologies the Zimbabwe government can provide are no where near the quality of those the U.S. government provides. Thus the relevant comparison when examining the desirability of public vs. private protection technologies for Zimbabwe is not U.S. government-quality public technologies vs. Zimbabwe-quality private ones. It is Zimbabwe government-quality public technologies vs. Zimbabwe-quality private ones. As Djankov et al.'s (2003) framework suggests, the efficient "mix" of more or less reliance on private vs. public protection technologies will consequently depend upon the specific case and, in particular, upon how well-functioning or dysfunctional government is in that case.

4 Empirical Reality and the Protection Thesis

In a recent piece for the IMF entitled "Assume Anarchy?," Raghuram Rajan (2004) persuasively argues that rather than assuming well-functioning public protection technologies, as might be appropriate for the developed world, when it comes to understanding the developing world, a more sensible approach would begin by assuming the complete absence of public protection technologies. As noted above, one of the chief characteristics connecting the various countries that make up the world's "least developed countries" is the weakness of effective public protection technologies in them.

Rajan's point is related to our own in drawing attention to the need to more fully appreciate the role of private institutions in protecting property where government is unable or unwilling to do so. We know productive-tier entrepreneurial activity does not come to a halt in

this situation. Additionally, we know protective-tier entrepreneurial activity is responsible for this fact. However, as discussed above, we also know protective-tier entrepreneurship may thwart expanding productive-tier entrepreneurship at the same that it makes productive-tier entrepreneurship possible.

Somalia's situation, analyzed by Coyne (2006), Leeson (2007), Powell et al. (2008), and others, provides a useful case study to better understand the connection between productive- and protective-tier entrepreneurship in the developing world. In 1991 central government in Somalia collapsed. Since then the country has operated under anarchy. Somalia is different from other least developed countries in this respect. The rest of the developing world has weak or ineffective governments while Somalia has none at all.⁷ Nevertheless, Somalia's situation before and after statelessness ensued sheds light on the importance and difficulties of private protection technologies in many of these other nations. The reason for this is straightforward. While officially these countries have governments, when it comes to property protection, in practice, many do not. According to the Failed States Index nearly half the world's governments are on or near the cusp of "failing" (Foreign Policy/Fund for Peace, 2006). Here, government cannot or does not effectively perform even the most basic functions. The sizeable percentage of countries for which this is the case suggests Somalia's experience is highly relevant for the developing world more generally.

Between 1969 and 1991 Somalia was ruled by a ruthless military dictator, General Siad Barre. Barre's regime and its dire effects on Somalia are not atypical for the poorest of the developing world. His government was highly predatory and systematically expropriated and exploited Somali citizens. A decade after British Somaliland and Italian Somalia gained independence from their colonizers government thrust the country into full-blown socialism.

⁷ The Transitional Federal Government remains unable to exert its authority as a state.

Before 1969 Somalia had a democratic political organization and relatively functional constitution. However, Barre completely removed these checks on political power, legally empowering government to plunder Somalis at its whim. As part of Barre's nationalization program, for example, government confiscated Somalis' property holdings and converted them into state-owned farms and factories.

In the early 80s, after a failed war in Ethiopia in which the Soviets backed Ethiopia instead of Somalia, Barre officially renounced socialism. However, *de facto*, the economy remained under government's control until its demise in 1991. In 1979 the government introduced a new constitution that purported to guarantee democratic elections. Unfortunately, like many others in its mould, the rights guaranteed to citizens under the new constitution proved to be no more than words on a page. Rampant state corruption and predation continued unimpeded.

Part and parcel to government's predatory policy was systematic clan favoritism whereby Barre privileged political supporters and members of his own clan, the Marehan, at other clans' expense. As Somalia expert Peter Little (2003, p. 36) put it, "The Barre regime awarded certain client groups preferential access to arable land and water . . . Indeed, the Somalia case is a good example of ethnic (and clan) favoritism where private land-grabbing in the Jubba and Shebelle Valleys favored the late president's clan, the Marehan, while alienating other groups."

The result of nearly three decades of uninhibited state predation on the Somali population decimated development. Ironically, the inter-clan tension generated by Barre's strategy of ethnic favoritism was ultimately his downfall. In 1988 civil war erupted in Somalia with a number of the alienated ethnic groups seeking to oust Barre. In January of 1991 they were successful. However, disagreement between faction groups led to escalated civil conflict rather than to a

new central government. Although the conflict between these groups has abated substantially, Somalia remains without a central government.

Under Barre's regime a robust black market economy emerged as an unofficial outlet for productive-tier entrepreneurship, satisfying the needs Somalis could not satisfy through official channels that government controlled. For instance, in the early 1970s stringent state restrictions on imports led to a situation in which many Somalis lacked essential foreign-supplied goods they required. In the face of this situation a black market in import goods emerged. Supporting this productive-tier entrepreneurial activity was an informal, trust-based system of clan networks that arose along with it to provide traders property protection. The system was a simple one. Somali middlemen would receive foreign currency remittances from migrant workers employed abroad (usually in the Arab states). In repayment, middlemen would offer Somali currency or goods to workers' families in Somalia at the black market exchange rate. Middlemen then used their foreign currency to illegally import foreign goods demanded by local Somalis.

Critical to this activity's success was assurance that middlemen would not abscond with money remitted to them from abroad. To overcome this security threat, traders relied on intra-clan diasporas to facilitate their operations, protecting them against the likelihood of fraud and theft. Those remitting were frequently members of the same extended clan. They could therefore reasonably trust that traders would not cheat them. Once this arm of the activity was accomplished traders could sell their imports illegally relying on simultaneous trade and reputation to avoid the potential for private predation on the other end of their business transactions. At first Barre's government attempted to crack down on this illegal trade. But it found these attempts futile. In 1976 the state officially sanctioned the activity, which became

known as the *franco valuta* system. In 1982 government criminalized the activity again but it continued to operate as it had before 1976 in the unofficial economy.

Since government's collapse in Somalia 18 years ago, protective-tier entrepreneurs have developed several more elaborate and far-reaching private protection technologies to facilitate productive entrepreneurship. Nenova (2004), Nenova and Harford (2004), Coyne (2006), and Leeson (2007a) describe them in greater detail. Here we only briefly point to a few.

In stateless Somalia, central government's absence has eliminated public predation as a threat to citizens' property. However, private predation remains a threat. To cope with this problem property protection is largely secured at the clan-level via private, clan-based militias. Additionally, businesses, seaports, large markets, and trade convoys employ militiamen-for-hire to prevent theft. *Shari'a*, a form of religious law/courts that has long existed in Somalia but lost most of its authority under government, provides a degree of legal order and security by defining rules of behavior based on Islamic beliefs and through including guards in their court militia in return for payment from businessmen who desire protection. Somali customary law, *xeer*, also privately provides law and order. *Xeer* establishes rules for marriage, war, resource use, and social contracts between clans.⁸ Similarly, a private customary institution called *diya* helps regulate conflict by defining compensatory damages for bodily injury and murder.

Closely connected to the *franco valuta* system is the modern *hawilaad* system of remittances, which has evolved into a substantial industry in its own right. *Hawilaad* companies handle an estimated \$500 million-\$1 billion annually in remittances from Somalis abroad. In addition to connecting domestic Somalis with much-needed financing from abroad both for sustaining droughts and expanding commercial enterprises, *hawilaad* firms also perform some

⁸ Using the distinction between public and private institutions we draw in footnote 3, *Shari'a* and *xeer* are considered private institutions since these legal institutions are not the product of, nor are they enforced by, an agency with a monopoly on the legitimate use of coercion in Somalia.

quasi-banking functions. Some offer travelers checks, make small loans, and offer non-interest bearing deposits (Nenova 2004). Without a government to enforce *hawilaad* interactions in Somalia, Somalis rely on private protection devices. One concern, for example, is fraudulent receivers seeking to steal remitted funds. Tatiana Nenova and Tim Harford describe the *hawilaad* mechanism and how it deals with this threat. “A person in New York wishing to send money to his family in Tog-waajale gives the *hawala* agent in New York the sum in cash, paying a 5 percent commission. The agent deposits the cash in a local bank account to be transferred to the company bank account in Djibouti or Dubai, then alerts the clearinghouse in Hargeisa, which passes details on to Tog-waajale. When the recipient shows up, the local agent quizzes him about his clan lineage using questions provided by the relative overseas as security against fraud. The transaction is usually completed within 24 hours” (2004, p. 3).⁹ This system is highly successful at preventing private predation and illustrates the important connection between, and mutually supporting properties of, productive- and protective-tier entrepreneurship.

As Leeson (2007) points out, predatory government’s absence, together with privately created institutions of property protection, has led to surging entrepreneurial activity in several of Somalia’s critical economic sectors. The cross-border livestock trade, for example, has doubled since government’s collapse (Little, 2003). Facilitating this growth is the use of a private protection technology called *dilaal*—a system of middlemen/brokers. *Dilaal* act as a form of insurance for livestock traders who seek to avoid purchasing stolen cattle, as this may bring them into conflict with others. For a fee, usually jointly paid by both parties to the exchange, *dilaal*

⁹ It should be noted that in some cases the *hawilaad* system benefits indirectly from well-functioning public protection technologies in other countries. Somalis remitting from the Western Europe, for example, enjoy the state-provided property protection required to feel safe conducting business with *hawala* agents in Western Europe. However, *hawilaad* firms also facilitate remittances from Somalis in countries where public protection technologies cannot be similarly relied upon and transfer money between Somalis domestically where no government exists for this purpose. Thus the system does not seem to depend upon well-functioning public protection technologies to exist or operate.

certify the legitimacy of the livestock in question and assume liability in the event the traded animals turn out to be illegitimate (Little, 2003).

Despite the effectiveness of some private protection technologies, such as *dilaal*, in facilitating productive-tier entrepreneurship in Somalia, there may be as much reason to be worried about Somali protective-tier entrepreneurship as there is reason to be pleased with its success. Although Somalia has enjoyed marked economic improvements since its predatory government crumbled, it remains one of the poorest countries on the globe.¹⁰ This fact points to the limitations of private protection technologies mentioned in Section 3. Trust-based *hawilaad* systems, *dilaal*, private militias, and private courts may only be able to take Somalia so far. This is partly due to the fact that private protection technologies typically work best among modest-sized, close-knit groups. But continually expanding economic growth requires large numbers of anonymous strangers to be able to realize the gains from exchange.

This is not to say that private protection technologies are necessarily unable to facilitate widespread exchange in all cases. International trade, for example, involves massive volumes of exchange—sufficient to constitute nearly one quarter of world GDP—between socially, culturally, and geographically distant trade partners. Private protection technologies, such as private international commercial law and private international arbitration associations, are largely responsible for this exchange (Leeson, 2008a). Historically, private protection technologies have facilitated exchange between anonymous, socially diverse individuals in other contexts as well (see, for instance, Leeson, 2006, 2008c). Leeson (2008b) develops a theoretical model of self-enforcing exchange that explains how private protection technologies can support such interactions, which, together with the evidence pointed to above, suggests that the limitations on private protection technologies' ability to secure large and growing trade have

¹⁰ Somalia's per capita GDP is only \$600 (PPP).

been overstated. Still, we have no cases of flourishing economies based solely on private protection technologies and Somalia's continuing poverty seems to confirm the traditional emphasis on the limitations of such technologies rather than the reverse.¹¹

Perhaps equally important, at least one of the private protection technologies used in Somalia today stands to cut against growing productive entrepreneurship for reasons noted in our earlier discussion of the mafia. While clan militias and militiamen-for-hire perform a critical service in protecting property in the absence of a state, some have also abused their positions to extort weak portions of the population. Thus, although protective-tier entrepreneurship has enabled an important expansion of Somalia's economy after Barre's predatory regime, it remains susceptible to undermining the very productive-tier entrepreneurship it gives rise to.

5 Concluding Remarks

Our analysis leads to several conclusions. First, economists who do not recognize both tiers of entrepreneurship considered here are likely to underestimate the true level of entrepreneurship in the developing world and misunderstand the fundamental nature of the problem connecting entrepreneurial behavior, property rights, and economic performance. This connection is as much through protective-tier entrepreneurial activity, which has typically been ignored, as it is through productive-tier entrepreneurial activity, which has typically received all the attention. We have tried to point out that crucial to small-scale investment in productive technologies in the developing world, which Bauer insightfully notes has been underestimated by the development

¹¹ By the same token, however, it would be a mistake to conclude from Somalia's poverty that private protection technologies are incapable of generating high levels of wealth. The situation in Somalia is complex and private protection technologies have hardly been allowed to develop unencumbered in light of the international community's repeated attempts to reestablish central government in the country. These attempts have disrupted private protection technologies in a number of instances, disrupting their evolution and effectiveness. See, for instance, Coyne (2006).

community, is a parallel entrepreneurial activity that supports this investment by devising private protection technologies where the state is weak, absent, or neglectful. Productive-tier entrepreneurship is not possible without protective-tier entrepreneurship and the latter comprises a good deal of the entrepreneurial activity that goes on in developing countries.

Second, analogous to Buchanan's paradox of government, which identifies the problem of public protection technologies, there is a paradox of private protection technologies. This consists in the double-edged sword of these private mechanisms, which at once enables the commercial activity required to keep developing economies above subsistence and at the same time may thwart this activity's expansion much beyond this threshold.

Finally, our analysis suggests that public protection technologies might be best thought of as outputs of economic development rather than as inputs into its making. P.T. Bauer constantly reminded his readers that the world was not created in two parts, one with a readymade infrastructure and capital stock, and the other without. Investment in productive technologies, which is the essence of productive-tier entrepreneurship, was required to generate the impressive level of development that characterizes today's wealthy economies.

It is equally important to acknowledge that neither was the world created part with institutions of property protection and the other without such institutions. Protective-tier entrepreneurship that developed private technologies of property security was necessary to create the climate needed for productive-tier entrepreneurship to grow. The developed world was also once at point when it relied predominantly on private institutions of property protection. It was able to overcome the potentially upsetting features of these protection technologies and evolved its institutional forms of property security to include relatively well-functioning public technologies. However, these public institutions emerged only after some level of development

was achieved. Just as policy directed at increasing capital formation in the developing world has proved largely ineffective, our analysis suggests that the current focus on strengthening public institutions of property protection may also be misplaced. These efforts are unlikely to yield the desired effect until some higher level of development has been reached and may even exacerbate existing problems in the meantime if to do so they give dysfunctional governments more power. Short of solving the problem of public predation—i.e., establishing well-functioning, constrained governments in the developing world, which our discussion suggests we are unlikely to be able to do—the best policy for reaching this threshold of wealth in poor countries may simply be to avoid actions that interfere with protective-tier entrepreneurship that provides critical security against private predation.

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