There is increasing focus, both in the policy and academic realms, on the entrepreneur as the driver of economic change and growth. For policymakers, the focus on entrepreneurship has been a recent phenomenon. In 1998, for example, the Organization for Economic Cooperation and Development launched a program, *Fostering Entrepreneurship*, to better understand the role of entrepreneurs in the economy.\(^1\) Along similar lines, governments throughout the world have launched various initiatives designed to promote entrepreneurship and economic growth.\(^2\) The importance of the entrepreneur in economic development has also been realized by key international aid organizations. The World Bank, the United States Agency for International Development (USAID), and the International Monetary Fund (IMF) have undertaken initiatives to understand and promote entrepreneurship in developing countries.\(^3\)

Although many in the economics literature realize the importance of the entrepreneur, this topic has not received the widespread recognition that it deserves.\(^4\) This lack of focus results primarily from the fact that it is difficult to formally model and measure entrepreneurial behavior.\(^5\) Institutions are also often missing from formal models and their influence on economic decisions is often ignored. Economists associated with the Austrian school of economics, on the other hand, have long focused their attention on
the economic study of entrepreneurship and institutions, providing a robust literature emphasizing the importance of these areas.6

Institutions refer to the formal and informal rules governing human behavior and vary across time and space. In contrast to other schools of economic thought, the Austrians have not only realized the importance of institutions, but have attempted to provide a connection between an economic understanding of institutions, the market process, and entrepreneurship. This is an important connection because institutions create the rules of the game that influence the behaviors of private actors including entrepreneurs.

Further, Austrians stress that entrepreneurship does not describe a distinct group of individuals, but rather, is an omnipresent aspect of human action. In fact, the entrepreneurial element in human action entails the discovery of new data and information; discovering anew each day not only the appropriate means, but also the ends that are to be pursued.7 Moreover, Austrian scholars show that the ability to spot changes in information is not limited to a selective group of agents—all agents possess the capacity to do so (see Chapter 1 in this volume).

The recognition that the institutions in which economic agents (including entrepreneurs) operate in—political, legal, and cultural—directly influence their behavior and hence economic development is a recent development. Until very recently, as we will discuss in the next section, economists interested in growth and development had been largely influenced by the work of the economist John Maynard Keynes. Keynes’s main work, *The General Theory of Employment, Interest and Money*, provided a critique of the classical model of self-regulating markets, a diagnosis of why the economies of Great
Britain and the United States had entered a depression, and policy advice on how to alleviate the problems of unemployment and instability. In short, Keynes argued that markets were not self-regulating and self-correcting. Because of this, he argued that government intervention was necessary to correct these failures and stimulate investment and consumption. In the context of economic development, those influenced by Keynes emphasize the importance of foreign aid and government planning to overcome the failures of unregulated markets and forgot to pay attention to institutions.

Only in the past few decades have academics and policymakers focused on the role that institutions play in the facilitating or constraining efforts at generating sustainable growth. It is our goal here to contribute to this discussion by exploring how various institutional structures influence entrepreneurial behavior and the linkage between the latter and sustainable economic growth. The underlying logic of the connection between institutions and entrepreneurial behavior is the realization that institutions, or the rules of the game, provide a framework that guides activity, removes uncertainty, and makes the actions of others predictable. In short, institutions serve to reduce the costs of action and facilitate the coordination of knowledge dispersed throughout society. Simply put, entrepreneurs do not act in a vacuum. Instead their actions are constrained by both the formal and informal rules of the game. This indicates that only by understanding the impact of institutions can we truly understand various types of entrepreneurial behavior.

We proceed as follows. In the next section we explore how the development community has neglected the important connection between entrepreneurial behavior and institutions for understanding economic outcomes. In the succeeding two sections, we
further develop the critical connection between institutions and entrepreneurial behavior. For example, we discuss why we observe entrepreneurs contributing to economic progress and development in some countries but not in others. And argue that the answer to this question lies in the institutional environment in different countries. It is our contention that entrepreneurs can be found in all countries and in all settings. As such, institutional, and not cultural, explanations can best aid us in understanding different entrepreneurial behaviors and economic outcomes. The next section explores the implications of the connections between institutions and entrepreneurial behavior. While entrepreneurs are the means to economic change, they can only act productively once certain institutions are in place. As such, certain institutions must be in place prior to the occurrence of productive entrepreneurial activity. Finally, the penultimate section considers the implications of our analysis for future research and the last section is the conclusion.

Before proceeding, we would like to emphasize that the analysis that follows is applicable to entrepreneurial behavior in a wide variety of settings. We focus on economic development as one specific example of how institutions relate to entrepreneurial behavior in order to illuminate our claims. The implications of the analysis, however, can be generalized well beyond economic development and applied to all growth-related issues.

The Rise of Development Economics and the Neglect of Entrepreneurship and Institutions
A brief review of the evolution of development economics will serve to illuminate a more
general point. Specifically, it highlights the neglect of institutions and entrepreneurial
behavior and the resulting implications for our understanding economic outcomes. In
fact, such neglect leads to incomplete and inaccurate analysis and conclusions.

The issue of economic development can be traced back to at least Adam Smith. However, it was only after World War II that economists began to pay particular
attention to the needs of poor countries. Prior to World War II, economists studying
growth theory focused mainly on wealthy countries. These economists, influenced by
the Great Depression in the United States and the industrialization of the Soviet Union
through forced investment and saving, focused on a labor surplus that they concluded had
to be absorbed. The result was what became known as the investment gap theory.
According to this view, capital accumulation was critical because growth was
proportional to investment. How was this investment gap to be filled?

Lacking a well-defined notion of entrepreneurship and entrepreneurial behavior,
development economists at the time postulated that poor countries would be unable to
save enough to grow. Foreign aid and investment from wealthy countries were needed to
fill the gap. This aid would, in theory, increase investment in capital in the poor countries
and lead to greater output and growth. Because foreign aid would flow from the
governments of wealthy countries to the governments of poor countries, the state was
placed at the center of all efforts at economic development. Indeed, the intellectual
climate in the 1950s was grounded in the belief that state planning within both developed
and developing countries was critical for economic success.
Amid the widespread acceptance of the investment gap theory, Nobel Prize winner Robert Solow published his famous growth model in 1957.\textsuperscript{13} The underlying argument was that investment cannot sustain growth due to diminishing returns. Simply put, the incentive to invest falls as an individual invests more. For Solow, long-term growth could only be sustained with technological change, not investment. Solow’s model was fiercely debated in the literature and while it had a large impact, development economists were hesitant to accept that investment was not the dominant cause of long-term growth.

Solow’s model is important for our purposes for a few reasons. For one, it illustrates the neglect of the entrepreneur in the economics profession and larger development community. Solow’s model failed to incorporate the entrepreneur and answer the question, where does technological change come from? Further, a consideration of the conditions, or institutions, under which sustainable technological change could take place was completely absent. This neglect was due to the absence of a theory of entrepreneurship and an understanding of how institutions influence entrepreneurial behavior.

This neglect continued for several decades following the initial publication of Solow’s model. For instance, with the advent of the computer in the 1970s, economists attempted to calculate the exact amount of foreign aid necessary to fill the investment gap. The revised standard minimum model was developed with the growth part of the model known as Harrod-Domar. The Harrod-Domar model postulated that the growth rate of GDP was proportional to last year’s investment level.\textsuperscript{14}
Eventually, it was realized that investment was not the key to sustained growth. The assumptions of the aforementioned models were simply unrealistic. For instance, it was assumed that aid would correlate with investment one-to-one. It was also assumed that the country receiving aid would increase its level of national saving. Finally, it was assumed that there was a linear relationship between investment and GDP growth.

The major issue was that there was no incentive for individuals in the country receiving aid to increase their own level of savings. There were incentive issues in terms of the government as well. Most important, government officials, when operating under the investment gap theory, have the incentive to maintain or increase budget deficits since doing so widens the gap leading to more aid. Although the investment gap theory eventually fell out of favor in the academic literature, Easterly notes that it is still widely used in the many international financial institutions that make decisions regarding aid, investment, and growth.15

A shift in the trend of economic development occurred in the 1980s and 90s. Unfortunately, this shift continued to neglect the role of entrepreneurship and institutions in generating sustainable economic development. Instead, it was argued that investment in physical capital was not the only factor of production. Also important was investment in human capital. Given this, the Solow growth model was augmented to control for the education of workers.16 The fashionable trend in development economics became pushing an agenda of government-sponsored education. Adriaan Verspoor of the World Bank perhaps summarizes this position best: “The education and training of man—and although often neglected—of woman contributes to the economic growth through its
effects on productivity, earnings, job mobility, entrepreneurial skills, and technological innovation.”

With the human capital model gaining momentum, there was an explosion in education. As of 1960, only 28 percent of countries worldwide had 100 percent primary enrollment. The worldwide median primary school enrollment increased to 99 percent in 1990, from 80 percent in 1960. Further, between 1960 and 1990, the median college enrollment rate of countries worldwide increased from 1 to 7.5 percent. Despite the growth in education, it is widely agreed that the actual correlation between growth and schooling is highly disappointing.

To understand why the investment in education failed, consider that education and skills provide a benefit in an uninhibited marketplace where labor resources are free to move and where institutions create a relatively high payoff to an ethic of workmanship and entrepreneurship. If these conditions do not exist, the incentive to take full advantage of educational opportunities remains small. With little incentive to develop one’s skills, few individuals become educated and the circle of poverty continues. Simply forcing education has little or no effect without the other contributing factors. Transferring resources to build schools and providing teachers does not lead to growth. Instead, a country’s environment must provide a set of incentives that creates a high payoff to investing in one’s future.

In this section, we have traced the evolution of development economics. When one considers this evolution, the neglect of entrepreneurship, entrepreneurial behavior, and institutions is glaringly apparent. As we will discuss in subsequent sections, the entrepreneur is the means through which desired outcome of economic change and
progress is realized. Institutions create the rules of the game that influence entrepreneurial behavior and the range of possible outcomes that can be achieved.

Unfortunately, even today the importance of entrepreneurship and institutions does not receive the attention it deserves, both in the development community and more generally in the social sciences. In the development community, the emphasis on human capital and education, while failing to produce results in terms of sustained growth, has remained one of the key focuses of both development economists and international organizations involved with development. It is true that no unskilled country has become rich. But then why have efforts to invest in education failed? There must be something else that is being overlooked.

**Filling the Missing Gap: The Importance of Institutions for the Direction of Economic Activity**

As mentioned at the outset of this chapter, only recently have economists begun to pay attention to the role of institutions and how they influence entrepreneurial behavior. The recognition that institutions matter is largely a response to the work of Nobel laureate Douglass North, who emphasized the importance of institutions and institutional change. In this section, we discuss how institutions influence the behavior of entrepreneurs and economic activity.

As discussed in the Introduction, institutions can be understood as the formal and informal rules governing human behavior and their enforcement. This enforcement can occur 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 utilize force
on violators of the rules. Institutions can be traditional values or codified law, but as binding constraints on human action, they govern human affairs for good or bad, and as they change, so will the course of social development.

Formal and informal institutions influence the behavior of individuals of all cultures and traditions. Indeed, while cultural factors may explain some aspects of human behavior, they cannot explain all behaviors. The same individuals, with the same motivations, will tend to act very differently under different sets of institutions. To illustrate this point, consider Alvin Rabushka’s analysis of the three Chinas. His examination of the post–World War II development of mainland China, Taiwan, and Hong Kong, three jurisdictions with a common cultural heritage, suggests that economic and social progress depends far more on economic institutions than on cultural traits of the populace or the availability of natural resources. Institutions serve to constrain the set of feasible opportunities and actions. This realization applies to individuals with similar and different cultural backgrounds.

This has major implications for the way we understand economic change and progress or the lack thereof. It is not the case that cultural factors play no role in economic and social activities. Instead, focusing exclusively on cultural traits overlooks what all individuals have in common across cultures—namely alertness to profit opportunities and the desire to better their lot in life. These are distinctive traits of entrepreneurial behavior and individuals who are driven by these motivations can be found in all cultural settings. As Baumol indicates, the institutional environment of a society will determine the relative payoffs attached to various opportunities. As such,
the institutional environment will direct entrepreneurial activity toward those activities where the payoff is relatively high.

**Institutions and Entrepreneurship: Productive, Unproductive, and Evasive**

Within a given set of institutions, individual actors can increase their wealth and generally better their position through three main courses of action. Entrepreneurs can engage in *productive, unproductive, or evasive* activities. Here we build on William Baumol’s earlier work, which made the distinction between productive and unproductive activities. We contribute to this existing work by also considering evasive activities as a category of entrepreneurial behavior and by exploring how institutions direct entrepreneurial behavior. We consider each of these potential courses of entrepreneurial behavior in turn.

Productive activities—arbitrage, innovation, and other socially beneficial behaviors—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 toward the economically (and technologically) efficient production point. The second role takes place via innovation. In this role of an innovator, the entrepreneur shifts the entire production possibility frontier (PPF) outward. 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 include business start-ups, foreign investment, foreign trade, and the use of capital and financial markets among other measures.
When undertaking productive activities, entrepreneurs drive economic growth 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. Additionally, entrepreneurs entering existing markets increase competition and place constant pressure on incumbents to innovate and satiate consumer wants.

In contrast to productive activities, unproductive activities include crime, rent-seeking, and the destruction of existing resources among other socially destructive activities. 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. Rent-seeking occurs when actors seek to extract uncompensated value from others by manipulating the economic and political environment. Examples would include lobbying efforts for tariffs, subsidies, and other barriers to competition. While rent-seeking activities lead to increased profit for the entrepreneur undertaking the activity, they result in a larger deadweight loss for society as a whole. Proxies for the magnitude of unproductive activities would include the level of corruption, per capita number of rules and regulations passed in a specific period and per capita numbers of lines of work that assist in unproductive activities. For instance, Murphy et al. looked at the proportion of engineers to lawyers. They concluded 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.

To productive and unproductive entrepreneurship, one can envision a third category of entrepreneurial activity—evasive entrepreneurship. Evasive activities include the expenditure of resources 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 evasive activities would include the size of the black markets and tax evasion. As rules become more burdensome and raise the costs of interaction, one should expect economic actors to invest more resources in avoiding those rules.

In summation, entrepreneurs are present in every country and every cultural setting. The institutional environment will direct the behaviors of these entrepreneurs. If individuals can profit and better their position by engaging in productive activities, we should expect them to do so. Likewise, if the profits attached to unproductive activities are relatively greater as compared to productive activities, more individuals will undertake the former. We observe different outcomes from entrepreneurial behaviors because 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 by the existence of profit opportunities yielding outcomes counter to economic progress. In other words, in some countries, profit opportunities may be tied to socially destructive behaviors. To reiterate our main point, entrepreneurial behavior is directly tied to the institutional environment. Institutions serve to create the payoffs to various alternative
behaviors. Economic growth and progress requires that higher payoffs be attached to productive activities.

**Institutions as Cause, Entrepreneurship as Consequence**

A key insight of the Austrian school is that entrepreneurship is an omnipresent aspect of human action. While the level of alertness varies across individuals, entrepreneurs are present across all times and locations. As discussed in the previous sections, the institutional environment guides the direction of entrepreneurial behavior. Although we illustrated this point by discussing its implications for economic development, the same framework can be applied to a wide array of settings.

A key implication of our analysis is that entrepreneurs are the means while institutions are the cause of economic change and progress. Since entrepreneurs are present in all settings, it is the different institutional structures which generate the large variances in standards of living across societies. What this indicates is that it is the adoption of appropriate institutions that, by increasing the relative payoff to productive activities, provides incentives for individuals to engage in entrepreneurial activities that generate economic growth. In other words, the adoption of certain institutions has to precede productive entrepreneurial behaviors because these institutions enable the right type of entrepreneurship.

Once certain institutions are adopted, entrepreneurs will recognize the profit opportunities attached to productive, socially beneficial activities and tend toward engaging in those activities. In other words, entrepreneurs are the means through which outcomes such as economic growth and progress come about. However, given that
entrepreneurial behavior is influenced by institutions, institutions are the cause of economic growth. It is the institutional environment that directs entrepreneurial behavior toward productive, unproductive, or evasive activities. In this section, we focus on understanding the institutional environment conducive to productive entrepreneurship.

To illustrate our argument, we return to our discussion of economic development. For example, given the realization that economic growth and development are a consequence of specific institutions and policies, we can better understand why we observe an increasing world income gap and a lack of convergence between rich and poor countries. The problem lies in the combination of private and public institutions currently in place in less developed countries. Unfortunately, as discussed earlier, over the last several decades, the development community has met with continued failure by focusing on foreign aid instead of the institutional environment of less developed countries. The key question then turns to the institutional environment that promotes productive entrepreneurial activity.

One of the earliest to recognize the institutions and policies necessary for productive entrepreneurship was Adam Smith in 1776:

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. All governments which thwart this natural course, which force things into another channel or which endeavor to arrest this progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical.27
As research by Gwartney et al., Scully, and the Fraser Institute indicates, Smith’s claim was on target. Their work, among others, has highlighted the importance that economic freedom, manifested through well-defined property rights, a freely functioning price mechanism, a stable legal system and the rule of law, and trade liberalization plays in providing incentives for productive entrepreneurship and in generating economic growth.

When one compares those countries possessing economic freedom to those lacking these freedoms, the differences are staggering. Perhaps the best illustration of this is provided by the Economic Freedom Index. This annual index analyzes and scores economic freedoms across a wide range of activities including government intervention, monetary policy, foreign intervention, wages and prices, property rights, regulation, and trade among others. In other words, the Index provides a measure of some of the key institutions which influence entrepreneurial behavior. To understand the impact of institutions that allow for economic freedom, consider that the per capita income of countries in the top quintile of economic freedom is more than nine times that 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 most key margins, 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 1000 births for those countries in the bottom quintile to 9 per 1000 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.  

Of course a central question in economics and political science focuses on understanding how to establish sustainable institutions which direct entrepreneurial behavior toward productive activities in countries where such institutions are lacking. The analysis put forth in this chapter suggests that in order to adopt policies that promote productive entrepreneurial behavior, we need to understand the conditions and institutions necessary for political entrepreneurs to adopt such policies. In other words, our analysis applies not only to the private realm, but also to the public arena and to the metarules followed by policymakers. Political entrepreneurs act within a set of metarules which determine the rules of the game faced by private actors. We will return to this last point in the second half of the next section.

**Implications for Future Research**

The connection between entrepreneurship and institutions has implications for future research efforts across social science disciplines. The main implication is the need for the study of everyday life. This approach combines “on-the-ground” research with an analytic narrative approach to understand the formal and informal institutions of various organizations and societies. This approach is already in use in disciplines such as anthropology and sociology. However, other disciplines in the social sciences, such as economics and political science, could also benefit from the use of this method. To
clarify our position, consider the matrix in Table 7.1, which depicts the landscape of the social sciences.

Given the insights of this chapter, the upper right quadrant is the domain that research in the area of entrepreneurial behavior is best suited to occupy. For instance, economists have traditionally approached their subject matter by providing a parsimonious theory and then confronting that theory with as clean an empirical test as possible. The problem with this approach is that by stressing the universal in all human behavior the specific is lost, whereas in asserting that all behavior is specific as in traditional anthropology, the ability to communicate and understand across history and culture is lost. Neither thin/clean, nor thick/dirty provide satisfactory explanations of the world. But somewhere between the economist’s penchant for the general (the thin and clean), and the anthropologist’s demand for respect for the specific, there lies an approach that maintains the analytical structure of the economic way of thinking, but respects the unique institutional arrangements that structure the rules of the game and their enforcement in any particular historical setting. This is the intellectual space where progress in research on institutions and entrepreneurial behavior will be made in the coming decades. This method also provides a means of finding common ground across the social sciences.

Realizing the critical connection between institutions and entrepreneurial behavior means that social scientists must broaden their notion of empirical work to include the narrative form that permits detailed examination of the historical and social conditions that shape social phenomena. The analytical structure provided by basic economics enables the scholar to examine the incentive structures and the flows of information that
are embedded in the historical setting under examination. In the process, the connection between institutions and entrepreneurial behavior in various settings will be illuminated in rich detail. This method can be applied to a wide range of situations from developing countries to business organizations—both profit and nonprofit—as well as government organizations. In each of these cases, the institutional environment will influence entrepreneurial behavior for better or worse. Only by understanding the incentives that entrepreneurs face can one hope to understand their behaviors.

One readily apparent example of the type of analysis we are promoting is the work of Hernando de Soto. In *The Other Path*, for example, he printed a picture of researchers from his Instituto Libertad y Democracia with a printout 30 meters long of the procedures an entrepreneur would need to set up a small company. De Soto and his team of research compiled the list of procedures by actually going through the process of setting up a business. In Lima, Peru during the 1980s, de Soto estimated that the informal sector comprised 60 percent of the economy. This channeling of economic activity into informal markets was a function of hundreds of regulations that made it next to impossible for an entrepreneur to negotiate the bureaucracy and start a new business. In other words, the institutional environment was such that the payoff to unproductive and evasive activities was relatively high compared to productive activities.

In *The Mystery of Capital*, de Soto modifies this conclusion slightly to warn that the act of unleashing the productive capacity of capitalism requires more than government curtailing its onerous regulations. The fundamental problem that countries face is turning “dead capital” into “live capital.” In de Soto’s narrative this is a function of formal property holdings. The de facto owners discussed in *The Other Path* can realize
the gains from exchange, but they cannot realize the full benefits of specialization and exchange that a more secure property system would enable. The formality of property holdings is required in order for entrepreneurs to be able to use their ability to raise live capital that can generate new wealth-creating activities.\(^\text{34}\)

There is often a tendency in the social sciences to divide disciplines into theory and empirics (whether historical or statistical). This is especially evident in economics but also in political science. We contend that the most pressing questions are to be found in the institutionally contingent theory discussed in this chapter. In the context of this chapter, social scientists must move to a model that relies on understanding the institutional specifications within which entrepreneurs act. Only by understanding the institutional context can we hope to understand why we observe different behaviors by entrepreneurs and potential entrepreneurs across settings and over time.

The approach that we are advocating is broadly conceived and includes anthropology, economics, legal studies, the management sciences, political science, psychology, and sociology. It is the study of the evolution of institutions that will allow us to understand things such as economic, organizational, political, and social changes. Thus, it is the study of institutions that will also allow us to understand the behavior of entrepreneurs and its variety across cultures and contexts. Only by understanding institutional arrangement, can we explain how a particular entrepreneurial environment emerges in various settings. This requires social scientists to expand their research approach to allow for institutional contingencies.

At the end of the last section we briefly discussed the notion of political entrepreneurs and changes in the overarching metarules in which private entrepreneurs
act. The main focus of this chapter has been on the actions of entrepreneurs within a given institutional framework. But the recognition of the importance of overarching metarules raises another important area for future research. This is the recognition that entrepreneurship can take place both within a set of institutions and rules but also over the rules and institutions in which others act. When we focus on the role that institutions play in directing entrepreneurial activity, we are treating the rules of the game as an exogenous constraint. It is important to recognize that changing the rules of the game also involves entrepreneurship that generates change in the rules of governance.

Entrepreneurship over the rules of the game entails alertness to new forms of governance that change the relative price of private and public governance. The analytic narrative approach can contribute to understanding the barriers to changes in the rules of the game. These barriers may include political and bureaucratic constraints that prevent the movement toward the adoption of institutions which foster productive entrepreneurship and economic growth.

A final area of research that deserves attention is entrepreneurial behavior in the nonprofit realm. In short, the central question is, what factors influence the behavior of social entrepreneurs? Understanding the behavior of entrepreneurs in the nonprofit sector is critical, especially in particularly difficult circumstances. For instance, in the wake of Hurricane Katrina, one observes many nonprofit organizations contributing to the recovery. Understanding the institutions—both within the larger United States, but also within the specifics of nonprofit organizations—that allow these organizations to be entrepreneurial and behave as they do will yield important insights into our understanding of, responding to, and recovering from natural disasters.
Conclusion

In summation, entrepreneurs are present in all societies no matter the time or place. Institutions determine the relative payoff to various courses of actions and hence direct entrepreneurial behavior toward productive, unproductive, or evasive activities. Poor institutions that create a higher relative payoff to unproductive and evasive activities will reduce productive behaviors. For instance, in the case of less developed countries, it is not the case that there is a lack of entrepreneurial spirit, but rather that there is a relatively higher payoff for unproductive and evasive activities. This reasoning applies beyond economic development and to a wide range of situations. The types of for-profit and nonprofit organizational forms as well as political and social changes one observes are all connected to entrepreneurial behavior which is, in turn, linked to the institutional environment. The most fruitful way for the study of entrepreneurial behavior and institutions to proceed is to recognize how the rules of the game and their enforcement dictate how entrepreneurs behave.

Notes

Financial assistance from the Earhart Foundation and Mercatus Center is acknowledged. The authors thank Maria Minniti for useful comments and suggestions. The usual caveat applies.

1. An overview of the Fostering Entrepreneurship program is available at:

3. For instance, the World Bank supports the National Foundation for Teaching Entrepreneurship and also undertakes many activities related to entrepreneurship through the International Finance Corporation, which is the private sector arm of the World Bank group. A central aspect of the Millenium Challenge Account (MCA), which aims to fund initiatives to improve less developed countries, is the recognition of “sound economic policies that foster enterprise and entrepreneurship.” For more on the MCA, see http://usinfo.state.gov/journals/ites/0303/ijee/usaidfs.htm.


9. More specifically, Keynes argued that investment was unstable because it was based on the volatile expectations of investors and their moods of optimism and pessimism. In addition, Keynes argued that the introduction of money into an economic system repudiated the classical law of markets that maintained self-regulation. Prices were not linked to the supply and demand for money any more than investment was determined by the interest rate in the modern economy, according to Keynes. The introduction of expectations into economic analysis ruptures the old relationships that were established in classical economics. For example, during a recession, because of expectations that the economy is caught
in a liquidity trap, attempts to get out of that trap through monetary policy stimulus will be ineffective. If investment is not rational, but instead based on “animal spirits,” then private markets cannot be relied upon to assess the marginal efficiency of capital allocations among competing projects.


12. A major driver of the focus on development economics was aggregate techniques developed in the Keynesian revolution. These techniques provided economists with a way to easily measure economic development through per capita income.


15. Ibid., pp. 35–37.


18. Easterly, 2001, pp. 73.
19. On this point, see Maria Minniti, William Bygrave, and Erkko Autio, *2005 Global Entrepreneurship Monitor* (London: London Business School and Babson College, 2006) who found that while education is important, the least educated individuals in high-income countries are just as likely as highly educated individuals in that country to own an established business. In other words, it is not education alone that generates entrepreneurship but the institutional environment which directs entrepreneurial behavior.


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Table 7.1