

Entrepreneurship: Productive, unproductive, and destructive—Relative to what?



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ABSTRACT

We identify an ambiguity surrounding institutions and entrepreneurship. While entrepreneurship creates social value at the economy level in the appropriate institutional environment, individual entrepreneurs may create or destroy value in *any* institutional environment. This raises the question: under what conditions does entrepreneurship create social value? Social value creation depends on the entrepreneur's next best alternative, and institutions are constraints on the relevant alternatives. Hence, society is better off when entrepreneurs navigate poor institutions relative to reduced entrepreneurial activity. Furthermore, entrepreneurs engaging in seemingly “productive” activity need not create social value. We illustrate the argument with two examples.

1. Introduction

Over twenty-five years after its original publication, Baumol's (1996) trichotomy of productive, unproductive, and destructive entrepreneurship is seminal to the entrepreneurship literature. Productive entrepreneurship is that which contributes to societal well-being, including the introduction of new products or new production processes. Unproductive entrepreneurship is aimed at obtaining transfers, typically via rent-seeking or violence. Entrepreneurship becomes destructive when resources are expended to capture rents or expropriate wealth.

Baumol suggests that the total quantity of entrepreneurial activity is relatively stable, but the allocation of entrepreneurial resources varies considerably across societies. The variation in entrepreneurial activity is determined by the “set of rules” governing social interaction—in other words, the institutional framework. He thus provides a meta-view of entrepreneurship. Where the rules of the game facilitate market-based innovation, entrepreneurs engage in productive activity; where the rules facilitate corruption or rent-seeking, entrepreneurs choose unproductive and destructive ends (Boettke and Coyne, 2003, 2009).

Empirical analysis broadly affirms Baumol's insights (Murphy et al., 1991; Sobel, 2008). Furthermore, a large body of literature documents that productive entrepreneurial activity has massive implications for economic development; indeed, productive entrepreneurship captures the very essence of economic growth (Holcombe, 1998). Meanwhile, barriers to wealth-creation (e.g., the regulation of entry) have deleterious consequences (Djankov et al., 2002).

Another foundational figure in modern entrepreneurship scholarship, Israel Kirzner, has written several essays on the relationship between entrepreneurship and public policy (Kirzner, 1979, 1982). Kirzner argues that an institutional environment of property rights, market prices, and the rule of law allows for the entrepreneurial discovery of opportunities that are both privately and socially value-creating. The opportunities to which entrepreneurs are alert are “profit” opportunities precisely because they improve social coordination, by directing prices toward market equilibrium; losses are downplayed in this framework (Foss and Klein, 2010, p. 110). Meanwhile, socialism, cronyism, and interventionism all hamper this entrepreneurial discovery. Like Baumol, then, Kirzner suggests

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that entrepreneurship within good (poor) institutional environments improves (reduces) the well-being of society at large.¹

At the economy-level, both of the above frameworks usefully identify the seminal role of institutions in the entrepreneur's creation of social value. Indeed, the aggregate effect of entrepreneurship within market institutions is productive: society is made better off whilst individuals aim to capture private value via production and exchange. At the level of the individual entrepreneur or venture, however, this distinction is theoretically ambiguous or even misleading. Since institutions constrain the individual's opportunities, any given entrepreneur or venture may create or destroy social value in *any* institutional context. When the analysis is restricted to relevant alternatives *for the actor* (e.g., the individual's opportunity cost), many actions that appear “unproductive” are indeed “productive”—and vice versa.

The above considerations beg a broader question: under what conditions does entrepreneurship create social value? While this question has been studied in depth at the economy level (e.g., the frameworks above), the relationship between this work and individual entrepreneurs or ventures is often unclear. We suggest that social value creation is only determined relative to the individual's next best alternative, and that institutions constrain the relevant alternatives. This yields two implications. First, society is better off when entrepreneurs navigate poor institutions relative to reduced entrepreneurial activity, and society becomes increasingly better off as entrepreneurs interact with better institutions. Second, social value need not be created by entrepreneurs engaging in seemingly “productive” activity (e.g., startup activity, research and development), particularly when those activities are publicly funded.

The paper proceeds as follows. [Section 2](#) describes how entrepreneurs can navigate cumbersome institutions to create social value. [Section 3](#) highlights the ambiguous social value of subsidized entrepreneurial activity. [Section 4](#) offers a discussion. [Section 5](#) concludes.

2. Regulation, entrepreneurship, and relevant alternatives

Institutions enable and constrain entrepreneurial action. This suggests that some institutions may be comparatively superior to others at facilitating entrepreneurial innovation and production. Conversely, more cumbersome regulatory environments, for example, may make research and development, startup activity, and new product development more difficult.² Regulation can reduce production and divert entrepreneurial effort to capturing existing value. Weak enforcement of property rights can also hinder economic activity. However, individual entrepreneurs subject to a “poor” institutional environment can still act to increase social value in spite of that environment.

Consider a hypothetical example. Imagine that an enterprising oil company owns land above an untapped oil reserve. Part of the reserve is under a valley, while part is under a mountain; the altitude of the ground above the reserve varies dramatically (see [Fig. 1](#)). The cost-minimizing choice of where to drill is where at the lowest possible altitude (Hole A).

Now consider that same oil company facing a regulated price for its product. Under the regulation, any oil obtained from wells of up to a specified depth is subject to a fixed price. This regulation might be thought of as reducing the relative payoff to productive entrepreneurship by making some ventures more costly. With the price regulation, it may not be profitable for the firm to drill the well.³ The forgone output from this reserve is an example of such a reduction.

Imagine now that the regulation contains a caveat: oil obtained from wells that are drilled to at least a certain depth is not subject to the price control. So as to not deter deep well drilling, the regulation only applies to standard-depth wells. Learning this, the entrepreneur in charge of this oil company becomes alert to an opportunity: if the firm drills some distance up the mountain (Hole B), the well will be considered “deep.” The extracted oil will then not be subject to the regulated price. The entrepreneur estimates the additional cost of a deeper well and the additional return from the higher price. She hires lawyers to confirm the legality of the decision. All goes as planned. With the expectation of profit, she arranges for the well to be dug at Hole B.

Has the entrepreneur destroyed social value by expending resources to avoid the formal legal institution? A common reading suggests that the answer is yes: the evasive effort is unproductive. The additional resources that the firm expends on a deeper well are wasted for the purpose of obtaining a greater share of surplus at consumers' expense. An insightful scholar might even invoke Bastiat to highlight “that which is unseen.” The opportunity cost of the resources employed in drilling at Hole B is unobserved, but would seem to be surely significant.

The problem is that this answer considers the relevant alternative to be “drilling Hole A without price regulation.” This is an unconstrained vision ([Sowell, 1987](#)). In other words, the relevant alternative is taken to be one where currently binding constraints do not exist. In a world without the price ceiling, Hole A will be drilled, and resources will be saved relative to Hole B.⁴

However, *given that the price regulation is in place*, this entrepreneurial activity increases social value. From the perspective of the entrepreneur, the regulation is a binding constraint. The decision to drill Hole A is no longer the relevant alternative for the firm. As the problem is constructed, a well for price-regulated oil is unprofitable—even at the shallowest possible depth. Hole A is not the

¹ In many ways, both Baumol's and Kirzner's notions share conceptual ground with the standard distinction in economics between “efficiency” and “rent seeking” by private actors (see, for instance, [Tullock, 1967](#)). Baumol focuses on the role of innovation in the entrepreneurial creation of social value, while Kirzner emphasizes entrepreneurial discovery. Both are argued to result from entrepreneurship within market institutions.

² Alternatively, some regulations may actually increase the quantity of activities such as R & D. For example, regulation may incentivize innovation for compliance reasons.

³ This holds as long as supply is not perfectly inelastic.

⁴ One is reminded of the Biblical account of the deceased Lazarus, whose sister lamented to Jesus, “If you had been here, my brother would not have died” (John 11:21, NIV).

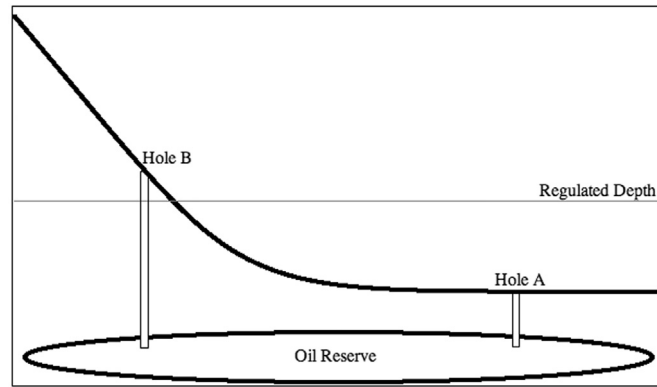


Fig. 1. Oil Drilling Decision.

relevant alternative, because the individual entrepreneur does not expect this to be profitable and would not undertake the project voluntarily. Instead, the choice is to drill Hole B or not drill at all in the reserve. Within this constrained view, the entrepreneur increases the supply of oil available to consumers by drilling Hole B.

Despite a deleterious institution, the entrepreneur increases social value, expanding the range of choice available to consumers and enabling further exchange. The costs incurred to this end—including the additional inputs of steel, rigging equipment, and lawyerly advice—are all inputs into this productive activity. Since economic profits are earned, the individual's pursuit of private gain may be deemed socially productive *ex post*.

More broadly, consider the prospect of innovation around a trade-inhibiting regulation. Relative to an unregulated market, resources incurred to escape the hindrance are socially wasteful. In this view, ride-sharing companies' early efforts to avoid regulators would be deemed value-destroying. Yet, relative to a regulated market where production is decreased, these innovations are more akin to costs of doing business. Social value is increased as a direct result of the additional costs incurred. If we take the rules of the game as given, then many actions that are costly to society in absolute terms may actually benefit society compared to the relevant alternative (e.g., by working around hindering institutions).⁵

3. Entrepreneurship policy and relevant alternatives

Entrepreneurial activities yielding new businesses and products are often deemed to increase social value *ex ante*. However, emphasizing the relevant alternatives reveals that this kind of seemingly productive entrepreneurial activity need not be. This approach has implications for public policies aimed at increasing observed entrepreneurial activity.

With the insight that entrepreneurship is critical to economic growth and development has come a host of entrepreneurship policy initiatives to increase entrepreneurial activity. Minniti (2008) suggests that entrepreneurship policy may be productive or unproductive. In the developed world, a common policy utilized to promote (ostensibly productive) entrepreneurship is the introduction of public venture capital (PVC). PVC is provided to new and small businesses and is funded through public finance (present or future taxation). Two standard arguments support this policy (Audretsch et al., 2007). First, knowledge spillovers may cause private venture capitalists to fail to obtain the full benefit of the productive output of new firms, creating an undersupply. Second, asymmetric information may preclude the private identification of promising investments.

Consider a government with the option of introducing a PVC initiative, which eventually leads to the creation of a large number of new ventures. Some of those ventures may indeed produce goods and services that people value. By typical aggregate measures of wealth (GDP, for instance), the effect of such initiatives has been positive. Compared to a world where these ventures are not undertaken, such a policy is reasonably construed as improving societal well-being. A government initiative can increase entrepreneurial activity relative to the starting point at the introduction of the legislation.

This conclusion—when offered *ex ante*—stems from an unconstrained vision. The relevant constraints must be clearly stated in order to identify the creation of social value; only then is forgone activity illuminated. The comparison directly above assumes that the relevant alternatives are “world with PVC firms” and “world without PVC firms and no alternative ventures.” The logic becomes less straightforward when adopting a constrained vision. The constrained vision considers the opportunity cost of these PVC firms to be forgone investments: the alternative use of the funds now directed to certain firms. Given that PVC often redirects private venture capital (Lerner, 2002), can increase it for an industry (Leleux and Surlemont, 2003), and may crowd out private investors (Cumming and MacIntosh, 2006), these programs will cause alternative ventures to be undertaken. Whether or not these alternative ventures

⁵ As another example, Leeson (2011) employs the “relevant alternative” standard to evaluate the Medieval practice of “trial by battle.” Relative to a world of costless dispute resolution, “trial by battle” is inefficient. But relative to the (relevant) world of Medieval Europe, the practice emerged as a least-cost dispute resolution mechanism. Leeson and Coyne (2012) argue that the contemporary Liberian practice of poison-ingestion as a means of criminal dispute resolution enhances social coordination and facilitates interaction in the face of a dysfunctional legal system. Demsetz (1969) is the seminal treatment of irrelevant comparisons in the economics literature.

create more value than their unrealized counterpart—whether any given program produces more value than the activity it replaces—remains an unanswered question.⁶

The literature on public entrepreneurship has similarly indicated the necessity of specifying the institutional “rules of the game” before identifying any given entrepreneurial act as productive (Ostrom, 2005; Klein et al., 2013). Public entrepreneurs may act within given institutional constraints, or they may act to innovate over the institutions themselves (Klein et al., 2010). In both cases, public organizations may create or destroy value—just like private organizations. Determining which has occurred is often difficult, however. Since the output of public organizations is often not sold in markets, there are no market prices for the output (Klein et al., 2013). Thus, the evaluation of public entrepreneurship must be done in the absence of the *ex post* feedback of monetary profits and losses. But public entrepreneurs increase or destroy social value on a variety of margins: e.g., effecting institutional change for other entrepreneurs, imposing or removing regulation, or redirecting resources (as in the case of PVC).

As Bylund (2016) suggests, the “unrealized” is an important starting point when evaluating whether or not entrepreneurial action creates value for society. When resources are redirected via entrepreneurship policy (in this case, through public funding), those allocating public funds must be *better* able to identify value-creating ventures than individual suppliers of capital. Furthermore, these ventures must create *more* social value than the alternative uses of the resources collected for the program via increased taxation. This includes consumer spending on goods from and investment in other businesses from whom value is unwittingly diverted—representing an additional cost to society that may be significant.

4. Discussion

In much of the entrepreneurship literature, the introduction of new businesses or products is the very essence of entrepreneurship. Baumol's (1996) distinction between productive and unproductive entrepreneurship has provided a fruitful lens for conceptualizing the allocation of entrepreneurial effort. But these terms have become synonymous with observable instances of entrepreneurship. “Productive” entrepreneurship is taken to mean “new business creation” or “market innovation;” “rent-seeking” or other political activity is deemed “unproductive” entrepreneurship. But not all businesses create social value, and not all interaction between private firms and political entities destroys wealth (Klein et al., 2010; Fuller and DelliSanti, 2017).

Similarly, Kirzner's (1973) emphasis on entrepreneurial discovery has provided a fundamental basis for understanding how individual profit opportunities in the market process yield social coordination. However, value creation is limited to the profit opportunities the entrepreneur discovers within a given set of market institutions. In his explicit treatments of regulation, Kirzner, (1979, 1982) points out the myriad margins on which individuals adjust to intervention. He argues that institutions that divert market activity hamper the entrepreneurial discovery process.⁷ But while poor institutions can indeed reduce market activity, entrepreneurs will find ways to capture value by working around hampering institutions. An individual can increase social value much more if she does not have to navigate a poor institutional environment, but she can still capture profits—and increase social value in the process—under the institutional constraints she faces.

Scholars have attempted to address these theoretical tensions with various alternative terms. Padilla and Cachanosky (2016) attempt to resolve the tension by introducing “indirectly productive entrepreneurship” to account for efforts to mitigate the perverse consequences of government regulation. Coyne and Leeson (2004) introduce the notion of “evasive” entrepreneurship to capture entrepreneurial efforts aimed at avoiding the legal system. Elert and Henrekson (2016) ask when entrepreneurship might be deemed evasive. They suggest that evasive entrepreneurship be measured relative to a society's institutional framework; evasive entrepreneurs act to exploit institutional incongruities. For example, Uber and Lyft have avoided taxi regulations by offering an alternative service using smartphone technology and ride-sharing. By taking existing institutions as given, Elert and Henrekson (2016) are able to characterize acts of evasive entrepreneurship as productive, unproductive, or destructive.

We have argued that the existing institutional framework is the relevant starting point for *all* entrepreneurship. When taking an institutional framework as given, no entrepreneurial activity is productive or unproductive *ex ante*. Any given venture is only shown to create or destroy value *ex post*, compared to a clearly identified relevant alternative.

An “occupational” approach to entrepreneurship would seem to suggest that introducing new business ventures and products produces social value *ex ante*, contributing to economic development.⁸ “Business starting” and “productive entrepreneurship” are often treated as virtually synonymous. However, business ventures in the market regularly fail, with or without regulation. Failure in the market amounts to losses—which are defined as a destruction of value. Both market and government activity can create or destroy value. It may be that a “functional” view of entrepreneurship (Kirzner, 1973; Foss and Klein, 2012) is useful, as this approach emphasizes the institutions that create a tendency for entrepreneurship to yield desirable or undesirable outcomes. Individual entrepreneurs and ventures may increase social value by bearing uncertainty, offering new products, and engaging in arbitrage, but such efforts may also go awry, destroying social value. “Good” institutions (property rights, market prices, the rule of law, etc.) tend to reward individuals whose plans create social value, but institutions need not be good for individuals to find productive courses of action.

⁶ Contributions like Brander et al. (2008) suggest that PVC underperforms private venture capital, but other scholars have found more promising results.

⁷ Kirzner (1979) distinguishes between “stifled” and “superfluous” discovery. Institutions may impede and divert entrepreneurial discovery.

⁸ See Klein (2008) for a discussion of the “occupational” (an employment category), “structural” (a market structure) and “functional” (an activity or a process) approaches to entrepreneurship. Our paper perhaps suggests that the “functional” view of entrepreneurship is useful for determining the tendency toward productive entrepreneurial outcomes and identifying social value creation.

5. Conclusions

We identify a theoretical ambiguity surrounding institutions and entrepreneurship. Namely, while entrepreneurship creates social value at the economy level in the appropriate institutional environment, entrepreneurs may create or destroy value as they pursue their individual plans in any institutional environment. Our work indicates that increased discussion of the rules governing entrepreneurial action is necessary. Institutional context matters (Boettke and Coyne, 2009), and the line between context and action must be clarified. In the present view, whether any entrepreneurial endeavor creates social value can only be measured relative to the alternatives available to the entrepreneur. An explicit appreciation of the constraints entrepreneurs face will allow precision in identifying the positive and negative implications of both entrepreneurial action and entrepreneurship policy across institutional environments.

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