

THE INSTITUTIONAL ENTREPRENEUR

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For several centuries already, social philosophers and economists have been considering what is the environment needed for entrepreneurial success and have described, sometimes in detail, such an environment as “the rule of law”. Not of any “law” though, but one such where general rules exist for the respect of private property rights, the fulfillment of contracts, a trustworthy currency, a non-exacting tax system; in short, an institutional framework where power is restricted by institutions and the creativity of individuals can flourish through entrepreneurial productive activities, sports, the arts, science, and many others.

Centuries of debate and the drastic conclusions of empirical results have not been enough to close the matter altogether and we find ourselves discussing many of the same things that were the subject of debates in the past.

And although the consideration of why such recurring discussions come up time and again is a subject interesting enough, this paper will concentrate on another issue: why do those institutions which allow entrepreneurial activity come to exist?

Which brings us to a quite interesting debate among prominent members of the Mont Pelerin Society with regard to the role of evolution and the active design of rules or one might say, the “invisible” versus the “visible” hand in the development of institutional frameworks.

Invisible hand processes

There is a good deal of scientific work in support of the evolutionary origin of institutional frameworks, which may surely go back to the Enlightenment, or the Greeks for that matter. In more modern times it was clearly presented by Carl Menger, explaining the origin of money¹. He was also concerned with the origin of institutions in general:

“the most important problem of social sciences is to explain how institutions that serve the common welfare and are extremely important for its development came to exist without a common will aimed at establishing them.”².

These conclusions were not far from those arrived at by what would later be called “game theory”. The concern about the origin of institutions was already present with Von Neumann and Morgenstern³, and later Axelrod showed that repeated games of the Prisoner’s Dilemma

¹ Menger, Carl. "On the Origin of Money," *Economic Journal*, June 1892; reprinted in *Austrian Economics: A Reader*. Vol. 18, Richard M. Ebeling, ed., Hillsdale, MI: Hillsdale College Press, 1991, pp. 483-504.

² Carl Menger, *Problems in Economics and Sociology*, (Urbana, IL: University of Illinois Press, 1981 (1947)).

³ John von Neumann & Oskar Morgenstern, *Theory of Games and Economic Behavior* (Princeton, NJ: Princeton University Press, 1990 (1944)).

type would give origin to spontaneous and self-motivated cooperation⁴. As expressed by Adam Smith:

“Whenever commerce is introduced into any country, probity and punctuality always accompany it. These virtues in a rude and barbarous country are almost unknown. Of all the nations in Europe, the Dutch, the most commercial, are the most faithful to their word. The English are more so than the Scotch, but much inferior to the Dutch, and in the remote parts of this country they (are) far less so than in the commercial parts of it. This is not at all to be imputed to national character, as some pretend. There is no natural reason why an Englishman or a Scotchman should not be as punctual in performing agreements as a Dutchman. It is far more reducible to self interest, that general principle which regulates the actions of every man, and which leads men to act in a certain manner from views of advantage, and is as deeply implanted in an Englishman as a Dutchman. A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps 20 contracts in a day, he cannot gain so much by endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose. When people seldom deal with one another, we find that they are somewhat disposed to cheat because they can gain more by a smart trick than they can lose by the injury which it does their character”⁵.

Such cooperation gives birth to important “informal” institutions as reputation; customs and practices originate expectations, which in turn guide the actions of people, and those observable practices give birth to “formal” institutions, such as trademarks, through the “evolutionary” common law⁶.

The difference between informal and formal regulation would be only a matter of degree with a continuum of taboos, customs and traditions in one extreme and written constitutions in the other moving, from one to the other as societies advance from less complex to more complex.⁷

Friedrich A. von Hayek was also a supporter of the evolutionary concept, presenting, as examples of the result of such a process, those fundamental institutions for entrepreneurship as language, currencies, the right to private property, trade and the *lex mercatoria*.

Now, there are two questions that need to be addressed:

- The first one is to what degree such a process is “spontaneous” and what do we mean by that.

⁴ See Robert Axelrod, *The Evolution of Cooperation*, (New York: Basic Books, Inc, 1984).

⁵ Adam Smith, *Lectures in Jurisprudence* (Oxford: Oxford University Press, 1978), p. 538.

⁶ Bruce L. Benson, “The Spontaneous Evolution of Commercial Law”, *Southern Economic Journal* (January 1989) p. 644-61.

⁷ North, Douglass C., *Institutions, institutional change and economic performance*, (Cambridge: Cambridge University Press, 1990).

- The second is whether such an evolutionary process would “spontaneously” lead to those institutions that we may call “optimum”, or may end up leading to something quite different.

Geoffrey Hodgson⁸ calls this second one “the Pangloss problem”, with reference to the character in *Candide*, by Voltaire, who says that it is demonstrated that things cannot be otherwise, being them made for a certain purpose, they must be necessarily made for the best of purposes. Hodgson calls it a fallacy that all adaptations are necessarily functional or almost optimal and endorses it to two different strands: the first would be the attempt to justify the rational or maximization conduct appealing to the notion of natural selection, which he attributes to Milton Friedman and F. A. Hayek, since those types of conduct are the result of such a process and also “superior” and relatively efficient. The second is the proposition that capitalistic competition acts like an evolutionary process favoring those institutional forms or industrial organizational models, which are more efficient, in a kind of survival of the fittest argument attributed to Jensen, Meckling, North, Williamson and others.

Such a critique would be shared by Stiglitz:

“those who appeal to the evolutionary process [e.g., Hayek and Armen Alchian] also claim too much: There is no reason to believe that evolutionary processes have any optimality properties...”, “It seems nonsensical to suggest that we should simply accept the natural outcome of the evolutionary process”.⁹

And clearly by Brennan & Buchanan:

“...social conventions that emerge and take on the status of ‘unwritten rules’ do not necessarily produce the best conceivable pattern of outcome. Some modern social analysts (notably Hayek and his followers) display an apparent faith in the forces of social and cultural ‘evolution’ to generate efficient rules. There seems to be no reason to predict that these forces will always ensure the selection of the best rules”.¹⁰

This would alert us to the need to consider rules as objects of choice and to review them periodically; and, according to Brennan & Buchanan, to the possibility of government facilitating a shift from old rules to new ones, being government a representative elected assembly, the entire set of players or a random dictator-king. With regard to game theory the “Folk Theorem”, with the many possible “equilibria”, would appear to give approval to Hodgson, Stiglitz, Brennan & Buchanan against Hayek, but Hayek himself took some distance from a Panglossian perspective:

⁸ Geoffrey M. Hodgson, *Economics and Evolution: Bringing Life Back to Economics*, (Spanish translation: Madrid: Celeste Ediciones, 1995)

⁹ Quoted in Whitman, Douglas Glen, “Hayek contra Pangloss on Evolutionary Systems”, *Constitutional Political Economy*, 9, 45-66 (Boston: Kluwer Academic Publishers, 1998), p. 46.

¹⁰ Brennan, Geoffrey & Buchanan, James M., *The Reason of Rules*, (Indianapolis, IN: Liberty Fund, Inc., 2000), p. 13.

“It would however be wrong to conclude, strictly from such evolutionary premises, that whatever rules evolved are always or necessarily conducive to the survival and increase of the populations following them. We need to show, with the help of economic analysis, how rules that emerge spontaneously tend to promote human survival. Recognising that rules generally tend to be selected, via competition, on the basis of their human survival-value certainly does not protect those rules from critical scrutiny. This is so, if for no other reason, because there has so often been coercive interference in the process of cultural evolution.”

“Bertrand Russell provides a good example in his claim that ‘if evolutionary ethics were sound, we ought to be entirely indifferent to what the course of evolution might be, since whatever it is thereby proved to be the best’ (*Philosophical Essays*, [Londres: Allen & Unwin, 1910/1966]). This objection, which A.G.N. Flew (1967: 48) regards as ‘decisive’, rests on a simple misunderstanding. I have no intention to commit what is often called the genetic or naturalistic fallacy. I do not claim that the results of group selection of traditions are necessarily ‘good’ – any more than I claim that other things that have long survived in the course of evolution, such as cockroaches, have moral value”¹¹.

With all the emphasis Hayek always made against the concept of “general equilibrium”, its requirement of perfect knowledge, and his concern with the “market process”, it would be contradictory for him to take a Panglossian view. In terms of institutions we would never be in a Pareto optimum but in a constant process of change, taking into account that some of those institutions are the result of compulsion more than spontaneous evolution. There would always be room for improvement, particularly for those rules that were imposed and work against the smooth working of the marketplace and the evolution of society.

But the attempt by Hayek to move away from a Panglossian interpretation is difficult at least, since he also said the evolutionary process was a “selection” process where the best rules are followed because they produce valuable results. Since those groups survive which have selected the best rules, it is hard to see how can we avoid the Panglossian argument that whatever has evolved up to this time must be the best if not for other reasons, because they have stood “the test of time”.

An interpretation has been made of Hayek’s evolutionism as showing that optimal results may come only under certain specific circumstances which are “liberty, general rules and competition”¹², and since liberty and competition can only exist under general rules, it is this the necessary and sufficient conditions for the emergence of efficient orders. Of course, one cannot avoid the feeling of circular reasoning: general rules are needed for the emergence of general rules, but this is not what Arnold says, he asks himself what the precondition for the

¹¹ F. A. Hayek, *The Fatal Conceit*, (Chicago: The University of Chicago Press, 1988), p. 20 & 27.

¹² Arnold, Roger A., “Hayek and Institutional Evolution”, *The Journal of Libertarian Studies*, Vol IV, N° 4, (Fall 1980) p. 350.

emergence of general rules is and gives as an answer “a certain moral code; specifically one that places (abstract) justice over (concrete loyalty)”.

True enough, but we are then moved towards asking ourselves what explains the existence of certain moral codes, to which the same dilemma of visible vs. invisible hands may be applied (counting the hands of God on either side, since they may be visible, as with Moses, or invisible, through the Holy Spirit’s inspiration).

If we leave aside “survival of the best” concept of evolution and come back to a more Mengerian interpretation the idea has an intuitive appeal, particularly considering what the same Hayek mentions as the superiority of those orders being the result of free actions of individuals, an idea shared by de Jasay:

“Indeed, it is hard to prove that they are always beneficent *on balance*, or that they are *lesser evils*, more benign than their constructed counterparts. Where spontaneous order is not value-free, however, is in the deontological dimension. A constructed order entails the imposition of the will of some upon others; some choices will dominate, others will be dominated. Spontaneous orders, whatever else they may be or do, are intrinsically voluntary.”¹³

Therefore, even though there is no guarantee that evolutionary processes may lead to orders that support “entrepreneurial success” at least being the outcome of free decisions they could have more chances of being so. And what about “constructed orders”?

The visible hand

Of course, nothing can assure that a constructed order will be one that respects private property rights or the fulfillment of contracts, not even one with the unanimous agreement of all participants, a difficult concept to consider taking into account that there is no such a thing as a “general interest” or “public interest”, or an agreement on what that is. Public choice has shown us how private interests are disguised as general ones, and even those that we cannot label as “interests” but are merely “ideas” also present many different sets of values or worldviews on what society should be.

And that is not the only problem of the visible hand. There is another: the action of considering the efficiency of rules, review them and even try to change them has all the characteristics of a “public good”:

“Who are to take upon themselves the personal burden of designing provisional proposals for basic changes in the rules when the promised benefits accrue *publicly*, that is, to all members of the political community, and with no differentially

¹³ De Jasay, Anthony, “The Cart before the Horse: On Emergent and Constructed Orders and their Wherewithal”, in Frei, Christoph and Nef, Robert (editors), *Contending with Hayek: On Liberalism, Spontaneous Order and the Post-Communist Societies in Transition*. (Berlin: Peter Lang, 1994), p. 29.

identifiable residual claims to the promised ‘social’ profits? What is the constitutional equivalent of the patent law, which guarantees a special, even if limited, monopoly privilege to the inventor and which, in turn, offers incentives for creative effort by all potential inventors? What is the political-constitutional equivalent of entrepreneurial profits, the search for which drives the economy and motivates attempts to locate higher-valued ways of organizing production and combining resources, both within and across markets, broadly defined?

Can general rules be changed in a deliberative process of collective choice, even if there are acknowledged possibilities of Pareto-superior reforms? And if not through deliberative choice, how can general rules be modified? Must we resign ourselves to the acceptance of one of what seem to be only two alternatives? Must we acknowledge that changes in basic institutions can be imposed only nondemocratically, by a group seeking to promote its own interests, [...]? Or failing conscious constitutional change and eschewing nondemocratic ‘reform’, must we fall back on slow, unconscious, and unintended processes of social-cultural evolution, with little more than pious hope that such changes as do occur will lead us toward rather than away from a set of arrangements that might be conceptually evaluated to be Pareto optimal?”¹⁴

B&B correctly point out that the mainstream model of the *homo economicus* cannot explain this. No wonder then, that already most such economics, prone to finding “market failures” everywhere, is already saying that the supply of institutions cannot be left to the “market” or to spontaneous orders and write themselves in as the first suppliers. Nevertheless, by doing that, they are showing a certain entrepreneurial activity. Therefore, how come that they are active in making proposals for institutional change if they can not accrue the benefits for themselves? Or can they?

“To the extent that ‘investment’ in institutional analysis, design, argument, dialogue, discussion, and persuasion is costly in a personal sense, the individual of the orthodox model will forgo such investment in favor of more immediate gratification of privately directed desires. Why should anyone do ‘good’? There is no way that economists who stay within the strict limits of the discipline can respond to such a question; they cannot manipulate utility-maximizing actor so as to offer a satisfying response”¹⁵

After this, B&B ask themselves: if persons do not behave in accordance with their own economic self-interest, objectively defined and measured, on what basis do they act? According to them the positive economist mounts an “effective” critique when others try to produce an alternative model with predictive content. But the problem we have here is that it is the positive economist of maximizing objectively measured economic self-interest the one that cannot predict and much less explain why would anyone “do good”.

¹⁴ Brennan & Buchanan, op. cit., p. 160.

¹⁵ Brennan & Buchanan, op. cit., p. 162.

In order to explain this, B&B introduce a distinction between a constitutional and a postconstitutional period. In this last one, the relative costs of promoting institutional changes would be too high relative to the increment in “public good” promised by the result of such action, but in the first one, the constitutional, the costs of doing so would be significantly lower so that the individual who follows his narrowly defined self-interest would have an incentive to act towards such a goal.

The question then is, how do these constitutional periods come about? And are they not the result of someone’s actions and in that case how is that they were motivated to act? Aren’t the efforts to open up a constitutional period also a “public good”?

Were they in a preconstitutional period when the dangers of a hobbesian state of nature would prompt them to act? Or was it a postconstitutional period of any kind? And should not we consider that even the ‘state of nature’ is postconstitutional in some sense, since at least there must be some “evolved order”?

A Misesian “institutional entrepreneur”

After this, Brennan & Buchanan just move from the positive to the normative and make a call to their fellow academics to build a “civic religion”, where they believe the process of institutional change must begin “accepting Keynes dictum about the influence of academic scribblers”, that is, in the field of ideas.

But before moving to the normative side, there are still things to be said on the positive one where a bridge could be found between the invisible hand or spontaneous processes and purposeful action. And such a bridge would be the “visible” hand of entrepreneurship. It is not strange, then, that the search for the reasons to explain the institutions that allow entrepreneurship to flourish are to be found... in entrepreneurship itself.

Despite Brennan & Buchanan’s despair against “unconscious” and “unintended” processes, that what Adam Ferguson called “the consequences of human action, and not of human design” involves purposeful action, which is the clear opposite from those unconscious and unintended reactions.

But then, conscious and intended actions by whom?, since the *publicness* of institutional change would guarantee that we would all be free riders of the supposed efforts of others who cannot exclude us from them.

That model must be rejected altogether in order to move back to the subjective value scale individual who attempts to do “good” on whatever merits that may be based. Curiously enough, this misesian “acting man” has been rejected as the result of tautological analysis in the sense that self interest is anything that interests the self, but it looks like much more explanatory than the “objective maximizer”. The first view could even explain the likes of Bin Laden, Mother Theresa, Hernando de Soto, or the academics that are called to build such a civic religion.

Why would they do that? Or as B&B say, where are the equivalent of entrepreneurial profits in the marketplace of ideas? There are several that one can think of: reputation, prestige, printed books, the Nobel prize, speaker fees, university chairs and the like. There seems to be an incentive enough to foster the proliferation of academic texts and institutional analysis and proposals.

There is another way, though, through which an “institutional entrepreneur” can claim the receipts of institutional proposals, and that is power. At this point I was tempted to take a pessimistic stand by arguing that those who strive for more government and more power have an upper hand since they can get the proceedings from their own proposals while those who stand for less government have only an idealistic incentive, but I finally discarded the idea: values being subjective there is no reason to say that material rewards are stronger incentives than religions or ideologies: examples like Francis of Assisi trying to reform no other thing than the corrupted Catholic Church, Thomas Paine arguing for independence and freedom, Harriet Beecher Stowe writing against slavery, Alexander Solzhenitsyn against the Gulags, Nicolaus Copernicus, Galileo Galilei or Giordano Bruno advancing science against prejudice. There have been those on the other side, who did not seem to be specifically motivated by material rewards either.

Together with the Lockes, Humes, Smiths and many others, were they not those who shaped the world we live in today? Whatever motivated them was strong enough for some of them even to risk their lives. They showed all the elements of the entrepreneur.

In this regard, B&B and Hayek have the same position, when they affirm that their efforts should be aimed largely at the academic constituency. Says Hayek:

“The state of opinion which governs a decision on political issues is always the result of a slow evolution, extending over long periods and proceeding at many different levels. New ideas start among a few and gradually spread until they become the possession of a majority who know little of their origin. In modern society this process involves a division of functions between those who are concerned mainly with the particular issues and those who are occupied with general ideas, with elaborating and reconciling the various principles of action which past experience has suggested. Our views both about what the consequences of our actions will be and about what we ought to aim at are mainly precepts that we have acquired as part of the inheritance of our society. These political and moral views, no less than our scientific beliefs, come to us from those who professionally handle abstract ideas. It is from them that both the ordinary man and the political leader obtain the fundamental conceptions that constitute the framework of their thought and guide them in their action”.¹⁶

Or Mises:

¹⁶ Hayek, Friedrich A. von, *The Constitution of Liberty*, (Chicago: The University of Chicago Press, 1960), p. 112,

“The history of thought and ideas is a discourse carried on from generation to generation. The thinking of later ages grows out of the thinking of earlier ages. Without the aid of this stimulation intellectual progress would have been impossible. The continuity of human evolution, sowing for the offspring and harvesting on land cleared and tilled by the ancestors, manifests itself also in the history of science and ideas. We have inherited from our forefathers not only a stock of products of various orders of goods which is the source of our material wealth; we have no less inherited ideas and thoughts, theories and technologies to which our thinking owes its productivity”.¹⁷

Such evolution is not “spontaneous” in the sense that it “happens”, but it is motorized by the actions of “entrepreneurs of ideas”. Which, it seems to this author, it is what Mises implies when he writes about the origination of ideas in “the head of an individual” as an “innovation”:

History is the record of human action. Human action is the conscious effort of man to substitute more satisfactory conditions for less satisfactory ones. Ideas determine what are to be considered more and less satisfactory conditions and what means are to be resorted to alter them. Thus ideas are the main theme of the study of history. Ideas are not an invariable stock that existed from the very beginning of things and that does not change. Every idea originated at a definite point of time and space in the head of an individual. (Of course, it has happened again and again that the same idea originated independently in the heads of various individuals at various points of time and space.) The genesis of every new idea is an innovation; it adds something new and unheard of before to the course of world affairs. The reason history does not repeat itself is that every historical state is the consummation of the operation of ideas different from those that operated in other historical states.¹⁸

Which leads to ask ourselves in the end: what kind of theory do we finally have with regard to the environment necessary for entrepreneurial success? And the answer is: one that allows us to understand why did such environment evolved in a certain place, although not one that could help us forecast when and where that would happen.

Entrepreneurs of ideas compete in the marketplace of ideas, and some of these move outwards from the center of the circle or downwards from the top of the pyramid and may come to influence events in society, turning it into one direction or another. We cannot say what direction that will lead to, nor can we be sure it will be an improvement. There is one aspect that may give higher probabilities for improvement though, which is the advance of knowledge and science, therefore the reduction of error; but we must also take into account that group interests may give blind eyes to those improvements in knowledge and have a vested interest in the continuation of error, most probably under new forms (reds turn into greens, etc.).

¹⁷ Mises, Ludwig von, *Human Action*, 3rd. Revised Edition (San Francisco: Fox & Wilkes, 1963), p. 178.

¹⁸ Mises, Ludwig von, *Theory and History*, (Auburn: The Mises Institute, 2000), p. 224.

We may not be able to forecast the future with this, but at least we are able to understand the past, something that mainstream economics is not even able to do with their “market failure-public goods-free riders” hypothesis. And that may be as far as we can get.