The role of institutions in entrepreneurship: implications for development policy

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Abstract

The last fifty years of development aid have not been rewarded with success. Part of the reason for this failure has been the focus on macro approaches and policies, which did not emphasize the local institutional context faced by economic agents.

In the last decade, the notion of institutions has come to the forefront of policy advice. At the same time however, the role of institutions in economic development remains unclear. As a result, it is being challenged by those who think that institutions are just the fad of the moment.

This Policy Primer explains how institutions are vital to the expansion of entrepreneurial activity, which is at the heart of the process of development and economic growth. What is generally missing in countries with lackluster economic performance is not entrepreneurship as such but the right institutional context for entrepreneurship to take place and to be socially beneficial. What matters for development are the rules that individuals follow and how these rules are defined and enforced.

In a successful economy, formal rules are aligned with informal norms and foster entrepreneurial activity by defining and enforcing property rights. The aim of economic policy and social reform must be to re-establish an institutional framework that allows for socially productive entrepreneurial activity to flourish by reducing the cost of engaging in productive activities. This Policy Primer offers three policy implications: define a starting point for reform; build institutional capacity; prepare an environment that favors productive entrepreneurship.

In spite of the uncertainty surrounding the path to reform, it is important to keep in mind that the quality of the formal and informal institutions is the main determinant of productive entrepreneurship.

1. Introduction[1]

After half a century of efforts in development aid, "institutions" have come, in the last few years, to the forefront of policy advice. Many organizations involved in fostering development and helping transition economies have adopted the view that institutions matter, and mainstream economics pays more and more attention to the notion of institutions. At the same time however, the role of institutions in economic development remains unclear for many, and as a result it is being challenged by those who think that institutions are just the fad of the moment.

This Policy Primer explains how institutions are vital to the expansion of entrepreneurial activity, which is at the heart of the process of development and economic growth and that the concept of institution is, when given real content and not merely used as a buzzword, not just another fad in economics but a crucial component of successful policymaking.

It is argued in the following pages that what is generally missing in countries with lackluster economic performance is not entrepreneurship per se but the right institutional context for entrepreneurship to take place and to be socially beneficial. Therefore, what matters for development and entrepreneurial activity are the rules that individuals follow and how these rules are defined and enforced.

The fundamental message of this Policy Primer is that unless the formal rules (a) are aligned with the informal norms that individuals follow, (b) favor entrepreneurial activity (i.e. define and enforce property rights, the law of contracts, etc.), and (c) are effectively enforced in an environment that operates under a rule of law, development and sustained prosperity cannot become a reality.

This Policy Primer is divided into three parts:

- An analysis of institutions and entrepreneurship;
- An empirical illustration from a Mercatus Center field study: Entrepreneurial activity in rural Romania; and,
- Implications for development policy.
  - Effective policy reform begins with a credible baseline that considers the informal as well as formal institutional structure and takes the perceptions of local economic actors into account.
  - Successful reforms build the institutional capacity necessary for their implementation.
  - Successful reforms will prepare the environment for "productive entrepreneurship" by reducing the cost of engaging in productive activities relative to engaging in evasive or socially destructive economic activities.

2. Analysis

Most economists and policy makers would agree that institutions and entrepreneurship are important components of a prosperous society. The aim of this analysis is to explain how a robust institutional environment and entrepreneurial activity are important to development and economic performance by showing how they interact with one another. In other words, this analysis presents a short but detailed analysis of how institutions shape entrepreneurship, that is, the driving force of a prosperous market system.

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Institutions

It is not always clear what economists and policy makers mean by the term "institutions". For instance, institutions are sometimes confused with organizations. However, as Nobel Prize winning economist Douglass North explains: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (1990 p. 3)[2]. Institutions are simply the rules and norms that individuals follow in their daily lives, the formal and informal constraints and their enforcement characteristics.

To use the analogy of sport, institutions are akin to the rules that allow tennis players to know what they can or cannot do. Without these rules, there would be no tennis, as no one could devise a way to play and win. A sport requires rules that frame the behavior of each participant. Similarly institutions in society are the rules that provide the framework within which people interact[3].

Institutions provide guidance, allow for routines to develop and ultimately reduce the uncertainty of social interaction. These functions are all faces of the same coin but can be analytically distinguished to better flesh out the role institutions play.

If institutions frame the behavior of individuals, they also, as a consequence, structure the incentives that individuals face in their activities. In other words, if one cannot win at tennis by playing outside the lines or letting the ball bounce twice, then the players will be motivated to develop the capabilities to play within the boundaries and to always run to return the ball before it bounces a second time. If I know that I can only win by playing within the lines, it will force me to become good at hitting the ball within the limits of the court. This will also guide my actions and my expectations regarding what my opponent in the game can or cannot do[4].

By guiding actions, institutions facilitate social interaction in our daily lives. For instance, driving on the right-hand side of the street is a rule which guides motorists in ways that permit the coordination of cars. Such a coordination of vehicles happens because everyone follows the same rule, which facilitates the choices drivers must make on the road. As North explains, it is the existence of an imbedded set of institutions in our daily lives which removes many difficult choices that, in the absence of institutions, would have to be made in order to obtain social interaction[5]. On the road, we don't have to choose which side to drive on every time we encounter another vehicle because we all accept and follow the same rule.

It follows that institutions reduce the uncertainty of social interaction by providing a structure within which everyone can act. This function is very important because it allows for the coordination of plans. Indeed, one could not interact socially in the total absence of knowledge about what guides the actions of others in the social context. If I don't know the rules which my opponent will follow, I cannot engage myself in a tennis game because it would be too uncertain. The same is true in the "economic game". Because institutions guide human action in the social context, they reduce the uncertainty of social interaction. To go back to the "rules of the road" example, the uncertainty every driver faces with regard to the actions of every other driver is reduced by the existence of rules. Because of rules, driving on the road is more certain.

With this analysis in mind, it is easy to understand that in order for institutions to reduce uncertainty, they must be as stable and predictable as possible over time so that they can be used as guiding tools in social interaction.

Institutions can take the form of both formal and informal rules. Institutions can be formal and explicit such as the US Constitution. They can also be informal and implicit such as behavioral social codes that are accepted by most (in culturally homogenous groups) but written nowhere (e.g. social rules of courtesy towards elderly people).

The rules of tennis referenced above are formal: they are written down in the official International Tennis Federation rulebook. However, constraints on human behavior don't have to be formal and explicit to operate. In fact, conventions and social codes of behavior are everywhere and change depending on the social environment. For instance, while formal tennis rules are written and detailed, they don't cover everything about tennis. Tennis players also follow unwritten rules: these are rules about courtesy, warming-up, serving, making calls, disputes, etc.[6]

The distinction between formal and informal institutions is at the core of the economics of institutions. The rules that govern social intercourse are generally not limited to formal institutions; they also include informal (i.e. unwritten) norms of conduct that individuals follow in their day-to-day activities. The institutions that matter to individuals are those that they follow (whether formal or informal). Taking the formal/informal distinction into account is crucial when designing policies that are intended to influence the behavior of people.

As we will see below, economic performance suffers when formal and informal rules don't overlap. This is typically the case when the formal rules do not reflect the informal norms of conduct.

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[2] Institutions taken together with the individuals taking advantage of them and seeking to achieve some common goals are called organizations.

[3] See Douglas North (1990) Institutions, Institutional Change and Economic Performance, Cambridge: Cambridge University Press. As North puts it: "institutions include any form of constraints that human beings devise to shape human interaction" North (1990: 4). See also North (2005) Understanding the Process of Economic Change, Princeton: Princeton University Press.

[4] In this sense, institutions are "a guide to human interaction, so that when we wish to greet friends on the street, drive an automobile, buy oranges, borrow money, form a business, bury our dead, or whatever, we know (or can learn easily) how to perform these tasks… In the jargon of the economist, institutions define and limit the set of choices of individuals" North (1990: 3-4).

[5] North (1990: 22).

[6] The same is true of spectators at tennis tournaments: they follow unwritten behavioral rules. Notice the difference in behavior between tennis spectators and football or basketball fans, for instance.

Institutions only affect people's behavior when they are enforced. In situations where there is no overlap between formal and informal rules, and formal institutions cannot be enforced properly, it is the informal rules that take priority. This makes the enforcement of the formal rules difficult and costly[7].

Enforcement can take many forms, be it a fine for violating the rules of the road or a sneer when showing disrespect toward an elderly person. The enforcement costs of the formal institutional structure increase as the overlap between formal and informal rules shrinks. The smaller the overlap, the more difficult it will be for policy makers to have an effect on individuals' behavior and the more expensive the enforcement of the formal system will become.

Without a reasonably good knowledge of the informal institutions that exist in society, policy makers cannot reform the formal institutions and assume that they will "stick". Whether individuals follow the formal rules legislated by governments will depend to a large extent on the alignment between formal rules and informal norms of conduct.

One of the goals of policy reform must be to identify the overlap (or lack thereof) between the formal and the informal rules in order to minimize the enforcement costs of the formal legal system. The enforcement arrangements are part of what defines institutions and thus are an essential component of institution building.

Where there is an overlap between the formal and the informal, enforcement costs will be lower than when there is none. The goal of sustainable policy reform should be to encourage this overlap when possible[8].

While it is true that stable and predictable institutions are necessary if they are to fulfill their function, both formal and informal institutions can change or evolve over time. Those that are designed can be amended or reformed and those that are not formally created evolve spontaneously based on how useful they are to the individuals in society.

Informal rules are difficult to influence, at least in the short run. They are nonetheless important to understanding the limits of institution building because ignoring the informal rules always makes it more costly to enforce the formal ones. The design of formal institutions requires that policy makers pay attention to existing informal institutions because of the consequences for economic performance[9].

Entrepreneurship

Entrepreneurship is the ultimate source of change in the economic system and economists increasingly attribute a large role to the entrepreneur when explaining economic performance. This section describes the entrepreneurial function and why this function is the source of economic development.

The problem of poverty and development is not that entrepreneurship is abundant in some countries and lacking in others. Entrepreneurial activity is never in short supply.9 Entrepreneurship encompasses not only exceptional risk-taking activities (e.g. setting up firms) but also many mundane activities both within and outside organizations. This is because entrepreneurship is about creation and discovery: something that every individual is capable of to some degree. Entrepreneurial behavior is not dependent on culture or race, it can be observed in every society and across all ethnicities. Creation and discovery can exist in non-commercial contexts. However, what matters to policy is entrepreneurial activity in the social context of market exchange.

Traditionally economists have viewed the challenge of economic growth as an issue of overcoming the problem of diminishing returns (i.e. the continued use of a resource produces less and less output). In theory, the solution to this problem lies in the existence of mechanisms (e.g. education, research, infrastructure, etc.) that increase productivity (i.e. over time more is produced with less). But what has been lacking is an explanation for how increases in productivity are actually achieved.

The answer to this problem lies in understanding that productivity increases are increases in the amount of socially useful knowledge. In other words, the source of changes in productivity lies in the increase in knowledge that entrepreneurial activity generates: the tyranny of diminishing returns is overcome by human ingenuity displayed in entrepreneurship.

The recognition of entrepreneurship as the engine of growth leads to the following fundamental question: if entrepreneurship is never in short supply and is the ultimate source of economic growth, why are some countries rich while others are poor?

Why institutions matter to entrepreneurship?

We saw above that no one can play tennis without formal and informal rules. What defines tennis is not only the use of a racket and balls but also the rules that players fol-

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7 In his book The Other Path (New York: Harper and Row Publishers) published in 1989, Hernando De Soto provides many examples of costly enforcement of formal rules. See for instance his examples on informal housing. Another example is jaywalking in the U.S. While the law (i.e. formal rule) bans jaywalking, it is often cost effective for individuals to cross streets in places where they are not supposed to cross. While some jaywalking may be curbed by the existence of the law, it would be too costly to strictly enforce it.

8 The exception being when informal norms are not conducive to social progress. How to determine whether this is the case and what to do about it are difficult but very important questions. This Policy Primer argues that the impact on the "gains from trade" should be the main benchmark used to judge rules and norms that individuals follow.

9 The informal rules are part of what one may call "culture" or what economists also call "civic capital" or "metis" (common knowledge). Informal norms may be influenced in the long run by the formal institutional framework. However, informal rules almost always take priority in the short run. This is where the difficulty with culture lies: it is fundamental to the success of reforms but it is difficult to change and affect. For more on the subject see "Why Culture Matters: Economics, Politics, and the Imprint of History" by Peter Boettke (reprinted in Peter Boettke (2001) Calculation and Coordination, London: Routledge).

low. Similarly, entrepreneurship cannot exist without rules: what matters to entrepreneurship is not only the discovery and exploitation of a profit opportunity but also that this process takes place in the context of rules that structure the way the economic game is played.

For this reason, institutions matter for economic performance. In order to understand the performance of economies, one must look at the nature of the formal and informal institutions that operate because these rules affect the type of entrepreneurial activity that takes place.

As mentioned above, entrepreneurship is traditionally understood in the social context. This means that entrepreneurial discoveries will tend to be socially beneficial (i.e. they benefit all the parties to the exchange, and, by creating further opportunities for other entrepreneurs, they benefit others not directly involved). Entrepreneurs discover unknown gains from exchange through the discovery of profit opportunities. As such, the process of discovery relies primarily on the existence of profits[10].

However, profits do not exist in a vacuum; they proceed from the existence of institutions. Therefore the institutional arrangements that govern the existence of profits will determine the nature of entrepreneurship.

The puzzle, as stated above is this: since entrepreneurship is never in short supply, why do some countries seem to benefit from entrepreneurial activity while others languish?

The response lies in recognizing that while entrepreneurship is always present it may not always be directed towards socially productive activities. This will depend on the incentives created as a result of the formal and informal institutions that exist in a society[11]. The formal legal system provides the basic structure around which entrepreneurial activity is organized. Depending on the nature of the formal institutions, entrepreneurship will be directed towards either one (or more) of these three types of activities:

- productive activities;
- evasive activities; and/or,
- socially destructive activities.

In this case, the formal institutions reflect the informal norms of conduct and provide incentives for entrepreneurs to discover and capture socially beneficial opportunities. Formal institutions define and enforce property rights over goods and services that are exchanged. The enforcement costs of the formal legal system are low and society benefits from productive entrepreneurship as entrepreneurs discover and exploit profit opportunities.

In this second case, formal institutions provide incentives for entrepreneurs to ignore, and thus avoid, the formal institutional framework. This is because the formal legal system reduces the value of the gains from exchange and thus drives individuals out of formal arrangements. Most commonly, this corresponds to situations where taxation and regulation are high or where legislation is unstable and doesn't provide the necessary certainty for exchange and investment to take place (property rights, thus understood, are weak or uncertain). Evasive entrepreneurship is costly to society since entrepreneurs, as they go underground to continue exploiting socially productive opportunities, must allocate resources to avoiding the formal system. These resources could have otherwise been employed in productive activities.

Socially destructive entrepreneurship occurs when society offers incentives to engage in socially destructive activities (i.e. zero or negative-sum games)[12]. Rent-seeking (i.e. obtaining revenues through activities that are protected by legislation and at the expense of consumers and taxpayers) and theft are the most common examples. If formal institutions are not stable and/or can be manipulated to one's gain, they create incentives to engage in the exploitation of the formal rules by predating over those who engage in socially productive activities.

The formal and informal institutional environment in which entrepreneurs operate will influence how entrepreneurs use resources at their disposal. Entrepreneurship is not dependent on the resources in an economy. Rather, the key is the quality of institutions that permit the exploitation of resources and opportunities.

Individuals and the rules they follow are the ultimate resources to which economists and policy makers must pay attention. In the final analysis it is neither the distance to markets and commercial centers nor the amount of natural resources that a country possesses, which make a country economically vibrant. It is the extent to which formal and informal institutions (and their enforcement arrangements) direct entrepreneurship towards socially productive activities.

The fundamental message of the analysis above is that different institutional frameworks offer different incentives for entrepreneurs. This also means that the knowledge generated by entrepreneurial activity will vary depending on the institutional background of society. Ultimately, the issue of institutions and entrepreneurship is an issue of the generation of knowledge that is necessary for productivity increases to take place and for individual plans to become better coordinated. My claim is that only a society with an institutional environment that favors productive entrepreneurship can generate the knowledge necessary for constant productivity increases and effective coordination of individual activity.

3. An example from the field: entrepreneurship in Romania

The Mercatus Center has studied the issues addressed above (the small overlap between the informal and the formal, the different types of entrepreneurship, etc.) in

[10] On the role of profit and entrepreneurial alertness to profit opportunities, see the work of Israel Kirzner, especially Competition and Entrepreneurship, Chicago: University of Chicago Press, 1973.

[11] For an exploration of the subject see for instance Peter Boettke and Christopher Coyne (2003) "Entrepreneurship and Development: Cause or Consequence?" Advances in Austrian Economics, vol. 6, 67-87; and Christopher Coyne and Peter Leeson (2004) "The Plight of Underdeveloped Countries" Cato Journal, vol. 24(3), 235-249.

[12] "Zero or negative sum games" correspond to situations where no gains emerge from social interaction.

Romania[13]. The difficulties experienced by many transition economies in Eastern Europe can be directly linked to deficiencies in their formal institutional structure. Romania is a specific example of this general problem.

The obstacles on the way to prosperity in Romania, as in so many developing and transitioning countries, stem from the nature of the formal institutional structure. In many cases, the payoffs offered for unproductive and evasive entrepreneurship in Romania are higher than those offered for productive activities. Among the issues that plague the economy are: corruption (i.e. evasion of formal institutions), excessive and uncertain regulations, and random and ineffective enforcement of those regulations.

Legal uncertainty

Legal activism (i.e. the frequent issuance of legislation) can be observed in most countries and Romania is no exception. For instance, the Romanian government can issue "Emergency Ordinances" – immediately active decrees – which frequently change the rules of the game for entrepreneurs. Between 1997 and 2000 for instance, 684 Emergency Ordinances were issued representing 43% of all laws created during this period. Moreover, changes to the rules and the regulatory framework are often poorly drafted, vague, and can be contradictory.

As a result of these constant changes in the formal regulatory framework, formal institutions, far from alleviating uncertainty, create additional uncertainty. Under these conditions, it is difficult for entrepreneurs to engage in forecast, planning and other necessary activities to conduct business. Surveys show that as a consequence only a quarter of the Romanian population has trust in the government and more than fifty percent consider most public officials to be corrupt.

Romanian entrepreneurs indicated that regulations were numerous and often changing, and thus it is difficult to know what the law requires on any given day. Public officials also have problems finding their way through the legal uncertainty. It follows that the rules cannot be enforced well and the court system cannot operate effectively. In the case of dispute settlement for instance, entrepreneurs often rely on informal arrangements because of the inefficiency of the formal alternative.

The black market

Entrepreneurs who are alert to business opportunities must often pay officials bribes to obtain the appropriate permits, licenses and authorizations. They can also choose to evade formal institutions when doing business and this situation has created an informal sector. The most common forms of evasive activities are tax evasion (including understatement of revenue, tax on labor, etc.) and evasion of the formal legal process (to set up a new firm, to re-charter a company statute, etc.). Evasive entrepreneurship thrives as a reaction to the uncertainty created by the formal legal system. This is costly to society because, on the one hand, entrepreneurs allocate resources to avoid the formal system that could have been used for productive activities and, on the other, the enforcement costs of formal institutions are much higher than they need to be.

Rent seeking

Because formal laws change all the time and the legislative process is susceptible to external influences by pressure groups and powerful individuals, it makes sense for individuals to try to affect those changes in their favor. The incentives for entrepreneurs are directed towards rent seeking in order to obtain privileges from those in positions of power. Such a context is perfect for the flourishing of unproductive or even socially destructive entrepreneurship, where some individuals engage in negative or zero-sum games by destroying resources that would have been useful to other market participants.

Productive entrepreneurship in Romania is hampered by the fact that formal institutions only partially fulfill their function which is to reduce the uncertainty of social interaction by providing a guide to social intercourse. When this guiding function is inoperative or diminished and the incentives for entrepreneurship are distorted towards socially wasteful activities, economic growth is stifled and the economy may stagnate or even retrogress.

Entrepreneurial activity is not lacking in Romania and neither are entrepreneurs, but the formal rules of the economic game are poorly defined, so that entrepreneurship is directed towards unproductive activities.

4. Implications for development policy

The analysis above and the example of Romania lead us to important conclusions about the role of institutions in fostering entrepreneurship. Formal institutions can be designed to offer incentives to engage in productive activities but they may also render productive activities too costly with regard to alternatives. Badly designed formal institutions and institution building that does not take into account the gap between formal and informal rules create incentives for individuals to:

- Evade the formal legal system and follow conflicting informal norms of conduct;
- Engage in unproductive or even socially destructive activities.

Ultimately what matters to economic policy is the reality of the incentives entrepreneurs experience. Since entrepreneurship is never in short supply, the overall implication of the analysis above is that effective policy should always aim at making unproductive activities more costly to engage in than productive activities. Economic development and growth require that incentives direct entrepreneurial activity to productive not unproductive opportunities.

However, implementation of good policy is not easy because obstacles stand in the way of good policy reform. The wrong incentives are often given to reformers who can privately gain from catering to special interests as opposed to adopting policies beneficial to society. This last section offers three steps policy makers (who want to change the

[13] See Paul Aligica, Peter Leeson and Christopher Coyne (2003) "Extending the Analysis: Romania" USAID Forum Series on the Role of Institutions in Promoting Economic Growth: http://www.mercatus.org/pdf/materials/433.pdf. See also Christopher Coyne and Peter Leeson (2004)

incentives that society provides to entrepreneurs) can follow. The overarching idea is that the goal of economic policy must be to change the relative payoffs society offers to entrepreneurs in order to foster productive entrepreneurship.

Policy implication #1: define the starting point for reform

Before attempting reform aimed at changing the relative payoffs available to entrepreneurs, it is necessary to establish a credible baseline, or "starting point" that considers the formal as well as the informal institutions within which entrepreneurs operate.

A credible assessment and accurate account of the starting point for reform that reflects the perceptions of key economic actors is crucial because:

- Reforms will need to be tailored to the actual situation in a given country, and general recipes for reform may not be adapted to the local circumstances and therefore will not "stick"; and,
- Reforms have the potential of making things worse if ill-adapted to the situation. Moreover, without an accurate baseline there is no way to measure success or failure and problems can be generated from reforms without policy makers ever knowing about them.

A detailed knowledge of the actual incentives entrepreneurs face in their activity is necessary to define a starting point. This can only be obtained by speaking to the people who are involved in business activities in the country of concern. Law books are useful to know what the formal incentives are. However, one cannot only rely on them to understand the incentives and the rules that entrepreneurs follow on the terrain. Detailed surveys of entrepreneurs are crucial to establish the real nature of the incentives they face.

Interviewing entrepreneurs helps uncover the prevalence of unproductive and evasive entrepreneurship. The lack of overlap between formal and informal institutions is a good signal that the formal legal structure is stifling for economic development and growth. The definition of the starting point helps establish the nature and the extent of the problem faced by policy reformers.

This first policy implication may seem obvious but policy makers frequently lack a relevant baseline when initiating reforms or merely rely on a formal account of the institutional environment contained in legislation. One way to check this is by always asking the following questions:

- Do I know how things actually are in the country of concern?
- How do I know (i.e.: where does my information come from and do I trust that it reflects the "real life" economy in the country of concern)?

Policy implication #2: Institutional capacity building

While defining the current situation, one also needs to set in place the conditions under which institutional change and capacity building can occur. The main reason for institutional capacity building is to generate policy ownership such that change is seen to be organic and driven towards goals that are desired and beneficial to the local population. Adoption of policies identified by outsiders is often difficult to achieve, as interest groups and institutional inertia support the status quo. The difficulty is to find the agents of change within the population that can rally the populace around the necessary reform. The commitment of national leaders to reforms is necessary. Also, identifying informal institutions aligned with proposed reforms can help achieve policy ownership because these norms of conduct are accepted by the local population as means of coordinating activities and solving conflicts.

Mapping institutional stakeholders will help identify who is entrenched in decision-making positions. Political mapping identifies the groups (whether they work for the state or they are private parties) that have an interest in using the law to concentrate the benefits in their hands while dispersing the costs over the entire population. Political mapping allows reformers to manage the opposition to reform by making it less painful for those who are losing most (e.g. through the grandfathering of certain policies, etc.). Identifying the various interest groups requires on the ground work with people in civil society and in government. While it may be arduous, it is a relatively inexpensive exercise and will provide critical information regarding the feasibility of the reforms.

The next step is to implement policies that favor productive entrepreneurship and to remove those that provide incentives for socially destructive entrepreneurial activity. The overarching goal of public policy must be to reduce the relative cost of engaging in socially beneficial entrepreneurship. The engine of development and growth is productive entrepreneurship. One must provide the correct environment for entrepreneurs to create wealth if reforms are to be successful.

The main implication of the analysis above is that the formal legal system must be reformed in order to establish a property rights environment that provides clearly defined, fully tradable, real, and personal property rights that are alienable and defendable in impartial tribunals. While establishing a well-defined and encompassing property right environment will not solve all the ills of developing nations, it will go further than policies that overlook the importance of property rights.

The pitfall to avoid in designing policies is to try to provide direct help for entrepreneurs. Neither old-style industrial policy nor financial help from the government is what is required. Policy reforms that favor socially productive entrepreneurship should primarily aim at defining and enforcing institutions.

This Policy Primer argues that institutions are not the fad of the moment but are fundamental to the existence of a vibrant and productive entrepreneurial activity. Institutions are defined as the rules of the economic game and their enforcement arrangements. Entrepreneurial activity is about creation and discovery in the commercial context, that is, within the price system with the guidance of the profit-and-loss mechanism.

What matters to economic performance is a set of institutions that favor socially productive entrepreneurship. The problem with most developing countries is not that entrepreneurial activity is missing but that it is misdirected into socially destructive activities. The aim of economic policy and social reform must be to re-establish an institutional framework that allows for socially productive entrepreneurial activity to flourish. The Policy Primer offers three policy implications:

- Define a starting point for reform;
- Build institutional capacity;
- Prepare an environment that favors productive entrepreneurship.

In spite of the uncertainty surrounding the path to reform, it is important to keep in mind that the quality of the formal and informal institutions are the main determinant of productive entrepreneurship. Institutions are not just the latest buzzword in development economics; they are the crucial and unavoidable foundation upon which societies develop and grow.