

# **Social Cooperation and the Process of Economic Development**

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## **Social Cooperation and the Process of Economic Development**

The greater productivity of work under the division of labor is a unifying influence. It leads men to regard each other as comrades in a joint struggle for welfare, rather than as competitors in a struggle for existence. It makes friends out of enemies, peace out of war, society out of individuals.

--- Ludwig von Mises

Much of the population of Africa languishes in abject poverty. Latin America suffers from social unrest and political turmoil. Western Europe has been attempting to climb out of economic stagnation for over a decade, while the countries of East and Central Europe are throwing off the shackles from a state-communist past with varying degrees of success. And the former Soviet Union seems to have traded in the crony socialism for crony capitalism. The status of the intellectual argument for a liberal market economy is much less secure well into the first decade of the new century than it was during the closing decade of the last century. How did it happen that the decisive practical victory of capitalism over socialism in the late 1980s has given way to an intellectual consensus that the market met its match in the era of transition and globalization?

It is my contention that the basic argument for the liberal society was misunderstood for the past century by the mainstream of our intellectual and political culture in the West. The arguments for limited government and a market economy cannot be divorced from one another. It is not self-interest that explains the relative effectiveness of markets, self-interest drives our quest for power as well, so it is a universal given in some basic sense. But our self-interest is directed by institutions within which we find ourselves inhabiting. In other words, markets are neither good nor bad, they just are, but the behavior exhibited in them is either socially cooperative or anti-social depending on the institutional setting. Self-interest in an environment of private

property protected by the rule of law generates one set of consequences, while self-interest in an environment of communal property and arbitrary government rule will result in a completely other set of consequences.

Mankind exhibits two natural propensities --- on the one hand we constantly reveal our creative and cooperative abilities to realize the gains through “truck, barter, and exchange”, and on the other hand we continually demonstrate our destructive tendencies through “rape, pillage and plunder”. The modern era of “globalization” is no different. Commerce reaches every corner of the world and we can now experience products and ideas which before were only the domain of some far away region. At the same time, our vulnerability to terrorism highlights how easy it is to find new and morbidly fascinating ways to annihilate ones enemies.

At first it may seem that we cooperate with those that are socially close to us and are contentious with those who are socially distant. But familiarity and strangeness are not the determining factors. As Adam Smith pointed out in *The Wealth of Nations*: “In civilized society [man] stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons.” The market-order of the “Great Society” aligns individual incentives, utilizes information, and promotes social learning so that social cooperation in anonymity can be realized and wealth enhanced through specialization and exchange. Strangers are mobilized to serve the interests of one another and improve each others lot in life.

This ability to realize these gains from cooperation among socially distant and anonymous actors is actually a rarity in human history. Instead, throughout most of our existence we treated strangers with distrust and even exhibited great violence upon those

who were familiar to us. Most human societies may have sanctions against incest and promise breaking, but our propensity to destroy and wreck havoc on one another is evident throughout human history and in our contemporary society as well. A quick look at any national newspaper reveals both the human capacity to realize gains from trade and innovation, and our opportunistic ability to prey on those weaker than us or who find themselves in the unfortunate circumstance of vulnerability.

Whether human societies are wealth enhancing or wealth destroying is a function of the rules of the game which are respected and enforced in any society, and which channel our proclivities in the direction of either the “truck, barter, exchange” or “rape, pillage, plunder”. The modern intellectual history of development economics has gone through various different intellectual fads and fashions. During the hegemony of neo-Keynesian synthesis in economics and public policy (1950-1980), orchestrating economic development in the less developed world was the job of enlightened government policy. William Easterly’s *The Elusive Quest for Growth* contains perhaps the best discussion of the failed efforts of governments to accomplish this task of orchestrating development with foreign assistance policies of infrastructure projects to fill the investment gap; schools to address educational needs; and condoms to control population growth. A lone wolf during the 1950s and 1960s, it turns out that P T Bauer (1915-2002) had the best explanation for economic development --- private entrepreneurs and not bureaucrats were responsible for the economic development of the West and could be relied upon to bring development to the less developed world as well. This, of course, was a central message of Joseph Schumpeter and his fellow Austrian economists.

Entrepreneurship is the prime mover in the economic system. As the leading representative of the modern Austrian school of economics, Israel M. Kirzner, has put it, individuals will be alert to that which is in their interest to be alert. If the rules of the game and their enforcement are such that rewards for individual initiative are best served in attempting to utilize the instruments of state power to direct resources into the coffers of the state bureaucracy, then keen 'entrepreneurial' alertness will be exercised in so doing. On the other hand, if the rules are such that the rewards to individual initiative are in market experimentation and satisfying the demands of fellow citizens through voluntary exchange, then keen 'entrepreneurial' alertness will be exercised in so doing. In other words, entrepreneurship is omnipresent, it is a human capacity to be alert to that which is in our interest to be alert to. But this human capacity will be directed toward realizing gains from trade and innovation, or theft through predation. The cause of economic growth and development is to be found in the rules of the game which promote the free exchange of goods and services, but the active agent in realizing the mutual gains from exchange will be the entrepreneur.

Realizing the role of entrepreneurs as the catalyst of economic growth, it is often assumed that a lack of economic growth means that there is a shortage of entrepreneurs and entrepreneurship more generally. However, this overlooks the very essence of entrepreneurial alertness. When we realize that alertness to profit opportunities is the central tenet of entrepreneurship, it is clear that a lack of economic progress is due to the fact that profit opportunities are either lacking or are tied to perverse ends. In other words, the profit opportunities in underdeveloped countries are tied to negative-sum or zero-sum activities. In contrast, profit opportunities tied to positive-sum activities are necessary for positive economic growth.

It is often assumed that the existence of profit opportunities necessarily leads to economic growth, but this may not be the case. Rather, given that entrepreneurship is omnipresent, it is critical to realize that the institutional context creates payoffs to a set of activities which may possibly lead to economic growth, but which may also lead to economic stagnation. In short, the profitability of a certain activity is not simultaneous with positive economic growth. The critical realization is that profit opportunities must be connected to positive-sum activities in order for entrepreneurial undertakings to produce economic progress.

For instance, in an institutional setting like that which characterized East and Central Europe during the 1990s, where there were ineffective courts and insecure property rights, we would expect entrepreneurs to direct their efforts elsewhere from above ground markets and long term investments. Likewise, a society characterized by rent-seeking and corruption will serve to direct entrepreneurial efforts toward those activities. The underlying point is that entrepreneurs are alert to profit opportunities. The issue then becomes whether these opportunities are tied to positive-sum situations in which the economy at large can benefit or if they are negative-sum or zero-sum situations in which a few benefit at the expense of society. The former is the essence of economic growth while the latter characterizes the plight of underdeveloped nations.

Realizing the importance of the institutional context for directing entrepreneurship, a complete theory of the entrepreneur must provide some understanding of factors which direct the alertness of individual entrepreneurs. In other words, entrepreneurs can engage in *productive* activities which are positive-sum and result in economic growth or they can engage in *unproductive* and *evasive* activities which are negative-sum or zero-sum and result in economic stagnation.

Productive activities – arbitrage and innovation – 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 towards the economically (and technologically) efficient production point. The second role takes place via innovation which use resources in a more efficient manner. This shift represents the very nature of economic growth – an increase in real output due to increases in real productivity.

In contrast, unproductive activities include crime, rent-seeking and the destruction of existing resources. In the case of unproductive entrepreneurship, it is possible that innovation is taking place, but the activities do not increase real productivity. For example, consider new techniques for engaging in rent-seeking. While they lead to increased profit for the entrepreneur undertaking the activity, they result in a deadweight loss for society as a whole.

To productive and unproductive entrepreneurship we can add a third category – evasive entrepreneurship. Evasive activities include the expenditure of resources and efforts in evading the legal system or in avoiding the unproductive activities by other agents. Tax evasion is one readily apparent example of evasive activities as are efforts to avoid having to pay bribes to corrupt officials. But so would any number of non-compliance issues in regulation and law-enforcement.

Entrepreneurs are present in every country and every cultural setting. We observe different outcomes from entrepreneurial activities because activities yielding the highest payoffs vary across societies. In countries with low growth, it is not that entrepreneurs are not acting, but rather that they are stymied by either a lack of profit opportunities or

the existence of profit opportunities yielding outcomes counter to economic progress. Put simply, countries that suffer from systemic poverty do so because the incentives in those countries are aligned with rewards for predation by private and public actors as opposed to productive wealth creation. The game is structured such that our “rape, pillage, plunder” propensity is exercised while our “truck, barter, exchange” propensity is suppressed.

Freedom and prosperity are intimately related and mutually reinforcing as argued by both F. A. Hayek, *The Road to Serfdom* and Milton Friedman, *Capitalism and Freedom*. Monopolistic power results from the erection of political barriers to entry. Freedom of entry threatens the monopoly status of enterprises, but also is one of the most effective challengers to the political power of entrenched interests. With my colleague Chris Coyne ([www.ccoyne.com](http://www.ccoyne.com)), we have studied entrepreneurship in the first-, second-, and third-world. Professor Coyne’s work on *After War: The Political Economy of Reconstruction* addresses these issues in the context of war-torn Afghanistan and Iraq, and my own earlier work *Why Perestroika Failed: The Politics and Economics of Socialist Transformation* sought to examine the post-communist situation. Other work addresses the plight of underdeveloped economies in general, and the tackles the problems of sustainability among the Western democracies as well. We believe one can derive the following general guidelines from our work to achieve economic progress:

1. Entrepreneurship is omnipresent – Entrepreneurs are present in all settings. Cultural explanations for a lack of entrepreneurship overlook what people have in common – namely alertness for profit and to improve their general situations. Underdeveloped nations do not lack entrepreneurship. Rather,

entrepreneurial activities exist, but are not directed toward productive ends conducive to economic progress.

2. Government cannot create entrepreneurship – Given that entrepreneurs are omnipresent, government policy cannot “create” entrepreneurship. Instead, emphasis should be placed on creating a general institutional framework, making payoffs to productive entrepreneurship relatively high compared to unproductive and evasive activities. Resources should not be allocated to “encouraging” or “training” entrepreneurs, but to developing the necessary institutional context to allow productive activities to come to the forefront.
3. Transparency and accountability are critical for reform – In many cases, the lack of transparency and accountability allows officials to abuse the law for personal gains. One key mechanism for creating transparency is a free media industry which serves as a check on those in positions to abuse the political and legal institutions. Increased transparency and accountability reduce the payoff to unproductive activities.
4. Reform needs to be decentralized – Reform efforts should be decentralized to the local level so that those that truly understand these challenges are involved in the reform process. For example, as discussed previously, entrepreneurs in rural Romania face a special set of challenges. Currently, the national government controls all reform efforts and neglects the unique situation of rural entrepreneurs.
5. Identifying and maintaining indigenous institutions is key – Indigenous institutions are embedded and accepted means of coordinating activities and

overcoming situations of conflict. As such, they provide a ready-made framework for increasing coordination on a large scale. Institutions, practices and markets that are informal or “black” should be incorporated into the formal sector.

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