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FROM A RENT-SEEKING ECONOMY TOWARD AN ENTREPRENEURIAL ECONOMY IN LATIN AMERICA: THE ROLE OF INSTITUTIONAL QUALITY REFORM

Trabajo realizado por: Jhon Valdiglesias Oviedo
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From a rent-seeking economy toward an entrepreneurial economy in Latin America: The role of institutional quality reform

Author: Jhon Valdiglesias Oviedo
Institution: Desco
Country: Peru

Abstract

This essay evidence Latin America as a rent-seeking region. Given its high scale of return, the rent-seeking sector attracts the best and brightest people, eliminating potential entrepreneurs who should create innovation, technology and value to ensure productivity and sustainable economic growth. Meantime, governments grant the right of exploitation of rent-seeking activities in exchange for bribes. Finally, we propose the improvement of institutional quality as instrument of solution.
1. Introduction

Entrepreneurship and the allocation of talents is a considerable source of sustainable economic growth not studied in the proper intensity by conventional wisdom. Neoclassical theory assumes this variable as exogenous, while new, complementary theories aim to analyze the endogenous process of how the best brightest people has the potential of search and select new opportunities in order to create value, innovation and technology. On the other hand, a wrong allocation of these best talents in unproductive sectors or rent-seeking sectors would bring catastrophic consequences for the economy.

Latin America poses the characteristic of being a rent-seeking region. The endowment of natural resources has made deviations of talents toward rent-seeking activities, which in turn explains the lack of innovation, technology and competitive market in the region. Potential entrepreneurs enjoy privileges from the government in having the right to exploit the rent of these natural resources, involving bribes and corruption. On the other hand, due to that this sector has the high scale of return, absorb the best human capital of each country, transforming potential entrepreneurs to rent-seekers and practically eliminating all possibility of counting with an improvement of productivity and a sustainable economic growth.

The present essay is divided in four parts. The first part is the introduction. In the second part it is analyzed the characteristic of the region as a rent-seeking region based on the necessary theoretical concepts. In the third part it is evaluated institutional reforms as the main instrument to overcome the rent-seeking problem. Finally, in the fifth part we conclude.
2. **Latin America: a rent-seeking economy**

The present essay evidences Latin America as a rent-seeking region. Countries depend strongly on the exploitations of natural resources, while governments grant the right of its exploitations in exchange for bribes. Moreover, given its highest scale of return, rent-seeking sector attracts the best and brightest people, eliminating potential entrepreneurs who should create innovation, technology and added value.

To understand the rent-seeking problem and the lack of entrepreneurship in the region, we need to use the definition of “entrepreneurship” in the traditional Schumpeterian meaning. Thus entrepreneurship means the value-creating force in a competitive market where the potential for rents provides the incentive for resource owners to seek out more efficient allocations of their resources (Rajan, 1988). In the same line, Sanders (2009) regards entrepreneurship as a force of change, innovation and development, bring new and better products to markets, restore allocative efficiency through arbitrage and reinvest their profits.

Although economic theories had extensively identified technological progress as the key factor for economic growth, for these theories, technological progress is an exogenous variable, thus not analyzed properly. In contrast, Joseph Schumpeter had explained the specific mechanism by which entrepreneurship influences economic growth, through technological progress. In his framework, innovation is the central activity undertaken by entrepreneurs. In the same line, Baumol has placed emphasis on the role of individual entrepreneurs as promoters of this innovation; where institutional considerations decisively affect the allocation of entrepreneurs (Larroulet, 2009).

Liebenstein (1968) listed some characteristics of entrepreneurship, such as the ability to search, discover and evaluate economic opportunities, marshal the financial resources, be the ultimate risk bearer, search and discover new economic information, provide leadership for the group, etc. These characteristics are not exogenous, but the product of a discovery process.
On the other hand, Dietz (2007), based upon Tullock (1980), holds rent-seekers as individuals who invest in something that will not improve productivity or will actually lower it, however raise their income because it gives them some special advantage or rights, granted by the government. Rent-seeking activities may be efficient and rational from the standpoint of these individuals; but, involve a tremendous waste from the standpoint of the society as a whole. Large resources in terms of human capacity are diverted to the rent-seeking part of the government and the private sector.

Latin-American states with bureaucratic corruption are also considered rent-seeking actors Mukum (2008). This involves the paying of bribes and the use of other forms of pressure to persuade bureaucrats to grant entrepreneurs access to privileges. These individuals manipulate public policy to enrich themselves at the expense of the overall society. The state also becomes rent-seeking, imposing legal and other restraints, motivating people to spend resources in rent-seeking activities Dietz (2007). States rent-seekers also obtain a percentage of the rents.

For Graf (2002) rent-seeking is an interaction between the state and private parties, where the state has the monopoly on allocating property rights, be it by certain laws, regulations, subsidies, taxes, tariffs, import quotas or by awarding contracts in public procurement. Private firms will try to influence the decision to favor their own benefit.

In fact, in Latin America, the rent-seeking actions are presented, mainly, through two procedures: (i) activities of exploitation of natural resources, and (ii) bad practices made by corrupt officials in the government. At the same time, there is a lack of productive sectors to create value, innovation and technology to ensure sustainable economic growth rates.

Taking the criteria of World Bank (2011) which measure the rent-seeking size via the indicator of primary exports as a share of total export; the following graph shows a high dependence of the countries in the region: near 90% for Venezuela, Chile, Ecuador, Peru, and Paraguay; and above 50% for Colombia, Argentina and Brazil. These primary products are, mainly, oil, minerals, coffee, fish, soy, etc. (ECLAC, Dataset).
Dietz (2007), who studied rent-seeking in Latin America, taking Lima-Peru as case study, found out that in the region, rent activities started with the ownership of the land, while productive activities are of small scale and predominantly informal. The informal sector would be a response of a corrupt government and a formal economy that depend simultaneously on rent seeking instead of competitive markets to expand productivity. Despite the brightest are absorbed by the rent-seeking formal sector, this sector is unable to provide employment, innovation and value.

Due to the scarcity of specific works on rent-seeking of Latin American countries, below we show two cases on Paraguay and Brazil. For Paraguay Auriol et al. (2011), made a large scale micro-level analysis of rent-seeking, showing a large-scale network of favoritism between the government and privileged private rent-seekers. First, Paraguay enjoys an important source of rent from its big hydroelectric dams. The biggest one is Itaipú, in turn, the second biggest on the world. The Paraguayan government receives every year an enormous amount of royalties, equivalent to 5% of its GDP and 50% of its total government tax collection.
Those resources allow the government handles a huge public procurement system, which is the main commercial activity in the country. It grants to certain individuals the right import goods and services and then resells them to the system. However, actually corrupt officials distort rules to get bribes and allowed a few entrepreneurs that were on good terms with them to become rich. This fact shaped the growth of the Paraguayan “rent-seeking economy”, fostered a culture of intense rent-seeking and corruption. The entrepreneurs are also the ablest ones, resulting in a misallocation of talents in the economy Auriol et al. (2011).

Lovell (2005) describes a case of rent-seeking in the coffee sector in Brazil, when the International Coffee Agreement (ICA) imposed a global export quota, divided among member country exporting countries. Being Brazil the world’s largest coffee exporter, received the largest country quota. Then, Brazil created the Brazilian Institute of Coffee (IBC), in turn, establishing its rent-seeking behavior through two instruments: (i) causing exporters to compete for a part of the quota, through irregularities and bribes, and 2) making the government implement an export tax in order to capture a part of the rent.

In practice, the government captured around the third part of the rent, and the rest was captured by the private sector. This rent seeking activity reduced efforts to improve industry efficiency. In early 1990, the newly Brazilian government abolished the IBC, liberalized the sector and eliminated the export tax. Accordingly, the sector significantly increased efficiency and productivity. Today the IBC remained in the minds of Brazilians as one of the most corrupt and inefficient government institutions Lovell (2005).

Whilst some economists hold that the entrepreneurship, as any resource, is a scarce resource in developing countries like Latin America Rajan (1988); we hold a different view, that the region possesses the enough “amount” of entrepreneurship, but it is deviated toward unproductive rent-seeking activities.

The work of Murphy et al. (1991) is the first to formalize that in one country, when the best and brightest people become entrepreneurs, they improve the technology and productivity with positive and sustain effect on economic growth. Otherwise, if these talented people deviate their ability to rent-seeking activities, they only redistribute
wealth and reduce growth. Being people free, they choose occupations that offer them the highest returns on their abilities. The author evidences that in most countries, rent seeking rewards talent more than entrepreneurship does.

The most recent evidences Ebeke et al. (2011) about the deviation on the distribution of talents in 69 developing countries rich in natural resources, confirm that when the most talented people of a nation become entrepreneurs, they enable innovation and technology, leading to increased productivity and fostering the economic growth. Conversely, when they become rent-seekers, this hurts the economic growth. Thus the exploitation of natural resources causes the displacement of private agents from the most productive sectors towards the natural resource sector, inducing rent-seeking behavior, given the profitability of the rent-seeking sector Ebeke et al (2011).

The following graph shows that, in Latin-America, less than 15% of the enrolments belong to training in engineering, manufacturing and construction fields related to productive sectors, while far more, around 30% of students enroll training related to rent-seeking activities such as social science, business and law. Moreover, people who enroll rent-seeking trainings are far more dynamic than the other trainings.

**Graphic 2: Enrolments by broad field in tertiary education, in Latin-America**

Source: UNESCO
For Murphy et al. (1991) this kind of deviation of talent could be the cause of stagnation in countries from Africa and Latin America as well as could explain the development of East Asian countries. Thus, if the proportion of entrepreneurs is crumbling, technological progress slows and growth weakens. For Landes (1969), the efficient allocation of talented people in England allowed the Industrial Revolution in the eighteenth century.

Baumol (1990), Mehlum et al. (2003) and Acemoglu (1995) argued that whether energy and talent can be allocated to unproductive ends and reduce total welfare, presenting models that analyze the allocation of a given entrepreneurial talent over destructive and productive activities. Thus the predatory rent-seeking activities aim at profits, which is not only unproductive, but destructive, since reduces welfare.

Ka (2005) analysis how the endogenous career choice between productive entrepreneurship and rent-seekers can influence aggregate output. Baumol (1990) provides historical examples that the returns to rent-seeking affect the allocation of entrepreneurship. Murphy, et al. (1991) shows how agents can go to the rent-seeking and lead to a lower economic growth.

Ragnar (2001) built a simple model to explain why natural resource abundance lowers income and welfare. In that model with rent seeking, a greater amount of natural resources increases the number of entrepreneurs engaged in rent seeking and reduces the number of entrepreneurs running productive firms.
3. Toward an entrepreneurial economy: the role of institutional quality

The problem depicted above describes how Latin-America countries have consolidated a rent-seeking culture. In fact, repeated interactions between corrupt institutions and rent-seekers produce the absorption of entrepreneurs toward unproductive sectors. It is expected that more entrenched, in the way here noted, are the institutions more would be consolidated a rent-seeking society.

One of the pioneers works related to this problem evidences the improvement of institutional quality as an instrument of solution. Thus the seminal regression of Sachs and Warner (1995) shows a negative correlation between dependence on natural resources and economic growth. Then, several channels have been examined through which natural resources could undermine development. The main differences rely on the quality of institutions.

Similarly, the work of Gylfason (2001) being one of the first to empirically focus on the relationship between natural resources and education. The author showed clearly how oil-producing countries tend to have low levels of education. The author explains this result by the fact that the dependence on natural resources, such as oil or minerals, neglects the necessity of improvement in human capital.

The old question about why there still poor countries even when they are rich in natural resources? Could be reasonable answered by the work of institutions. Diverse author such as Knack and Keefer (1995) and Acemoglu, Johnson, and Robinson (2001, 2002), among others, find that higher institutional quality has a positive effect on economic growth. In the same line, Baumol (1990) hold that institutions determine the pay-offs to both types of sectors (rent-seeking and productive) and hence drive this allocation of entrepreneurs.

Ebeke et al. (2011) develops diverse econometric exercises and based on a sample of 69 developing countries highlights that oil rents determine the allocation of talents but this effect is not linear, since it depends on the quality of institutions. Thus, oil rents in
well governed countries tend to orient talents towards productive activities; while oil rents in badly governed countries tend to orient talents towards rent-seeking activities.

On the other hand, oil rich and badly governed countries are likely to fall into a bad governance quality trap due to that more talented individuals are associated with training correlated with rent-seeking activities. Thus, bad governance quality environment is regenerated by the misallocation of talented individuals, which constitute a vicious circle Ebeke et al. (2011).

Baumol (1990), Murphy et al. (1991), Mehlum et al. (2003, 2006) and Acemoglu (1995) argue how the same energy and talent can also be allocated to unproductive ends and reduce total welfare of the society. Given that entrepreneurs can choose between productive ventures that increase total welfare and rent-seeking activities. For them institutions may avoid that a rent-seeking behavior could reduce the incentive to engage in productive ventures.

In fact in Latin-America, due to the absence of institutions of good quality, entrepreneurs abandon the productive sectors to engage in rent-seeking activities. This diversion from the productive sector leads to a decline in productivity throughout the economy of the region, in turn, leads to lower growth. Therefore, its natural resources are not a blessing, since they are not based on good quality of the institutions Mehlum et al. (2006).

According to the Global Entrepreneurship Monitor (GEM) indicator, Latin America has higher levels of entrepreneurship than the European Union, Asia, and North America. Notwithstanding, for Larroulet (2009) these higher levels not necessarily imply an efficient allocation of entrepreneurial talent, since some agents decide to allocate their entrepreneurial talent to unproductive activities. He holds that institutional factors are central to solve this problem in the allocation of talent.

Contrary, concerning World Bank (2011), there have been many instances in the Latin-American history when natural resource rents motivated corrupted institutional control. At the core of the institutional story is the potential for large and volatile rents from minerals and oil, to corrupt the political process, leading rent seeking.
Fortunately, there is an improving of the literature and indicators related to institutional quality. The following graph shows a comparison between Latin-America and OCDE's institutional quality, depicting a big gap, according to this Worldwide Governance Indicators (WGI), developed by the World Bank; the institutions of the region have a quality around 50%; while those of the OCDE countries are above 90%. The same result is offered by each indicator such as control of corruption, voice and accountability, political stability, government effectiveness and rule of law.

Graphic 3: comparison of institutional quality between Latin America and OCDE

Baland and Francois (2000) allow us to understand why the region is persistent in rent-seeking rather than in productive activities, even in situations of natural resource
booms, considering the relative importance of the rent-seeking sector in productive activities before booms. Thus if productive activities were more important than the rent-seeking ones, the productive sector will succeed in capturing this rent and there will be a dilution of rent-seeking activities. Otherwise, the activities of rent-seeking will be more important and persistent.

To overcome that, institutional setting must circumvent such behavior. Therefore, institutional reform is strongly suggested to prevent it. However, it is important to consider that the problem with that strategy is that institutions are not so easily built up or changed. Thus, if strong and wrong institutions exist and allow bad behavior, they are also likely to persist. From an institutional perspective, it is argued that institutions are largely historically determined, explaining in turn the persistence of bad institutions.

For Sanders (2009), even if the proper institutions are absent or weak it is not easy to just build the proper ones overnight. Therefore, in such a context pre-existing institutions have broken down and entrepreneurial talent can turn into a truly destructive force. Obviously institutional recovery helps. That should help to improve matters and help the economy move to productive entrepreneurship equilibrium.

In fact, although our proposal of institutional reforms as solution to the problem of deviation of entrepreneurship seems simple and overwhelming, however these measures require probably certain long time and its benefits could be also for the long term. The way most appropriated that emerges from the studies related to the solution of rent-seeking is to catch-up standards of institutional qualities, such as those from the OCDE countries.
4. Conclusion

Latin-America countries pose a rent-seeking culture. These economies depend strongly of the exploitation of natural resources such as oil, gas, minerals, etc. In consequence, the economic activities are, mainly, explained by these activities. In general more than 50% of export income and tax income come from natural resources exploitation, but not competitive markets. Yet, this sector does not allow creation of value, innovation or technology, therefore does not improve neither the productivity nor the sustainable economic growth. Worse, having the highest scale of return, therefore attract the best a brightest people, who being free of their choices, select the sectors which offer the highest profits or salaries.

In the region, the governments also pose a rent-seeking behavior due to its interaction and dependency with the private rent-seekers instead of the productive and competitive part of the economy. The government receive huge amount of resources from the rent-seeking sector, via inefficient taxes, for instance. At the same time, corrupt officials continuously shape the law in order to benefit its network of private comrades in exchange for bribes. The repetition of this process fosters the deviation of the best and brightest people to rent-seeking activities and therefore wastes resource to promote competitive sectors, which are able to create innovation and technology.

Diverse quantitative researches have determined the quality of institutions as the main tool to transform a society from a rent-seeking behavior toward and entrepreneurial one. However, given that institutions are built through a historical process both change and creation of new institutions symbolize a long-lasting work. In the present essay, we propose to improve the quality of the institutions in Latin America, through a process of catching up those of the OCDE countries, starting with aspects such as: regulatory quality, control of corruption, voice and accountability and so on.
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