



## Real-Estate Entrepreneurship from Baumol's Productive and Unproductive Typology: A Contestable Markets Approach

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### Abstract

The role of innovation in economic development has long been a topic of discussion among economists. Despite that, the economic pay-off mechanisms which support or hinder innovative entrepreneurial acts, particularly in the emerging economy context are significantly underexplored in academic studies. In this study, we aim to fill this important gap in the literature by taking Baumol's contestable markets theory and the typology of productive and unproductive entrepreneurship. As Baumol has advocated, the economies that offer higher pay-offs to productive entrepreneurial acts are more likely to thrive mainly due to the increased capacity of economic growth, while developing and poor economies struggle. In this study, we posit that in the developing and emerging market contexts, formal policies are claimed to prioritize the production of more innovative and productive start-ups and a climate that supports and fosters productive entrepreneurial acts. Despite that, there are still major administrative, social and cultural barriers towards creation of innovative start-ups and a productive entrepreneurship ecosystem. Here, continuing political, economic and social support towards unproductive entrepreneurship acts, in particular real-estate entrepreneurship emerges as one of the main factors that hinder the flow of funds towards innovation and technology. We thus argue that, being unable to balance the role of these unproductive entrepreneurial acts with productive ones in economy significantly deteriorates the sustainable economic growth and a high standard of living in emerging and developing economy contexts. In the implications section, several precautions and support mechanisms for overcoming the barriers towards productive entrepreneurship are presented and discussed.

**Keywords:** Entrepreneurship, Real-Estate Entrepreneurship, Baumol, Baumol's Productive and Unproductive Typology, Emerging Market



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# Real-Estate Entrepreneurship from Baumol's Productive and Unproductive Typology: A Contestable Markets Approach

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## I. Introduction

Today, although entrepreneurship is increasingly recognized as a more important channel for success, there is still limited knowledge about how entrepreneurship can foster economic growth and development. Transformation into sustainable products and processes is gradually turning into a structure that advocates entrepreneurship as a living space. However, the question of how entrepreneurship acts in promoting sustainable development involves many unknowns.

The acceleration of digital destruction brought along difficulties for incumbent firms to adapt. Top Fortune 500 profitability ratios show that today's profitability rates of most firms are higher. It is a fact that newcomers are of course growing very fast. Some creative destruction has indeed taken place in technology, media, and retail. Other major industries outside of these sectors have not faced similar devastation, thanks to a series of barriers that include high switching costs, economies of scale, trust, and regulation. Particularly with COVID-19, the notion of productivity began to be discussed rather than whether the entrepreneurial activity was innovative or repetitive, as the pandemic drew higher attention to the importance of institutions on entrepreneurship. This discussion was first brought to the spotlight with the original paper of Baumol (1990) and is considered as an important contribution to the entrepreneurial economics literature. After this seminal work, many articles defending this perspective appeared (Sobel, 2008). According to Baumol, it is assumed that entrepreneurial individuals direct their efforts in different directions depending on the quality of the prevailing economic, political and legal institutions. This institutional structure determines the relative reward for investing entrepreneurial energies in productive market activities versus unproductive political and legal activities (for example, lobbying and litigation). Good institutions maintain higher rates of economic growth, directing efforts towards productive entrepreneurship.

Baumol's productive entrepreneurship is parallel to the Schumpeterian definition of entrepreneurship and can be thought of as a broader

definition meaning 'realization of new combinations' (Baumol, 1990). Baumol's 1990 article, one of the most cited articles in the entrepreneurship literature, focused on the impact of the macroeconomic environment on entrepreneurship. Baumol argued that market economies benefit from the innovation that was initially developed. Then, the existence of a sufficient number of replicative entrepreneurship which acts as diffusers of innovation comes into play. In the entrepreneurship typology defined by this study, the quality of institutions is associated with the distribution of different types of entrepreneurial activity. The contribution of Baumol is accepted as a milestone in the field of economics (Minniti, 2016). This unique outlook towards entrepreneurship is in convergence with the living standards and economic development observed in developed countries. However, how the productive and unproductive nature of entrepreneurial acts impact the realization of entrepreneurial policies in developing economies remains to be underexplored in the literature. Thus, the main purpose of this study is to argue Baumol's point of view in terms of the rapidly changing financial conditions of today's global economy, and in particular the growth and development trajectories of emerging market economies.

## II. Baumol's Theory of Contestable Markets

For over 400 years, economists have contributed to the theory of entrepreneurship. Cantillon (1755) defined entrepreneurship as taking on the individual financial risk of a business. In 1848, Mill defined the entrepreneur as the person who assumes the risk and management of an enterprise and thus makes an implicit contribution to its operation and other business. In 1947, Schumpeter linked entrepreneurship with the creation of a novel product or service and defined the role of the entrepreneur as innovation. Since the 1960s, many economists have implicitly positioned entrepreneurship under technological innovation. As an exception, Baumol defined entrepreneurship as the center of the entrepreneurial market.

The socio-economic factors and the features of the entrepreneurial ecosystem in advanced and emerging economy contexts have to be separately explored for understanding the factors which may encourage or hinder entrepreneurial and innovative activities in different contexts. While trying to explain economic growth and productivity, Baumol defines productive entrepreneurship in terms of Gross Domestic Product (GDP) per capita as a cornerstone of economic growth. Sustainable growth reveals the necessity of technological advances and the use of new products and processes by all companies. Innovations are rarely watched in isolation or kept secret, and when there is pressure on firms to innovate, sharing this information enables all firms to benefit more from this larger investment pool (Baumol, 2000). He gives the examples of IBM and Toshiba, talks

about the synergy that comes from being aware of someone's innovation portfolios, and explains their strategizing at the top of their strategic initiatives in contestable markets (Baumol, 1982).

Competitive markets, which is an unknown but developing area of economic theory, are defined in the entrepreneurship and management literature as a market with a small number of established firms and at the same time a high degree of competition with short-term potential entries. The main features of this market are an environment where new entrants compete with the established ones, and in fact, this is one of the markets that explains today's markets the most. This market has three features: There are no barriers to entry and exit, no sunk costs, and all companies have equal access to all levels of technology. Although today's digital economy offers the opportunity to have no or low costs, new companies that do not have sufficient knowledge and technology face higher average costs and compete more difficult. Otherwise, we can say that very few markets are fully competitive. For example, the steel industry in the USA is an example. With the entry of small steel companies and the low-cost carriers and regulations in the seventies and eighties, the airline industry has also become a highly competitive market. Therefore, in the contestable market theory, the structure of the industry and the sector is determined endogenously by the strategic decisions of the firms. Baumol explains that beyond the industrial organization, pricing and production decisions are completely dependent on the market structure through competition. This logic enables us to better understand the bipolar world under the contestable markets and short-term entrepreneurial rents that innovative entrepreneurs face.

Another issue on the industrial organization is the cost disease approach. This approach argues that differences in productivity also have implications for strategic entrepreneurship. Manufacturing in some industries or sub-sectors while there is potential for sustainable long-term productivity growth in the long run, while in others such as art, it may be difficult to increase productivity significantly. In the long run, this asymmetry reveals that there are industries that fail to increase their productivity. While prices related to surgery procedures increase, automobile prices may not increase, as a result, the demand for output either decreases over time in sectors with low productivity or its share in the total expenditures of the consumer is increasing.

The role of the entrepreneur is more important and different for the case of SMEs. It is very important to understand not only the logic of disruptive innovation but also the fundamentals of the sectoral structure and competitive advantage. In this regard, the paper by Carree and others (2002) examined the relationship between business ownership and economic development and found a long-term equilibrium relationship between economic development and business ownership. One of the policy recommendations suggested by this study is to ensure dynamic entrepreneurial competition, to guarantee free entrepreneurial venture in any market, to ensure the existence of single opportunities, and to ensure financial burdens at the exit. The study suggests three perspectives: First business ownership equilibrium ratio is related to which stage of economic development, second what is the speed of convergence to equilibrium,

and thirdly, what is the deviation from the equilibrium rate? According to the findings of the study, business ownership in European countries attracts policymakers since limited economic growth and high unemployment rate in the post-war period. On the one hand, it has shifted from the new competitive European Union markets to low-cost Asian and central and eastern European countries. New inventions in the field of telecommunications and computers were the main reason for this. The capital and knowledge shifted to lower-cost locations around the world (Audredtsch & Thurik, 2000). The underdeveloped countries' focus on investment for technical efficiency, without taking into account market needs and the building of (dynamic) managerial capabilities, is limited for economic growth and prosperity in development. The capabilities approach has endless consequences in this regard. While the studies analyzing the relationships between innovation, technology, and development are increasing, there is still a need for studies that include a more complete model of the underlying factors, taking into account issues such as firm heterogeneity, the innovative performance of firms and productivity growth in the economy (Teece, 2019).

### III. Baumol's Unproductive and Destructive Entrepreneurship

The role of the entrepreneur has long been discussed within the theory of entrepreneurship (Minniti, 2016). For instance, according to Say (1803), the main role of the entrepreneur in the economy was value creation through directing resources from unproductive to productive activities. According to Schumpeter (1947), an entrepreneur is the source of creative disruption and innovation, making the existing products and markets obsolete.

Following their footsteps, Baumol (1990) in his seminal paper advocated that entrepreneurship is not always productive, but can be unproductive or even destructive (such as criminal acts) under certain circumstances. Here, he differentiated between the aggregate supply of entrepreneurs in an economy and the allocation of these individuals regarding their direction towards unproductive and productive activities (Minniti, 2016). Baumol built his propositions of this differentiation on the historical progress of entrepreneurial activity, holding that the innovativeness of an economy, together with the dissemination of technological innovations are strongly influenced by the productive or unproductive nature of entrepreneurial acts. Here, he argued that an entrepreneurial activity that does not contribute to increasing the productive capacity of the economy and wastes the entrepreneurial potential of an individual is unproductive. He also advocated that while entrepreneurial talent exists in every part of the world, whether that talent will be directed towards productive or unproductive, and even destructive activities is largely influenced by the social and economic payoff dynamics (Eliasson and Henrekson, 2004).

Baumol (2010) gave lawsuits and/or takeovers as examples of rent-seeking behavior, combined them with tax evasion, and smart financial operations (eg arbitrage), finally categorized them all together as unproductive entrepreneurship. He discussed that while all these acts are legal, they have zero or very low contribution to the total productive capacity of the

economy. Another main criticism that he mentioned was the wasted entrepreneurial talent diverted to these unproductive activities. What he proposed as solutions to this problem were first, modifying the rewards and relative pay-offs in such a way that they will be productive, serving the society as a whole. According to Baumol, since the total supply of entrepreneurs or the propensity of a population for entrepreneurship in different geographical locations can not be changed, the only mechanism to manage the entrepreneurial talent would be changing the pay-off or incentive structure gained from entrepreneurial acts, by the administrators or the society as a whole (Minniti, 2016). For example, limiting the legal processes and financial gains from the litigations is one of his proposals, which could potentially discourage the entrepreneur from entering into such an act. His second suggestion was to redefine the entrepreneurial goals towards more productive ones and reallocate the resources and efforts accordingly.

#### **IV. Real-Estate Entrepreneurship: Productive or unproductive?**

Real estate is an important real asset. In regards to institutional investors, it is a good diversifier and better inflation hedge than most financial assets (Illmanen, 2020). Within the last decades, private and institutional investors have been investing vast amounts of capital to residential real-estate markets, due to the increasing global housing prices (Knoll et al., 2017). From Baumol (2010)'s productive and unproductive entrepreneurship perspective, one detrimental factor hindering innovative entrepreneurship, particularly in emerging market economies can be discussed as "real-estate entrepreneurship". Housing wealth is the largest component of national capital stock (Jorda et al, 2019) as in a typical economy it comprises around one-half of cumulative national wealth (Piketty et al., 2014). Findings of the studies by Jorda et al (2019) for the 1870-2015 period in 16 advanced economies showed that concerning total returns, the highest total gains have been received from residential real estate both in real and nominal terms, making it "the best long-run investment over the course of modern history". The rate of returns in the real estate sector has long been attracting the interest of investors not only in advanced economies but emerging markets, as well. Although the real estate sector is a fast-growing aspect in terms of high market value and land stock, especially with real estate investment trusts, there are several aspects to be criticized. One of these negativities is regarded as society's welfare being compromised, as the urgent expropriation decisions, which have become standardized might make many people suffer. Although the main purpose seems to be public interest, when the projects implemented by the state with the urgent expropriation method are examined, it is thought that this purpose has deviated when the results of the project are not adequately expressed by the administration to the benefit of the public (Soyarat, 2017).

Real estate entrepreneurship is a special form of venturing (Linnemann, 2007). Besides being highly capital intensive, residential real estate and construction are traditionally known as low-innovative industries (Kung, 2020). While real-estate entrepreneurs can be present in every part of the globe who financially aim to

exploit the opportunities present in real-estate markets and benefit from other socio-cultural aspects, the flow of limited savings towards a less risky and potentially more promising investment area can be a major limitation for founding and growing new entrepreneurial ventures, where capital is a requirement both in start-up and growth phases. Any individual who has the plan to establish an innovative start-up can be discouraged both by the relatively higher returns of the real-estate sector and the other risk factors in these developing economy settings, negatively impacting the survival of the new venture. Studies show that only one in ten new businesses can continue their existence during the first three years of establishment (Bednar and Tariskova, 2017). Thus, having a more guaranteed and less risky investment alternative can cause the extra funds of institutions and individuals to be spent on buying and selling real estate where the historical trend of returns is highest.

Research studies indicate that the economic returns and the social norms greatly influence the investments flowing towards the real-estate sector, particularly in emerging economies, leaving the innovative new ventures with less and fewer amounts of start-up and growth capital. In unproductive entrepreneurship, the sole focus of the entrepreneur is to develop new forms of rent-seeking (Minniti, 2016). Thus, analyzed from Baumol's typology, real-estate entrepreneurship can be classified as "unproductive" for any type of economy. As the real-estate sector has very low innovativeness capacity, the opportunity cost of not using these funds for supporting new and promising tech startups is considerably high, particularly for developing and emerging economy contexts. Empirical findings support this argument. For instance, Li and Wu (2014) advocated that in China, "a prosperous real estate market may have a negative impact on entrepreneurship for people who have accumulated certain amount of wealth" and found empirical support for a negative relationship between housing prices and entrepreneurial activity in that context. The researchers found that increasing housing prices rise the attractiveness of house purchases compared to starting a new business, due to both financial and socio-cultural reasons, stating that in China, the societal regard towards having a house or land is very high (Li and Wu, 2014). Similarly, a recent study focusing on the real-estate value increases in Turkey has shown that the real-estate sector is the most advantageous sector to invest in, compared to financial markets (Bayraktar, 2019). Another major advantageous element favoring real-estate investment against other alternatives in Turkey is the lack of taxation auditing in the real-estate sector. This inadequate and disproportional taxation practice is indicated in the public policy reports, stating that the real-estate sector has the smallest share of tax income in Turkey. The society's approach towards real-estate investments in this context is similar to China, as the public shows great respect towards real-estate ownership. For these reasons, it is a general practice in Turkey to invest funds in various real-estate alternatives, such as residential, commercial, and land purchases, rather than other financial alternatives such as bank deposits, stocks, or venture capital.

## V. Innovative Entrepreneurship: The True Path Towards Economic Development

While the role of the entrepreneur in the economy has been a topic of discussion among scholars for centuries, Schumpeter (1947) was the first to introduce the idea of creative destruction. Schumpeter stated that the innovations that emerged in economic life constitute "a balance within the imbalance" in terms of economic balance. Thus, entrepreneurship, in his regard, is presenting innovation to the market. It is a phenomenon that activates the industrial dynamics that disrupts the existing balance, challenges existing structures by creating differences. Therefore, the basis of Schumpeter's analysis of capitalist economic growth dynamics is freedom, money or innovation supply and entrepreneurship and structural competitiveness based on innovation taking place rather than the supply-side consequences of taxation. At this point, due to entrepreneurs who cannot innovate, companies' competitiveness might decrease, thus the process of creative destruction in economic life will cease to exist. At the same time, this modern entrepreneurial state, enacting patent laws, utility models and trademark applications for the success of entrepreneurship and innovation can make significant contributions to economic development (Kitapçı, 2019). Thus, any potential negative effects of creative destruction from innovation can be reduced.

In his seminal book "The Microtheory of Innovative Entrepreneurship", Baumol defined an innovative entrepreneur as an individual generating and realizing new ideas and analyzes the important role of innovative entrepreneurship on the economic growth and development of a society (Baumol, 2010). According to Baumol, one can differentiate between innovative and replicate entrepreneurship, where the former entails introducing novel products and techniques to the market (Minniti, 2016), whereas the latter refers to diffusing the innovative products, services, and processes once they have been created and they are accepted by the markets. He further developed this perspective of the innovative entrepreneur in his contestable markets theory, where he mentioned that entrepreneurs are obliged to keep the flow of unique services and products for maintaining the entrepreneurial rents they are seeking, thus are not some random contributors of new products and service development activities. Within this approach, the uncomputable and unplanned nature of innovative entrepreneurship is also highlighted (Koppl, 2008).

How innovation would affect economic growth has also been a major topic of discussion among economists (Hasan and Tucci, 2010), and several models are introduced to the literature, showing that industrial innovation practices are major factors influencing economic growth, stemming from their direct role on the process of production and positive externalities (Romer, 1990; Stokey, 1995). According to Baumol (2002), historically, innovative entrepreneurship has been the key driver of industrialization and a free-market economy, leading to economic development and prosperity. Recent empirical findings support his view. For instance, in their analysis on 58 countries between 1980 and 2003, Hasan and Tucci (2010) found that the quantity and quality of innovative activities, in particular patents, are positively linked with economic growth. As the theoretical models

backed with empirical findings indicate, innovation has a strong impact on economic development and prosperity. For this reason in every type of economy, policymakers are aiming to foster "innovative entrepreneurship", which is closely linked with socio-economic development. In Baumol's view, the pressure caused by intense competition in free markets would encourage innovative acts thus would lead to increased productivity, taking an economy's production possibility frontier further (Baumol and McLennan, 1985). Increasing the number of activities entailing new/product-service development mainly through advanced technologies thus should be regarded as a priority particularly in emerging and developing economies. Baumol himself has highlighted the vital need for increased innovative entrepreneurship activities in poor and developing economies, stating that these economies can only make breakthroughs and change productivity levels and per capita income by innovation and technology (Minniti, 2016). While this is the case, in most emerging economies, the pay-off structure of unproductive entrepreneurial and economic acts remains to be positive, generally supported by indirect governmental incentives, such as inadequate controls and taxation mechanisms, backed up with social norms and acceptances.

## VI. Conclusion

In today's postmodern global capitalist world, Schumpeter's (1947) views on entrepreneurship and innovation come to the fore again. With the modern economies becoming more complex, building appropriate systems for supporting and nurturing the climate for producing more innovative entrepreneurs became the only path to productive and fair economic development. According to Schumpeter, the state should not only be a tax-collecting structure but a modern entrepreneurial state that establishes and transforms economic life.

Following his initial giant steps, Baumol carried the role of the government for entrepreneurship further and made a breakthrough with his contestable markets theory and the notions of productive and unproductive entrepreneurship. Baumol advocates that underdeveloped and emerging economies can only prosper if the administrators and the society as a whole possess and sustains the pay-off mechanisms that would encourage innovative and productive entrepreneurship and discourage unproductive entrepreneurship. Unfortunately, while the advanced economies have succeeded to build both formal and informal support systems for innovators and their start-ups, emerging economies are still struggling in this regard.

Historically, the trend toward investing in real-estate markets due to several economic and socio-cultural benefits is observed throughout the globe. However, while the advanced economies have succeeded in balancing the relatively unproductive entrepreneurial acts, solely targeting economic rents, with productive and innovative new venture foundations, in most emerging economies, most funds are still spent in land and residential real-estate purchases. Interestingly, while the public policies developed and announced in these contexts are said to create the flourishing of innovation and technology, there are still underlying administrative mechanisms that help to sustain the majority of investments flowing to the real-estate sector. This study,

therefore, aims to shed light on this discrepancy between the wishful policy-making and the harsh reality between real-estate and start-up investments, hampering a healthy, strong, and sustainable socio-economic development.

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