




Do interactions between formal and informal institutions matter for productive entrepreneurship?

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Abstract

Motivation: Institutional and Entrepreneurship theory pays attention to institutions and their influence on productive, unproductive and destructive entrepreneurship in transition economies. However, according to the literature, it is not only institutions that matter for productive entrepreneurship, but also the interaction between formal and informal institutions. Moreover, transition economies needs the productive entrepreneurship ‘to catch-up’ with world leaders.

Aim: The aim of this paper is to advance institutional research through the development of a better understanding of the relation between formal and informal institutions and their influence on productive entrepreneurship in transition economies like CEECs.

Results: The paper demonstrates that strong formal and informal institutions, the ‘invisible hand’ of the state, as well as the complementary and accommodating relations between formal and informal institutions are necessary for productive entrepreneurship in transition economies.

Keywords: *formal and informal institutions; productive entrepreneurship; transition economies; institutional asymmetry, interplay between institutions*

JEL: D02; L26; O17; P37

1. Introduction

Entrepreneurship is one of the most important factors of the economic growth (Acs et al., 2008; Baumol, 1990, 1993; Wennekers & Thurik, 1999), especially in transition economies, like in Central and East European Countries (hereinafter CEEC¹), which want to ‘catch-up’ with world leaders. However, only productive entrepreneurship such as innovation lead to economic growth (Baumol, 1990), and unproductive entrepreneurship such as rent seeking or destructive entrepreneurship such as organized crime may lead to underground economic activities (Feige, 1997). Moreover, according to McMillan & Woodruff (2002, p. 168), equally important are entrepreneurs who act in the transition economies as ‘reformers’ of ways the business is done.

The concept of the importance of institutions for productive entrepreneurship has its theoretical basis in New Institutional Economics. Institutions matter for entrepreneurship because they define the entrepreneurial capacity of each nation (North, 1990), as well as reduce uncertainty, transaction costs (Williamson, 1979) or provide conditions for productive entrepreneurship (Baumol, 1990, 1993). Moreover, not only do the institutions matter, but also the interaction between them is crucial for the support of productive entrepreneurship (Williams et al., 2017). However, investigations into the interaction between formal and informal institutions in the context of productive entrepreneurship in transition economies, which may have different forms and strengths, are significantly less frequently undertaken by scholars. This article attempts to fill this gap.

Central point of this paper is to present the results of institutions and entrepreneurship literature review. The main subject of interest concerns the development of a better understanding of the relation between formal and informal institutions and their influence on productive entrepreneurship, in the context of transition economies, like CEECs. This paper provides an understanding of how formal and informal institutions, the ‘invisible hand’ of the state, as well as the relations between formal and informal institutions may influence the productive entrepreneurship of CEECs. Moreover, full congruence between formal and informal institutions is very rare in institutional practice. Instead of congruence, the institutional asymmetry was observed between formal and informal institutions.

2. Institutions and productive entrepreneurship in the context of transition economies: literature review

Institutions are defined by North (1990) as any form of constraint that shapes human beings’ interaction. North (1990) distinguishes between formal and in-

¹ CEECs is an OECD term for the group of countries comprising Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, Slovenia, Estonia, Latvia and Lithuania.

formal institutions. Formal institutions such as: formal rules, laws or constitutions are the visible ‘rules of the game’ enforced by governments. Informal institutions such as: constraints, customs, norms or culture are the invisible ‘rules of the game’ which are not legally enforced (North, 1990). Although not all scholars accept such definitions or distinctions between institutions², in recent years there has been an enormous number of scientific publications concerning formal and informal institutions (see table 1), but a limited number of publications concerning interactions between institutions in the context of productive entrepreneurship and transition economies. Institutions (formal and informal) interact with each other ‘in a variety of ways’ (Helmke & Levitsky, 2004, p. 728). This variety of interactions explains, according to Chavance (2008), the multiplicity of CEECs’ transformation process pathways.

The CEECs, due to their communist past, didn’t inherited from centrally planned systems entrepreneurship culture (Peng & Heath, 1996). The majority of CEECs, which started the transformation process in the 90s, were lacking the necessary business infrastructure with the supporting formal and informal institutions (Aidis, 2005). Moreover, according to McMillan & Woodruff (2002, p. 166), entrepreneurs play a central role in transition economies because of ‘the welfare effects of entrepreneurship’, like the creation of new jobs.

Furthermore, productive entrepreneurship requires not only strong and stable formal institutions (Baumol, 1990), but also strong informal constraints (Sauka & Welter, 2007). Productive entrepreneurship refers ‘to any activity that contributes directly or indirectly to the net output of the economy or to the capacity to produce additional output’ (Baumol, 1993, p. 30). In addition, Aidis (2003), argues that in transition economies productive entrepreneurship is associated with individual ability and the willingness to find and use opportunities that will give economic growth.

Formal and informal institutions provide a variety of opportunities and incentives for entrepreneurs. If incentives promote productive entrepreneurship, entrepreneurs will adapt their activities to these opportunities. However, when the costs of illegal economic activities or rent-seeking behaviour are much lower than possible profit, entrepreneurs may engage in destructive or unproductive entrepreneurship (Aidis et al., 2008).

The literature, in the context of transition economies, highlight the existence of productive (Frye & Shleifer, 1997; Sauka & Welter, 2007; Wennekers & Thurik, 1999; Williams et al., 2017), unproductive (Aidis et al., 2008; Feige, 1997; Williams et al., 2017) as well as destructive (Chilosi, 2001; Shleifer & Vishny, 1993) forms of entrepreneurial business activities.

In addition, the transition process of CEECs highlight that institutions matter for productive entrepreneurship (Williams et al., 2017). However, according to Aidis (2003, p. 52), ‘in transition economies productive entrepreneurship cannot be taken for granted’ because in centrally planned systems entrepreneurial activities were focused on rent-seeking behaviour, which leads to unproduc-

² See for example: Hodgson (2006) or Voigt (2012).

tive and destructive entrepreneurship (Feige, 1997). According to the literature, it is not only institutions that matter for productive entrepreneurship, but also the interaction between formal and informal institutions, and the interplay between institutions determines the nature of productive entrepreneurship (Williams et al., 2017).

Finally, institutions influence the entrepreneurs' payoffs and allow for effort allocation between productive and unproductive entrepreneurship (Minniti, 2008).

3. Methods

This paper compares the theoretical and empirical achievements of New Institutional Economies with Entrepreneurship Theory in the context of transition economies like CEECs. Institutional theory pays attention to institutions and their influence on productive, unproductive and destructive entrepreneurship in transition economies (Aidis, 2003; Williams et al., 2017). In order to fulfil the aim of this paper Boolean keyword and subject term searches of Emerald, Google Scholar, JSTOR, ProQuest and Scopus databases were performed by using search phrases reflecting the phenomena of Boolean search operators such as AND, NEAR and PHRASE between 25 and 30 June, 2018 and between 8 and 11 January, 2019.

The coexistence of the different interactions between formal and informal institutions in the context of transition economies and productive entrepreneurship was investigated. This allows the author, by using a detailed literature review, to demonstrate the specificity and the variety of relations between formal and informal institutions which may support, replace or undermine each other, as well as may influence the nature of entrepreneurship. The distribution of the search phrases in the Boolean search is presented in tables 1 and 2.

4. Results: interaction between formal and informal institutions in the context of transition economies

In the literature on the subject there is a lack of a consensus about the relation between formal and informal institutions. Some scholars, like Axelrod (1986, p. 1107) or McAdams (1997), highlight that informal institutions reinforce (complement) formal ones such as, for example, property rights. Other scholars, like Böröcz (2000, pp. 351–352) or Williams et al., (2017), stress that informal institutions undermine formal ones such as, for example, corruption or clientelism. While Pejovich (1999, p. 170), as well as Grzymala-Busse (2010) and Helmke & Levitsky (2004) consider four different type of interaction between formal and informal institutions. However, Pejovich (1999) focuses on formal institutions and their impact on informal ones, while, Grzymala-Busse (2010) and Helmke & Levitsky (2004), focus on the informal institutions and their im-

impact on formal ones. Pejovich (1999) distinguishes four types of interaction between formal and informal institutions: (1) formal institutions suppress informal ones; (2) formal institutions conflict with informal ones; (3) formal institutions are neutral to informal ones or ignore them, and (4) formal institutions cooperate with informal ones. Meanwhile, Helmke & Levitsky (2004) differentiate: (1) complementary informal institutions; (2) competing informal institutions; (3) accommodating informal institutions and (4) substitutive informal institutions. In addition, Grzymala-Busse (2010) following Helmke & Levitsky (2004) typology of informal institutions similarly distinguishes four types of interaction, i.e.: (1) informal institutions replace formal ones; (2) informal institutions undermine formal ones; (3) informal institutions support formal ones, and (4) informal institutions compete with formal ones.

4.1. Informal institutions support formal ones and vice versa

Informal institutions have, according to Czech (2014, p. 317), ‘the greatest power to shape social order’ and may use this power for the reinforcement of formal rules that favour productive entrepreneurship such as commercial law, bankruptcy law, the law of contracts, antitrust law or the judicial system (Chilosi, 2001).

Helmke & Levitsky (2004) highlight that informal institutions may reinforce formal ones by being complementary or accommodating. Complementary informal institutions ‘fill in gaps’ either by addressing contingences not dealt with in the formal rules or by facilitating the pursuit of individual goals within the formal institutional framework, as well as serve as the foundation for formal institutions (Helmke & Levitsky, 2004, p. 728). On the other hand, accommodating informal institutions alter the effects of formal institutions without violating them, as they contradict the spirit of formal institutions (Helmke & Levitsky, 2004, p. 729). Grzymala-Busse (2010, p. 311) argues that ‘the elite competition generated by informal rules’ influences which interaction between informal and formal institutions will dominate. Informal institutions may support formal ones by ‘defining and expanding’ formal institutions’ domains or by ‘providing incentives and information to follow formal institutions’, like, for example, informal sanctioning or reporting to formal authorities about all non-compliance with formal rules (Grzymala-Busse, 2010, pp. 311, 318).

Pejovich (1999, p. 170) highlights another point of view and stress the opposite relation between formal and informal institutions, and argues that formal institutions might ‘suppress but cannot change informal institutions’. Moreover, formal institutions may try to ‘institutionalize’ informal institutions, in order to better cooperate with them (Pejovich, 1999, p. 170). In such situations, formal institutions may support informal ones, like the development of property rights (Williamson & Kerekes, 2011), or national corporate governance codes may comply with the business codes of listed companies, or with shared values among these companies (Godlewska & Pilewicz, 2018).

4.2. Informal institutions replace formal ones and vice versa

Informal institutions substitute formal ones in situations when formal institutions fail (North, 1990). Moreover, substitutive informal institutions ‘achieve what formal institutions were designed, but failed to achieve’, and emerge where formal institutions are weak or there is a lack of enforcement (Helmke & Levitsky, 2004, p. 729). For example, informal institutions may replace formal ones in resource distribution via family and personal networks like clientelism, charity or nepotism (Grzymala-Busse, 2010, p. 318).

On the other hand, McAdams (1997, p. 346) argues that formal institutions might replace informal institutions like, for example, law that made seat belt use mandatory in the United States.

4.3 Informal institutions undermine formal ones and vice versa

Transition economies like CEECs inherited from the communist past weak informal institutions, such as a ‘soviet-style corruption, a culture of non-compliance, employee theft, distrust of the government, and a highly skewed distribution of wealth and information’ (Aidis, 2003, p. 31). Moreover, Helmke & Levitsky (2004) highlight that informal institutions may undermine formal ones by competing with them. This may happen when formal institutions are not enough enforced, and outcomes are divergent. Furthermore, according to Grzymala-Busse (2010), informal institutions may undermine formal ones by exploiting loopholes of formal institutions, for example by using clientelism, patronage, or subletting and subcontracting, as well as directly contravening formal rules and eroding them by paying bribes instead of using a legal system. Weak informal institutions like corruption, tax evasion, clientelism, patrimonialism or clan politics (Aidis, 2003; Böröcz, 2000; Chavance, 2008; Helmke & Levitsky, 2004) undermine the power of formal institutions. Furthermore, when informal institutions undermine formal ones, the transaction costs will rise, and that will diminish the establishment of potential new business transactions and the creation of wealth in the society (Meyer, 2001).

However, Pejovich (1999, p. 170) argues that formal institutions are ‘in direct conflict with informal rules’, like in the ‘religions market’ in Russia, where the law is used to restrict voluntary changes in informal rules. In such case formal institutions tend to undermine informal ones.

4.4 Institutional asymmetry

Institutional asymmetry takes place when formal institutions do not support informal ones and vice versa, in the form of ‘misalignment between formal and informal institutions’ (Williams et al., 2017, p. 7). In such cases entrepreneurial activity will be diminished (Williams & Vorley, 2015) and informal institutions will not create and strengthen incentives to comply with formal institutions (Baumol, 1990; North, 1990). Moreover, entrepreneurs in transition econo-

mies with a weak formal institutional environment have to deal with unstable regulations, which influences their effectiveness (Williams et al., 2017).

Williams et al. (2017) and Williams & Vorley (2015) argue that institutional asymmetry (depending on the economic development level of each country) may cause the following consequences for productive entrepreneurship: (1) decreasing the ambition of entrepreneurs; (2) limiting the results of start-up programmes; (3) initiating difficulties with a culture averse to entrepreneurship; (4) skepticism of the wider public toward entrepreneurs; (5) poor perceptions of the opportunities and the ability to act on them by entrepreneurs.

In addition, institutional asymmetry due to limited congruence between formal and informal institutions in transition economies like Poland, Bulgaria, Croatia, Ukraine or Russia has undermined their entrepreneurship (Lubacha-Sember & Godlewska, 2018; Williams et al., 2017; Williams, 2008). Furthermore, the ‘grabbing hand’ of the state and the institutional environment may hamper entrepreneurship if the government is above the law, the legal system does not work, and the state uses its power to extract rent and introduce predatory regulations for doing business, or introduce corruption (Frye & Shleifer, 1997, p. 356).

5. Conclusion

Institutions, as well as the interactions between them, are important for the development of entrepreneurship and the institutional framework because they ‘define the incentives for individuals to turn their ambitions into actions’ (Caree & Thurik, 2010, p. 587). Moreover, according to North (1994), if institutions reward only productive activities, in response to these incentives entrepreneurs move their activities from unproductive to productive ones.

Productive entrepreneurship according to the literature requires (see scheme 1): (1) strong formal institutions which are well enforced and stable, and clear regulations for entrepreneurs; (2) complementary or accommodating relations between formal and informal institutions that will allow the reinforcement of formal institutions by informal ones. This means that informal institutions will provide incentives for entrepreneurs to comply with formal rules; (3) the invisible hand of the state, where the government is not above the law and courts enforce contracts; (4) informal institutions are strong, and entrepreneurs have a positive attitude toward risk or cooperation, a high level of trust for institutions, as well as are directed by their own business codes of ethics; (5) personal characteristics which allow for the recognition of opportunities which exist in the surroundings, and for using them through productive entrepreneurial activity, and (6) macroeconomic stability, which supports the trading relationships between sellers and buyers.

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Appendix

Table 1.
Number of search phrases results in selected scientific databases

Key word Boolean operators	Google Scholar	Emerald	JSTOR	ProQest	Scopus
formal institutions (FI)	3710000	49775	139946	313348	12925
institutional context	3410000	69440	136433	339413	30732
informal institutions (II)	3230000	28772	63835	137865	6607
cultural context	3180000	88717	231875	293369	84688
transition economies (TE)	2420000	29895	34783	499553	20506
institutional asymmetry (IA)	606000	8140	8375	33931	1168
productive entrepreneurship (PE)	499000	6402	4835	30526	489

Source: Own preparation based on search performed between 25 and 30 June, 2018.

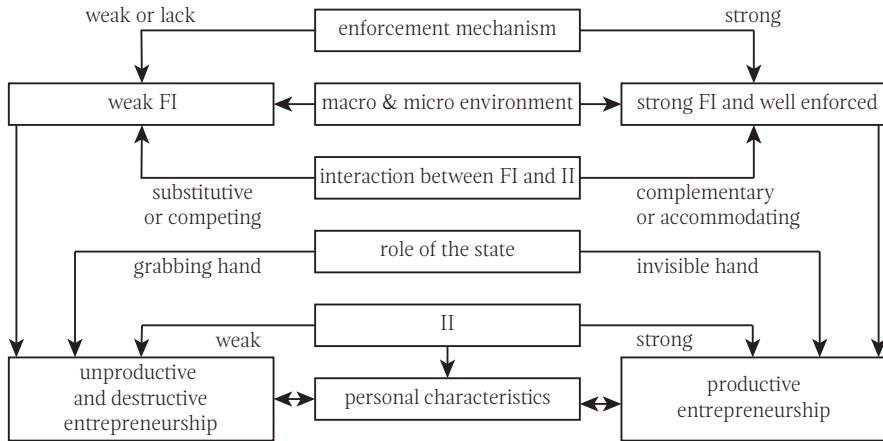
Table 2.
Results of Boolean Search in selected scientific databases

Key word Boolean operators	Emerald	Google Scholar	JSTOR	ProQest	Scopus
interaction between FI AND II AND TE / PE	3195 / 383	254000 / 48	3191 / 380	20065 / 3	10 / 0
interaction between FI AND II NEAR TE / PE	761 / 96	130000 / 44	1717 / 240	959 / 0	0 / 0
IA between FI AND II AND TE / PE	460 / 81	35700 / 7	449 / 62	3712 / 1	2 / 0
IA between FI AND II NEAR TE / PE	97 / 14	25900 / 6	235 / 32	319 / 0	0 / 0
II support FI AND TE / PE	1247 / 172	452000 / 43	5199 / 526	30487 / 4314	8 / 1
II support FI NEAR TE / PE	1101 / 127	217000 / 39	2646 / 316	1142 / 0	0 / 0
II undermine FI AND TE / PE	199 / 33	114000 / 28	1804 / 198	7431 / 1	1 / 0
II undermine FI NEAR TE / PE	282 / 42	66400 / 26	1130 / 143	319 / 0	0 / 0
II replace FI AND TE / PE	290 / 46	163000 / 45	1884 / 226	11406 / 1	2 / 0
II replace FI NEAR TE / PE	626 / 82	87100 / 41	1246 / 165	397 / 0	0 / 0
FI support II AND TE / PE	559 / 0	492000 / 45	5509 / 545	312460	11 / 1
FI support II NEAR TE / PE	1158 / 134	231000 / 41	2768 / 321	1149 / 0	0 / 0
FI undermine II AND TE / PE	1037 / 155	120000 / 28	65 / 9	254 / 0	0 / 0
FI undermine II NEAR TE / PE	301 / 46	69300 / 26	1167 / 145	23 / 14	0 / 0
FI replace II AND TE / PE	2101 / 261	180000 / 47	1970 / 232	401 / 132	0 / 0
FI replace II NEAR TE / PE	651 / 86	94400 / 43	1281 / 165	402 / 127	0 / 0

Source: Own preparation based on Boolean Search performed between 25 and 30 June, 2018 and between 8 and 11 January, 2019.

Scheme 1.

Productive, unproductive and destructive entrepreneurship in transition economies



Source: Own preparation based on: Acs et al. (2008); Aidis (2003); Baumol (1990, 1993); Frye & Shleifer (1997); Helmke & Levitsky (2004); McMillan & Woodruff (2002); North (1990); Puffer et al. (2010); Shane & Venkataraman (2000); Wennekers & Thurik (1999).