Entrepreneurship and Institutional Change in Transition Economies: a Discussion Paper

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1. Introduction

This paper is concerned with the role of institutional change in the development of entrepreneurship in countries which, until recently, were operating under the rules of central planning. Transition economies represent an appropriate ‘laboratory’ in which to examine the relationship between institutional change and entrepreneurship, in view of the extent of the change required as these societies move from central planning towards market-based systems. The paper aims to make a theoretical contribution to the field of entrepreneurship, whilst drawing on empirical evidence from three contrasting transition environments, namely, the Commonwealth of Independent States (CIS)\(^1\); Central and East European countries (CEECs)\(^2\) that are

\(^1\) The Commonwealth of Independent States is a loose association of countries that are former Soviet Republics.
now part of the European Union (EU); and China. A growing number of researchers have recognised the appropriateness of an institutionalist framework for the study of entrepreneurship in environments, where external conditions can be a dominant influence on entrepreneurial behaviour (e.g., Manolova, Eunni and Goychev, 2008, Peng and Heath 1996, Peng, 2000, 2003, Radaev, 2001, Smallbone and Welter, 2001a). As a result, an institutionalist approach is used in this paper to provide a guiding frame of reference to analyse the role of institutional change in entrepreneurship development, in countries where entrepreneurship is a relatively recent and emerging phenomenon.

The approach adopted in this paper adds value to the existing literature in two important respects. Theoretically, the paper seeks to explore the two way interaction between institutional change and entrepreneurship development in former centrally planned economies, which are at different stages of market reform. On the one hand, it will critically assess the role of the state as an agent of institutional change, with regards to entrepreneurship development; and, on the other, examine the role of entrepreneurship in contributing to institutional change. This aspect is important because it has been previously noted that progress with market reforms tends to produce a more enabling environment for productive forms of entrepreneurship over time, with the strength of environmental constraints on entrepreneurial behaviour tending to decrease (Smallbone and Welter, 2009a). The paper is also distinguished

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2 These CEECs are Poland, Hungary, Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Bulgaria, Romania,
empirically by the inclusion of evidence from China, as well as from CEECs and the CIS, thereby capturing a diverse range of transition environments and experience.\(^3\)

The paper starts by reviewing some of the key concepts related to institutions and entrepreneurship development, focusing on the role of institutional change. This is followed by a discussion of institutional change and entrepreneurship in the CIS, where entrepreneurship has been slow to develop, constrained by the slow and deficient nature of institutional change. The following section focuses on the role of the state as an institutional change agent in relation to entrepreneurship, based on the experience in the new member states of the European Union. The next section discusses institutional change in China where both entrepreneurs and the state have acted as drivers of change, although formal institutional change has tended to follow rather than lead entrepreneurship development. The final section presents some conclusions.

2. Institutions, Institutional Change and Entrepreneurship: some Key Concepts

The concept of ‘institutions’ refers to the “the rules of the game in a society” (North 1990), which when stable can assist in reducing uncertainty and risk for individual behaviour, as well as the transaction costs connected with conducting entrepreneurial activity. These rules include ‘formal’ institutions, such as the constitutional, legal and organisational framework for individual actions, but also ‘informal institutions’, which refers to culturally transmitted codes of conduct, values and norms (North, 1990). Informal institutions embrace uncodified attitudes, which are embedded in a society, and which act as regulators on individual behaviour.

\(^3\) The evidence used in the paper is drawn from empirically based research undertaken by one or both of the authors in a variety of transition economies that include the Russian Federation, Ukraine, Moldova, Uzbekistan, Belarus, Poland, Estonia, Latvia, Lithuania, Bulgaria, Romania and China.
North (1994) suggests it is the interaction between the rules of the game and organisations that shapes the institutional evolution of an economy, in which organisations and entrepreneurs are players.

In any context, institutions represent both constraining and enabling forces with respect to entrepreneurship. However, in the initial stages of transition, their role is often mainly a constraining one, as the environment is characterised by a high level of uncertainty, associated with rapidly changing external conditions and major institutional deficiencies. Such conditions can result in significant additional operating costs for businesses seeking to comply (Smallbone and Welter, 2001a), as economies such as Belarus, Uzbekistan and other NIS illustrate (EBRD, 2009).

Although an institutionalist frame is used as a starting point, the approach needs to allow for the recursive nature of the relationship between institutions and individual behaviour (Zafirovski 1999), as well as between formal and informal institutions. For example, whilst informal institutions can develop as a result of spontaneous and intended individual actions, they can also partly result from formal institutions, which they can in turn modify. In this regard, informal institutions evolve as a culture-specific, collective and individual interpretation of formal rules. For example, while a specific legal framework normally contains explicit regulations for implementing laws, over time these regulations are complemented by unwritten rules, which provide an implicit understanding of their content. In this sense, informal institutions may fill legal gaps, which may only become apparent when laws and regulations are applied to daily life.

To a considerable extent, the nature and extent of entrepreneurship development across different environments reflects varied institutional settings and
enforcement mechanisms (Oliver, 1991). Formal institutions are enforced by coercive mechanisms, which are mainly set down in government rules and regulations, while informal institutions are enforced by normative and mimetic mechanisms. Normative mechanisms assist in creating legitimacy, which is of particular importance in the case of nascent entrepreneurs and entrepreneurs in contexts where the newness of the concept of entrepreneurship may affect its acceptance in the wider society. Clearly, the way that government deals with entrepreneurs influences the extent to which involvement in entrepreneurship is an acceptable form of behaviour within the population as a whole, as does the behaviour of entrepreneurs themselves. This illustrates the relationship between firstly, the behaviour of formal institutions and informal institutional change; secondly, between informal institutional change and entrepreneurship development; and thirdly, the recursive link between entrepreneurship and informal institutional change.

A deficient legal infrastructure, which includes implementation gaps and/or a lack of suitably qualified judges and economic courts, can restrict entrepreneurship development. In such circumstances, an ‘institutional void’ (Polishchuk, 1997) allows for discretionary actions on the part of administrative authorities, since this can foster rent-seeking behaviour, corruption and non-compliant or deviant (entrepreneurial) behaviour. Such conditions are associated with what Baumol (1990) describes as unproductive and destructive entrepreneurship. It is only in situations where formal and informal institutions combine to form a coherent framework that formal regulations and the ‘rule of law’ will positively shape individual behaviour. By contrast, in fragile settings where the rule of law is largely absent, ‘non-compliance with the formal rules becomes pervasive’ (Feige, 1997: 32).
Institutional change is an integral part of the process of market reform, as an economy adapts from an institutional framework appropriate for centrally planning to that required to facilitate market development. Institutional change can positively influence entrepreneurship when it removes or lowers barriers to market entry and market exit, thus creating opportunity fields for entrepreneurs. An example is the introduction of private property rights which occurred in some transition countries at the beginning of the transformation process. However, institutional change itself is affected by the complex relations between formal and informal institutions, as path dependency not only result in distinctive patterns of entrepreneurial behaviour; it also constrains institutional change (Peng 2003b). In this context, entrepreneurs frequently rely on forms of behaviour, which assist them in coping with the constraints imposed by unstable and weakly structured institutional environments, but which may not fit the changed formal institutional frame. Therefore, in situations where formal and informal rules conflict, previous experiences and tacit knowledge are the main influences on entrepreneurial behaviour, whilst a change in informal institutions would require an environment conducive for entrepreneurial (re-learning).

For entrepreneurs, uncertainties in institutional rules, associated with institutional change, can be a mixed blessing. In defining so-called ‘institutional holes’, Keming Yang (2007) draws on Burt’s concept of structural holes, which are said to exist when gaps in information flows mean that complementary resources remain poorly connected (Burt, 1992). Entrepreneurs who are connected to many such sites can gain competitive advantage, through the creation of effective links, based on their social connections and networks. Keming Yang (2007) further develops Burt’s notion of ‘institutional holes’ as ‘structural positions that have contacts with different formal roles within an organisation’, by adding the idea of
institutional fields, which refers to an aggregate of organisations that share a common institutional life (Powell and DiMaggio, 1991). In Yang’s interpretation, institutional holes are viewed as ‘structural gaps between at least two persons or organisations located in different institutional fields’. As such, these institutional holes provide opportunities for entrepreneurs to exploit and the existence of institutional holes may be considered as a distinctive characteristic of economies in transition. This is because transition involves a shift from one set of institutional arrangements to another, which is likely to involve more institutional disjunctions and segmented niches than in mature market economies, by virtue of the extent of the changes occurring and their inherent lumpiness. Just as entrepreneurial opportunities arise from gaps in the market, which entrepreneurs may seek to address by creating new ventures, entrepreneurial opportunities can arise from institutional holes, although entrepreneurs vary in their ability to identify and exploit them. With respect to former centrally planned economies, several authors have described how individuals use social contacts and individual networks, based on strong personal trust in order to pursue business endeavours (e.g., Ledeneva, 2006, Manolova and Yan, 2002, Peng, 2000, Smallbone and Welter, 2001a, Yan and Manolova, 1998). In such conditions, these personal networks represent an important potential resource in identifying and exploiting opportunities associated with institutional holes.

3. Institutional Change and Entrepreneurship in the CIS

In the context of uncertain and unstable external conditions, such as those pertaining in ‘early stage’ transition environments or those where the process of market reform has stalled, institutional change is an important factor influencing the pace of development of entrepreneurship. At the beginning of the transition period, potential
business opportunities were embedded in the changes that occurred in the formal institutional environment, when the initial legal and administrative reforms made it legally possible for non-state owned businesses to compete with state owned enterprises (REFERENCE?). The legalisation of private enterprise allowed entrepreneurs to exploit gaps in the market. Much of the initial explosion of entrepreneurship that occurred in the early stages of transition was based on an exploitation of entrepreneurial opportunities in consumer-related activity, which had not been a priority under central planning. This illustrates, on the one hand, how formal institutional change can contribute to new market opportunities for entrepreneurs, and, on the other, that their exploitation depends on the human agency represented by the response of entrepreneurs.

New opportunity fields for entrepreneurs may also be associated with institutional change that malfunctions, or is incomplete, resulting in deficiencies or ‘holes’ in the institutional structure. In the CIS, this may be illustrated with reference to the development of the business services sector in Ukraine in the late 1990s (Smallbone et al., 2010 forthcoming). At this time, the customers of small business consultancy firms looked for them to supply a full range of services to avoid the necessity of employing several specialist companies.

The distinctive nature of the entrepreneurship which institutional deficiencies encouraged in this case is reflected in the full service portfolio offered by consultancy firms. This included not just business advice and consultancy, but also the acquisition of the necessary licences and permits needed to run an enterprise and/or develop a new project, requiring personal contact with appropriate officials, as well as technical expertise. The consultancy firms that developed services to fill this niche
were not grey sector enterprises, but some of the most innovative and successful firms in the business services sector. The entrepreneurs running these firms had responded positively to a market opportunity created by the specific institutional conditions pertaining in Ukraine at the time. Whilst the specific nature of the opportunities may be transient, as the institutional environment for productive entrepreneurship improves, the behaviour demonstrated by these enterprises shows a high level of sensitivity and responsiveness to the needs of customers, which are themselves heavily influenced by institutional conditions. Moreover, their behaviour illustrates one of the mechanism Kalantaridis (2007) identified for entrepreneurs to influence institutional change, namely the way entrepreneurs interpret (novel) institutions and develop solutions to institutional deficiencies.

At the same time, institutional change itself is affected by the complex relations between formal and informal institutions, as inertia and socialist legacies can constrain it (Chavance, 2008, Peng, 2003b). The time-lag apparent in human actions and individual preferences for known patterns of behaviour emphasises the recursive links between individual and societal perceptions (i.e., informal institutions) and changes in formal institutions. Whilst changes in formal institutions create opportunity fields for entrepreneurship, informal institutions influence the collective and individual perception of entrepreneurial opportunities. In situations where formal and informal rules conflict, previous experience and tacit knowledge are the main influences on entrepreneurial behaviour.

From an institutional perspective, the concept of path dependency can help to explain behaviour which ‘…may bear little resemblance to the legitimate courses of action stipulated by the formal rules’ (Nee, 1998: 86). Whilst laws and official
regulations may be easily modified and transformed, norms of behaviour and values tend to be more persistent, only changing slowly (Williamson, 2000). This influences entrepreneurial behaviour in those situations where a new regulatory frame is introduced and previous codes of conduct and values guiding individual behaviour, no longer fit (Mummert, 1999). This misfit encourages individuals to resort to familiar courses of action, often resulting in an escalating commitment of entrepreneurs at the individual level to viable, but not necessarily the best courses of actions (Whyte, 1986). Such behaviour further constrains the required adaptation of norms and values, thus leading to vicious circles and low-level efficiency traps for entrepreneurship development, which is a widespread phenomenon in transition economies, especially during the early phases of transition (Kuznetsov, 1997). Thus, in a situation where individual behaviour no longer fits the prevailing business codes of conduct, this might lead entrepreneurs to over-conforming, in order to re-establish legitimacy in a new order; although it might also result in avoidance strategies, in the early stages of transition particularly.

Coping and evasion behaviour can be found in relation to many aspects of the legal and regulatory framework in the CIS, reflecting deficiencies in business regulations and/or their implementation. This typically leaves too much room for interpretation by officials, thereby contributing to corruption (see Smallbone and Welter, 2009b). A typical example is the case of a female entrepreneur from Ukraine. When she set up her business “(...) there were problems with tax agencies and customs. After three months of operations the tax inspector did not approve our report because there was no ‘funds movement’.” She explained that nothing was sold during these first three months as the goods were halted by the customs. She had little experience with customs officers and was unable to solve this problem until
she found a person who served as an “authorized agent” for customs officials. This person took the bribe and the documents from her, which she presumed were passed on to the official, because after this, the goods were allowed into the country. This kind of behaviour prevails in most transition environments where the legal framework does not function properly (Smallbone and Welter 2009a).

The problem in such circumstances is how to break the vicious circle of path-dependent behaviour, in order to foster further institutional change. Initially, at the micro level, firms may survive and grow by using network-based strategies based on personal trust and informal agreements among managers and officials in order to overcome institutional uncertainties (Peng & Heath, 1996). However, at the macro level, extensive and sustained development of productive private entrepreneurship is unlikely to occur unless an economy is able to move from a relationship-based, personalised transaction structure to a rule-based, impersonal exchange regime (Peng, 2003a, 2003b).

Whilst informal institutional change may arise out of intended human behaviour, change in formal institutions might be a result of the cumulative effect of the uncoordinated actions of individuals (Ben-Ner and Putterman, 1998: 38). With regards to informal institutions enabling entrepreneurship, the role of government includes its attitude towards private entrepreneurship and business ownership, which in some of the CIS is far from positive. Deficiencies in the formal institutional framework often reflect a lack of political commitment to facilitate private enterprise development, which has been the situation in Belarus under President Lukashenka (Smallbone and Welter, 2009a). In such conditions, the role of the state as change agent becomes explicit. For example, in the Russian Federation and Belarus the
absence of a recent tradition of private business ownership, combined with a lack of self-governing (business) organisations and a poor public perception of the contribution of small business to social and economic change, means that the state must take a lead in modifying the institutional conditions and in establishing the ground rules on which business is conducted.

Although the slow pace of institutional change in the CIS has constrained the development of productive entrepreneurship, there are ways in which entrepreneurship development may be said to have contributed to institutional change in these countries. One example is the contribution of entrepreneurship to increasing flexibility in the labour market. Temporary, unregistered employment in small private firms was initially one of the ways in which employees of state owned enterprises in the CIS survived when they were placed on ‘administrative leave’; another was to start an (unregistered) enterprise. All transition economies initially had a highly distorted size distribution of enterprises, combined with considerable disguised unemployment in state enterprises, inherited from the Soviet period. Once transition commenced, the reaction to new market conditions was either to place labour on so-called ‘administrative leave’ (short time work or unpaid leave) or to shed labour (Standing 1996). In this context, newly created small enterprises provided one of the few job opportunities for redundant workers (Jackman and Paun 1997),

Research undertaken in 1999/2000 into employment and the use of labour in Russian SMEs showed that younger and smaller SMEs in particular favoured flexible (but illegal) agreements with their employees (Welter et al, 2003). A common practice was ‘enrolment on order’. This involves the management of an enterprise simply issuing an order to employ an employee, without a formal contract, thereby violating the labour law. However, as Clarke and Borisov (1999) pointed out, the
prevalence of verbal contracts does not necessarily suggest a deliberate labour law violation. Instead, it may simply be a more appropriate way to regulate labour in very small firms, which implies that the legal framework in Russia had not been adapted to meet the needs of an emerging private sector. Instead, small private firms were forced to operate outside the formal labour laws. In two thirds of surveyed enterprises labour contracts were not legally valid, suggesting that ‘illegal’ forms of contract were widespread in the emerging private sector (Welter et al, 2003). At the same time, most surveyed entrepreneurs were willing to include non-mandatory terms into their labour contracts, which formally increased the job security of their employees. In other words, despite their violation of the labour law, Russian SME employers were willing to provide some social guarantees, suggesting that operating illegally does not necessarily mean that entrepreneurs are operating irresponsibly. The example demonstrates how SMEs were not only creating jobs in a context where large SOEs were typically shedding labour. They were also taking a lead in challenging the formal institutional rules governing labour market behaviour.

4. The State as an Agent of Change: the Case of New Member States of the European Union

In Central and East European countries (CEECs) that are now members of the EU the state has become a positive agent of institutional change with respect to entrepreneurship development. At the same time, it may be argued that entrepreneurs have contributed to creating a demand for institutional change through the key role they played in the development of the economies in the first decade after the start of transition. However, the process of accession to the EU has contributed to institutional development and administrative reform, driven partly by
the need for Accession countries to meet the conditions for entry laid down by the
EU, and partly by their desire to have the institutional conditions in place that would
enable them to successfully access EU Structural Funds to facilitate economic
restructuring. This has affected the institutional structures, including the development
of sub-national institutional frameworks (in some countries), policy processes as well
as policy itself.

The institutional frame for entrepreneurship can be considered at different
levels of scale (Welter, 1997). At the macro level, it includes the responsibility for
policy making with respect to entrepreneurship and/or SME development within
government, together with the mechanisms for policy implementation. At the meso
level, it includes the system of banking and other financial institutions; the training
and business support systems; but also organisations that seek to represent special
interest groups in dealing with government (such as employers’ associations and
Chambers of Commerce). At the micro level, institutional development focuses on
the operation of macro- and meso-level organisations within the institutional frame at
the local/regional level. This includes the operation and behaviour of business
development centres but also local offices of regulatory bodies and those of national
agencies and organisations. National policies may exist for these organisations but
their implementation at a local level may vary. The effectiveness of the overall
institutional frame as an enabling influence on entrepreneurship development is
affected by the relationships between these different levels, as well as by the
behaviour of individual organisations within them.

In most CEECs, the attention of policy makers in the 1990s, as far as
entrepreneurship and SMEs were concerned, focused on establishing the framework
conditions for private sector activity to become established. Direct intervention and business support programmes tended to be left to international donors with little strategic direction evident in state policy in the host countries (Bateman, 2000). At the same time, accession to the EU contributed to a more active stance on the part of government in some countries in the late 1990s. For example, in Poland, this was reflected in the publication of strategic policy documents in 1995, 1999 and 2003; in Estonia, by explicit enterprise policy documents published in 2002 and 2006 (Smallbone and Welter, 2009a). In terms of institutional change, one sign of increasing attention being paid to the SME sector in new member countries is a reorganisation of responsibilities for SME policy within government. In Estonia, for example, this involved a decision by government in 2000 to centralise responsibility for SME policy in the Ministry of Economic Affairs and Communications, since previously four Ministries had been involved. It also involved the creation of Enterprise Estonia, with responsibility for implementing business support measures. Enterprise Estonia is accountable to the Ministry of Economic Affairs, who are responsible for policymaking. A clear separation of policy making from policy implementation is one of the more explicit influences of EU membership on institutional change in a number of the new member states. In Poland, the Polish Agency for Enterprise Development (PAED) was established in 2000 as the implementation agency for SME and enterprise policies, which are developed by the Ministry of Economy.

Opportunities for facilitating structural change with the help of EU funds (initially pre-Accession funding and latterly Structural Funds) have encouraged new member states to adjust their institutional structures and processes to increase their chances of securing this funding, some of which can be used to promote and support
entrepreneurship at the national and regional levels. Apart from a clearer separation of policy making from policy implementation, with potential benefits in terms of greater transparency and accountability, the EU influence has also extended to the policy process itself. This includes requiring explicit links between strategic policy objectives and action plans, which are tied into the budgetary process. This has helped to reduce the so-called ‘implementation gap’, which has previously been identified as a common feature of government policy in transition countries (Smallbone and Welter, 2001b). Although EU procedures are often criticised for being overly bureaucratic, a need for transparency, accountability and auditability has led the EU to suspend financial transfers to countries where an inadequate system of financial control is evident, in order to pressurise them to change their practices. Whilst this may not benefit entrepreneurs directly, there are potential indirect benefits in terms of increased transparency in funding allocations, representing a form of institutional change.

At the same time, there are constraints on the effectiveness of formal institutional change, particularly in cases where a substantial culture shift is required in terms of institutional behaviour. One example is where a fundamental change in the system of public financing is required, towards a target-based system. In the words of a consultant from the Netherlands, working on a technical assistance programme in the Polish Ministry of Economy, ‘The problem is that this involves more than a technical change; it also requires officials operating the system to change their mindsets away from a narrow emphasis on applying the rules governing

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4 For example, in December 2008, the EU decided to freeze Structural Fund payments to Bulgaria over alleged corruption.
how funds should be allocated and who is eligible to receive them to one that emphasises the achievement of targets, within the rules.’

Another challenging aspect of institutional change concerns the involvement of entrepreneurs in the policy process. The effective institutionalisation of SME policy depends on the development of organisations to represent the interests of entrepreneurs and businesses, acting as an interface between individual businesses and government. Such organisations represent a direct pathway showing how entrepreneurs can potentially influence institutional change (Kalantaridis, 2007), as well as being affected by it. Moreover, in a context where there is no recent tradition of self-governing organisations, the creation of effective non-government (NGOs) has wider significance for the institutional change required across the entire society. However, the experience in Poland and other former socialist economies is that establishing effective membership organisations for entrepreneurs is not an easy task. Without some regulation by the state, a multiplicity of under-resourced membership organisations tends to emerge, with limited lobbying capacity and influence. This contrasts with mature market economies where self-governing organisations act as professional intermediaries in the process of dialogue between government and entrepreneurs, to ensure that the interests of entrepreneurs are considered at different stages of the policy process. At the same time, establishing institutions to facilitate effective dialogue between business and the state also requires a willingness to participate on the part of entrepreneurs, who can be a difficult to reach group for policy makers for consultation purposes, even in mature market economies (Hart, 2003). In emerging market economies, where there is no

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5 Although there are different models in different countries, one approach is to make membership of a Chamber of Commerce compulsory for all registered businesses.
recent tradition of participation in voluntary associations, developing an effective consultation system is doubly difficult. Issues of path dependency affect the nature of institutional trust, combined with a lack of any recent tradition of self-governing organisations.

The process of EU accession has undoubtedly contributed to institutional change in new member states, which is contributing in turn to the development of an institutional framework for the longer term development of productive entrepreneurship. At the same time, It must also be recognised that institutional changes driven by the state on the supply side of the economy as far as entrepreneurship is concerned, need to be matched by institutional change on the demand side. This draws attention to the role of entrepreneurship education at different levels, since this is likely to affect the number of potential and nascent entrepreneurs. Entrepreneurship is ultimately dependent on the drive and commitment of individuals, which government can facilitate through an appropriate and effective functioning institutional frame, although the state cannot substitute for individual entrepreneurial endeavour.

4. Entrepreneurship and Institutional Change in China

The experience of China with respect to entrepreneurship development is of particular interest internationally because of the impressive performance of the Chinese economy in recent years, reflected in a 300% increase in GDP per head in the course of a decade. A number of factors have contributed to this performance, including the attraction of foreign direct investment as part of China’s open door policy; the restructuring and reforming of many state-owned enterprises; building up a selected number of large enterprises to become globally competitive national
champions; investing in science and technology infrastructure; and fiscal decentralisation. But the key that has unlocked the door has been the enabling stance adopted by the Communist Party towards private business ownership, although this has rarely been explicit.

A key part of an institutionalist approach is the role of formal and informal rules in shaping individual behaviour. In this regard, rules for entrepreneurship in China range from legal codes at the most formal end to spontaneous statement by political leaders, which are part of the informal rules of the society at the other. The Government in China has often ruled by Communist Party policies rather than by legal statutes, although over time an increasing number of Party policies have been translated into laws. The process starts with ideas being presented by Party leaders, followed by discussion of them in a wider group, such as the Central Committee of the Communist Party. The Party then reaches a collective decision, which may be specified as a regulation by the State Council. The point is that these ideas can influence behaviour without necessarily reaching the final stage. However, such an approach places considerable discretionary power in the hands of Party officials, which entrepreneurs need to negotiate, if they are to successfully establish and develop a business. As in other transition economies, institutions provide the rules of the game for entrepreneurs, although the way the rules operate in China is distinctive.

A key theme emerging from CEECs and the CIS is the important role that institutions play in influencing the nature and pace of entrepreneurship development. In the CIS, the slow pace of institutional change has limited the number of private firms that exist and required those that are established and survive to engage in
forms of behaviour that appear unproductive in terms of resource allocation. By contrast, in CEECs that are now part of the EU, institutional change has facilitated the development of productive entrepreneurship, as part of the wider process of market reform, such that in some countries the level of entrepreneurship per capita is approaching that of some of the more established EU member states.

However, in China, whilst institutional change (particularly in informal institutions) over the last 30 years has undoubtedly contributed to creating the conditions in which entrepreneurship has been able to develop, few would argue that the rapid development of entrepreneurship has been facilitated by a clearly defined and well enforced institutional framework. As a consequence, one of the key questions to be answered in a Chinese context is how to explain the explosion of entrepreneurship that has occurred when there is evidence of considerable institutional deficiencies. Applying the logic derived from a CIS and CEEC context, it is difficult to explain the rapid development of entrepreneurship in China, leading to what has been referred to as the ‘Chinese puzzle’ (Keming Yang, 2007).

For most of the reform period, private enterprise has developed in China without private property rights, leading to collusion between local governments and entrepreneurs and the use of rent seeking behaviour. In practice, alliances between entrepreneurs and local officials have acted as a mechanism for the growth of non-state owned enterprises, especially in rural areas in the 1980s and 1990s, reflected in the rapid growth of Township and Village Enterprises (TVEs). For a period, TVEs were a driving force for non-state enterprise development in China, employing 134m by 2003 and contributing 30% of GDP, although since then a large number have been restructured into more conventional forms of private ownership. As a result,
although shaped by collusion and rent seeking behaviour, productive forms of entrepreneurship have emerged, which have themselves shown remarkable adaptive capability as external conditions have changed. This adaptive capability also applies to much of the financial and non-financial support infrastructure developed initially to support TVEs.

Although through most of the 1980’s and 1990s, entrepreneurs in China have found the institutional environment increasingly liberal, ‘objective’ evidence points to considerable ongoing institutional deficiencies, with potential implications for entrepreneurship development. For example, in the IFC/World Bank’s ‘Doing Business’ report 2009, whilst China is ranked 83 out of 181 countries on the overall ‘ease of doing business’ index, it is only 151/181 with respect to the ease of starting a business (World Bank, 2009). Compared with more advanced countries, starting a business in China involves more procedures, is significantly more time consuming, more expensive and requires a higher minimum capital to register,

In addition, evidence from an enterprise survey undertaken in 2003 shows that China performs poorly in terms of the administrative burden of regulations on enterprises, the implementation of the tax system and access to bank finance. It also reveals that about three quarters of Chinese respondents expected to have to make informal payments to officials to ensure their compliance (World Bank, 2009). Based on this evidence, at least, the formal institutional framework does not appear particularly enabling for Chinese entrepreneurs, although the reported level of informal payments gives a clue as to how the regulatory system actually operates in practice. The contemporary development of entrepreneurship in China has occurred in the context of institutional deficiencies, raising the question of how so many
opportunities for profit-seeking entrepreneurial activity have been generated. The dual concepts of institutional holes and double entrepreneurship may be used to help provide an answer to this question.

Many entrepreneurs in China have found creative ways around formal institutional deficiencies, often, as mentioned previously, with the collusion of local officials. For example, in some rural areas, private enterprises have been able to obtain a collective license to operate by paying an ‘administration fee’ to a state or local government organization to receive its stamp on their application for registration. Such firms are known as ‘red hat’ firms, because they were registered as having collective ownership when in fact they were privately owned. The so-called ‘red hat’ enabled them to avoid the prohibition of private firms and ideological harassment by government. In Shunde, Guangdong, almost all firms at the village level were ‘red hat’ firms before the enterprise ownership reform programme took place in 1992, encouraged by some local government officials.

More recently, the difficulties that SMEs in China typically experience in accessing bank finance (an institutional hole) has contributed to the emergence of an informal ‘back-street’ banking system, which has been growing rapidly, particularly in the eastern part of the country. The value of this informal capital market is estimated to represent 2-5% of GDP or bout 950m RMB (China Peoples Bank, 2005).

In China, institutional holes exist to be exploited by entrepreneurs and institutional actors alike. As a result, neither the state nor Chinese entrepreneurs have much interest in searching for the best institutional rules, but instead prefer to explore what they can do within the context of the (ambiguous) rules that exist. In this context, Keming Yang (2007) describes the concept of ‘double
entrepreneurship’, which has a socio-political as well as an economic dimension. It is suggested that as well as addressing gaps in the market, successful entrepreneurs in China need to be able to both make a profit and obtain socio-political security, in a way that is mutually supportive, rather than destroying each other. As a result, it may be argued that in China entrepreneurship involves two distinct but related dimensions: the first dimension is economic, the second socio-political. Hence, ‘double entrepreneurship’ refers to a situation where entrepreneurs fill gaps in the market, on the one hand, and respond to opportunities resulting from gaps in institutional rules on the other. Double entrepreneurship seeks to combine high economic reward with low socio-political risk. Both aspects are part of the entrepreneurial process in China.

Since institutional holes are associated with ambiguous institutional rules, entrepreneurial opportunities are often open to negotiation between entrepreneurs and institutional ‘rule-makers’. These institutional holes and ambiguities are a key element in the institutional frame in China. For example, the institutional changes required to initiate private sector development in the contemporary period in China started with the Third Plenum of the Chinese Communist Party's 11th Central Committee in 1978. Although no specific announcement was made with respect to the development of private business, the Plenum’s emphasis on economic development and individualistic incentives gave an impetus to the development of private business in the country. It illustrates how official statements made by Communist Party leaders contribute to an environment in which entrepreneurship development is encouraged, acting as an incentive to local officials to find ways of achieving it.
At the outset, the private sector was limited to individual businesses (getihu), which developed initially in a regulatory vacuum. At the time, the private sector’s role was initially seen to focus on filling gaps in the economy left by State Owned Enterprises (SOEs), focusing particularly on the distribution of consumer goods and services. Such thinking led to restrictions being placed on the types of enterprise that could be created, with the number of employees being limited initially to 8. In practice, the number of private enterprises with more than 8 employees increased rapidly after 1981, although they were not regulated until 1988. Formal institutional change followed a period of ‘policy experimentation’ to which both Party officials (at different levels) and entrepreneurs contributed.

Because of the Chinese emphasis on decentralisation and local experimentation with reforms, private sector development has been greatly influenced by local conditions. This includes the attitudes of local government towards the role of the market, which itself may be viewed as a form of informal institution. As a result there are marked regional variations in the nature and extent of private enterprise development in which institutional factors play a key role. Eastern China, where the pace of economic development has been the most rapid, dominates in terms of private sector development, accounting for 67.3% of all private firm and 66% of private sector employment. Moreover, within the Eastern region private enterprises are particularly concentrated in the provinces and municipalities of Jiangsu, Zhejiang, Guangdong, Shanghai and Shangdong, which account for almost half of all private enterprises in China and half of private sector employment. These are areas with business traditions, access to foreign markets and preferential policies to promote entrepreneurship. This contrasts with the environment for entrepreneurship in some of the western provinces, where lower enthusiasm for
private sector development by local governments combines with low purchasing power, the effects of selective outmigration and less of an entrepreneurial tradition to limit the development of entrepreneurship. Both formal and informal institutional change has been much slower in the West than in Eastern provinces, which is an imbalance recognized by the Chinese government in its current policy priorities.

5. Conclusions

The paper has analysed the relationship between institutional change and the development of entrepreneurship in countries with varying degrees of market reform. Although an institutionalist approach provides an overall guiding frame of reference, differences can be identified in the relationship between institutional change and entrepreneurship in the three groups of transition economies investigated.

In the CIS, where market reform has been slow, and stalling in some cases, the development of entrepreneurship has undoubtedly been constrained by deficiencies in formal institutions (such as the operation of the legal framework) as well as by informal institutions (including public perception of entrepreneurs). In such a context, the lack of the basic framework conditions for market development in general and for entrepreneurship in particular affects the number of businesses established and their contribution to economic development. Not only that, but those enterprises that do exist are forced to adapt to institutional deficiencies in ways that result in resources being tied up in non-productive activities. In such environments, the slow and partial nature of institutional change has constrained the development of productive entrepreneurship.
At the same time, even in the CIS, institutional change may be said to have created opportunities for entrepreneurs. The administrative reforms at the start of the transition process which made it possible for private enterprises to legally exist represent one example. The effect of deficiencies in the operation of the system of licences and permits on the business consultancy market in Ukraine is another, demonstrating the adaptive capability of entrepreneurial firms. Whilst in both cases it may be argued that the nature of the opportunities created is often transient, institutional change can be said to have stimulated an entrepreneurial response. In principle, entrepreneurs can contribute to a demand for institutional change, when it becomes apparent that existing institutional arrangements are incompatible with a market based approach. However, whether or not this is translated into formal institutional change is likely to depend on the government’s commitment to market reforms. The case of Russian labour laws showed entrepreneurs to be engaged in widespread evasion of laws which, if rigidly applied would reduce employment opportunities. This has led to tacit acceptance by the state and thus informal institutional change.

In CEECs that are now members of the EU, the relationship between institutional change and entrepreneurship development has additional dimensions. These are mainly associated with EU membership which has led to the state becoming an important agent of formal and informal institutional change. In most of these countries, entrepreneurship developed rapidly in the period after 1989, representing one of the sources of dynamism in economies going through a period of major transformation. EU accession and the path leading to it have contributed to significant institutional change in terms of both institutional structures and processes, and providing access to financial and technical resources to assist in
creating a facilitating environment for entrepreneurship development. In such conditions, entrepreneurs have not simply been passive recipients of institutional change but have contributed to it. This includes formal institutional development through their involvement in self governing organisations and informal institutional change by contributing to a growing acceptance of entrepreneurship within the population at large. Unlike the CIS, where governments often lack commitment to supporting private enterprise development, governments in CEECs that are now EU members are generally more positive towards entrepreneurship, encouraged by the opportunities to attract EU funding to facilitate the required restructuring and the priority given to entrepreneurship in EU policy, reflected in the co-called Lisbon strategy.

The inclusion of China in the paper raises additional perspectives, because of the distinctiveness of the Chinese approach to market reform. Based on experience in the CIS, the holes that still exist in the formal institutional frameworks in China do not lead to an expectation of significant entrepreneurship development. The double entrepreneurship which Keming Yang describes can help to explain the so-called Chinese puzzle, although the systemic collusion between entrepreneurs and the state in China occurs within a context of strong government by the Communist Party whose leaders are currently promoting socialist market model. The wider political context for entrepreneurship development in the CIS is typically less supportive for entrepreneurship.

The Chinese experience is also a story of ongoing experimentation, with formal institutional change typically following rather than leading entrepreneurship development, after a period of toleration of private entrepreneurship. The
experimental nature of private sector development initially, in an environment of legal and regulatory uncertainty is a distinctive feature of the Chinese model. It means that for most of the reform period, private enterprise has developed without clearly defined property rights, using a particularistic approach rather than one based on universal rules, although this has led to collusion between local governments and enterprises, including the use of rent-seeking behaviour.

In this regard, the paper illustrates the complex relations between formal and informal institutions, where the government can play an important role as a change agent, although CEECs, the CIS and China differ in this regard. In CEECs, the state actively took over as change agent, at least from the mid-1990s onwards and assisted by the European Union during preparations for, as well as after, EU membership. Contrary to this, in most CIS the state is less of a change agent, as governments have not fully recognised the (potential) role of entrepreneurship in fostering economic development and institutional change. In China both state and entrepreneurs can be characterised as change agents, although neither the state nor Chinese entrepreneurs have much interest in searching for the best institutional rules, but instead prefer to explore what they can do with the (ambiguous) rules that exist.

Thus, China illustrates how institutional change can happen as an interactive learning process between entrepreneurs and state. In this regard, it illustrates Douglass North’s statement that ‘it is the interaction between institutions (rules of the game) and organisations that shape the institutional evolution of an economy’ (North, 1994), in which organisations and entrepreneurs are players. By contrast, in most CIS where governments adopt a passive role at best (i.e. letting change
happen) illustrates the important role of entrepreneurs in shaping the institutional environment although mainly by circumventing and avoiding the new institutions. At the same time, evidence also shows how entrepreneurs creatively use institutional loopholes to set up and develop their businesses. This questions the often taken-for-granted detrimental role of informal institutions in the form of the socialist heritage and non-conformity which are said to restrict entrepreneurship development. Instead, the paper highlights 'positive path-dependent informality' (Chavance, 2008: 67) in fostering entrepreneurship in a transition context.

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