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**Article**

## Do institutions matter for entrepreneurial development?

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# Do institutions matter for entrepreneurial development?

In post-Soviet countries, well-functioning institutions are needed to foster productive entrepreneurial development and growth

Keywords: entrepreneurship, institutions, transition countries

## ELEVATOR PITCH

Supportive institutional environments help build the foundations for innovative and productive entrepreneurship. A few post-Soviet countries have benefitted from international integration through EU membership, which enabled the development of democracy and free market principles. However, many post-Soviet economies continue to face high levels of corruption, complex business regulations, weak rule of law and uncertain property rights. For them, international integration can provide the needed support to push through unpopular yet necessary stages of the reform process.

## KEY FINDINGS

### Pros

- ⊕ International integration such as EU membership enables member countries to enact the reforms needed for productive entrepreneurship.
- ⊕ Globalization and cross-border mobility to advanced market economies can facilitate productive entrepreneurial development, even in less supportive institutional environments.
- ⊕ Online technology entrepreneurship offers new opportunities for entrepreneurial success in post-Soviet countries.
- ⊕ Increasing numbers of productive entrepreneurs can support sustained institutional reform.

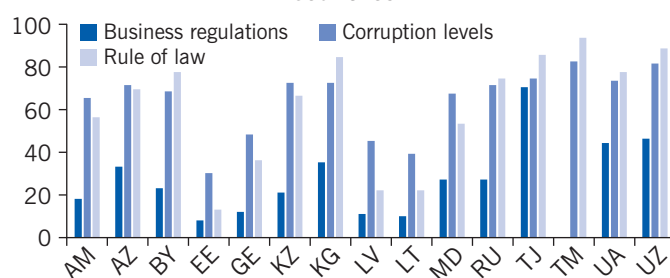
### Cons

- ⊖ The Soviet legacy of negative attitudes and restrictive policies towards entrepreneurship continues to shape institutions in a number of post-Soviet countries.
- ⊖ High levels of corruption undermine productive entrepreneurial development and institutional reform.
- ⊖ Established networks inherited from the Soviet system disproportionately benefit elites and do not foster broader entrepreneurial development.
- ⊖ Weak institutional environments stunt business growth and drive entrepreneurs to operate in the informal sector.

## AUTHOR'S MAIN MESSAGE

Successful entrepreneurs are expected to create jobs, pay taxes, introduce innovations, and contribute to sustained economic growth. Governments are expected to create conducive conditions for entrepreneurs such as the protection of property rights, functioning free markets, and good governance. In many post-Soviet countries, a detrimental legacy toward entrepreneurship continues to stunt its development. However, through committed institutional reform and international integration some post-Soviet economies have been able to cultivate thriving, innovative, and productive entrepreneurial cultures.

Regulations, corruption, and rule of law in post-Soviet countries



Source: Business regulation levels from World Bank's 2015 Ease of Doing Business Index (best conditions = 1; worst = 100); corruption levels from Transparency International's 2015 Corruption Perceptions Index (lowest overall level = 1; highest = 100); rule of law data from 2015 Worldwide Governance Indicators (best = 1; worst = 100).

## MOTIVATION

Twenty-five years after the breakup of the Soviet Union, the differing paths chosen by the transition countries that made up the former Soviet Union offer insights into how institutions affect entrepreneurial development. Institutional weakness due to corruption, lack of property rights, length of communist rule, and lack of commitment to reform are some of the main causes of lower levels of entrepreneurship [1]. Free markets are not enough to sustain entrepreneurial prosperity in post-Soviet countries; rather, supportive institutions are also needed to safeguard the rule of law. In 2015, Pavel Durov, a successful Russian tech entrepreneur and creator of VKontakte (VK), the Russian equivalent of Facebook, left Russia, choosing exile over a likely politically motivated arrest. Though extreme, this example is not unusual and illustrates the often contradictory business environment that characterizes the post-Soviet context in a number of countries: business opportunities abound but weak institutions result in real threats to sustaining successful entrepreneurial livelihoods.

### How post-Soviet countries are classified

According to the World Bank's 2015 country classifications, the vast majority of post-Soviet countries are classified as "lower-middle-income" countries. These 11 countries include: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Russia, Latvia, and Lithuania are considered high-income, non-OECD countries. Latvia, Lithuania, and Estonia are also EU member countries, having joined the union in 2004. All three have switched to using the euro as their currency: Estonia was the first to introduce the euro in 2011, followed by Latvia in 2014 and Lithuania in 2015. Estonia is the only post-Soviet country to be classified as both high-income and an OECD member country.

## DISCUSSION OF PROS AND CONS

### The importance of institutions for entrepreneurial development

Entrepreneurs and their activities are influenced by opportunities and incentives provided by a country's context, which is made up of both formal and informal institutions. Put simply, formal institutions are the visible "rules of the game," for example constitutional law, which can be altered quickly to adapt to changing economic circumstances [2]. Governments generally enforce these formal rules. In contrast, informal institutions are the invisible rules of the game, made up of norms, values, acceptable behaviors, and codes of conduct; informal rules tend not to be legally enforced [3]. Often, informal and formal institutions coevolve. Through their collective actions, economic agents such as entrepreneurs can trigger institutional change [4].

Entrepreneurial development is a continuous process, but not all entrepreneurs will respond to the same institutional conditions. Rather, the types of entrepreneurs that will be "activated" (i.e. start businesses) in a given situation are largely affected by the existing incentives structure that results from a combination of formal and informal institutions. When the institutional environment is supportive of entrepreneurship, there tend to be larger numbers of "productive" entrepreneurs—those who create economic wealth through innovation and filling market gaps. Conversely, when the institutional

environment is less favorable, there are larger numbers of non-productive entrepreneurs—those who engage in activities such as rent seeking from government agencies through privileged monopoly positions or individual tax and regulatory exemptions. In conditions where rule of law is very weak, there will be a higher chance of destructive entrepreneurs emerging and engaging in criminal activity like drug production and distribution, or prostitution [5]. Different combinations of formal and informal institutional arrangements change the balance of incentives that induce individuals to choose between very different entrepreneurial activities, thereby influencing the pattern of economic growth. Productive entrepreneurship contributes positively to economic growth, whereas unproductive and destructive entrepreneurship have no or even a negative effect on economic growth.

In other words, if the benefits of engaging in illegal entrepreneurial activity outweigh their costs, entrepreneurs tend to be more inclined to engage in destructive entrepreneurship, that is, entrepreneurship that is detrimental to economic development. Conversely, if the incentives are greater for productive entrepreneurship, then this form will predominate. In each case, entrepreneurs weigh the existing incentives, considering both regulations (formal rules) as well as the prevailing cultural values and norms (informal rules). This does not mean that the same individual will engage in productive, unproductive, or destructive entrepreneurship; rather, different individuals will embark on entrepreneurial activities under different incentive structures.

In the post-Soviet countries' initial transition period, the development of formal institutions such as the adoption of a free market economy was prioritized. However, the same level of emphasis was not placed on the development of supportive informal institutions. This narrow focus on free market mechanisms was not sufficient. Rather, formal institutions such as the rule of law and property rights needed to be safeguarded and enhanced by the development of supportive informal institutions such as the reduction of corruption.

### **Institutions that matter for entrepreneurship in post-Soviet countries**

When institutions are not supportive of entrepreneurs they form additional barriers for productive entrepreneurial development. In the post-Soviet landscape, weak property rights, cumbersome business regulations, lack of trust, and high corruption levels are some of the main impediments addressed in the literature. Research indicates that property rights play a pivotal role in determining entrepreneurial activity in post-Soviet countries [6]. Weak property rights interfere with business growth since they discourage entrepreneurs from reinvesting profits [7]. High taxation levels are a universal complaint by business owners. Furthermore, high levels of corruption can undermine a tax system's effectiveness, substantially raising the cost and inconvenience of running a business. This can cause entrepreneurs to stay small or to exit the formal market altogether.

Arguably, the single greatest impediment to productive entrepreneurial development in post-Soviet countries is corruption [8]. In fact, the level of corruption in post-Soviet economies provides a good proxy for overall institutional weakness. Corruption is especially damaging since it affects the functioning of formal institutions and negatively influences the development of informal institutions. Moreover, high levels of corruption can exacerbate problems related to weak property rights, arbitrary state administration, a weak judicial system and an excessive, opaque regulatory framework. Small- and medium-sized businesses are especially vulnerable to corruption in post-Soviet economies because

they lack the bargaining power of large firms in regard to state bureaucracies. High levels of corruption further discourage non-corrupt entrepreneurs from starting or scaling-up their businesses or drive entrepreneurs to operate in the informal economy.

Another important factor for entrepreneurial development is the length of time spent under communism, specifically as part of the Soviet Union. To a large extent, this characteristic alone explains the differences in entrepreneurial start-up rates across post-Soviet countries. Older generations in post-Soviet economies are far less likely to engage in business start-ups than their counterparts in other regions of the world [9]. By contrast, the younger generation has learned to adapt to the new context and conditions and are more inclined toward starting a new business. The longer a country spent under communist rule, the lengthier the process is likely to be.

In the literature, networks have been linked to entrepreneurial opportunity recognition as well as business success. Networks denote a system of personal relationships based on trust that provide entrepreneurs access to critical resources (such as information, finance, and labor) and also increase their abilities to recognize new business opportunities. In the absence of functioning institutions, established networks can become even more important [10]. In the Soviet context, Russians developed network strategies, referred to as “blat,” as a way to obtain scarce resources within the malfunctioning Soviet regime. Blat denotes a system of informal agreements, exchange of services, use of connections, and so on, to achieve results to “get ahead”; it spread widely throughout the Soviet Union. Originally, under Soviet rule, blat provided access to scarce resources for the masses; however, after the breakup of the Soviet Union, it never transformed into a role of providing access to scarce resources for entrepreneurs. Instead, blat transformed into an effective tool for the elite (in the Russian Federation). Blat’s shift from a network that was open to and utilized by the general public into an elite-only network is attributed to two main factors. First, blat was never rooted in a moral system: even during the Soviet regime, it was seen as “antisocial” and as a way of “cheating the system,” thus carrying amoral connotations [11]. This resulted in blat being easily manipulated toward opportunistic activities focused exclusively on personal gain. Second, since blat functions best by utilizing strong ties, those individuals closest to individuals with power, that is, the elite, are arguably able to benefit from it much more than less well-connected individuals. This has serious implications for broad-based entrepreneurial development, since in the strong-tie based network system, only the individuals in the inner circle of the elite can successfully utilize blat resources for business formation.

Limited access to effective networks within failing institutional environments has also exacerbated the lack of trust that already existed in post-Soviet countries. Lack of trust negatively affects entrepreneurial development as it influences expectations amongst the general population that may result in a self-fulfilling vicious cycle of poor institutional practices and corruption.

Though the interactions between institutions and entrepreneurial dynamics are complex, reducing corruption may be one of the key elements for supporting productive entrepreneurial development. However, it is difficult to test this relationship empirically given the lack of comparative data for entrepreneurial activity in most of the post-Soviet transition countries.

## Two differing paths for entrepreneurial development: Estonia vs Russia

The cases of Estonia and Russia provide interesting insights into the effects of different degrees of institutional reforms on productive entrepreneurial development. Estonia has been able to create a thriving institutional environment for productive entrepreneurial development while support for entrepreneurial development in Russia has been less effective.

Three important factors contributed to the positive development in Estonia. First, Estonia excelled as an “early adopter” of technology by digitally connecting its population through the internet. This has had a positive spillover effect for business development; business regulations are streamlined and new businesses can register online quickly and easily. In addition, almost universal wifi access has fostered technology-oriented entrepreneurial development by creating an online savvy population and a pool of experienced software developers that have open access to the greater EU market.

Second, Estonia benefitted significantly from EU integration in four key ways: (i) the EU provided a standard for “a normal society,” where corruption is not tolerated and entrepreneurship is promoted; (ii) the EU facilitated the direct transfer of functioning institutions from other EU countries that support entrepreneurship; (iii) the EU introduced institutions that reinforce democracy and free market principles; and, (iv) the EU provided direct access to a larger European market for goods and services [12]. Initially, following accession into the EU, Estonia’s GDP per person increased by 30%. At the same time, Estonia continues to be a net receiver of EU funds. It is estimated that by 2020, Estonia will have received €11 billion in EU support. However, it should be noted that while EU membership has been beneficial for Estonia, EU accession was by no means a “painless” process; it necessitated extremely high levels of commitment both domestically and in EU bodies to ensure successful institutional reform.

Third, Estonia has excelled at institutional reform. In 2011, seven years after becoming an EU member, Estonia became the first ex-Soviet republic to join the Eurozone. Compared with other post-Soviet countries, Estonia has been ranked near the top in a number of international assessments, including the World Bank’s 2015 Worldwide Governance Indicators, Transparency International’s 2015 Corruption Perceptions Index, The World Economic Forum’s 2014–2015 Global Competitiveness Index and in the World Bank’s 2015 Ease of Doing Business Index (see the illustration on p. 1). These rankings demonstrate the success Estonia has achieved in terms of promoting positive institutions and facilitating the development of productive entrepreneurship.

In contrast, Russia’s support for entrepreneurial development has been less focused [11]. Though the government is making large-scale investments to support high-tech entrepreneurial development, entrepreneurs are still routinely criminalized and imprisoned. From 1992 to 2012, Russia imprisoned nearly three million entrepreneurs, accounting for approximately 7% of Russia’s total prison population. Anecdotal evidence indicates that many entrepreneurs are imprisoned for small transgressions where a simple warning would have sufficed. The existence of high-profile arrests intensifies the threat to livelihood that can befall Russian entrepreneurs.

Initially, during the early years of transition, entrepreneurial development was not prioritized due to Russia’s abundance of natural resources, the influence of oligarchs and the “state capture” of economic policies (state capture refers to a situation in which firms are able to shape the laws, policies, and regulations of the state to their

own advantage by providing illicit private gains to public officials). However, the recent decline in oil prices has instigated a push toward economic diversification and has renewed interest in supporting entrepreneurial development. The creation of industrial parks is one of the most visible business development initiatives in Russia. According to the 2012 Entrepreneurship Barometer, 32% of entrepreneurs surveyed in Russia currently use or have used business incubators, which provide targeted support for new businesses, compared to the G20 average of 21%. This is a positive sign, indicating that these initiatives are taking root in supporting and helping new business development. Moreover, in 2013 the Russian government allocated US\$200 million of government-backed financing to invest in internet start-ups. However, corruption continues to be a concern for many Russian entrepreneurs. According to the 2012 survey by Opora Russia, an organization that represents small businesses in Russia, 42% of Russian business owners reported “severe difficulties” in starting a new company; 27% of whom reported frequent inspections by regulators that led to the paying of bribes. In the end, the lack of consistent institutional reform and political commitment in Russia results in a precarious situation for productive entrepreneurship development.

### **Soviet and post-Soviet entrepreneurs**

Under Soviet rule, legal forms of private business ownership were severely limited. In the mid-1980s, the individual sale of handicrafts or produce grown on private garden plots was legalized. Regulations were further relaxed and by the late 1980s individuals were allowed to form limited forms of cooperative style enterprises. But it was only in the mid-1990s that all forms of private enterprise were finally legalized.

However, even when it was illegal, certain forms of entrepreneurship existed and even thrived during Soviet rule. Although it may seem like a contradiction in terms, the very nature of the planned economy inadvertently promoted the development of widespread illegal entrepreneurial activity, largely as a response to the chronic shortages of consumer goods that plagued the Soviet system. These illegal entrepreneurs identified opportunities and developed their business know-how and skills running profitable underground businesses. A unique characteristic of this illegal entrepreneurship experience is that it was acquired without the expectation that it would ultimately be useful in a market-oriented system. Research on entrepreneurs with illegal pre-transition experience shows that they are likely to continue operating and growing a business in a market-oriented economy [13].

In the post-Soviet context, entrepreneurs can choose to start businesses in the formal or informal sectors (or both). But when the governing structures are predominantly corrupt and rent seeking, entrepreneurs may choose to function solely in the informal sector. While informality may be advantageous in the short term, in the long term, businesses functioning in the informal sector are more limited in terms of their access to key resources such as finance, business networks, and support programs.

There are also growing numbers of self-employed individuals in post-Soviet countries. However, the self-employed should not be confused with individuals who operate a private business as entrepreneurs. It is common for a number of professions, such as consultants, dentists, accountants, and domestic cleaners, to own their own businesses. But entrepreneurs are different. They are involved in innovative activities related to the creation and growth of new ventures.

## Entrepreneurship in weak institutional environments

The post-Soviet landscape includes a number of countries where the institutional environment remains weak and incentives are lacking for productive entrepreneurship development. The weak institutional environment enables unproductive or destructive entrepreneurship to develop. Once entrepreneurial activity becomes associated with corruption, rent seeking, and illicit activities, productive entrepreneurs are less likely to engage in entrepreneurship, or, when they do, more likely to move their operations into the informal sector.

Tajikistan provides the most extreme case of institutional failure and lack of support for productive entrepreneurial development. Tajikistan's national income is based on two main sources: remittances and drug trafficking. Domestic entrepreneurial activity is largely focused on the illegal drug trafficking of heroin that is produced in Afghanistan and sold in Russia.

Though lucrative, the high domestic dependence on "illicit entrepreneurship" has a negative effect on productive entrepreneurial development in Tajikistan in four key ways: (i) it has led to corruption within the higher levels of government; (ii) close ties have developed between the government and drug lords, which fosters the rise of a corrupt elite and ineffective law enforcement; (iii) illicit entrepreneurship crowds out the development of productive entrepreneurship in sectors most targeted for criminal investment such as bars and restaurants, construction, wholesale and retail trade, transportation, real estate activities, and hotels; and, (iv) the weak institutional environment has led to state capture and control of the media. In Tajikistan, as in other countries with weak institutional environments, it is common to find larger numbers of entrepreneurs starting businesses "out of necessity" and operating in the informal sector rather than founding "opportunity-driven" businesses in the formal sector.

However, the technology sector can provide opportunities for entrepreneurs to start and grow businesses, even in countries where institutions are weak. Entrepreneurs operating in the technology sector, for instance, tend to be less affected by the prevailing corrupt conditions due to four reasons: (i) lower startup costs; (ii) the ability to function under the radar, even informally at first, in a largely unregulated, non-monopolized and less corrupt sector; (iii) ease of mobility within and beyond a country's borders; and, (iv) the potential for rapid growth and high profit margins. However, there are also disadvantages for technology sector growth and expansion in weak institutional environments. The relative immaturity of the technology sector results in a lack of access to the key resources needed for tech sectors to expand and grow (such as mentors, informal "angel" investors and partners). Moreover, the technology sector can become a silo: entrepreneurs who are successful in the technology sector may encounter difficulties in entering other lucrative economic sectors due to existing monopolies or corrupt practices.

## LIMITATIONS AND GAPS

The main limitation for conducting entrepreneurship research for post-Soviet countries is the lack of reliable comparative data. The most comprehensive data set that currently exists is the European Bank of Reconstruction and Development's Life in Transition Surveys (LITS), which include all 15 post-Soviet countries and were conducted in 2006 and 2010. Other data sets such as the OECD and Eurostat Entrepreneurship Indicators



Program, or the Global Entrepreneurship Monitor's data contain a sub-sample of some of the more economically advanced post-Soviet economies, but are not sufficient for conducting thorough cross-country analyses.

Furthermore, many post-Soviet countries continue to be characterized by large informal and shadow economies where many entrepreneurs operate. Though notoriously difficult to collect, comparative estimations on the size and scope of informal entrepreneurship in post-Soviet countries could provide a more accurate account of how institutions affect entrepreneurial outcomes in post-Soviet countries.

Further knowledge gaps exist when it comes to understanding the links between corrupt behavior and other influencing factors such as the existence of a free press and media, civic engagement, network behavior, civil servant wages, and job rotation. More research is also needed on how informal institutions such as beliefs and attitudes shape entrepreneurial development. Specifically within the post-Soviet context, a better understanding is needed about how these societies' deeply rooted views affect entrepreneurial development and how they can be adapted to create an enabling environment for productive entrepreneurial development. Additional qualitative insights are also needed on how different forms of entrepreneurship influence institutional change.

## SUMMARY AND POLICY ADVICE

More than 25 years since the breakup of the Soviet Union, many post-Soviet countries are still grappling with the legacies of their Soviet-style institutions. Corruption and weak rule of law continue to inhibit the development of productive entrepreneurial development. The formal and informal institutional environments play critical roles in shaping incentives that drive the allocation of entrepreneurial talent to productive and non-productive activities. Therefore, it is paramount that policies address both the formal and informal institutions that impede entrepreneurial development. Institutional and policy initiatives that focus on reducing regulatory burdens are important, but must also be combined with reduced corruption and a commitment to long-term economic, political, and institutional reform. International integration such as EU membership has provided a solid template for building institutions that reinforce democracy, free market principles, and support entrepreneurial development. These effects are visible in countries like Estonia, Latvia, and Lithuania, who joined the EU in 2004. Other international membership organizations such as the Asia Pacific Economic Cooperation (APEC) or the World Trade Organization (WTO) may also help sustain commitment to the institutional reforms needed to foster productive entrepreneurial development.

However, even where rule of law is weak and corruption high, the new globalized, digitized world economy provides opportunities for technology-based entrepreneurs to interact with a broader market and, if needed, operate informally. In order to be successful, these entrepreneurs may need to leave their home countries and immerse themselves in more conducive environments located in advanced market economies with technology hubs such as Silicon Valley, London, Berlin, or Paris. While there, they can access those locations' existing funding opportunities and support networks, launch their products or services in mature foreign markets, and then duplicate their business model back in their home country. These entrepreneurs can serve as much-needed role models and potentially play a future role in fostering the institutional change needed for developing a productive entrepreneurial society.

Instead of restricting movement out of a fear of brain drain, it would be wise for post-Soviet countries to embrace “entrepreneurial circulation” by removing the barriers for returning entrepreneurs. Returning entrepreneurs can bring knowledge, capital, and networks, which may be the missing piece for jumpstarting economic development through increased innovative entrepreneurial activity. Moreover, engaging the diaspora of successful entrepreneurs living abroad can provide local entrepreneurs with the support and resources they need, even in weak institutional environments. Informal networks of investors can be cultivated within the business community or through non-governmental organizations (NGOs) to provide capital and mentorship to entrepreneurs in their home countries.

Successful institutional reform may not be enough to retain entrepreneurship capacity given the small size of the domestic market and limited talent pool in some post-Soviet countries. Community diversity has been found to increase entrepreneurship activity in advanced economies as well as in post-Soviet countries. Encouraging diversity through immigration may provide benefits for expanding the scope of productive entrepreneurial activity. To expand its entrepreneurship base, Estonia recently introduced an e-residency program that allows entrepreneurs, regardless of nationality or citizenship, to register their internet-based businesses in Estonia without ever physically visiting or setting up business operations in there.

Though it is relatively easy to identify impediments to entrepreneurship such as corruption and excessive regulations in the post-Soviet context, it is far more difficult to alter these practices. Unwavering and focused commitment on the part of key stakeholders like the government is critical to push through often unpopular yet necessary stages of the reform process. Post-Soviet countries can also learn to adapt new techniques for reducing corruption from other countries and regions. Two effective examples include the introduction of a “zero rupee note” in India by the NGO Fifth Pillar to deter bribing and the “I paid a bribe” internet platform and movement initiated in India that has expanded to include Ukraine and Azerbaijan. Both initiatives have been successful in not only raising awareness about the need to reduce corruption, but also in providing tools that empower individuals to take action to stop corrupt behavior.

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### **Competing interests**

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

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