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## Assignment

### “Advanced Studies in Entrepreneurship”

**“The role of institutions and entrepreneurship in post-socialist economies – A review”**

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## Abbreviations

CEE	Central and Eastern Europe
CIS	Commonwealth of independent states
CPI	Corruption perception index
EBRD	European Bank for Reconstruction and Development
FDI	Foreign direct investment
GDP	Gross domestic product
GEM	Global entrepreneurship monitor
OLS	Ordinary least squares
PS	Post-socialist
SME	Small and medium sized enterprises
VC	Venture Capital

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## **1 Introduction**

The fall of the Berlin wall and the collapse of the Soviet Union during the 1980s and 1990s coincided with the demise of centrally planned economic systems in most of the Central and Eastern European (CEE) countries, resulting in the transition to a free market economy<sup>1</sup>. A number of authors have suggested that the end of transition is achieved by reaching this level. It seems clear that the eight transition countries that are now European Union (EU) members fulfill the criteria and could be categorized as post-transitional countries. However, the Soviet heritage still remains persistent regarding rules, industry structure and also cultural aspects. Changing the rules between government and private sector is difficult. Furthermore the establishment of reasonable norms and laws to protect investors and to give appropriate incentives to entrepreneurs usually takes a long time. Therefore inappropriate institutions could be classified as a systemic failure.

A case study from Smallbone and Welter (2001, p.257) illustrates the ongoing transformation processes, especially the obstacles to private initiatives: “Mr. O [...] used his political contacts to speed up the privatization process of a state clinic in Kishinev where he worked previously. He initiated the reorganization and privatization process himself, although this took more than 3 years from the time of the application until permission was granted because of a general lack of co-operation and constant hassling by minor officials. O claimed that he was only able to complete the privatization by using his political contacts with the Chairman of the national parliament to put an end to the harassment from 'lower-level' administration”.

## **2 Institutional theory and entrepreneurship development**

### **2.1 Research questions and selected articles**

Examining the institutional setting for entrepreneurship during the transition process one can scrutinize which types of entrepreneurship might occur, which role the institutional setting plays in shaping entrepreneurial activity and how entrepreneurship and institutions could be measured or compared. Regarding these

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<sup>1</sup> An economic and social system is considered to be conducive to free-market entrepreneurship if the means of production are mostly privately owned and a market economy operates, that is, decisions are influenced by competition, supply, and demand. (Kshetri 2009)

questions I analyzed the following articles. Table 1 provides an overview about these sources (main articles are highlighted in boldface type).

*Table 1: Overview about the articles*

Article	Publication	Type
Aidis, R., 2005. Entrepreneurship in transition countries: a review.	Working Paper	Conceptual (Summary)
<b>Johnson, S., McMillan, J. &amp; Woodruff, C., 2000. Entrepreneurs and the Ordering of Institutional Reform: Poland, Slovakia, Romania, Russia and Ukraine Compared.</b>	<b>Economics of Transition</b>	<b>Empirical (Own data)</b>
<b>Tominc, P. &amp; Rebernik, M., 2007. Growth Aspirations and Cultural Support for Entrepreneurship: A Comparison of Post-Socialist Countries</b>	<b>Small Business Economics</b>	<b>Empirical (GEM)</b>
<b>Aidis, R., Estrin, S. &amp; Mickiewicz, T., 2008. Institutions and entrepreneurship development in Russia: A comparative perspective.</b>	<b>Journal of Business Venturing</b>	<b>Empirical (GEM)</b>
Smallbone, D. & Welter, F., 2001. The distinctiveness of entrepreneurship in transition economies.	Small Business Economics	Explorative (Own data)
Kshetri, N., 2009. Entrepreneurship in post-socialist economies: A typology and institutional contexts for market entrepreneurship.	Journal of International Entrepreneurship	Conceptual

*Source: Own investigations*

The three main papers did empirical cross-country analyses comparing Poland, Slovakia, Romania, Russia Ukraine, Hungary and Slovenia with regard to different institutional factors. Moreover a conceptual framework with propositions based on institutional theory by Kshetri (2009) and a seminal article by Smallbone and Welter (2001) as well as a review article by Aidis (2005) have been credited to lay out the theoretical foundations for this work.

## **2.2 Theoretical approaches**

To establish a base of theory it is necessary to define the institutional context. First of all North differentiates between formal, codified rules, laws and informal, spontaneously created institutions such as behaviors and other conventions (Aidis et al. 2008). This rough definition is further refined by a regulative, normative and cognitive distinction. Regulative institutions consist of “explicit regulative processes: rule setting, monitoring, and sanctioning activities” (Kshetri 2009, p.247). They are linked to regulatory bodies and the existing laws and rules that influence entrepreneurship. Normative components introduce “a prescriptive, evaluative, and obligatory dimension into social life”. (Kshetri 2009, p.249) They include

habits that are consistent with and take into account different assumptions and value systems which are then more likely to be successful in this particular context. Cognitive institutions are arguably most closely associated with culture. “These institutions represent culturally supported habits that influence entrepreneurship. In most cases, they are associated with cognitive legitimacy concerns that are based on subconsciously accepted rules and customs as well as taken-for-granted cultural account related to entrepreneurship” (Kshetri 2009, p.250).

Furthermore Aidis and colleagues (2008) identified two streams of literature mainly dealing with the relationship of entrepreneurship and institutions. Firstly Baumol states that “institutions are important as the structures that provide the incentives for different types of economic activity”. Secondly North argues that “entrepreneurs are the main agents of change. Organizations such as firms set up by entrepreneurs will adapt their activities and strategies molded to fit the opportunities and limitations provided through the formal and informal institutional framework” (Aidis et al. 2008, p.658)

### **2.2.1 Types of entrepreneurship and societal implications**

Baumol further assesses different types of entrepreneurial activity that could emerge due to institutional conditions. Productive (free-market entrepreneurship) depends on (newly created) market institutions, private enterprises and the mechanism of supply and demand and the introduction of change and innovation. Unproductive or even destructive entrepreneurship refers to criminal or quasi-criminal activities such as organized crime. In this case institutional forces pushed economic activity to the underground.

North on the other hand formulates conditions under which market entrepreneurship is most likely to occur. Ideally, “formal rules are designed to facilitate exchange reducing transaction costs, they are also likely to affect individuals or groups in different ways. Formal rules and institutions, since individuals create them in their own private interest, do not necessarily operate in the interest of social well-being” (Aidis et al. 2008, p.658).

### **2.2.2 Entrepreneurship in post-socialist transition countries**

As indicated above the transition period is characterized by a shift from public to private ownership, the introduction of a market mechanism and increase in market opportunities and amplified level of competition. Empirical evidence based on European bank of reconstruction and development (EBRD) indicators shows that between countries where market institutions have been properly installed (e.g. Poland, Estonia) and those which are slow in adapting these standards (Ukraine, Belarus) there is a measurable gap of entrepreneurial activity (Smallbone & Welter 2001) and a lack of stability in the external economic and political environment (Kshetri 2009).

Aidis et al. (2005) elaborated patterns for stages of small and medium sized enterprise (SME) development in post-socialist (PS) countries, notably in Russia, Lithuania and Poland. During the early stages of transition until 1995 these countries experienced a high growth in the number of SMEs mostly in the consumer goods, trade, housing and communal services sector. Afterwards, the combination of increasing regulations (such as administrative requirements, taxation) coupled with decreasing business opportunities (due to increasing competition) seemed to influence the decreasing numbers of private enterprises. On the other hand this could also be interpreted as a stabilization and less turbulence. The third stage is basically characterized by the EU Accession of certain CEE countries. The market integration will increase overall business opportunities but EU assessments already indicate that enforcement problems of EU laws exist in the new accession countries. Uneven implementation and enforcement could easily be influenced through networks and corrupt behaviors resulting in unfair policy application. A summary of institutional barriers to entrepreneurship at different stages of transition can be found in the Appendix (Figure 1).

The issue here is not that PS economies lack entrepreneurship talents but that a significant proportion of entrepreneurial ventures in these economies lack the characteristics of productive free-market entrepreneurship. The real question then is, what conditions can transform the rules of the game (Baumol) so that various forms of unproductive and inefficient forms of entrepreneurship can be converted

into productive and efficient free-market entrepreneurship (Kshetri 2009). Transplantation of western institutions failed because of mental and moral disposition inherited from the old regime. Below different market institutions that might affect this process are outlined.

## **2.3 Market institutions**

### **2.3.1 Legal conditions**

Government laws and regulations define rights, the rules for exchanging them and most importantly these rules provide the infrastructure to enforce them. They also set the rules for market entry and exit respectively support competition and they set the basic framework in which entrepreneurship can develop. That involves laws relating to property, licensing and the registration of enterprises as well as for bankruptcy, contracts and taxes (Aidis 2005). In countries where transformation is more advanced, such as Poland or Hungary, the establishment of an appropriate legal system and infrastructure to facilitate the development of markets is more or less complete, and personnel for law enforcement exists. However, in less advanced transition economies a highly inadequate legal system poses a major barrier for entrepreneurs. Generally, in less free states, entrepreneurial efforts are diverted from wealth creation to non-market behaviors (Kshetri 2009) thus resulting in unproductive or destructive forms.

### **2.3.2 Tax system**

Other highly important state-related barriers seem to be either the high level of taxes, the frequent changes to tax policies and the ambiguity of tax policies (Aidis 2005). Moreover penal levels of taxation, complicated tax structures, as well as unstable macroeconomic situations lead many enterprises to operate at least a part of their activities in the shadow economy in order to survive (Smallbone & Welter 2001).

### **2.3.3 Financial system**

A number of studies have indicated that the lack of finance is a barrier for businesses in the transition context (Aidis 2005). Still a significantly positive relationship is found between a business environment that promotes access to financing

and the size of the SME sector. In this regard the level of venture capital (VC) correlated with entrepreneurial activity, e.g. Hungary which has a developed VC market has a comparably high number of start-ups. But also an open capital market to encourage foreign direct investment (FDI) plays a role. FDI needs to be backed up by property rights to ensure stability and security for investors (Smallbone & Welter 2001). Nevertheless, financing is a complex issue to analyze since there are several interacting dimensions: firm size and sophistication, general macroeconomic development, competition, the existence of informal sources of financing and the development of the banking sector (Aidis 2005).

#### **2.3.4 Bureaucracy and corruption**

Studies conducted in China, Russia, and Eastern European economies found out that another highly important barrier in the transition to free-market economy centered on Communist Party bureaucrats' resistance (Kshetri 2009; Aidis 2005). This resistance is usually associated with significantly augmented costs of doing business which in turn prevents potential entrepreneurs from starting a business. Overregulation and interference with the private sector further led to increased levels of corruption (Aidis 2005) which results in higher uncertainty.

#### **2.4 Entrepreneurial Culture**

Smallbone and Welter (2001) state that one extremely important role for the state in relation to entrepreneurship and the development of private business is through its influence on the value placed on enterprise and entrepreneurship within society. Regarding cultural support for entrepreneurial motivation, a higher degree of motivation for entrepreneurship can be expected in those environments where entrepreneurship is socially legitimate and viewed as acceptable behavior (Tominc & Rebernik 2007). Likewise, with the development of skills and expertise needed for free-market entrepreneurship, the psychology of risk taking, and social networks to provide support for entrepreneurship, governments are likely to face pressures to enact new laws and regulations (Kshetri 2009) to facilitate the creation of new enterprises.

## **2.5 Business networks**

It is also necessary to take into account the importance of networks and informal connections as institutions, which adds a transition-specific dimension to the previous management and entrepreneurial experiences. In an unstable and weakly structured environment, informal networks often play a key role in helping entrepreneurs to mobilize resources, win orders and cope with the constraints imposed by highly bureaucratic structures and often unfriendly officials (Smallbone & Welter 2001). Consequently they represent a substitute for weak institutional environments. In this respect trust is a good example. It takes time for a trustworthy relationship to be established through repeated business interactions. Therefore those already in a business network may have a significant advantage over newcomers (Aidis et al. 2008).

## **3 Methods**

### **3.1 Variables**

#### **3.1.1 Institutional measures**

Above all researchers face difficulties to measure institutions in an appropriate way. They usually rely on questions about perceptions or expert interviews which are not unbiased. Aidis et al (2008) use the corruption perception index (CPI) from Transparency international as an overall measure of the level of institutions combined with a legal origins category variable “viewed as a proxy for the government's proclivity to intervene in the economy and the stance of law toward security of property rights” (Aidis et al. 2008, p.660) which describes the different density levels of regulation in these countries. Similarly Tominc and Rebernik (2007) employ the degree of growth aspiration in employment, market creation and technology through (perceived) business opportunities, cultural support for entrepreneurial motivation and self-confidence in skills, knowledge and experience needed for entrepreneurship. Finally a larger study by Johnson et. al (2000) directly employs various institutional indicators through the usage of monetary equivalents or costs to explore the development of market infrastructure e.g. security of property (law suits), cost of doing business and finance (reinvestments of profits) which avoids the perception bias.

### **3.1.2 Entrepreneurship measures**

Entrepreneurial activity can be measured in several ways, depending on the step of the entrepreneurial process which is on focus. One article used start-up activity and business owners of established firms (Aidis et al. 2008). Other scholars employed the concept of nascent and early stage entrepreneurs which are identified as those individuals, who are, firstly, personally involved in the creation of a new venture or who are, secondly, employed as owners/managers of a new firm less than 42 months old (Tominc & Rebernik 2007). However the former does not explain whether these individuals really start and/or are successful. Eventually self-employment respectively employment growth within small firms have been utilized as an entrepreneurship proxy (Johnson et al. 2000), which unfortunately is a very broad definition of entrepreneurship.

## **3.2 Data analyses**

### **3.2.1 Available Datasets**

The missing research in the area of entrepreneurship in PS countries is related to missing data and the low quality of existing data making it difficult to compare regions. With the extension of the Global Entrepreneurship Monitor (GEM) researchers had a new standardized instrument that allows them to control for a variety of individual characteristics. On the other hand more specific data from a survey of private manufacturing firms, undertaken in Russia and Ukraine, as well as in Poland, Slovakia and Romania (Johnson et al. 2000) was used as well.

### **3.2.2 Techniques**

One team of authors used ordinary least squares regressions (OLS) predicting the percentage growth in employment (Johnson et al. 2000). Further Aidis et al. (2008) carried out probit regressions to examine differences between countries in terms of legal origin, entrepreneur's characteristics and entrepreneurial knowledge. Another comparison technique was utilized by Tominc & Rebernik (2007) who calculated chi-squared tests for differences in growth aspirations employment, market creation/technology to compare nascent/new entrepreneurs. This econometric method is relatively weak compared to probit regressions.

## 4 Discussion

### 4.1 Analysis of methods

Within the exploratory study by Johnson et al. (2000), EBRD measures of legal effectiveness as well as financial system reform measures constitute their theoretical framework. Although a range of indicators (e.g. Index of Economic Freedom) is presented they only make use of a small fraction. Their survey is based on small and medium sized manufacturing firms albeit excluding firms with less than 10 employees which is a bias. The authors then explore employment growth and sales growth in a two-year period by using OLS regressions and ordered probits. They control for funding, security of property rights and courts which can be used to enforce contracts as well as overall employment and industry respectively country dummy variables. Regressing employment growth by using employment in a certain year seems questionable since these might be highly correlated. Interestingly they distinguish between newly created firms and “spin-offs” from former state-owned enterprises. Only in Poland, Ukraine and Russia these did contribute to employment growth, most of them shed labor during the period of examination.

In sum, the authors find evidence for an association between sales growth on the one hand and internally financed investment and security of property rights on the other hand. Still, they can uncover no evidence that access to external finance is associated with faster growth. So, if entrepreneurs are subject to discretionary expropriation, they will be reluctant to invest even if finance is offered. The biggest differences in both growth rates occurred between CEE and the former Commonwealth of independent states (CIS) countries (e.g. Russia and Ukraine) The authors also conclude that market reforms only have an effect if corruption is controlled and stability is demonstrated (Johnson et al. 2000) which is consistent with theory above.

In their study Aidis et al. (2008) merge individual characteristics from the GEM database with country controls such as governance indicators of the Worldbank (voice and accountability, regulatory quality and governmental effectiveness) and a legal origin proxy variable which is questionable since there might be a gap be-

tween legal framework and actual enforcement. Moreover the CPI index as a perceptive variable is included in the country-specifics. Combining different data sources is problematic as they are collected in different ways (perception vs. direct questions) but this is unavoidable since the GEM index does not provide any institutional variables. Firstly they compared Russia to 30 countries from the GEM datasets to examine institutional influences. Secondly according to theory above the authors argue that entrepreneurial networks would have a positive influence. They use business angel and personal contact to an entrepreneur as variables. With regard to these networks only Russia, Brazil and Poland have been compared which is somehow a breach in methodology as they used the full GEM sample in the first place. The authors justify their selection by arguing that Poland has a comparable history and Brazil a similar GDP figure with regard to Russia. This is maybe due to data availability. However the institutional setting might differ in CEE countries (e.g. Poland) compared to former CIS countries.

The analysis reveals a significantly lower start-up rate in post-socialist countries which have been defined by legal origin. Russia even scores lower and is different to CEE region. With regard to informal networks the authors compared pseudo-R<sup>2</sup> for the three different countries. So business angels and the knowing of entrepreneurs increases the probability of becoming an entrepreneur. This is also influenced by the level of education and of the fact if they are current business owners. Still much of the networks concern unproductive activities. Thus “the weakness of institutions is detrimental to entrepreneurial activity and though networks are important, they are not entirely able to offset these deficiencies” (Aidis et al. 2008, p.670). Above all the method they use only allows for the fact that differences in levels of entrepreneurship across countries are explained which might have other influences although they control for a wide range of personal indicators.

A comparison of CEE countries regarding entrepreneurial culture has been done by Tominc & Rebernik (2007). Their theoretical part is based on the entrepreneurial process of opportunity recognition, evaluation and exploitation which is reasonable as they empirically build upon the concept of nascent and new en-

trepreneurs. The authors expect the cause of higher growth aspirations of early stage entrepreneurs to be a higher degree of alertness to unexploited perceived opportunities among adults in a particular country. Cultural support for entrepreneurial motivation (societal norms) are incorporated in adults' opinions, self-confidence in skills, knowledge and experience needed for entrepreneurship. These might be different in Slovenia, Hungary or Croatia although these countries share geographic proximity and a common non-capitalist history. However they differ in size which could affect their openness towards markets. Smaller countries tend to be more open since they only have a small domestic market.

Findings suggest that the perceptions of good business opportunities by adults in Slovenia are significantly different from the perception by adults in Croatia and Hungary. Cultural support for entrepreneurial motivation is different in Slovenia as well. Most of the components of cultural support for entrepreneurial motivation are incorporated in adults' opinions in Slovenia to a greater degree than they are in Hungary or Croatia. Furthermore there is no difference between Slovenia and Croatia, while Hungary differs statistically regarding beliefs among adults about knowledge, skills and experiences needed for entrepreneurship. The majority of differences occurs between Slovenia on the one hand and Croatia respectively Hungary on the other hand (Tominc & Rebernik 2007). These disparities might also be an indicator for different levels of openness towards markets. Furthermore they assess peoples' opinion towards entrepreneurship by asking for general intentions but this does not concern the actual level of early entrepreneurship in that particular country. For example in Slovenia the actual level of entrepreneurial activity is relatively low despite the high growth aspiration. Although the authors did not provide specific policy implications improving entrepreneurship education to enhance the skills on the one hand and creating entrepreneurial role models to garner more societal support might be advisable.

#### **4.2 Limitations**

One main drawback of analyses in post-socialist countries is the data availability. Governmental agencies lack the infrastructure to collect data and make it available to the scientific community (Johnson et al. 2000). Therefore no time-series exist

to carry out longitudinal studies which could model the transition process. Similarly the usage of different approaches might cause problems. GEM data is comparable in the majority of cases, but many surveys cover specific industries or countries. For example two of the main articles use GEM data whereas the third gathered own data from manufacturing firms. Another methodological issue concerns the theoretical frameworks. Many of the niche-journals and working papers do not have grounded theory (Aidis 2005; Johnson et al. 2000). Additionally these publications do not supply testable hypotheses but rather explore data from conducted surveys. This leaves some phenomena unexplained.

When exploring entrepreneurship it is also necessary to distinguish between direct and indirect effects.<sup>2</sup> In the transformation context it would be particularly interesting to see how incumbent firms react and how strong the supply side effects (e.g. in terms of employment growth) would be. Other factors to be taken into account are the limited policy implications of the research. Transition as a political process might have different outcomes related to entrepreneurial activity as it comprises an interplay of socialist leftovers and culture. Especially in early stages of transition Smallbone and Welter (2001) suggest as an example that many enterprises are set up, survive and sometimes even grow despite government interventions, because of the creativity and drive of individuals and their flexibility in adapting to hostile external environments.

### **4.3 Future research**

Further research areas could include the impact of the EU-Accession on entrepreneurial activity in certain CEE countries and possible policy implications to foster an entrepreneurial culture through the development of institutions.

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<sup>2</sup> Direct effects: e.g. employment growth within new firms

Indirect effects: e.g. market creation, , incumbent employment, overall employment

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## Appendix

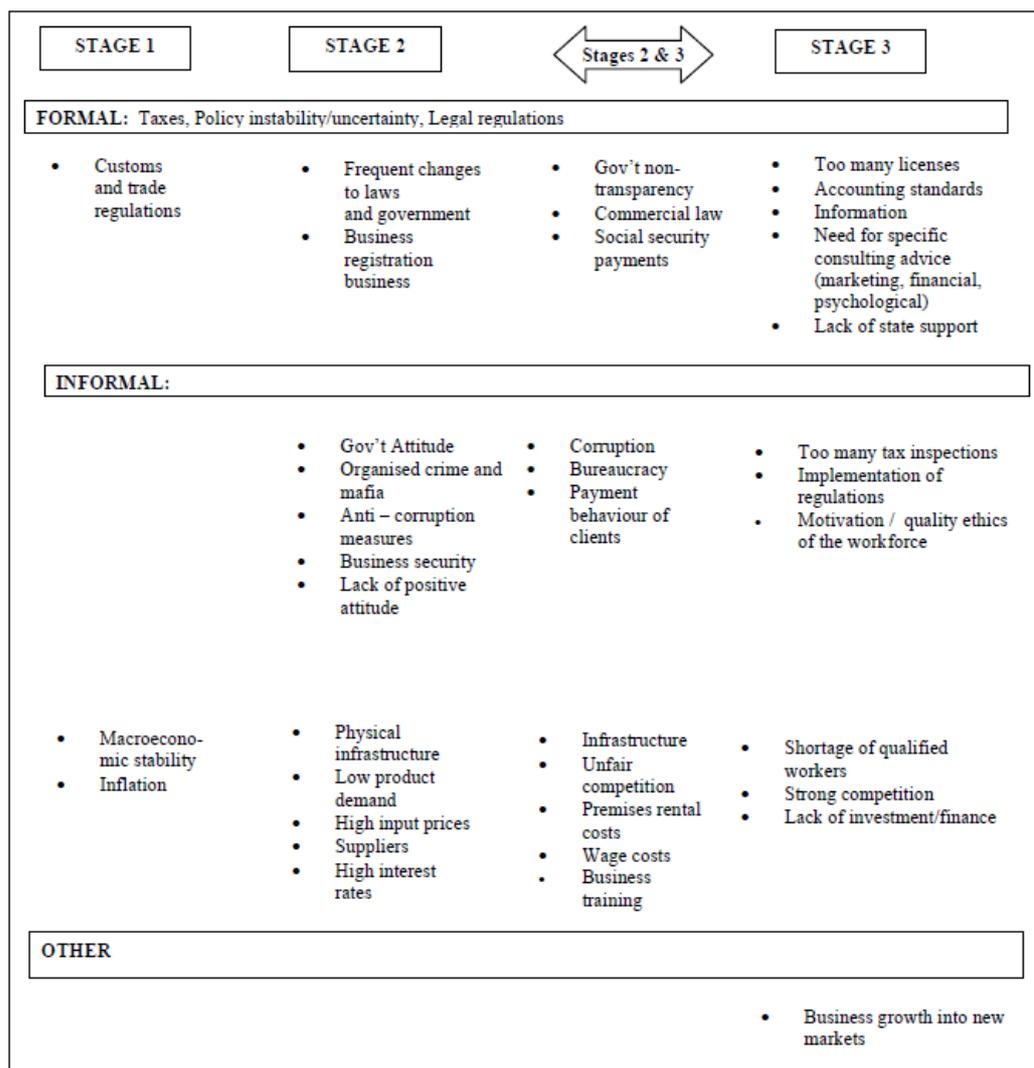


Figure 1: SME Barriers at different transition stages

Source: Aidis (2005)