Economic Regulation, Institutions and Entrepreneurship: Perspectives from the Experience of States in Transition

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Abstract

The present paper analyses the evolution of entrepreneurship in former communist countries during their transition to a market economy, seeking to identify the rules, regulations and institutions that influenced this evolution. I start by exploring the theoretical link between regulations, transition, and entrepreneurship, concluding, based on existing literature, that there exists a "vicious circle" between the three elements, which are strongly interlinked. I then observe this relationship in practice, by focusing on the case of the former communist countries from Eastern Europe and Central Asia. I analyse the interplay between data on the intensity of business activity, and multiple measures of regulations relevant for entrepreneurship in the above-mentioned countries, carrying out comparisons and attempting to draw inferences on causality. I show that the quality of regulations matters for business success, and good rules such as the protection of private property, reduced bureaucracy, low tax rates, and the control of corruption are crucial for supporting entrepreneurship.

Keywords: *entrepreneurial activity, economic regulations, taxation, private property, control of corruption.*

JEL Classification: K11, K34

1. Introduction

This paper analyses the evolution of entrepreneurship in former communist countries, seeking to identify how did economic rules and regulations influence it. In other words, I want to understand if and to what extent the quality of economic rules and regulations matters for business success. For this, I choose to analyse the evolution of transition countries, as all had to build from scratch their legal and economic systems around the same time, when they experienced the regime change, making a very good sample for comparisons and investigations of the link between regulations and entrepreneurial success.

I start by exploring the theoretical interconnection between economic regulations, transition, and entrepreneurship, and I conclude, based on existing literature, that there is a "vicious circle" between these three elements, which are strongly interlinked: quality of regulations is essential for the development of entrepreneurial activity, the latter being, in turn, a key driver of transition and economic development. I then observe this relationship in practice, by analysing the interplay between data on different measures of entrepreneurial intensity in the former communist states, and multiple indicators of regulations relevant for entrepreneurship in the above-mentioned countries, carrying out comparisons and attempting to draw inferences on causality based on regression analysis. I show that the quality of regulations matters for business

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success, and good rules such as the protection of private property, reduced bureaucracy, low tax rates, and the control of corruption are crucial for supporting entrepreneurship.

2. Theoretical approach

Along with macroeconomic reforms, transition economies had to build from zero a new regulatory system, one that would support the emergence of a market economy, as very few of the legal and institutional structures remaining from the communist regime could act as a foundation for entrepreneurial activity[2]. Roland (2001)[3] explains that building of this new regulatory system was not only needed but may actually be considered the key element of transition, as explained by liberalization, stabilization and privatization reforms do not deliver the expected, successful results if not grounded in proper institutions. Many other scholars (such as Dewatripont & Roland, 1996[4]; Moers, 1999[5]; Havrylyshyn & Van Rooden, 2003[6]; Fischer & Sahay, 2004[7]; Murrell, 2006[8]) acknowledge the role of institutions for economic growth in transition countries, explaining how they provide the fundamental structure for a market economy.

However, what this new regulatory system implied? Shleifer (1997)[9] defines this new regulatory system as "the creation of laws and legal institutions that protect private property, enforce contracts between private parties, but also limit the ability of officials to prey on private property", as well as "the creation of regulatory institutions that deal with competition, securities markets, banking, trade, patents and so on." Also, from Shleifer (1997)[10] we can summarize the characteristics of a successful institutional and regulatory transition, that should:

1. guarantee property rights and their enforcement.
2. ensure the enforcement of contracts through a strong judicial system.
3. restrict government's ability to pray on the private sector, for instance through corruption and demands of informal payments.
4. support free competition on the market.
5. support free trade;
6. support the development of a strong financial sector.

Yet their progress in developing such a system was rather slow, and the main incentive for carrying out legal reforms was the need to comply with the European Union

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[2] Estrin, S., Meyer, K. E., & Bytchkova, M., *Entrepreneurship in transition economies*, in Casson, M., Yeung, B., & Basu, A. *The Oxford handbook of entrepreneurship*, Oxford University Press on Demand, 2008.

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[8] Murrell, P., *Institutions and transition*, Prepared for The New Palgrave Dictionary of Economics, 2nd edition, 2006.

[9] Shleifer, A., *Government in transition*, in European Economic Review, 41(3), 1997, pp. 385-410.

[10] Ibid, pp. 385-410.

(EU) regulations as a necessary condition for EU accession[11], and not the importance of the quality of regulations itself for a better functioning of the economy. Regulatory reform was also not an easy task, as changing the rules that govern the interplay between different actors encounters serious resistance[12]. Estrin et al. (2009)[13] notice that transition economies are, as many other developing countries, characterised by many elements rather associated with a "weak" regulatory environment, such as poorly conceived and/or ineffectively enforced property rights, or insufficiently developed capital markets. In addition, there are still many informal practices reminiscent of the communist period that, in combination with weak or partially developed market regulations, may determine entrepreneurs to develop a counterproductive behavior in order to offer a proper response to such challenges[14].

Regulations are not only relevant for successful transition, but they have also been proven to play a crucial role in shaping the entrepreneurial activity in a general context. As highlighted by Wennekers & Thurik (1999)[15], institutions and regulations affect both the supply and the demand of entrepreneurs, through their influence on economic behavior and transactions. When financial and legal regulations are inefficient and not properly enforced, entrepreneurs are more likely to engage in corrupt practices, which become justifiable when they see illegal business activities as a widespread business practice[16]. Murphy, Shleifer and Vishny (1993)[17] explain that corruption makes tallent shift away from productive entrepreneurial activities to unproductive rent-seeking ones, while Basu, Estrin & Svejnar (2005)[18] also indicate that if the institutional context is weak, then entrepreneurs might become involved in unproductive practices, such as corruption.

Williams & Vorley (2015)[19] demonstrate the link between institutions and entrepreneurship by investigating the impact of formal and informal institutions on entrepreneurship in Bulgaria. They find that, despite the reform of formal institutions, there exists an 'institutional asymmetry' between formal and informal institutions, hampering productive entrepreneurship. In the case of Russia, the empirical work of Aidis, Estrin & Mickiewicz (2008)[20] shows that the country's regulatory and institutional

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[11] Estrin, S., Hanousek, J., Kočenda, E., & Svejnar, J., *The effects of privatization and ownership in transition economies*, in Journal of Economic Literature, 47(3), 2009, pp. 699-728.

[12] Johnson, S., McMillan, J., & Woodruff, C., *Entrepreneurs and the ordering of institutional reform: Poland, Slovakia, Romania, Russia and Ukraine compared*, in Economics of Transition, 8(1), 2000, pp. 1-36.

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[14] Estrin, S., Meyer, K. E., & Bytchkova, M., *op. cit.*, p. 75.

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[17] Murphy, K. M., Shleifer, A., & Vishny, R. W., *Why is rent-seeking so costly to growth?*, in The American Economic Review, 83(2), 1993, pp. 409-414.

[18] Basu, S., Estrin, S., & Svejnar, J., *Employment determination in enterprises under communism and in transition: Evidence from Central Europe.* ILR Review, 58(3), 2005, pp. 353-369.

[19] Williams, N., & Vorley, T., *Institutional asymmetry: How formal and informal institutions affect entrepreneurship in Bulgaria*,in International Small Business Journal, 33(8), 2015, pp. 840-861.

[20] Aidis, R., Estrin, S., & Mickiewicz, T., *Institutions and entrepreneurship development in Russia: A comparative perspective*, Journal of Business Venturing, 23(6), 2008, pp. 656-672.

environment is detrimental to entrepreneurship development, explaining why the level of entrepreneurial activity in Russia is relatively low. The same conclusion is drawn also by Vorley & Williams (2016)[21], who analyse the case of Romania and Bulgaria arguing that a weak regulatory and institutional environment limits entrepreneurial planning, aspirations and ambition. However, the same conclusion is reached not only when analysing transition countries. For instance, using a sample of 34 developing, transition, but also developed countries, Stephen, Urbano & van Hemmen (2005)[22] provide empirical evidence illustrating the importance of institutions in promoting entrepreneurial activity. Using data from 44 developing and developed countries, Aidis, Estrin & Mickiewicz (2009)[23] also offer empirical evidence supporting those formal institutions and regulations significantly influence entrepreneurship levels. Acs, Desai & Hessels (2008)[24] provide a general discussion about the importance of institutions as part of the environment affecting entrepreneurship.

Entrepreneurship is an essential driver in the development of the private sector during transition (EBRD, 2016[25]; Estrin, Meyer & Bytchkova, 2008[26]; Williams & Vorley, 2015[27]), being vital for wealth creation and economic progress in transition countries[28]. SMEs are often regarded as the backbone of the economy, their emergence and growth being important both at the beginning of transition[29], as well as in its advanced stages[30]. Indeed, as highlighted also by McMillan and Woodruff (2002)[31] and Tyson, Petrin & Rogers (1994)[32], the degree of success of a transition economy was mostly influenced by the performance of its entrepreneurs and restructuring of its entrepreneurial sector.

On one hand, the importance of entrepreneurship for transition stems from the ability of new firms to fosters the reallocation of resources towards more productive usages, which represents a key part in the transition process[33]. On the other hand, entrepreneurial activity is considered by many economists an engine of economic growth

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[21] Vorley, T., & Williams, N., *Between petty corruption and criminal extortion: How entrepreneurs in Bulgaria and Romania operate within a devil's circle*, in International Small Business Journal, 34(6), 2016, pp. 797-817.

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[26] Estrin, S., Meyer, K. E., & Bytchkova, M., *op. cit.* (2008), p. 78..

[27] Williams, N., & Vorley, T., *op. cit.*, 2015, pp. 840-861.

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[32] Tyson, L. D. A., Petrin, T., & Rogers, H., *Promoting entrepreneurship in eastern Europe*, in Small Business Economics, 6(3), 1994, pp.165-184.

[33] Estrin, S., Meyer, K. E., & Bytchkova, *op. cit.*, 2008, p. 80.

(see Wennekers & Thurik,1999[34] for a literature review), while economic growth in itself has been much needed and extremely important during the transition process given the strong drop in GDP levels experienced by countries at the beginning of transition[35]. As Acs (2006)[36] explains, entrepreneurship implies the creation of new businesses which, in turn, create new jobs, a stronger competition, and more productivity through technological change. Entrepreneurship is important for economic growth also because it encourages innovation and influences a country's competitive advantage[37]. Conversely, the level of economic development also affects entrepreneurship, as empirical research uncovers a U-shaped relationship between the level of economic development and the rate of nascent entrepreneurship[38].

Yet, despite its importance, the strength of entrepreneurial activity in transition was different from one country to another, depending on the 'baggage' inherited from the communist regime, and the development path chosen by each country[39]. In countries where it was more difficult and riskier, it was because of price volatility, unfair competition from state-owned firms, corrupt bureaucrats, unreliable courts and unavailability of finance that opening a business was more challenging than it usually is[40]. Moreover, empirical research also shows that the institutional environment in transition countries is unpredictable, hostile and inefficient, which hinder the creation of new and small businesses (see examples of literature in Manolova & Yan, 2002[41]).

As we have already seen, market-supportive regulations are more difficult to be built in transition, but institutional quality is essential for the development of entrepreneurial activity, which, in turn, represents a key driver of transition. There exists, therefore, a "vicious circle" between the three elements that are strongly linked to each other. It has been proven that institutions matter a lot for the entrepreneurial activity. The main idea is that institutions, as rules, shape the incentives and influence the behavior of entrepreneurs. Entrepreneurship, in turn, has proven to be a crucial element for transition, both as an outcome, as well as a means for countries to develop and advance towards a mature market economy. This is because the new firms are the creators of jobs, the providers of (previously scarce) goods and main opponents of state monopoly, representing the main driver of transition and reform. Last, the transition process, in turn, is strongly influenced by the institutional setting. It was initially believed that the most important task in transition was only to decide upon the degree or sequencing of market-oriented reforms, yet transition has proven to be a more complex issue. Along with essential economic reforms such as price and trade liberalization, macroeconomic stabilization and privatization of state-owned enterprises, a key aspect

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[34] Wennekers, S., & Thurik, R., *op. cit.*, 1999, pp. 27-56.
[35] Shleifer, A., & Treisman, D., *Normal countries: the east 25 years after communism*, Foreign Aff., 2014, pp. 93, 92.
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in this process is the creation of state institutions that support the well-functioning of markets.

But which ones are the regulations and institutions that matter for entrepreneurship? I made a summary of the most important dimensions of the regulatory and institutional environment that matter for entrepreneurship success according to the literature; these are:

- protection of property rights and their enforcement[42], as well as the overal strength of legal enforcement[43].

- rules and regulations which should be designed such that they do not impose administrative barriers[44].

- fiscal legislation (tax rates and tax breaks) and the social security system[45]. Control of corruption and other incentives that make talent shift away from productive entrepreneurial activities to unproductive rent-seeking ones[46].

3. Empirical approach

For the empirical approach of this paper, I analyse data on different measures of entrepreneurial intensity in the former communist states; I group the states in three clusters: European countries which are EU member states, European countries which are not EU member states, and Central Asian countries. The measures of entrepreneurial intensity that I use are:

1. *The ratio of established business owners*, that is the percentage of adult population that own and manage a running business (data from *Global Entrepreneurship Monitor*);

2. *The entry rate*, that is the number of newly established limited liability companies per one thousand adults in that country (data from *World Bank*);

3. *The private sector share in GDP* (data from *European Bank for Reconstruction and Development*).

These three measures of entrepreneurial intensity are depicted in Figure 1, and all indicators paint the same picture: entrepreneurship is more intense in former communist countries that are now EU member states compared to the other two clusters.

[42] Fogel, K., Hawk, A., Morck, R., & Yeung, B., *Institutional obstacles to entrepreneurship*, in Casson, M., Yeung, B., & Basu, A. The Oxford handbook of entrepreneurship. Oxford University Press on Demand, 2008.

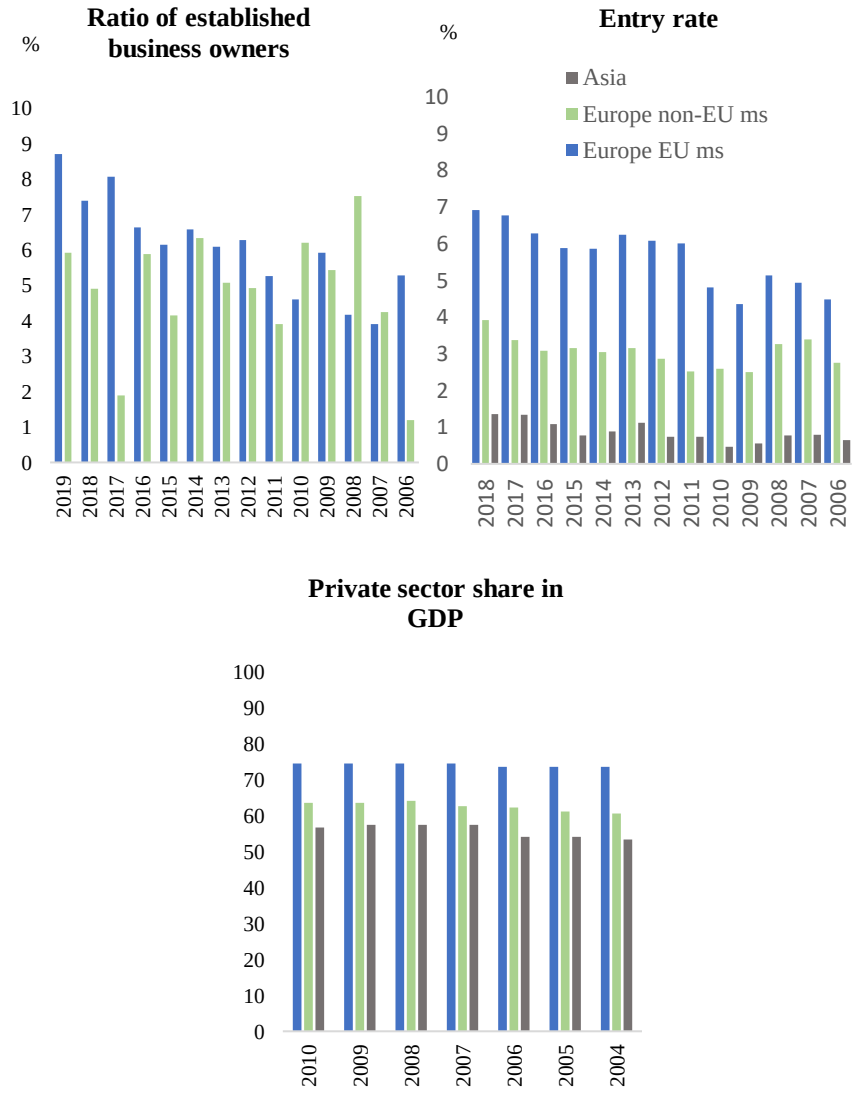
[43] Estrin, S., Meyer, K. E., & Bytchkova, M., *op. cit.*, 2008.

[44] Fogel, K., Hawk, A., Morck, R., & Yeung, B., op. cit., 2008; Estrin, S., Meyer, K. E., & Bytchkova, M., *op. cit.*, 2008.

[45] Wennekers, S., Van Stel, A., Thurik, R., & Reynolds, P., *Nascent entrepreneurship and the level of economic development*, in Small business economics, 24(3), 2005, pp. 293-309.

[46] Murphy, K. M., Shleifer, A., & Vishny, R. W., *Why is rent-seeking so costly to growth*?, in The American Economic Review, 83(2), 1993, pp. 409-414.

Figure 1: Entrepreneurial intensity in former communist states

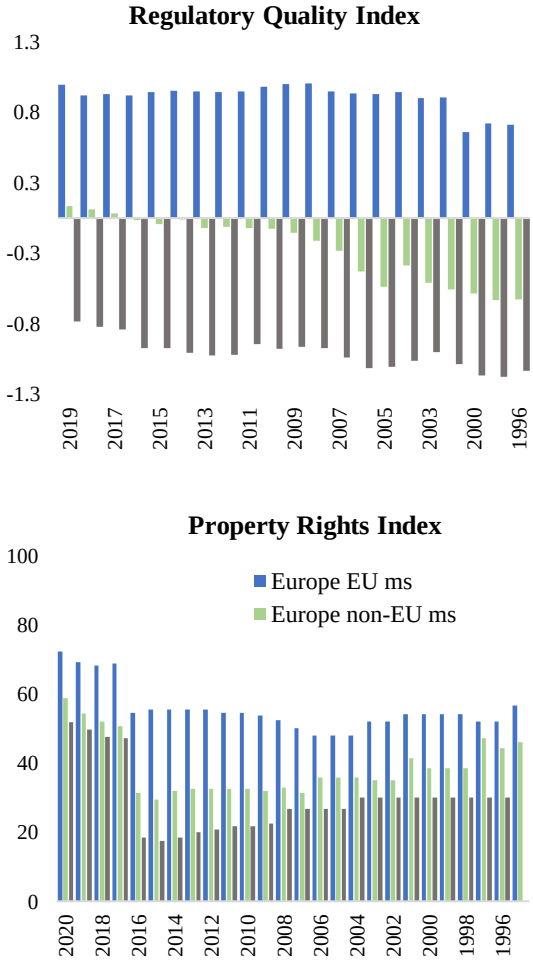


Source: Global Entrepreneurship Monitor, World Bank, European Bank for Reconstruction and Development

Next, I analyse the quality of several regulations that literature tells us are crucial for encouraging entrepreneurship. First, I look at overall regulatory quality, and I also try to capture how much the existing regulations protect property rights. For overall regulatory quality I use an index that is part of Worldwide Governance Indicators computed by the World Bank: the lower the index, the poorer the quality of regulation. And for protection of property rights, I also look at an index, provided this time by the Heritage Foundation, measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws. The

interpretation is the same: the higher the index, the better are property rights protected. The evolution of these two indices is depicted in Figure 2. Overall, we notice that rules are better and more respected in former communist countries that are now EU member states compared to the other clusters.

Figure 2: Overall regulatory quality and protection of property rights in former communist states

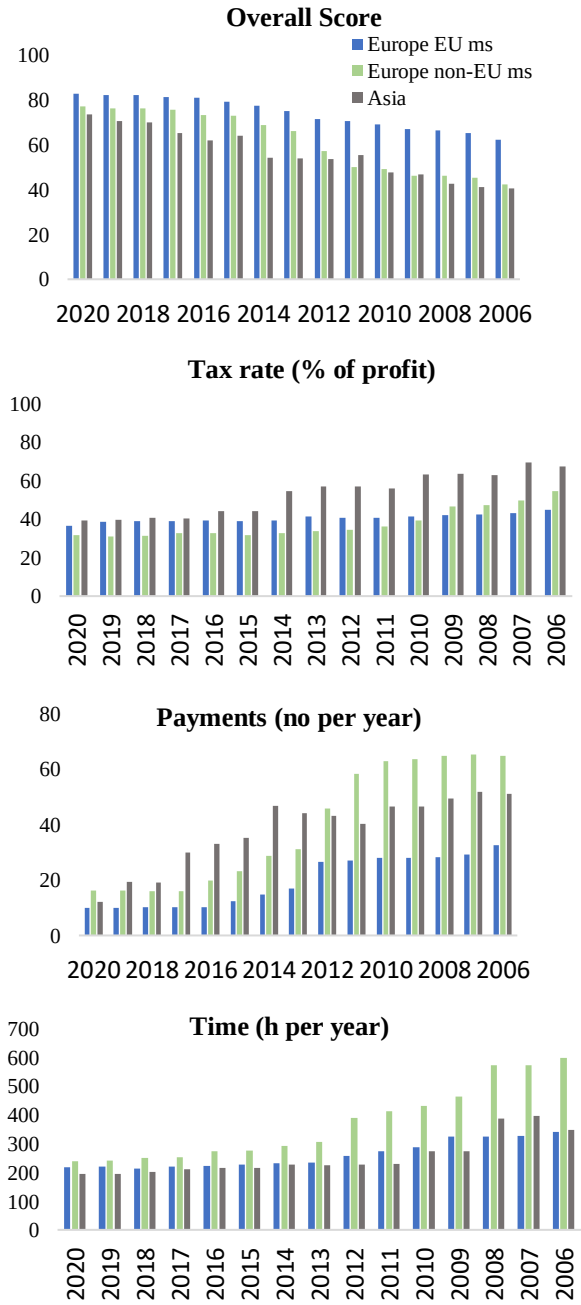


Source: World Bank, Heritage Foundation

Moreover, I take a closer look at the fiscal system in former communist countries. For this I use data from the Doing Business Report, also provided by the World Bank. I analyse the overall score (or index) for the quality of the fiscal system – the higher the score, the better performing the system -, as well as data on the tax rate expressed as a percentage of profits, the number of payments per year and the number of hours it takes to pay taxes for a business. Values are depicted in Figure 3. It can be

observed that, again, European former communist countries (and especially those who are now part of the EU) perform better than Central Asian countries.

Figure 3: The fiscal system in former communist states



Source: World Bank

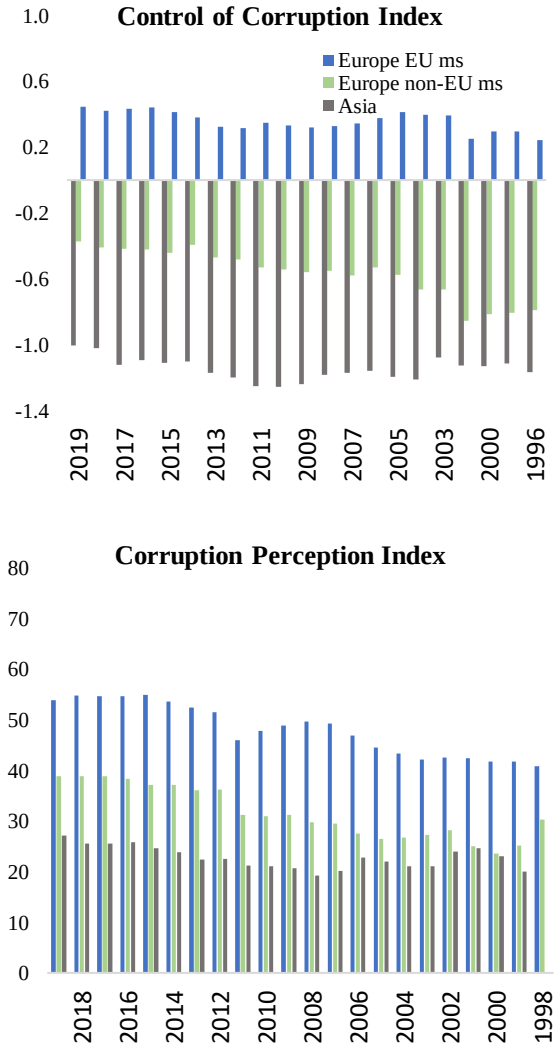
Last, I examine corruption in former communist countries, using two indices:

1. The "Control of Corruption" index that is also part of the Worldwide Governance Indicators computed by the World Bank, the higher the index, the better corruption is contained;

2. The "Corruption Perception Index" provided by Transparency International, the higher the index the lower the perceived corruption.

Values are depicted in Figure 4. On this fourth dimension, we observe that former communist European countries (and especially those who are now EU member states) also perform better.

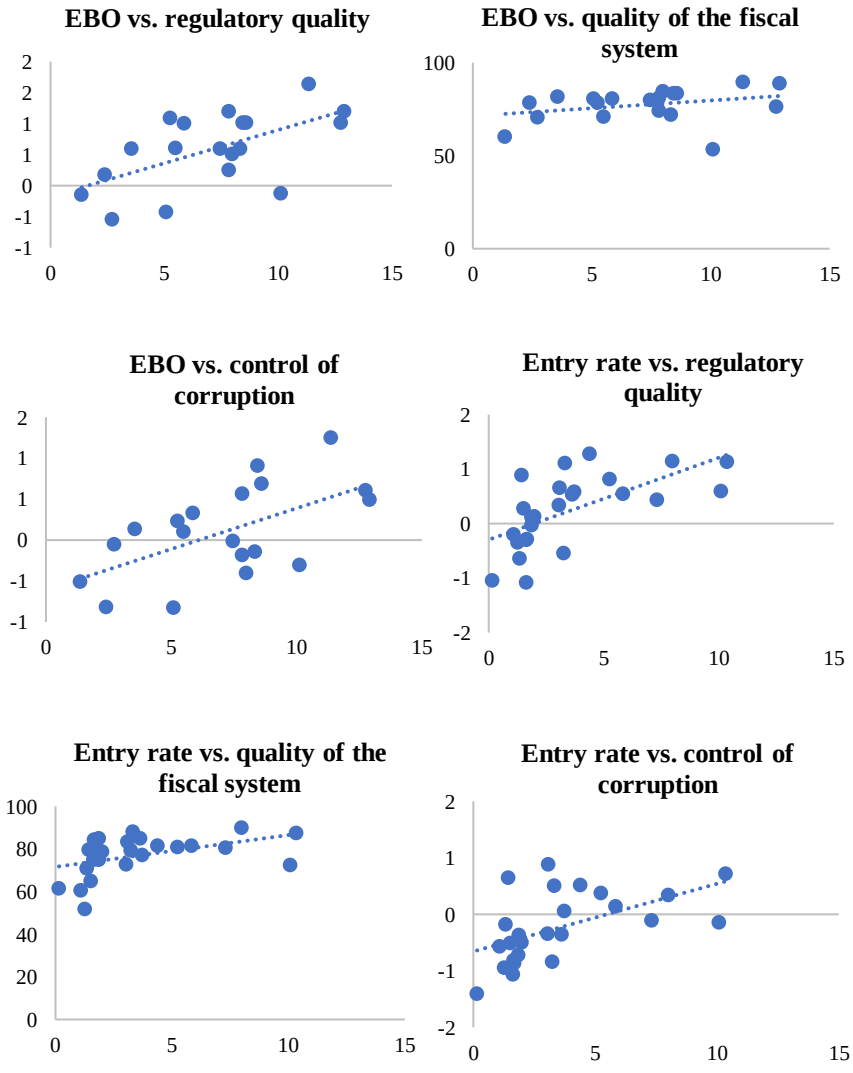
Figure 4: Corruption in former communist states

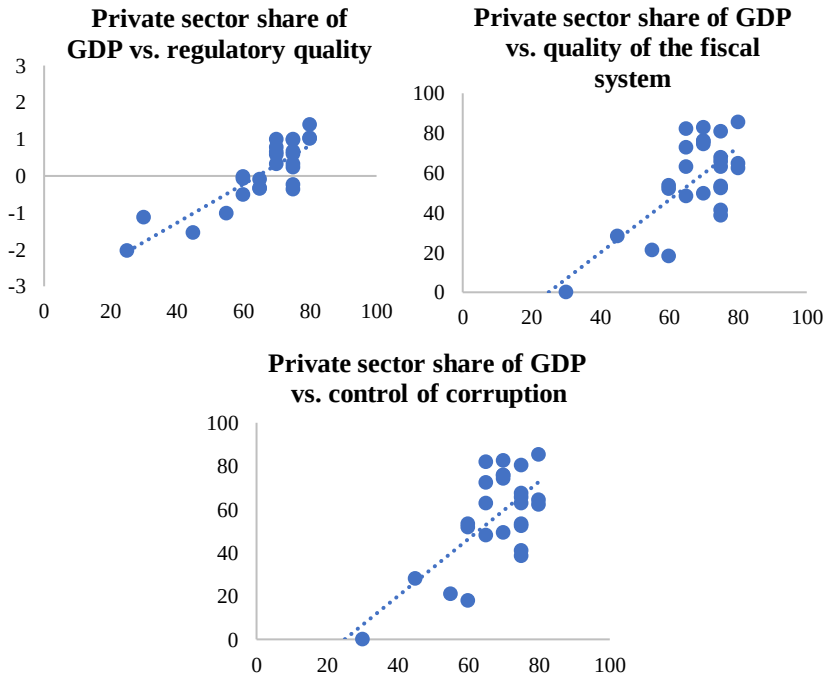


Source: World Bank, Transparency International

Overall, we notice a correlation between the intensity of entrepreneurial activity and the quality of the institutional environment, that is entrepreneurship is thriving rather in countries with better institutions (in our case, the European EU member states). Figure 5 represents a series of charts in which all three measures of entrepreneurial activity are correlated with a different regulatory dimension: quality of regulations, quality of the fiscal system and control of corruption, to support this conclusion. For these charts I use country-level data.

Figure 5: Correlation between entrepreneurial activity and various regulatory dimensions in former communist states





Source: Global Entrepreneurship Monitor, World Bank, European Bank for Reconstruction and Development

Yet we know that correlation is not causality, so I go one step ahead and run an OLS regression using the entry rate as a dependent variable, and the indices for regulatory quality, quality of the fiscal system and control of corruption as explanatory variables. I also control for the development level of the country by including the GDP per capita in the regression, and for the EU membership status. Results, presented in Table 1, suggest that all three explanatory variables – regulatory quality, quality of the fiscal system and control of corruption – have a positive and significant influence on the entry rate and, moreover, they explain about 50% of the model. I also run the same regression using the private share of GDP as dependent variable, results being also presented in Table 1. All three variables have a significant effect, yet it is interesting that "control of corruption" has a negative influence on the private share of GDP or, in other words, that the more corrupt a country is, the higher its private share of GDP. One explanation for this result could be linked to the privatizations that have taken place in these former communist countries: maybe it is difficult to entry on the market as a new business if the country is corrupt, yet higher corruption incentivized a higher degree of privatization, as officials wanted to privatize more, because that also brought them personal gains, they are motivated by obtaining rents from the privatization process).

Table 1: Results of an OLS regression of entry rate and private share of GDP on multiple measures of regulatory quality

Dependent variable	**Entry rate** (no. of new businesses per 1000 adult inhabitants)			**Private share of GDP**		
	(1)	(2)	(3)	(1)	(2)	(3)
Regulatory quality	0.957* (0.424)	1.075* (0.423)	0.088* (0.447)	0.381*** (0.027)	0.395*** (0.023)	0.409*** (0.025)
Quality of fiscal system	0.026** (0.009)	0.033** (0.010)	0.037*** (0.011)	0.002** (0.001)	0.003*** (0.001)	0.003*** (0.001)
Control of corruption	1.972*** (0.448)	2.391*** (0.478)	2.245*** (0.489)	0.287*** (0.026)	0.226*** (0.025)	0.215*** (0.023)
Log of GDP per capita		0.656* (0.274)	0.815** (0.298)		0.084*** (0.014)	0.079*** (0.014)
EU membership dummy			0.771 (0.569)			0.044 (0.031)
R squared	0.43	0.44	0.45	0.79	0.85	0.84
No. of observations	313	313	313	124	124	124

4. Conclusions

As we have seen, market-supportive regulations and institutions are more difficult to be built in transition, but regulatory and institutional quality is essential for the development of entrepreneurial activity. Good regulations such as the protection of private property, reduced bureaucracy, low tax rates, and the control of corruption are crucial for supporting entrepreneurship. In turn, entrepreneurial activity represents a key driver of transition. There exists, therefore, a "vicious circle" between the three elements that are strongly linked to each other.

However, in practice, the regulatory environment in transition countries is, most of the times, unpredictable, hostile and inefficient, hindering the creation and survival of businesses. In transition, the low quality of the regulatory environment has sometimes represented a source of barriers to entry that prevented entrepreneurs from taking advantage of newly emerged opportunities. Or it has created a void stemming from the underdevelopment of formal rules, which has been filled by informal ones, enhancing the risk and uncertainty affecting entrepreneurs. And faced with unstable, incoherent regulations, along with a hostile, corrupt institutional environment, entrepreneurs in transition were forced to respond in an unproductive manner, for instance through short-term orientation and opportunism.

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