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Entrepreneurship Prompts Institutional Change in Developing Economies

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Abstract: Entrepreneurship plays a pivotal role for institutional change and economic development in transition and developing economies. Formal and informal institutions in such countries are often sub-par, but rather than being constrained by them, entrepreneurship can often affect institutions and contribute to their evolution. We highlight three entrepreneurial responses to the institutional status quo: an abiding response, an altering response, and an evasive response. Each response can be either welfare-enhancing or welfare-reducing; more importantly, each response can affect the institutional framework of the society in which it occurs. Better knowledge of entrepreneurial responses to institutions and the context in which they occur offers a promising avenue for future research and a potential way of sustaining lasting institutional change and economic development.

JEL Codes: L5; M13; O31; P14.

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1. Introduction

Researchers increasingly recognize productive entrepreneurship as the *primus motor* of economic growth (Baumol 2002; Cohen 2010; Henrekson and Stenkula 2016). In turn, it is well-established that entrepreneurship is constrained and enabled by the institutional environment in which it occurs: Rules, norms, and other formal and informal institutions influence the extent and productive character of an economy's entrepreneurial activity and, consequently, its development (Baumol 1990; North 1990; Mueller and Thomas 2000; Hwang and Powell 2005; Stenholm et al. 2013). Many scholars and policymakers implicitly assume that when entrepreneurship in emerging and transition economies is conducted legally and morally, it will naturally translate into economic growth (Acs 2006; Anderson and Smith 2007). Conversely, researchers frequently point to a weak institutional environment as an explanation when entrepreneurship and economic growth fail to emerge (Khanna and Palepu 1997; Lee and Kim 2009; Sutter et al. 2013).

While not challenging the overall importance of institutions as rules of the game that are vital for entrepreneurship and economic development, we follow North (1990, p. 74) in acknowledgeing that "[e]ven with a constant set of rules, the games played will differ if they are played between rank amateurs and professionals or between a team in its first game and the same team in its one hundredth game together" (cf. Choi and Storr 2019). Moreover, the rules are rarely, if ever, constant: Individual entrepreneurs are embedded in an institutional context but their behavior may also change this context (DiMaggio 1988; Seo and Creed 2002). Thus, the view that institutions determine the extent to which entrepreneurship is productive is only part of the story. Causality is bidirectional, in that entrepreneurship is also one of the main drivers of institutional change (Elert and Henrekson 2017a). In the past, this important point has been appreciated by Austrian scholars such as Menger and Hayek (Yu 2001).

This article is motivated by the fact that this bidirectionality has been largely overlooked in development contexts, even though the manner in which entrepreneurs respond to institutions is likely to be especially relevant when institutional quality is relatively poor. Economic adaptability may therefore be difficult to achieve if actors invariably operate strictly within the limits of existing institutions (Etzioni 1985). Evidence from economic history shows that entrepreneurial responses to institutions induced many of the institutional developments that made the prosperous world in which we now live possible (Jones 2003; Mokyr 2010; Acemoglu and Robinson 2012; McCloskey 2016). Likewise, when entrepreneurs in today's developing and transition countries respond to institutional constraints – whether through "regular" business activity, institutional entrepreneurship, or evasive methods (Henrekson and Sanandaji 2011; Elert and Henrekson 2016; Elert et al. 2016) – they simultaneously affect future institutional evolution. This has important ramifications for development; both institutional change and economic development are contingent on the entrepreneurial response to institutions.

In advancing this bottom-up argument, we hope to stimulate additional research regarding an aspect we deem central to understanding how institutional change comes about and prosperity evolves. Our view also sheds new light on the enigma of the sharply divergent paths taken by developing countries that started at similar income levels some decades ago. Differences in entrepreneurial responses to institutions help explain why some countries made the transition to growing middle-income countries whereas others stagnated or regressed.

2. Entrepreneurial responses to the institutional status quo

All human action takes place in a world of radical uncertainty and fundamental ignorance (Mises 1949; Hayek 1955; Kirzner 1979). Institutions are generally seen as devices that reduce uncertainty and ignorance by regulating human interaction and preventing free-riding and conflict (North 1990; Williamson 2000; Schotter 2008). As to the plight of underdeveloped countries, "it is now widely accepted that the core problem is 'missing institutions' or 'perverse institutions' instead of 'missing money'" (Ostrom et al. 2002, p. 10). This recognition has led organizations such as the World Bank and IMF to adopt a best-practice reform approach in developing countries (Rodrik 2008). However, such best-practice institutions may not perform as intended if they are unsuitable for its pre-existing economic habits and policies, a point recognized by Austrian scholars (Chamlee-Wright 2005; Boettke et al. 2015), as well as the varieties of capitalism literature (Hall and Soskice 2001; Dilli et al. 2018).

Moreover, from a Schumpeterian or evolutionary perspective, the idea of an optimal set of legal rules ignores a central feature of successful economic development: the continual change, innovation, and adaptation of institutions that are necessary to maintain a competitive environment (cf. Harper 2014). While institutions in advanced countries are relatively conducive to innovation and economic change (Murphy et al. 1991; Rodrik 2008), problems caused by deficient institutions are ubiquitous in less developed economies (Hay and Shleifer 1998; Djankov and Murrell 2002; Acemoglu et al. 2006).

Institutions can inhibit innovation and economic change in many ways, and for many reasons. A prime reason is people's inherent skepticism towards the novel and the unknown; popular resistance against innovation has been the default response since time immemorial (Weber 2002/1930; Morison 1966; Mokyr 1992). An additional reason is that special interests strive to protect the value of their assets by using non-market means to block the market selection process, notably laws and regulations barring innovations by newcomers (Olson 1982; Bauer 1995; Mokyr

1998).

As a result, the existing (formal and informal) institutional setup usually favors the status quo, but all economic actors do not accept the status quo to the same degree. This is particularly true for entrepreneurs, who, oftentimes, are less constrained by the institutional framework than others, and therefore often challenge this framework (Obschonka et al. 2013; Lienhard 2006; Elert and Henrekson 2017a, 2017b). This observation conforms both with the Schumpeterian view of the entrepreneur as a rule-breaker (Schumpeter 1934, 1942; Zhang and Arvey 2009) and with Kirzner's (1973) view of the entrepreneur as someone who is alert to and ready to exploit profit opportunities.[1] Whether such challenges are problematic depends, in no small measure, on the quality of the institutional framework being challenged. In fact, when institutional quality is low, as in most developing and transition economies, deviations can prevent existing institutions from stifling economic development (Douhan and Henrekson 2010; Lucas and Fuller 2017).

As an illustration, consider Mokyr's (2010) account of the economic development in Britain during the Industrial Revolution. At the time, many British institutions impeded rather than supported economic development. The entrepreneurial response? "By ignoring and evading rather than altogether abolishing obsolete rules and regulations, eighteenth century Britain moved slowly toward a free market society" (Mokyr 2010, p. 397). As Jones (2003, p. 100) puts it, "[w]hat happened in Britain was that growth itself stimulated individuals to find ways around customary and legislative barriers to free market activity." Although best described as a second-best response, these entrepreneurial challenges of a low-quality institutional framework nevertheless had tremendous consequences for Britain, and arguably, for the entire world. In a similar vein, Wegner (2019, p. 1513) argues that the industrial revolution and the development of capitalism in Europe

> were paralleled by the establishment of a legal bureaucracy, which put the norms of equality before the law into practice and took shelter from arbitrary interference by political rule. Legal bureaucracy was supportive in overcoming pre-capitalist economic institutions and responding to nascent entrepreneurship, which sought to overcome traditional institutional constraints; as a result, the relationship between entrepreneurship and institutions was also bidirectional (Elert and Henrekson 2017[a]).

A wide-tent definition of entrepreneurship suggests that entrepreneurs are "social change agents who, despite the radical uncertainty we all necessarily confront in the world, notice, cultivate, and exploit opportunities to bring about economic, social, political, institutional, ideological, and cultural transformations" (Storr et al. 2015, p. 123). All these entrepreneurial actions take place in an institutional context that offers opportunities and constraints, but in the following, we mainly focus

[1] Of course, culture can affect how entrepreneurs perceive their available opportunities as well as the strategies that they employ in order to exploit them (Lavoie 1991; Chamlee-Wright 1997; Storr 2004, 2013).

on entrepreneurs who operate in the economic sphere. How such an entrepreneur uses his or her talents to respond to institutional constraints may be classified into three categories as shown in Figure 1. Entrepreneurs can abide by, alter, or evade existing institutions (cf. Buchanan 1980; Oliver 1991). In line with Baumol's (1990) well-known schema, all three responses can be either productive or unproductive/destructive. Furthermore, all three responses can have institutional consequences. The same individual may also shift between categories, just as a business entrepreneur may introduce a new product one year and then frivolously resort to legal action to bar competition the next.

Figure 1 A typology of entrepreneurial responses to institutions and some illustrative examples.

	Abide	Alter	Evade
Productive	Pursue a business opportunity within prevailing institutions.	Provide a new local public good, private security firms. Lobby for entry in previously closed markets.	Sidestep stifling labor market regulations through a new contractual form.
Unproductive/ destructive	Employ the existing legal system to sue competitors for a share of their profit.	Lobby for a new regulation to protect an industry. Repeal property rights to plunder a wealthy group.	Bribe a government official to obtain a contract or avoid audits. Illegal syndicates.

Source: Adapted from Elert and Henrekson (2017a).

Institution-abiding entrepreneurship is the most commonly studied entrepreneurial category. Though typically seen as productive, such entrepreneurs can abide by institutions and still engage in unproductive activities, e.g., by exploiting the judicial system to sue competitors for a share of their profits (Sobel 2008). Furthermore, institutional compliance does not preclude an effect on institutional evolution. First, entrepreneurs (and non-entrepreneurs) who abide by institutions tend to strengthen these institutions (Becker and Murphy 2000; Searle 1995). This tendency is particularly relevant for informal institutions, such as codes of conduct and traditions, but the law also derives much of its value from the respect it enjoys (Kasper and Streit 1998). Second, radical institution-abiding entrepreneurship can generate so much change that reform of the institutional foundation becomes crucial. For example, the ICT-revolution evolved in tandem with institutional changes pursued by politicians, such as the highly permissive framework regulating Internet activities established in the 1990s (Thierer 2016, pp. 13–15).

However, firms often actively engage in purposeful political activities to control and manipulate their unfavorable environment (Pfeffer and Salancik 1978). The second and third response categories are both examples of such institutional entrepreneurship, but they are sufficiently distinct to be separated analytically. The institution-altering entrepreneurial category is what is generally thought of when institutional entrepreneurship is discussed. Such entrepreneurs not only play the role of traditional market entrepreneurs but also help establish institutions in the process of their business activities (DiMaggio 1988; Garud et al. 2002; Dorado 2005; Li et al. 2006; Boettke and Coyne 2009), e.g., through lobbying or political activity (Khanna and Rivkin 2001; Battilana 2006; Battilana et al. 2009). Hence, these entrepreneurs cause institutional change through activities that are directly aimed at policymakers who have the power to alter institutions (Buchanan 1980; Lawrence and Suddaby 2006). While it is typically seen as problematic and detrimental to economic growth when large corporations attempt to shape government regulations in ways favorable to themselves (Hillman et al. 2004; Lawton et al. 2013; Mitchell 2014), Lambsdorff (2002) questions the validity of treating lobbying as equally wasteful as corruption. As we shall see, policy innovations originating with firms can improve welfare (Leyden and Link 2015), even in developing countries.

However, changing laws is neither costless nor easy, which implies that large, organized groups are more likely to engage in institution-altering behavior. This option is effectively unavailable to smaller firms, unable or unwilling to join forces with other actors. They therefore often resort to less direct institutional responses which fall into the third, evasive, category. The term evasive entrepreneurship was first introduced by Coyne and Leeson (2004), but already Adam Smith was aware of the phenomenon, stating that the "natural effort of every individual to better his own condition … [is] not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operation" (Smith 2007 [1776], p. 316).

Many firms in the sharing economy engage in evasive entrepreneurship, purposefully shaping their innovations to make it ambiguous which institutions apply (Elert and Henrekson 2016). As Mokyr's (2010) account regarding the importance of ignoring and evading obsolete rules and regulations in Britain during the Industrial Revolution illustrates, evasive entrepreneurship is highly relevant as a second-best solution when institutions stifle commercial activity (Mokyr 1992; Jones 2003; Acemoglu et al. 2005). That said, evasive entrepreneurship may also manifest itself in unproductive manners. For example, studies based on World Bank data reveal that up to 30 percent of small and medium-sized enterprises in the developing world pay bribes and evade taxes (Ayyagari et al. 2010). Nevertheless, it is difficult to judge whether the sum total of these practices are detrimental to these societies, given their poor institutional framework. Under such conditions, paying bribes may be necessary in order to get anything done. When the analysis is restricted to the entrepreneur's relevant alternatives in view of existing institutions, some seemingly unproductive or even destructive actions are best considered as second-best productive responses to suboptimal institutions (Douhan and Henrekson 2010; Lucas and Fuller 2017).

3. Entrepreneurial responses in developing/transition economies

Though habitually assumed to be a phenomenon of the post-war era, a strong case can be made that development economics actually started with Adam Smith's publication of *The Wealth of Nations* in 1776. Smith's main hypothesis—that development happens based on free trade and free markets, making possible the division of labor and gains from specialization—has withstood the test of time (Easterly 2019), and reflects a recognition of the importance of proper institutional underpinnings for development. Achieving these underpinnings through concerted interventions from the outside has proven to be exceedingly difficult; the likely success of any proposed institutional change is a function of that institution's status among indigenous agents (Boettke et al. 2015). Institutions that are designed and installed from the top down often lack legitimacy and result in defiance and resistence (Oliver 1991; North 1990, p. 36–45).

As pointed out by Easterly (2019), Adam Smith embraced what has been called "analytical egalitarianism" (Peart and Levy 2005) for all individuals, assuming that individuals everywhere are capable of acting in their own interest, and that these choices are beneficial for society as a whole. Whether this transpires depends on the institutional context in which the individual operates. In Easterly's (2019, p. 7) words:

> [i]f there are bad aggregate outcomes for a nation or racial group, in Smith's analysis, it reflects lack of opportunity for trade or bad institutions that deny individuals the freedom to make their own choices.

Easterly (2019) concludes that there is still not sufficient awareness of the importance of individual choice and consent in development programs in the economic development world. Indeed, humanitarian-led efforts in developing countries often suffer when they do not pay sufficient attention to the fact that intended program recipients will act strategically in response to new rules and incentives (Ostrom et al. 2002; Easterly 2006; Coyne 2013). As one illustration, Coyne (2013, p. 150) highlights how, in an attempt to deal with the accumulation of trash in Iraq during the American occupation, the U.S. military began paying Iraqis above-average wages to collect trash. This scheme not only increased the total amount of trash but also undermined productive entrepreneurship by causing people to shift their efforts to collect trash. Such experiences illustrate the need to think of economic development as a discovery procedure, in the sense that the relevant data, rather than being given, must be discovered through "experimentation, feedback, and adaptation" (Coyne 2013, p. 179). Development emerges spontaneously, "through the independent and competitive efforts of many" (Hayek 1960, p. 27).

Entrepreneurs are essential for development in developing countries because they fill important gaps left by incomplete and underdeveloped markets (Leff 1976; Acs and Virgill 2010). As Leibenstein (1978, p. 83) put it some 40 years ago, development economists should focus on "the gaps, obstructions, and impediments in the market network of the economy in question and on the gap-filling and input-completing capacity and responsiveness to different motivational states of the potential entrepreneurs in the population." Such a mental frame should also inform business activity and humanitarian efforts in developing countries. These approaches should benefit from a better understanding of the main ways in which entrepreneurs respond to institutions, and how those responses facilitate formal institutional change.[2]

3.1 Institution-abiding responses

Productive institution-abiding entrepreneurship is obviously important as a vehicle of growth, creating resources, jobs, and tax revenues that can further the emergence of capitalist institutions. Also, the mere act of abiding by institutions enhances their legitimacy; whether this is socially beneficial depends on the quality of those institutions, which is often poor in developing and transition economies. If the rules of the game are pernicious, playing by those rules is likely to yield socially harmful outcomes (Baumol 1990; Sobel 2008; Easterly 2019).

As de Soto (1989) has shown, it can take months – even years – to set up a legal business or buy real estate in many developing countries: Thus, following the rulebook is tantamount to not getting anything done. Likewise, when economic institutions disincentivize saving and investment (as in Sub-Saharan Africa; see Acemoglu and Robinson 2010), abiding by them is unlikely to yield much saving or investment, or, for that matter, much in the way of productive entrepreneurship. More importantly, in many such countries the formal sector of the economy and the political sphere are intertwined, often characterized by monopolies impervious to competition from political outsiders. Hence, an ambitious entrepreneur wishing to become rich by playing by the rules must become part of the ruler's patronage network (Wegner 2019). Moreover, those who benefit from the status quo usually have an enormous incentive to see that it is upheld (OECD 2005a, 2005b), precluding any genuine challenge to the institutional status quo. As one former oligarch (cited in Wegner 2019, p. 1526) descripes the present entanglement of the state with the economy in Russia:

> [T]he size of a business has to correspond to the political influence of its owners. If the size of a business corresponds to the political influence, the owners can be sure about their business, because they have the resources and energy to defend it. If the size of a

[2] As regards informal institutions, societies in developing countries have a mixture of cultural traits that are more or less inimical to entrepreneurship (Zapalska and Edwards, 2001; Dana 2000). Nevertheless, entrepreneurs in many countries have responded quickly once liberalization of formal institutions has occurred, suggesting that culture need not be as constraining as once believed (Lavoie and Chamblee-Wright 2002; Schramm 2004; McCloskey 2016).

> business significantly exceeds the political influence of the owners, it is very hard for them to hold on to it.

In such a system, incumbents under political protection have few incentives to innovate in order to defend their (politically protected) market positions, and innovation cannot result from competition since entrepreneurs outside of the network are kept at bay (Wegner 2019). However, this does not imply that institutional change through institution-abiding entrepreneurship never happens. Consider the case of M-Pesa, a mobile phone-based money transfer, financing and microfinancing service. Launched in 2007 by Vodafone for Safaricom and Vodacom, the largest mobile network operators in Kenya and Tanzania, M-Pesa has been described as “a classic case where innovation preceded policy” (Ndemo 2017, p. 356).

After being approached by Safaricom in the mid-2000s, the Central Bank of Kenya (CBK) elected to take a “test and learn” approach to the new technology, allowing Safaricom (and subsequently other mobile network operators) to provide mobile money services on a very lightly regulated basis without the need to wait for the establishment of a full-scale regulatory mobile payments framework (Muthiora 2015; Burns 2018). M-Pesa fundamentally challenged traditional banking institutions, causing incumbent banks to lobby the Kenyan finance minister in 2008 in an effort to curb M-Pesa’s growth. The attempt was unsuccessful, as an audit found no fault with the service, but following this regulatory defeat banks subsequently began to partner with M-Pesa and similar services to offer full-scale mobile banking products such as mobile savings, credit and insurance. As a result, this institution-abiding entrepreneurship provided a spark that transformed the underpinnings of the financial system.

M-Pesa has since spread to many other developing countries, even penetrating institutional basket cases like Zimbabwe and Somalia, and has been lauded for furthering financial inclusion by giving millions of people access to the formal financial system. Rollout has not been uniformly successful, however; in Nigeria and South Africa, the service has failed to take off, despite high urban populations and an institutional quality comparable to or better than Kenya’s. Burns (2018) argues that the one factor all successful countries share – and unsuccessful cases lack – is that they have emulated Kenya in creating an enabling regulatory environment with respect to mobile money.

Similar evidence that institution-abiding entrepreneurship, when successful, can usher in institutional change is provided by Samadi (2018), who studies the relationship between institutions and entrepreneurship in Middle Eastern and North African countries through an explicitly bidirectional lens. The author makes a core distinction between necessity and opportunity entrepreneurship and finds statistical evidence that the latter can affect institutional change, at least in the short run. These findings extend Holcombe’s (1998, p. 51) critical point that in exploiting profit opportunities, productive entrepreneurs “create new entrepreneurial opportunities that others can act upon. Entrepreneurship creates an environment that makes more entrepreneurship possible.” In other words, productive entrepreneurial activities have a multiplier effect resulting in increases in the extent of the market which is critical for economic development (Coyne et al. 2010). This multiplier effect may even have repercussions for the institutional context in which firms operate.

3.2 Institution-altering responses

As Olthaar et al. (2017, p. 251) stress, rather than being fixed, the institutional environment entrepreneurial actors face can sometimes be modified through their actions:

> In particular, in young markets where the institutional environment is weakly developed or enforced, individual entrepreneurial action may affect the institutional context.

When given the opportunity, many business people in developing countries will tailor the institutional framework in a manner that is beneficial for them. Such institution-altering entrepreneurship is often welfare-reducing, with a large literature suggesting that regulatory policy often reflects the economic interests of the powerful commercial interests the regulatory agency is assigned to regulate, rather than the needs of the public (Stigler, 1971; Hillman et al., 2004; Lawton et al., 2013). This is also the case for the developing world: “Crony capitalism,” by which entrepreneurs close to political policymakers receive favors allowing them to get excess returns, has been described by Raghuram Rajan as “one of the greatest dangers to the growth of developing countries.”[3]

Such collusion is best understood as a function of the institutional status quo. Consider the case of Kenya’s supermarket chain Nakumatt, described by Arunga and Beaulier (2008, p. 157) as “an inspiring and insightful lesson in entrepreneurship on the one hand and a depressing story of excessive government on the other.” Hailed as a driver of the reshaping of Kenyan retailing and related industries such as agriculture, the company’s success has nonetheless been ridden with charges of money laundering and corruption. While lamentable, such practices can be seen as an inevitable consequence of Kenya’s flawed institutional status quo: an economy lacking in reliable rule of law and protection of property rights will thrive on the collusion between governmental bodies and private parties, meaning that successful entrepreneurs eventually will face an institutional system full of incentives to use influence to gain advantage. “It is nearly impossible to emerge as a major retailer in a way that is free from all charges of corruption – the incentives just aren’t there to play the game in a completely clean manner” (Arunga and Beaulier 2008, p. 159).

[3] https://economictimes.indiatimes.com/news/economy/policy/raghuram-rajan-slams-venal-politicians/articleshow/40218627.cms

To repeat, what matters are the entrepreneur's relevant alternatives in view of existing institutions, and when these institutions are sub-par, seemingly unproductive or even destructive actions are best considered as second-best productive responses to suboptimal institutions (Douhan and Henrekson 2010; Lucas and Fuller 2017). Nonetheless, crony capitalism may emerge as a serious obstacle to growth-conducive institutional change. Iyigun and Rodrik (2004) use a theoretical model to study the interplay between entrepreneurship and institutional reform, finding that the reform's impact on growth depends on the level of entrepreneurial activity: Reforms have negative growth effects when entrepreneurial activity is strong and positive effects when it is weak. The reason may be that reforms impacting on existing entrepreneurs will induce these incumbents to bribe or be part of other rent-seeking activities aimed at eliminating possible competition (cf. Baliamoune-Lutz 2009).

A relevant question is how many would-be entrepreneurs never embark on a venture because they want no part in this corrupt system, and therefore "no longer become the engine for economic transformation that they otherwise would" (Storr 2002, p. 13). Moreover, people in corrupt countries likely come to view this purportedly capitalist system as unfair and favor increased regulations and government involvement (Di Tella and MacCulloch 2009). As a consequence, the cultural attitudes needed to support entrepreneurship, markets and economic growth will be undermined (Choi and Storr 2019).

In other instances, institution-altering entrepreneurship, even when done to further one's interest, can have welfare-enhancing consequences. During the West's industrial revolution, capitalists often promoted institutions that separated the economy from the state via independent civil courts or a public administration that committed itself to the rule of law. For instance, German states' capitalist transformation process during the nineteenth century witnessed continuing efforts to disentangle the economy from state interventions and regulations, ushering in competitive capitalism in the second half of the nineteenth century (Boch 2004). While the deck is often stacked against entrepreneurs attempting to achieve similar institutional change in today's developing and transition economies, collective action by entrepreneurs against the arbitrary state and on behalf of the rule of law becomes more likely when business growth outside the rulers' patronage network is ample and reaches a critical mass (Wegner 2019). Yakovlev (2014) offers an example of an attempt to affect such institutional change by a group of Russian small and medium-sized enterprises who canvassed support for a change of state-business relations between 2000 and 2006. While the business environment improved for a while, e.g., by simplifying the tax system and ending arbitrary arrests of business owners, the reforms were later reversed.

A more encouraging example is that ot the Chinese entrepreneur Jing Shuping, who openly called for and ultimately persuaded Chinese authorities to allow private entry into China's banking sector. Following this institutional change, he founded the country's first joint stock commercial bank China Minsheng Banking Corp. in 1996. In the next ten years, roughly 20 more banks based on mixed-ownership were established (Li et al. 2006, pp. 244–245). As shown by Li et al. (2006), lobbying by institution-altering entrepreneurs in China affected institutional change in other areas as well, notably the liberalization of interest rates for commercial banks, and the opening up of the market for non-state automobile manufacturers.

More generally, Boettke et al (2015) have argued that the ability of new institutional arrangements to take hold depends on whether the change emerged from the local culture or was imposed from an authority. Spontaneously evolved institutions are more likely to "stick" than formal institutions, whether the latter are implemented by local or foreign authorities. Thus, if an institution-altering entrepreneur has strong ties to the local community and his/her attempts to change the rules of the game are sensitive to traditional habits and practices, the likelihood that this attempt will be successful increases substantially (cf. Chamlee-Wright 2005; Boettke et al. 2015). In contrast, failure to take such local knowledge into account likely explains many failed attempts to improve institutions in developing and transition economies (see e.g. Levin and Satorov 2000).

3.3 Institution-evasive responses

Large-scale evasion is an important feature of today's developing world. de Soto (1989, 2000) particularly illustrates the informal sector's relevance in many developing countries, where firms operate without legal titles due to excessive regulation. Likewise, Tooley (2013) draws attention to the fact that millions of parents in the slums of developing countries send their children to private schools – typically at the cost of no more than 10 percent of the minimum wage – with superior results compared with public alternatives. To the extent that these schools are officially recognized, it is because they bribe their way through thousands of pages of regulations by which neither they nor the state schools abide. And while local teachers and community leaders who start such schools in hostile institutional environments certainly have their work cut out for them, these bottom-up approaches still face a greater probability of success than top-down attempts to establish a national education system in fragile states such as South Sudan (Longfield 2015).

Institutional contradictions are often critical to understanding the emergence of evasive entrepreneurship. Seo and Creed (2002, pp. 225–226) describe such contradictions as a "complex array of interrelated but often mutually incompatible institutional arrangements" that "provide a continuous source of tensions and conflicts within and across institutions". While they are generally unintentional in western democracies, they are sometimes intentional in poorer institutional settings, e.g., neo-patrimonial states. By making essentially compliance impossible, lawmakers and civil servants gain discretion over whether the inevitable transgressions are to be tolerated, provided the bribes are big enough (Wegner 2019).

While the friction ensuing from institutional contradictions is generally seen as a challenge to the entrepreneur, it can also be an advantage, offering flexibility in terms of how it can remain socially acceptable to exploit entrepreneurial opportunities (Endicott 2001). The ability to perceive, act on or even create such contradictions depends on the entrepreneur's ingenuity (cf. Alvarez 2005). A telling example on how to exploit institutional contradictions is the evasive strategy of sharing economy firms like Uber and AirBnb, who took pains to avoid being classified as belonging to the transportation and accomodations industries, respectively. Uber's former CEO even asserted that Uber was a technology company, not a transportation company, and therefore should not be regulated the way taxi companies are (Scheiber 2014).

Evasive entrepreneurs in developing economies often exploit the existence of an institutional void (Leff 1976), i.e., a lack of regulation and judicial precedence, making an activity's legality (or lack thereof) unclear. Obviously, no societal sphere is completely institutionally void (Mair et al. 2012; Olthaar et al. 2017),[4] but when a form of venturing is sufficiently new and unforeseen the term may still be apt. This is common in the emerging high-tech industry (Thierer 2016) and was also the case for India's IT sector, which was initially ignored by the typically quite interventionist government, which failed to grasp the sector's economic potential (Shah and Sane 2008). Another example is the emergence of the informal Chinese Shan-Zhai mobile phone industry, which grew to threaten the market shares of the state-licensed national champions. (Lee and Hung 2014).

Moreover, when the government fails to assume its role in creating and strengthening those institutions needed for markets to exist and to function properly in developing countries, business groups often step in to fill the void (Khanna and Palepu 2000; Khanna and Rivkin 2001; Leff 1978). Such activities are driven by the objective to create and capture economic value. Relatedly, it has been shown that in countries where trust in the legal system is low, few firms even contemplate to let courts settle legal disputes. Instead, they resort to relational contracting, building long-term, personalized relationships with their suppliers or consumers, sustaining cooperation through repeated interaction (Fafchamps 2004; Rodrik 2008).

[4] Studies increasingly emphasize how an informal institutional environment (local tradition, culture, and social ties) often substitute for the lack of formal institutional governance that typically characterizes what is described as an institutional void (Mair et al. 2012).

In other instances, the institutional void simply means that outright criminal activity will flourish (Zaitch 2002, p. 49). In the extreme case, a lack of enforcement or an incomplete state monopoly of violence can present an entrepreneurial opportunity in and of itself. Though often seen as a prototypical example of violent extortion and appropriation of rents created by others, organized crime can be argued to provide a substitute under unstable institutional circumstances (Bandiera 2003).

One example is the drug factions controlling the favelas of Rio de Janeiro, who, in addition to providing customary law ("the law of the hill") and government-type services like clean water and welfare assistance, willingly tolerate and even protect humanitarian organizations that operate in their territory to weaken the drug trade and reduce violence (Rodet 2016). The establishment of such "semi-formal but illegitimate institutions" (Sutter et al. 2013) is a common practice to fill the void left by weak or non-existant formal institutions in developing countries (World Bank 2011; Acemoglu and Robinson 2012) and has been described as "an entrepreneurial response to inefficiencies in the property rights and enforcement framework supplied by the state" (Milhaupt and West 2000, p. 43). In these Hobbesian situations, mafia activity can make the environment somewhat more predictable for the productive entrepreneur, in line with the argument concerning stationary and roving bandits (Olson 2000). Still, little is known about how such regimes facilitate or deter productive entrepreneurial activities, or how entrepreneurs respond to such institutional forces (Sutter et al. 2013).

A pertinent example of evasive entrepreneurship with vast institutional and economic consequences can be found among a number of farmers in a poverty-stricken village in the Chinese Anhui province in 1978 (Elert and Henrekson 2016). At that time, China had a collective farming system governing agriculture, i.e., a scheme of forced collectivization (Zhu 2012). In a secret agreement, the Anhui farmers decided to split up their land and allow each household to operate independently, to alleviate the perverse incentives created by forced collectivization (Lu 1994). While the farmers ran the risk of jail sentences for breaking formal property rules, they had the implicit support of local reform-minded officials, who chose not to enforce the collective farming rules. In the year following this *de facto* privatization, grain production in the village grew to equale the total production in the previous five years (Lu 1994). Moreover, in the following years, reform-minded local officials pointed to the Anhui farmers' experiment with private property when lobbying for reforms of the agricultural sector. This resulted in institutional change as the central government eventually validated and propagated the Household Contract Responsibility System (Lu 1994). This system, in which contracts allocated land to households on a long-term basis and allowed farmers to retain profits, became the foundation of China's agricultural reform, completed in 1984 (Li et al. 2006). Between 1978 and 1984, total factor productivity in the agricultural sector grew by 5.62 percent per year (Zhu 2012), and most of the productivity growth can be attributed to the price and institutional reforms that generated strong positive incentive effects on farmers' efforts and input choices (McMillan et al. 1989; Lin 1992; Coase and Wang 2012, p. 154).

On a more general note, Lu (1994, p. 117) concludes that "the Chinese policymakers did not predesign the boom of the private sector in the 1980s and the relating changes in institutions. In many cases, what happened was the official adaptation to reforms initiated by private entrepreneurs." (cf. Nee and Opper 2012). This strongly suggests that when evasive entrepreneurship is productive, it can be important as a source of growth in its own right, and, more importantly, serve as a diagnostic indication of the need for institutional change – provided such indications are heeded. If regulators and policymakers fail to develop appropriate response strategies, large parts of the potential benefits of evasive entrepreneurship are unlikely to be reaped. If, by contrast, they are successful in developing such strategies, the greater institutional adaptability can offset deficiencies in the existing institutional framework, and force incumbents to adapt to a changing market.

4. Prerequisites for Institutional Change

As regulatory policy often reflects the economic interests of powerful commercial actors, rather than the needs of the public, the status quo often results in barriers to entry, high prices, and reduced product quality (Koopman et al., 2015). As a consequence, policies then discourage potential entrepreneurs and hamper the process of creative destruction (Caballero and Hammour, 2000; Begley et al., 2005). Moreover, reforms to escape these less than ideal situations is unlikely because stakeholders in the regulated industry have capitalized on the gains from such regulation, and therefore they will vehemently resist all attempts at deregulation, in what Tullock (1975) brands a "transitional gains trap" (cf. Tollison and Wagner 1991).

This is not to say that institutional change never happens. For example, several Sub-Saharan African countries have adopted national economic policies aimed to transition from a natural resource-based economy to an entrepreneurial economy (Audretsch and Thurik 2000; Thurik et al. 2013) to generate economic growth and social progress. Still, whether these changes will be succesful depends, in no small measure, on whether the environment is perceptive to them. In fact, a formal institutional change can be successful if there is enough internal pressure in favor of changing a particular rule where such change was previously barred because it was too costly to deviate from the status quo without some form of mass coordination. As an example, consider the Kim Young Ran Act in South Korea, which sought to end the use of social connections, positions and small payments in political exchange. While South Korea had a norm, deeply embedded into the social fabric, of using such social lubricants, many individuals saw this norm as a costly burden. Prior to the reform, however, refusing to participate in these practices was too costly. As Choi and Storr (2019, p. 122) state, "[t]he new rules were necessary to convey new expectations and coordinate around a new equilibrium."

That said, in many instances of institutional change, veto players who would lose from the change must be persuaded in the existing political process to alter their position. Relatedly, informal complementary institutions must allow the new institutions to function in the desired manner (Aoki 2001; Boettke et al. 2015). The change process should also be accompanied by a provision of new information and the alignment of incentives, as well as the creation of common knowledge of actions to sustain the new equilibrium (Ostrom 1990; Dixit 2009). As Ostrom et al. (2002, p. xiv) put it,

> International development assistance is intended to help the people living in less-developed countries overcome poverty resulting from the wide diversity of often-unresolved or poorly resolved collective-action problems. Unless development aid properly addresses the incentives of underlying collective-action problems, it will likely be ineffective or, worse, even counterproductive.

All three entrepreneurial responses play crucial roles in this process. First, while the transitional gains trap seems to hold in static environments where markets for substitutes and related goods change little, Thomas (2009) demonstrates that deregulation can take place when dynamic factors affect relative prices, e.g., innovation in product technology or the development of substitute products. Obviously, there is a role for entrepreneurship here. Thomas (2009) studies the regulation of brewers in Cologne in the 15th century, arguing that a "transitional gains trap" prevented deregulation for a long time, as brewers had fully capitalized on the benefits of the regulation. In the case of Cologne, entrepreneurs outside of the area covered by the regulation sparked the change (p. 332):

> a relative price change in a substitute input factor, which ultimately led to de facto deregulation, was triggered by technological innovation outside of the geographic area to which the regulation applied.

Generally, it appears that many town guilds were undermined when new merchants located their activities to the countryside, where the guilds could not control labor (Jones 2003, p. 98). Moreover, whenever entrepreneurship is productive, it provides additional resources that make it possible to compensate losers from reform. Obviously, this is the case for institution-abiding entrepreneurship; furthermore, when such entrepreneurship is radical enough, and its benefits are sufficiently widespread, it may make reform seem necessary, even inevitable. Genuinely productive evasive entrepreneurship may play a similar role. Importantly, if evasive activities are welfare enhancing, they create additional resources *before* any reform, so that the gains from instituting an institutional reform making them legal become even more apparent. This conforms to the observation that Kevin Laws of the site *AngelList* (which unites startups and investors) once made, that “the approach almost all startups take is to see if they can be successful fast enough so they can have enough money to work with the regulators” (*Santa Clara High Tech Law Journal* 2013).

Nevertheless, such “ex ante investment with ex post justification” is a risky strategy, especially in developing countries (Li et al. 2006). To be sure, discontented incumbents who profit from the status quo may lobby for protection against evasive entrepreneurs, arguing, for example, that they still face various regulatory burdens that new entrants are evading—an understandable “level playing field” problem that often arises in sectors undergoing rapid technological change (Thierer 2016). However, as Bauer (1995, p. 28) notes, resistance to new technologies can set the legal system in motion, but a legal process initiated on those grounds is subject to different constraints. Those who object to a new innovation may initiate the legal battle, but they cannot control its outcome any more than the challengers can.

Institution-altering entrepreneurship aiming to change people’s perceptions also increases the likelihood of institutional change (Leyden and Link 2015); it may even be said that ideological change is a often precursor to institutional change (Storr et al. 2015). When such entrepreneurship strives to open government-controlled sectors of the economy, as was the case of Jing Shuping’s advocacy for private entry into China’s banking sector, the welfare effects are likely beneficial.

Evasive entrepreneurship can also play an educational role here: Whether productive or unproductive, widespread evasive activities provide a diagnostic indication that institutional reform is needed, and that governments seeking to foster entrepreneurial compliance need to improve the institutional environment. When discussing many African governments’ strong hold over all spheres of economic life, Heilman and Lucas (1997, p. 159), stress that “the informal sector and small-scale income-generating projects became a form of resistance against the state-controlled economy which forced the government to tolerate and eventually encourage private sector activities.” To be sure, calculating the commercial potential of innovations in light of the existing uncertainty is never an easy task (Verspagen 2007, p. 487), but evasive entrepreneurship gives an indication of the size of this opportunity cost. When circumstances are right, evasive entrepreneurship may even be useful as a source of ideas for public policies that aim to foster entrepreneurial compliance and economic prosperity by creating an economic environment that is conducive to value-enhancing activities in the face of uncertainty (Link and Link 2009; Leyden and Link

2015).

Finally, once a shift to a new institutional equilibrium occurs, an increase in productive entrepreneurship complying with the new rules will indicate that the institutional change was indeed welfare enhancing, thereby strengthening the institutional equilibrium. Furthermore, the fact that institution-abiding entrepreneurship increases will strengthen the legitimacy of the new institutional equilibrium. If, by contrast, evasion increases following an institutional change, it is likely an indication that the change was welfare-reducing.

5. Conclusion

We have highlighted the pivotal role played by entrepreneurship for institutional change and economic development in transition and developing economies. Our starting point was that entrepreneurs are less constrained by the institutional status quo than others; they will, therefore, take steps to sidestep and even change institutions when possible. Also, even when entrepreneurs abide by institutions, their activities can be sufficiently radical to make institutional change appear inevitable. The way they respond to and influence institutions are critical for understanding institutional change and inertia, as well as economic growth and decline.

We illustrated these points by way of several examples from transition and developing economies. Thus far, the specifics of the entrepreneurial responses to institutions are to a large extent indeterminate, meaning that improved knowledge of these responses and the context in which they occur would offer a promising avenue for future research. A natural starting point would be to strive for better knowledge of what factors influence the nature of entrepreneurial responses to institutions in developing countries, and whether these factors are general or specific to certain countries, regions, or institutional contexts. Another issue is to study the factors determining the regulatory counter-response: Under what conditions is it more likely that policymakers will create a regulatory environment that enables productive entrepreneurship?

The bidirectional perspective on entrepreneurship and institutions can also be informative for business and development agencies active in developing economies, and potentially stimulate lasting institutional change and sustained economic development. Bottom-up processes are crucial for breaking out of the low-income trap in which many countries still find themselves. Whether institution-abiding, -altering, or evasive, entrepreneurship is a central aspect of these bottom-up processes.

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