Entrepreneurship and Institutions: A Bidirectional Relationship

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Contents

Abstract

The interplay between entrepreneurship and institutions is crucial for economic development; however, the view that institutions determine the extent to which entrepreneurial activity is productive is only part of the story. We argue that causality is bidirectional, in that entrepreneurship is also, for better or for worse, one of the main drivers of institutional change. Through their actions, entrepreneurs have a fundamental influence on institutions, whether they abide by them, actively try to alter them, or evade them. Particular attention is given to evasive entrepreneurship, an entrepreneurial function which, until recently, has been an underappreciated and poorly understood source of innovation and institutional change. We argue that the influence of evasive entrepreneurship on the economic trajectories of societies is likely to only grow in the future.

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1

Introduction

> [T]he ratio of what is known to what is unknown with respect to the relationship between innovation, competition, and regulatory policy is staggeringly low.
>
> [Manne and Wright, 2011, 1]

The Schumpeterian [1934] view that an economy's long-run growth depends on its ability to exploit innovations has gained substantial traction in recent decades [Baumol, 1990, Cohen, 2010, Aghion et al., 2014]. As the individual responsible for creating these innovations, the entrepreneur has increasingly been recognized as the *primus motor* of economic growth [Henrekson and Stenkula, 2016]. Additionally, it has been realized that in this role, entrepreneurs are constrained and enabled by their institutional environments [Baumol, 1990, Aldrich, 2011, Estrin et al., 2013]. Rules, norms and other formal and informal institutions affect and incentivize individual behavior, thereby influencing the extent and productive character of an economy's entrepreneurial activity and, consequently, its economic development [Williamson, 1975, Olson, 1982, North, 1990, Mueller and Thomas, 2000, Hwang and Powell, 2005, Acs et al., 2008, Stenholm et al., 2013, Urbano and Alvarez, 2014].

Formal economic institutions that have been identified as particularly important for entrepreneurship include the protection of private property, tax codes, social insurance systems, employment protection legislation, competition policy, trade policies, capital market regulation, contract enforcement, and law and order [Hall and Jones, 1999, Henrekson and Johansson, 2009, Bjørnskov and Foss, 2013]. Yet much remains to be learned concerning the relationship between institutions and entrepreneurship. In this essay we will argue that the view that institutions determine the extent to which entrepreneurial activity is productive is only part of the story. Rather, causality is bidirectional, in that entrepreneurship is also, for better or for worse, one of the main drivers of institutional change.

Webb et al. [2013] note that scholars who employ institutional theory traditionally examine how institutional pressures lead to activities that conform to prescriptions. Hence, they assume, implicitly or explicitly, that entrepreneurs, even when engaging in sheer rent seeking, abide by institutions and act within prescribed institutional constraints [e.g., Baumol, 1990, Boettke and Coyne, 2003]. However, in the real world, the relationship between institutions and the actors that are supposed to conform to their prescriptions is more complex.

For example, at a conference on the sharing economy in 2013, Kevin Laws of the site *AngelList*, which unites startups and investors, made the following observation [*Santa Clara High Tech Law Journal*, 2013]:

> . . . 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.

This quotation is revealing: it suggests that, for startups in the increasingly important sharing economy (and possibly elsewhere), abiding by existing regulations may be too costly to even be considered. Instead, these entrepreneurs seem to have turned the quip that it is easier to ask forgiveness than to get permission into a strategic tool [Brenkert, 2009]. Thus, they embark on their entrepreneurial ventures with a strategy of ignoring or circumventing extant rules, with the idea of supplanting or complementing this strategy with a more costly institution-altering strategy when such a move becomes economically possible.

This strategy is not the way that entrepreneurs are *supposed* to respond to institutions according to mainstream institutional theory, but the prevalence of such evasive tactics are the motivation of this essay. The fact that such non-abiding responses are common should not be surprising. In a world in which "technology changes exponentially, but social, economic, and legal systems change incrementally" [Downes, 2009, 2], an additional day of regulatory delay can be extremely costly to the entrepreneurs [Prieger, 2007]. Discouraging examples of attempts to collaborate with regulators abound [Askin, 2013] and the cost of these institutional-entrepreneurial conflicts is in all likelihood high, when stated in terms of foregone innovation in areas such as the sharing economy, online genetic analysis, the Internet of Things, wearable devices, smart cars, commercial drones, bitcoin, 3-D printing, robotics, and advanced medical devices [Thierer, 2016].

We will explore the various ways that entrepreneurs can respond to institutions and delve into the institutional repercussions of these strategies. We will argue that institutional change is endogenous [Eggertsson, 2005] and that the institutional framework does not merely direct entrepreneurs' actions; entrepreneurs also influence the workings of that framework, whether through "regular" business activity, institutional entrepreneurship, or evasive methods [Henrekson and Sanandaji, 2011]. In exploring both sides of the interaction, we ask: How does the institutional framework influence entrepreneurship, and how do entrepreneurs, in turn, influence the emergence and evolution of institutions? In short, we explore the bidirectional causality between institutions and entrepreneurship.[1]

Special attention will be given to entrepreneurs' evasive responses to institutions, since this phenomenon remains understudied and underestimated in the entrepreneurship literature, although some steps forward

[1]This essay is an attempt to synthesize and extend a number of ideas that have been developed in a series of papers, particularly those of Douhan and Henrekson [2010], Henrekson and Sanandaji [2011], Elert and Henrekson [2016, 2017], and Elert et al. [2016].

have been taken recently [see, e.g., Elert and Henrekson, 2016, Elert et al., 2016]. Based on evidence from economic history we argue that such evasive entrepreneurship has induced many of the institutional developments that have made the prosperous world in which we now live possible. Taking this type of entrepreneurship into account is also essential for understanding many of the developments that currently affect the social and political order on a global scale.

The remainder of this essay is structured as follows. Section 2 will provide a precursory framework for institutions as functional responses to deviations, followed by an introduction of the idea of entrepreneurs as deviators. In Section 3, we begin by categorizing the three entrepreneurial responses to institutions — abide, alter, and evade — before discussing the first two at greater length. The subsequent two sections are devoted to evasive entrepreneurship, with Section 4 defining the concept and discussing the institutional features that make it possible, while Section 5 describes its economic consequences and its potential to usher in institutional change. Section 6 concludes by discussing the implications of our work for policy and future research.

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