Preliminary draft

Comments are welcome

Institutional Entrepreneurs[1]

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Abstract

In a market economy, entrepreneurs are businessmen who start a new business or expand an existing business by integrating production factors. In an emerging market economy, where market institutions are being established, in order to start or expand a successful business, a businessman not only has to possess the same ability as their counterpart in a market economy, he also has to overcome many institutional barriers. Often times, such entrepreneurs are at the forefront of destroying existing bureaucratic rules in many creative ways. We call them institutional entrepreneurs. Based on case studies, we analyze the behavior of institutional entrepreneurs and compare them with traditional entrepreneurs.

Keywords: Entrepreneurship, institutional change, institutional destruction, emerging markets, reform

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I. Introduction

A very interesting phenomenon in today's world, from an economist view, is the rapid growth of a few emerging market economies, including China, India, and Vietnam. The rapid growth is by no means accidental. Instead, in each case, great efforts have been made to change the prevailing institutions, which are defined as laws, regulations, and implicit rules governing economic activities. In the Chinese and Vietnamese cases, this has been the economic reform. In the Indian case, it is the reform started in the early 1990's. Therefore, to understand the driving forces of the rapid growth of the emerging market economies, we must understand the mechanisms that make the reform work.

Another common feature of the successful emerging market economies is that they witness rapid entry of new firms. The major obstacles preventing rapid entry of new firms is that the market institutions are gradually taking roots in emerging market economies. Therefore, founders of new enterprises not only face obstacles common to those in mature market economies, such as securing financing and recruiting suitable employees and establishing sales channels, they also face many institutional barriers. For example, government license may still be required for their businesses; land permits to newly established firms may not be automatically granted, etc.

Entrepreneurship in traditional sense cannot describe the challenges and the endeavors that many founders of enterprises in emerging market economies face. In an emerging market economy, founder of enterprise face additional challenges in navigating in an imperfect market environment. In many cases, they are destroyers of old and inefficient institutions and pioneers of new market institutions. Therefore, they have to be more versatile and possess more skills than their counterparts in mature market economies.

Motivated by many cases of the kind described above, in the paper we define the concept of institutional entrepreneurs, who not only play the role of traditional entrepreneurs in the Schumpeterian sense but also help establish market institutions in the process of their business activities. Based on cases from emerging market economies, we summarize that there are at least four alternative strategies that institutional entrepreneurs can utilize to advance market institutions in order for their business ventures to be successful. We analyze that institutional entrepreneurs must possess skills in addition to those of a traditional entrepreneur, including skills in dealing with government officials and public opinion. Moreover, institutional entrepreneurs also have to face more risks than their counterparts in a market economy, since they have to bear the risk of not being to change the existing institutions that are restrictive to their business venture. As a result, in comparison with traditional entrepreneurs, institutional entrepreneurs generate more significant positive externalities to the economy and constitute an important force of economic development and reform.

There is a long literature devoted to the study of entrepreneurship in economics and related disciplines. The origin of the studies of entrepreneurship is mature market economy. Schumpeter (1934) was the pioneer of the studies of entrepreneurs, explaining that entrepreneurs are innovators integrating resources in production for the market place. Baumol (1968) and Leibenstein (1968) are among many who emphasize that entrepreneurship is an engine of economic development, while economics has not devoted adequate attention to it. Our perspective is different from these previous studies in that we emphasize that in an emerging market economy, instead of just integrating resources for production, entrepreneurs have to destroy institutional barriers and therefore contribute to the establishment of market institutions.

The paper is also related to the literature of institutional change. Most studies, e.g. Davis and North (1961), emphasizing the importance of organized groups in pressuring or lobbying for institutional change, do not make the connection between institutional change and entrepreneurship. Indeed, in mature market economies, they belong to different universes, as institutional changes are pushed by pressure groups who are familiar with political establishments and entrepreneurs specialize in operations in the marketplace.

There are some studies outside economics analyzing entrepreneurship and institutions in emerging market economies. Yang (2004) argues that many entrepreneurs in China are institutional arbitragers, who take advantage of the inconsistencies among laws and regulations in a transition period and advance their business interest. We argue that there are also institutional entrepreneurs who do not arbitrage in existing institutions but proactively push for market oriented institutions.

II. Institutional entrepreneur and his behavior

We define an institutional entrepreneur as an innovative person who starts or to expands his business venture and in the process help destroy the prevailing non-market institutions in order for his business venture to be successful. By this definition, an institutional entrepreneur is a businessman, whose ultimate objective is the success of his business venture. However, in order to make his business venture a success, he has to effectively break existing institutions, which are obstacles to his business operation. Thus, his innovation is external, not just within his firm. His efforts and creativity help establish market-oriented institutions.

Unlike a traditional entrepreneur, an institutional entrepreneur faces constraints to his business venture in the form of institutional barriers. The institutional barriers come in different forms. A common kind of such barriers is entry restrictions. That is, existing regulations or laws prohibit new economic agents from entering the sector in which the entrepreneur sees great business potential. Another common type of barrier is excessive intervention or regulations after a business venture is established. Examples include overly complicated labor regulations, unreasonably tight safety regulations, etc.

How does an institutional entrepreneur effectively break institutional barriers and therefore push for better market oriented institutions? Based on case studies, we summarize that there are at least four common approaches.

1. *Open advocacy* Institutional entrepreneurs often openly advocate for changes to existing regulations or laws. Such changes are necessary for them to start or expand their businesses. There are many channels to openly advocate for such changes. For example, they may write for or interview with the media, organize public forums or conferences, sponsor policy or public opinion oriented research, etc. However, at least two necessary conditions must be satisfied in order for the behavior of open advocacy to be effective or even feasible. First, the government or the society in general has to be tolerant enough for opinions which are not mere praises of existing policies, regulations, or laws. Second, the changes that the

entrepreneurs openly advocate for should be, or at least perceived to be, beneficial to the majority of the general public, not just the individual entrepreneurs actively involved. If, on the contrary, the proposed changes are, or are perceived to be, only beneficial to a small group of the economy, including the entrepreneurs themselves, then the strategy of open advocacy cannot work and even backfires.

2. *Private Persuasion* Instead of openly advocating for changes in existing laws and regulations, institutional entrepreneurs sometimes choose to persuade privately relevant decision makers for such changes. For example, they may organize private meetings with key decision makers or they may sponsor non-published research reports in order to convince government agencies to take actions to make institutional changes. Relying on private persuasions or lobbying, rather than open advocacy, institutional entrepreneurs can be more explicit about their desired changes and can address the concerns of the government more effectively.
3. *Making cases of exceptions* The safest and often the most convenient way for an institution entrepreneur to initiate an institutional change is to argue that he has a special case that should be regarded as an exception to the existing laws and regulations and therefore his business should be allowed to operate. This strategy is safe for the institutional entrepreneur since he is not seeking to change, at least on paper, the laws and regulations. The worst outcome is a rejection from the government. It is also relatively easy, since even if the government agency approves the entrepreneur's request, the agency is not making an explicit commitment to further changes. However, in reality, once an exception is made, other cases can also be argued to be exceptions. The plural form of exception often times amounts to de facto institutional change.
4. *Ex ante investment with ex post justification (EIEJ)* This is perhaps the most interesting way for an institutional entrepreneurs to facilitate institutional change. This is a strategy opposite to that of open advocacy. That is, the entrepreneur may first start his business or expand his existing business by evading existing restrictive laws or regulations. When the business proves to be very successful and has generated large amount of employment, taxes, and/or any documented social benefits, the entrepreneur then makes formal reports to the government and uses the

success of the business to justify its earlier behavior and therefore persuade the government to make changes in existing laws and regulations in order to make his ex ante investment legitimate.

In order for this strategy to be successful, two necessary conditions must be satisfied. The first is that ex ante the entrepreneur must be able to persuade those government officials in direct control of his business, or, local officials. The local officials are crucial, since they have close observations of the entrepreneur's business startup or expansion and as a result, it is hard for the entrepreneur to completely hide his operations from the local officials. Second, the business that the entrepreneur starts or expands, when successful, should be readily projected to benefit not only the entrepreneur but also a large group of economic and political agents in the society, especially, government officials. Employment, taxes, and a large number of customers who become beneficiaries of the business are examples.

The EIEJ strategy is easily the most risky strategy for an entrepreneur, since by adopting it he faces dual risks. He not only faces the business risk that is common to all entrepreneurial activities, he also has to bear the risk of failures in the efforts of ex post justification. The second is compounded on the first one, since even if his business is very successful in a market economy sense, when he fails to justify the legitimacy of the business, he cannot benefit from his earlier business investments and moreover, he is likely to be punished.

III. Traditional entrepreneurs, institutional entrepreneurs, rent seekers, and politicians

A few comparisons are in order. Let us first compare institutional entrepreneurs with traditional entrepreneurs. There are at least three major differences. First, the amount and type of externalities they create are different. A traditional entrepreneur, through his business success, establishes a business model for businessmen to emulate. This can happen in different ways, e.g. a new method of management of the firm, a new business revenue model, a new market in which unsatisfied consumer demand is catered, etc. In comparison, an institutional entrepreneur also generate this kind of externalities and, in addition, through his efforts in making institutional change, open up new avenues for future businessmen to start and expand their businesses. The externalities that an institutional entrepreneur generates also include, most importantly, institutional change.

Second, the type and the amount of risks they bear are different. A traditional entrepreneur bears mostly market risk. In most cases, his evaluation of the market demand and the costs is critical to the success of his business. Once the evaluation proves to be too far from the reality, the business fails and the entrepreneur bears the burden of the failure, although other participants in the business may share the burden with him. In contrast to a traditional entrepreneur, an institutional entrepreneur bears dual risks. Besides market risk, he also has to face institutional risks, which come from the failure to successfully persuade the government to make necessary changes in existing institutions, without which, he cannot reap the benefit of the success of his business in the market place.

Third, as a consequence, traditional entrepreneurs and institutional entrepreneurs have different types of human capital. Simply put, an institutional entrepreneur must not only possess exquisite business intelligence but also excellent political sense and skills in order for him to manage effectively the risk involved in pushing for institutional change. This is why in many cases, an institutional entrepreneur has strong government background, having worked in government agencies and is adept in navigating government regulations and bureaucratic restrictions.

We can also compare institutional entrepreneurs with rent seekers. Rent seekers are interested in obtaining rent generated by non-market institutions. In their pure form, they do not have socially productive activities. To the contrary, institutional entrepreneurs look for changing non-institutions while trying to establish their own businesses. Thus, the latter are progressive in an emerging market economy. Conceptually, the distinction is clear. However, one may wonder that an institutional entrepreneur may become a rent seeker in circumstances when it is more profitable to do so for his business. Although this may happen, the skills of an institutional entrepreneur are meant to destroying existing non-market institution and are different from those for establishing non-market institutions. Also, fundamentally, institutional entrepreneurs are entrepreneurs to begin with and they are driven by market opportunities while rent seekers are driven by opportunities to arbitrage by taking advantage of non-market regulations. In reality, they are likely to have very different human capital profile.

The above remarks are also relevant when compare institutional entrepreneurs with politicians who are reform minded and are also looking for destroying prevailing non-market institutions. Institutional entrepreneurs are ultimately driven by profit motives. The latter are politicians, whose political objectives are behind their reform strategies. Institutional entrepreneurs push for market oriented reform out of their own economic interest from their gross root perspective while reform-oriented politicians facilitate reform from the top. Both roles are important. However, the role of the institutional entrepreneurs is often neglected in analysis of reform in emerging market economies.

IV. Summary

Entrepreneurs, in the Schumpeterian sense, are businessmen who discover new market niches by integrating production factors in order to make profits. We call them traditional entrepreneurs. We argue that in an emerging market economy, such talents and behavior are often inadequate for a businessman to be successful. In addition, a successful businessman needs to break or, de facto, destruct, existing institutions that have been preventing normal business from being initiated and being expanded and therefore the economy from realizing its development potential. We define and describe a new category of entrepreneurs, i.e., institutional entrepreneurs, who not only start and expand their businesses but also push for destroying existing non-market institutions in the same process. In comparison with their market economy counterparts, they face additional risks in their entrepreneurial activities. They have to bear the risk of failing to change effectively existing institutions, a necessary condition in order for their businesses to be successful. They rely on many different means to achieve the objective of changing institutions and have to possess political and governmental skills in pursuing their objectives. Once they are successful in changing institutions, they generate positive externalities for fellow businessmen. It is because of this reason, institutional entrepreneurs play an important role in emerging market economies in pioneering economic development and the formation of a market economic system.

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