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**Context Matters:  
Institutions and  
Entrepreneurship**

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# Context Matters: Institutions and Entrepreneurship

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## Context Matters: Institutions and Entrepreneurship\*

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### Abstract

This survey explores the important connection between institutions and entrepreneurship. Institutions consist of the formal and informal “rules of the game.” Entrepreneurs act within a context determined by these rules. The rules of the game create payoffs that make certain entrepreneurial opportunities more attractive than others. We explore the relevant literature from institutional economics and entrepreneurial studies, focusing on the important link between the two. Particular emphasis is placed on entrepreneurship within several different institutional settings — private for-profit, private nonprofit, and political — as well as the impact of entrepreneurship on institutions. We conclude by discussing the implications for future research on the topic.

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# 1

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## Introduction

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This survey aims to analyze the connection between entrepreneurship and institutions. Our goal is to provide a discussion of the literature on institutions in economics, develop the argument on the relationship between institutions and entrepreneurship and to apply this logic to a variety of entrepreneurial settings — private for-profit, private non-profit, and political. In addition to exploring entrepreneurship within several institutional settings, we also consider entrepreneurship on institutional arrangements. We end with a discussion of the implications for future research.

Entrepreneurship manifests itself in a variety of ways (see Parker (2005)). Buying low and selling high, the discovery and diffusion of lower cost technologies in production, the introduction of new products, learning how to better deliver goods and services to customers at lower cost, and the creation of new opportunities to alert potential buyers to the availability and desirability of new products are all entrepreneurial acts in the marketplace. There are numerous other examples of productive and wealth-enhancing arbitrage and innovation. For our purposes, the defining characteristic of entrepreneurship is that the entrepreneur seeks to better his own situation by engaging in beneficial exchange with others.

## 2 Introduction

Entrepreneurial opportunities and activities differ significantly across societies. These differences are one important factor in the varying levels of wealth and prosperity across societies and nations (see van Praag and Versloot (2007)). One explanation for these differences is purely cultural (see Harrison (2006)). Specifically, it might be argued that some cultures are lacking in “entrepreneurial spirit.” From an economist’s standpoint, this explanation is incomplete and unsatisfactory. Focusing on purely cultural explanations neglects the alternative, that individuals act purposefully to better their position. Of course, what individuals perceive as bettering themselves varies from place to place, but this does not neglect the fact that people act in a purposeful manner to achieve their desired ends. A key aspect of acting purposefully is responding to changes in relative costs and benefits. Given this, an alternative to the purely cultural explanation for differences in entrepreneurship focuses on the institutional context in which individuals act. The institutional alternative takes a broader approach and includes not only culture, or “informal institutions,” but also formal institutions as well (see Shirley (2005, 2008)).

For the purposes of this survey, we define institutions as both the formal and informal rules governing human behavior (see North (1990, 1991)). Because of the role of institutions as the “rules of the game,” a detailed examination of the institutional context is one important element of understanding the role of entrepreneurship in economic life. Institutional explanations for differences in entrepreneurship are more complete than cultural explanations because they recognize the importance of culture, which is considered one type of informal institution, while also recognizing the role of other informal *and* formal institutions.

We focus on the importance of productive entrepreneurship as a central catalyst of economic development and growth. Further, we take as given that entrepreneurs are present in all societies across time and space (see Baumol (2002) and Koppl (2007)). Individuals will be entrepreneurial in the sense they will employ their ingenuity to improve their position in life. Indeed, innovation has been a strong driving force in the survival and success of the human race over the course of its evolution and consequently that disposition is arguably present in all societies (see Seabright (2005) and Field (2007)). An African

tribesman, a European peasant, or an American farmer are all acting entrepreneurially when they pursue opportunities to better their personal circumstances through beneficial exchange and interaction. It is a human trait to be alert to those things that are in our interest to be alert to. Given this, differences in economic outcomes across societies are not due purely to differences in entrepreneurial spirit, but instead are due to differences in institutions. The institutional environment in which entrepreneurs act, shapes and constrains the opportunities available at any point in time.

Where institutions produce a net benefit to productive opportunities (e.g., arbitrage and innovation) entrepreneurs will exploit those opportunities resulting in the creation of wealth. Likewise, when there is a relatively high benefit to engaging in unproductive activities (e.g., rent-seeking and crime), entrepreneurs will take advantage of those opportunities. Unlike productive activities, unproductive activities result in economic stagnation or decline. In general, institutions shape entrepreneurial opportunities which have real effects on the ability of the economic system to realize the gains from social cooperation under the division of labor.

In the next section, we develop the notion of institutions and provide insight into what this concept entails. We then (Section 3) seek to understand how institutions matter for entrepreneurship and economic development. This is followed by a consideration of “social entrepreneurship” (Section 4) and “political entrepreneurship” (Section 5). In each case, we focus on how institutions influence entrepreneurial behavior in these alternative settings. We then turn to a consideration of the role of “institutional entrepreneurs” (Section 6) and their impact on the formation and evolution of institutions. The conclusion (Section 7) presents some areas for future research.

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