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FORMAL INSTITUTIONS IN EASTERN CROATIA

ABSTRACT

This paper has two purposes. First, it provides an assessment of the factors framing entrepreneurship in Croatia and how they influence the predominantly necessity-oriented entrepreneurship in the nation. The factors considered include – economics, formal institutions, culture, the industrial structure, human capital and social capital. The second purpose is to present possibilities on how different institutions, through their policies, programs and implementing organizations, impact the above factors. Understanding the sources influencing necessity entrepreneurship is important because the Croatian government's goal is to reach 75% of the EU25 mean GDP by 2013, partly using entrepreneurship development as an engine of this growth.³⁵

The method of research supports national economic strategies for increasing growth-oriented entrepreneurship because entrepreneurship is considered to be an effective way to raise national GDP (van Stel, Carree et al. 2005), increase employment (van Stel, Carree et al. 2005) create more robust industrial structures (Marshall 1919; Saxenian 1994; Uzzi 1997) as well as increasing social capital (Dakhli and De Clercq 2004). There are even benefits of growth-oriented entrepreneurship specific to the transition context. Researchers believe that it is a key factor in insuring the success of transition from Socialism to Capitalism (Ireland, Tihanyi et al. 2008; Smallbone and Welter 2009). The main results include three effects CEE that entrepreneurs have on economic development: being mechanisms for privatizing and restructuring state-owned enterprises; helping to transform the distorted and monopolistic centrally-planned industrial structure; and finally, establishing a private enterprise sector (Smallbone and Welter 2006).

Key words: *entrepreneurship, opportunity/growth entrepreneurship, institutions, policies, programs*

SAŽETAK

Ovaj rad ima dvije svrhe. Prvo: pružanje ocjene čimbenika koji uokviruju poduzetništvo u Hrvatskoj te kako utječu na poduzetništvo koje je u naciji pretežno egzistencijalno orijentirano. Razmatrani čimbenici uključuju ekonomiku, formalne institucije, kulturu, industrijsko ustrojstvo, ljudski i društveni kapital. Druga svrha je predočavanje mogućnosti kako različite institucije svojim politikama i programima te provedbene organizacije utječu na gornje čimbenike. Razumijevanje izvora koji utječu na egzistencijalno poduzetništvo je

³⁵ This is explicitly stated by the Croatian Ministry of Economy, Labour and Entrepreneurship's website as well as a variety of pre-EU Accession reports. (Source: telephone conversation with Ministry official)

važno, budući da je cilj hrvatske vlade ostvarenje 75% EU25 prosječnog BDP do 2013. godine, djelomično koristeći razvoj poduzetništva kao motor ovog rasta.³⁶

Metoda istraživanja podupire nacionalne ekonomske strategije za rastuće poduzetništvo koje je orijentirano na rast, budući da se smatra kako je poduzetništvo efektivan način povećanja nacionalnog BDP-a (van Stel, Carree et al. 2005). Njime se povećava zapošljavanje (van Stel, Carree et al. 2005), stvaraju robustnija industrijska ustrojstva (Marshall 1919; Saxenian 1994; Uzzi 1997) te ostvaruje povećani društveni kapital (Dakhli i De Clercq 2004). Čak postoje beneficije na rast orijentiranog poduzetništva, a koje su specifične za kontekst tranzicije. Istraživači vjeruju kako je to ključni čimbenik u osiguranju uspjeha tranzicije od socijalizma u kapitalizam (Ireland, Tihanyi et al. 2008; Smallbone i Welter 2009). Glavni rezultati uključuju tri CEE efekta koje poduzetnici imaju na ekonomski razvoj: mehanizmi za privatizaciju i restrukturiranje poduzeća u državnom vlasništvu; pomoć pri transformaciji središnje planiranog, iskrivljenog i monopolističkog industrijskog ustrojstva i, konačno, stvaranje sektora privatnog poduzeća (Smallbone i Welter 2006).

Ključne riječi: poduzetništvo, poduzetništvo mogućnosti/rasta, institucije, politike, programi.

1. Introduce

Of course, entrepreneurs do not function in a vacuum. Their actions are partly defined by their environment (Shane and Venkataraman 2000). Factors in the environment affecting entrepreneurship can, for example, include the macro-economic landscape as well as the way the entrepreneur's capability set is influenced by education, cultural norms, and career experience. Further, this "environment" is defined and controlled by the formal and informal institutions of a society. The operative part of institutions, their policies, programs and implementing organizations, are the focus of this research because they have direct and indirect effects on both the supply and demand of entrepreneurs. They do this by impacting the access to capital and other resources, as well as the entrepreneur's perception of opportunities. The formal/informal institutions in CEE still remain key obstacles in promoting entrepreneurship because of their incongruent transitions (Smallbone and Welter 2009). One of the largest problems for economic, institutional and entrepreneurship development in CEE is that formal institutional policies and structures supporting a free market have steadily emerged but informal institutions have not been able to catch up.³⁷ Therefore, understanding the present entrepreneurial milieu of transition Croatia and assessing its potential for development begins with these research questions:

- 1) **What are the characteristics of the factors framing necessity-based entrepreneurship in Croatia?**
- 2) **What institutions, policies and organizations impact these factors of entrepreneurship and how do they do it?**

³⁶ Ovo izričito navodi web stranica hrvatsko Ministarstvo gospodarstva, rada i poduzetništva, kao i niz izvješća pred pristupanje EU. (Izvor: telefonski razgovor sa službenikom Ministarstva)

³⁷ Formal institutions refer to the rules, regulations, laws and supportive apparatuses that establish order in economic, legal and political frameworks. Informal institutions include the norms, beliefs, values and conventions that form the socio-cultural relations within a society. North, D. (1990). Institutions, Institutional Change and Economic Performance, Cambridge University Press.

Informed by the answers to questions 1 and 2, the last question is answered in the conclusion:

3) Where is the potential for changing Croatian entrepreneurship into a more knowledge-based, growth-oriented entrepreneurship?

This paper is organized in the following manner. First, the theoretical portion is inspired by the Theory of Institutions and Institutional Change as brought forth by Douglass North (North 1990) and Richard Scott (Scott 1995) and Resource-Based Theory as defined by Edith Penrose (Penrose 1959). These theories are transposed into the entrepreneurship research paradigm with the help of studies by Boettke & Coyne (Boettke and Coyne 2007) and William Baumol (Baumol 1990). The theories are used to display a cause and effect dynamic between institutions, resources and the outcome of entrepreneurship. After that, the methodology is presented explaining my rational choice, constructivist approach. Here, the research framework is introduced. After the methodology, the research is presented in two ways. First, there is a descriptive part examining the factors framing entrepreneurship in Croatia, specifically, the economic, institutional, cultural, industrial, human capital and social capital factors. Some clues are sought within these factors to explain the predominance of necessity entrepreneurship in Croatia. Second, there is an explicative part which, through analysis, explains how the Croatian entrepreneurship framework is influenced by policies and organizations from international, national, and regional institutions. The conclusion provides insight into the potential of Croatian entrepreneurship evolving into growth-oriented, knowledge-based forms. The conclusion also provides some suggestions for policy-makers and other stake-holders.

2. Theoretical background

The theoretical portion of this paper explores ideas from previous researchers which shed light on how the outcome of entrepreneurship is determined by the institutional control of resources³⁸. First, some definitions are presented. Then the types of institutions and their control mechanisms are examined from the perspectives of North and Scott. Third, a look is taken at how entrepreneurship researchers use Institutional Theory to explain the outcome of entrepreneurship. Resource-based Theory (Penrose 1959) is used as the link between institutions and the entrepreneurial outcome.

2.2 Theoretical Framework

With the exception of an eclectic approach to entrepreneurship (Verheul, Wennekers et al. 2001; Shane 2003) and a population ecology approach (Aldrich 1999), most entrepreneurship theories focus on micro-level influences in order to explain new venture creation and development, taking the institutional environment for granted (Smallbone and Welter 2009). Empirical evidence from transition economies shows the external environment to be one of the dominant features influencing the development of entrepreneurship (Peng and Heath 1996; Smallbone and Welter 2006; Welter and Smallbone 2008). According to Smallbone & Welter's (2009) recent review of entrepreneurship theories, there is a growing body of literature which explicitly links entrepreneurship to the overall institutional environment [e.g. (Acs and Karlsson 2002)]. Few studies, however, examine informal institutions such as values and social norms, in other words, the influence of culture on entrepreneurship. The research which exists looks at countries with different institutional profiles and/or linking Hofstede's cultural dimensions to entrepreneurship (Audretsch, Thurik et al. 2002; Hofstede,

³⁸ In this paper, resources are implied when the term "factors of entrepreneurship" is used.

Nooderhaven et al. 2004). Moreover, important for this paper, Wright et al (Wright, Filatochev et al. 2005) point out that little institutional theory related research has been done on start-ups in transition economies.

3.Types of Institutions and their Control Mechanisms

Douglass North expressed that the formal and informal institutional environment determines the rules of engagement by placing constraints on human action. Institutions may increase or reduce uncertainty (North 1990), which can increase or reduce transaction costs associated with entrepreneurship. Formal institutions include the constitutional, legal and organizational framework for individual actions, while informal institutions adopt “uncodified attitudes”, which are embedded in society and regulate individual behaviour (North 1990). After North’s seminal work, later research differentiated institutions along other characteristics. For example, formal and informal institutions have different enforcement methods. Formal institutions are enforced by rules, while informal institutions are enforced by private actors using “psychological sanctioning” as a compliance device (Knight 1997). Formal and informal institutions have different channels of accessibility. Formal institutions are seen to be accessible to all, while informal institutions can be restricted to specific groups (Ebner 2006). Richard Scott links the role of institutions to their enforcement mechanisms (Scott 1995). Placing these mechanisms in the context of entrepreneurship it can be stated that **regulative** control defines the way trade is supported or not supported through various laws, statutes and informal rules. **Cognitive/cultural** control defines the way the individual views entrepreneurship and the process of trade based on the cultural framework. **Normative** control influences whether entrepreneurship is a socially accepted activity and under what norms and values is it practiced (Scott 1995). These control mechanisms are embedded in how policies, programs and organizations go about applying the goals of the envisioning institution. Such clean theoretical and definitional delineations may tempt one to think that formal and informal institutions as separate constructs in society. In reality, both formal and informal institutions are mutually dependent and they co-evolve (Ebner 2006). It is in this mutual dependence where institutional change can be hampered and where formal institutions evolve only as far as informal ones will allow. This tension highlights the dynamic of institutions in a transition context and their impact on entrepreneurship.

Institutions, Entrepreneurship and the Transition Context

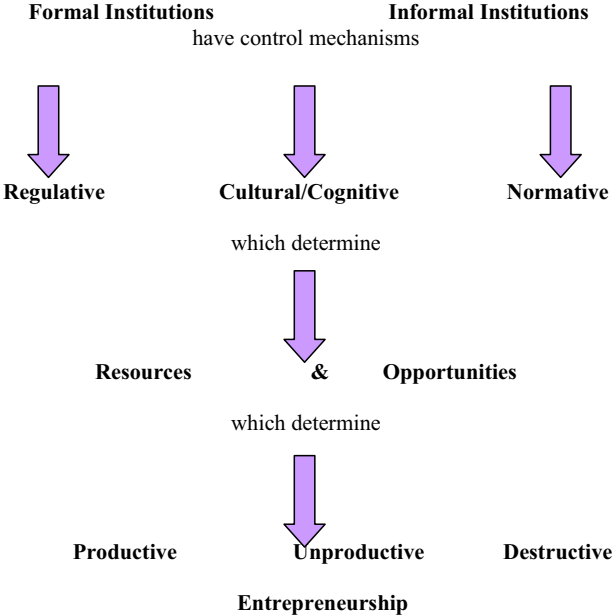
Formal institutions engender policies, programs, organizations and behaviors which affect entrepreneurship through the control of resources (Boettke and Coyne 2007). In an entrepreneurship context, resources can be found in the individual and his/her environment. Edith Penrose (1959) first put forth that resources imperative for firm growth could be found in individuals (Penrose 1959). She states that “heterogeneous, non-imitable resources, especially human and managerial”, are responsible for the creation and growth of firms (Penrose 1959). Since the entrepreneur functions as a firm, his/her capability set defines the outcome of entrepreneurship. In Baumol’s view, what matters is *how* institutions influence individual capability sets and how they channel the efforts of individuals. He believes it depends on the quality of the prevailing environment which he sees as the political, economic and legal institutions of a nation. He, like Mises (1949), believes that entrepreneurship is a characteristic of human action and is present anywhere and at anytime. Therefore, institutions decide whether the outcome of entrepreneurship will be productive, unproductive or destructive (Baumol 1990).

The role institutions have on entrepreneurship in a transition context is not different from any other in that they play a constraining and enabling role. Examples of **formal institutions** affecting entrepreneurship include the legal framework, the regulatory & policy framework, and the financial system. Laws might create new opportunities for entrepreneurship in transition countries with, for example, the introduction of property rights. On the other hand, a deficient legal infrastructure, manifested by inefficiencies, lack of judges, and courts lacking economic expertise, could restrict entrepreneurship. The presence of an institutional void allows for arbitrary actions by administrators which, as research in Eastern Europe tells us, fosters rent-seeking, corruption and non-compliant or defiant behavior of entrepreneurs (Lorentzen and Rostgaard 1997; Singer, Pfeiffer et al. 2003; Smallbone and Welter 2009).

Informal or normative/cultural-cognitive institutions can be portrayed on three levels. First, there is the societal level, where norms and values form attitudes towards entrepreneurship. Second, at the sectoral level, trade organizations and professions dictate codes of conduct through informal institutions. Finally, institutions exist on the level of communities, such as religious, kinship or ethnic groups. Normative elements contain the collective sense-making of a society, while cultural –cognitive elements refer to the individual’s perception of societal rules and values, which is influenced by the individual’s education and experiences. According to Smallbone and Welter (2009), there is a negative heritage of socialist experiences not supporting entrepreneurial action. These negative Socialist experiences influence the cognitive/cultural and normative elements of informal institutions. Some proof of this is found in empirical studies showing that variations in entrepreneurial behavior can be accounted for by entrepreneurship’s image in a specific country [e.g. (GEM 2006)]. What these theories and concepts warn of is that even if formal institutional structures to support entrepreneurship are well engineered, informal (societal, sectoral and community) institutions may derail the process if they are not aligned.

Therefore, in conclusion, institutions not only have an effect on the supply of resources but also govern how entrepreneurs view and use them. With the aid of theories from North, Scott, Penrose, Boettke & Coyne and Baumol, a stream of cause and effect linking institutions, control mechanisms, resources and entrepreneurial outcomes can be made. It can be described like this: Formal and informal institutions exercise cognitive/cultural, normative and regulative control affecting the availability of resources which determine the outcome of entrepreneurial activity into productive (opportunity), unproductive (necessity) or destructive forms. This interaction is seen in Figure 1. Further, if formal and informal institutions are not aligned in their goals then any changes will certainly be impeded.

Figure 1: Theoretical Framework - The Interaction between Institutions, Control Mechanisms, Resources to Define Entrepreneurship



Source: Author

This theoretical framework in Figure 1 captures the interdependence of institutions, resources and entrepreneurship. The figure appears to be linear but it is not. The outcome of entrepreneurship returns through the chain and affects resources, the control mechanisms and the institutional structure. In short, there is a recursive relationship. This interaction sheds light further along in the paper on why Croatia is mostly capable of engendering a certain type of entrepreneurship - the necessity variety – from the perspective of its institutions and their influence on the factors of entrepreneurship.

3. Methodology

In this section, an explanation of the research approach is given which focuses on secondary sources and telephone conversations/email exchanges with individuals in Croatian institutions. Second, the analytical framework is presented using a matrix which helps characterize the institutional presence in Croatia, its effect on the factors of entrepreneurship, the control mechanisms used, and the resources provided.

3.1 Research Approach

To answer the third research question, what is Croatia’s potential for developing a larger supply of growth oriented entrepreneurship, two objectives have to be met. The first objective is to assess Croatia’s necessity-based entrepreneurial environment by examining the economic, institutional, cultural, industrial, human capital, and social capital factors. When

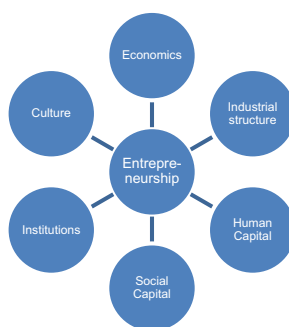
the focus of the entrepreneurship research community turned away from individual psychological traits as an explanation for entrepreneurship and more to the intersection of the individual and the opportunity, a group of authors suggested taking a closer look at the opportunity creating environment (Shane and Venkataraman 2000; Verheul, Wennekers et al. 2001; Shane 2003). The factors listed above are adapted from these studies and used to define the “environment” which I interpret as being instrumental in defining the opportunities available. The second objective is to understand how formal institutions in Croatia, through their policies/programs/organizations impact the environmental factors listed above.

This study is exploratory in nature using a qualitative research approach by assessing secondary sources and informal, unstructured interviews. The secondary sources of information are examined from an internal and external perspective. The internal sources are those published or presented by Croatians in the form of: Croatian National Bank statistics, entrepreneurship research carried out by Croatian researchers, policy documents, strategic plans and mission statements from institutions supporting entrepreneurship. The external sources are what “outsiders” say about Croatia. These come in the form of research from international organizations (OECD, EU, World Bank, GEM) and from assessments by non-Croatian researchers. Having this “internal/external” perspective should give a more balanced view. Informal telephone interviews were conducted with Chamber of Commerce employees, Croatian academics and Croatian representatives from business associations. The interviews were only used when published information needed clarification.

3.2 Analytical Framework

The analytical foundation is presented below in Figure 2 and is the paradigm for the analysis of the descriptive and the explicative parts of this research. The **descriptive part** characterizes the state of entrepreneurship in Croatia by briefly assessing, first, the influence of history on entrepreneurship and second, the qualities of the factors in Figure 2. These factors were isolated from previous authors’ contributions (Verheul, Wennekers et al. 2001; Shane 2003).

Figure 2: Factors Influencing Entrepreneurship



Source: Adapted from Verheul & Wennekers (2001), Shane (2003)

The **explicative part** of this research turns to an examination of the institutions active in Croatia accounting for the quality of the above mentioned factors. This examination includes information about relevant policies, programs and organizations. The institutions are assessed as to their impact on the factors of entrepreneurship, which control mechanisms they tended to

use, and what resources (or barriers) were made available. Table 1 sums up this process of analysis:

Table 1. Croatian Institutional Assessment

Impact on...	International Institutions	National Institutions	Regional Institutions
Economy			
Institutions/Policies/Organizations			
Culture			
Industry			
Human Capital			
Social Capital			
Control Mechanisms...			
Cultural/Cognitive			
Normative			
Regulative			
Resources Provided...			
Financial			
Physical Infrastructure			
Education			
Awareness			
Networks			
Knowledge			

Source: Author

The first step before applying this framework was to isolate which institutions were active in Croatia. After reading a variety of Croatian government, OECD, EU and World Bank reports, I soon began to see strong presences of certain institutions which I later sorted into the geographic categories, international, national and regional, in Table 1. After reading hard-copy and electronic documentation about their activities in Croatia, I targeted their impact through assessing their formally written goals and/or the manifestation of their actions. Their control mechanisms could often be identified in their mission or goal statements. Otherwise, I judged this based on the “way” they went about reaching their aims which was often found in the documentation of their procedures. The resources or opportunities they wanted to make available were often explicitly stated in their official documentation. Interestingly, I came across no internal documentation of “self-assessment” from the institutions nor of any of their policies/programs or implementing organizations. I found three external reports assessing the performance Croatian institutions: the OECD’s, the World Bank’s Global Competitiveness Index, and a report for the Global Entrepreneurship Monitor from Croatian researchers. These reports were used to assess the barriers the institutions create for entrepreneurship in Croatia. They provide assessments of the informal institutional environment which adds some depth to my formal, more structural assessment.

A possible challenge with using the above framework is that it is a snapshot which does not take into account the dynamic, learning nature of institutions. Therefore, there is no way to make room for or explain change. Also, because this study does not go in-depth in any one

institution, only the broad-strokes of each institution's actions could be captured and not their finer, more subtle goals and actions.

4. Conclusion

Therefore, in conclusion, institutions not only have an effect on the supply of resources but also govern how entrepreneurs view and use them. With the aid of theories from North, Scott, Penrose, Boettke & Coyne and Baumol, a stream of cause and effect linking institutions, control mechanisms, resources and entrepreneurial outcomes can be made. It can be described like this: Formal and informal institutions exercise cognitive/cultural, normative and regulative control affecting the availability of resources which determine the outcome of entrepreneurial activity into productive (opportunity), unproductive (necessity) or destructive forms. Further, if formal and informal institutions are not aligned in their goals then any changes will certainly be impeded.

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