Path Dependence and the Development of Formal Institutions in Central and Eastern European Economies

Abstract

Central and Eastern European (CEE) economies have been undergoing the transition from central planning to free market economy and capitalism. There is, however, a significant variation across these economies in terms of institutions to support private enterprises. Scholars argue that the CEE countries are prime examples of historical path dependence. This paper provides empirical documentation to this argument by comparing the development of formal institutions in two groups of CEE economies: the Orthodox group and the Latin group. Our data come from The World Bank Group's World Business Environment Survey, which was administered to enterprises in 80 countries in late 1999 and early 2000. We found that private businesses perceive the state more favorably in terms of regulatory roles, participatory roles and supportive roles in the Latin group than in the Orthodox group.

Introduction

Since 1989, Central and Eastern European (CEE) economies have been undergoing the transition from central planning to free market economy and capitalism (Haslach 1992). Most governments in these economies are wholeheartedly promoting free-market entrepreneurship (Stoica 2004). There have been some positive changes on this front such as a substantial amount of privatization and liberalization of markets (Aslund 1999).

The transition to market economy has, however, proven to be a challenging experience for these economies. Despite the optimistic promises of the transition, the benefits of changes have yet to reach large segments of the population (The OECD Observer 1999). One reason for this may be because of the absence of and difficult to construct appropriate political, legal, economic, and commercial structures needed for a free market economy (Blawatt 1995; Tyson et al. 1994; Smallbone and Welter 2001; Mugler 2000; Warner and Daugherty 2004). Beyond all that, there is also "apparent hostility" to entrepreneurship at the societal level (Kalantaridis 2000).

The lack of political and legal structures to promote entrepreneurship in CEE economies is reflected in macro-economic data. For one thing, the share of the economy represented by new and small businesses in CEE economies is much lower than in OECD countries (The OECD Observer 1999). For instance, only 10-15% of Russian GDP comes from the small businesses compared to more than 50% in the U.S. and most Western European economies (Goldman 2006). Yet, having said this, it is apparent, too, that individuals CEE economies do not have a lower propensity to engage in entrepreneurial activities than those in industrial economies. Indeed, according to International Social Survey Program data set, the proportion saying “I would prefer to be self-employed” was the largest in Poland-- 80% (Blanchflower, Oswald and Stutzer 2001). Experts argue that important structural changes are needed to encourage entrepreneurial activities in these economies (The OECD Observer 1999).

The key point from our perspective is significant variation across CEE economies in terms institutions to support private enterprises such as protection of property rights (Johnson, McMillan and Woodruff 2002). Socioeconomic data indicate more variation across CEE economies than many analysts had predicted (Fischer, Sahay and Vegh 1996; Spenner and Jones 1998). While some of these economies have made some great leaps on this front, the reform process has been relatively slow in others. For instance, while Hungary is described as an example of the post-1989 successful economy, Romania’s development is referred as “stalled” or even ‘de-development’ (Meurs and Ranasinghe 2003; Negoita 2006). Similarly Stoica’s (2004) study indicated the evidence of profound change in the entrepreneurial landscape more readily apparent in Hungary and Poland compared to that in Russia and Romania. Likewise, the OECD Observer noted in 1999 that Poland had about two million small businesses that year, which compared with 850,000 in Russia. Note that Russia has about four times as many people as in Poland.

To put things in context, regulative institutions are not changing at the same rate across CEE economies. In this regard, many fundamental considerations are not fully addressed in the existing literature. While the effects of formal and informal institutions on entrepreneurial development are examined (e.g., Acs 2007)[1], the relationships among various types of institutions from the standpoint of entrepreneurial development are left unexamined. An important but underexamined issue with respect to both institutional theory and entrepreneurship research is thus how informal institutions influence the development of formal institutions needed to promote free market entrepreneurship.

Second, while there are many country-level and societal-level studies, microeconomic evidence on institutions-entrepreneurial behavior nexus is limited (Johnson et al. 2002; Kalantaridis 2000)[2]. Scholars have called for research examining entrepreneurship related barriers at the micro-level (Kalantaridis 2000).

Third, institutional and entrepreneurship research, especially in CEE economies, suffers from a lack of empirical documentation. Scholars in prior research have suggested the possibility of informal institutions affecting formal rules (Axelrod 1997; Hayek 1979; North 1994). A related point is the argument that the CEE countries are prime examples of historical path dependence (Zweynert and Goldschmidt 2006, p. 895). There has, however, been surprisingly little empirical work on this front.

Fourth, in the CEE context, most empirical research has focused on larger economies (e.g., Russia) and economies that started the transition earliest (e.g., the Visegrad countries) (Spenner and Jones 1998). Despite growing interests in other CEE economies, the pace and proliferation of research have been slow in smaller and relatively backward economies (Bristow 1996; Zloch-Christy 1996; Spenner and Jones 1998).

How free market economy can be promoted to enable businesses to compete in the global market and to provide benefits to a broader range of people in these economies (The OECD Observer 1999) is a pressing policy and theoretical issue that adjoins larger political concerns of CEE societies as well as broad-based substantive interests within various social science disciplines. The purpose of this study is to fill the research voids. To more fully understand variation in formal institutions promoting entrepreneurship in CEE economies, in this article we integrate and apply findings in literatures on institutional theory and entrepreneurship. The theory we present in this article extends the theory of institutional changes and fills in some of the gaps that exist both in institutional theory and other entrepreneurship; and international economics/business related studies, especially those studies focusing on the effects of institutions on organizational performance. Our theoretical contribution is aimed primarily at testing the path dependence theory in the context of CEE economies.

In the remainder of the paper, we first discuss informal institutions' effects on formal institutions. Then, we describe our data and methodology. Next, analysis and findings are presented. The final section provides discussion and implications.

Informal Institutions' Effects on Formal Institutions

Theorists working in the neoclassical tradition give less importance to historical political and social institutions. In contrast institutionalists maintain that the market is embedded in historical circumstance and supported by a complex web of political and social institutions (Fligstein 1996; Murrell 1992). The path dependence approach views the locus of transition as a function of customs, habit, vested interests and social networks (Spenner and Jones 1998). In the CEE context, the central tenet of the path dependence theory is that informal rules of the pre-communist past influence the transition (Winiecki 2004, p. 143). The focus of our article is on the influence of informal institutions on formal institutions in these economies.

Prior to discussing the influence of informal institutions on formal institutions, it is necessary to create a theoretical framework about the nature and structure of formal institutions. In this article, we propose that regulative institution is not one thing but three things. First, Sobel’s (1999) conceptualization of "regulatory" and "participatory" state can be very helpful in understanding regulative institution or the state’s role in promoting entrepreneurship. It is argued that participatory and regulatory states reduce risk related to starting a new business (Sobel 1999). Of equal importance in the discussion of the state’s influence on entrepreneurial development is the supportive role. This role entails attacking the barriers related to skills, information, market and infrastructures by legal and non-legal means such as new laws, investment incentives and foreign technology transfer.

Regulatory roles

By regulatory state, Sobel (1999) means a set of factors that influence the enforcement of contracts, the rule of law, the risk of expropriation, corruption of government, and bureaucratic quality (also see The OECD Observer 1999). The rule of law is a central concept here. A country with a strong rule of law has “sound political institutions, a strong court system" and citizens are “willing to accept the established institutions and to make and implement laws and adjudicate disputes" (International Country Risk Guide

1996). Put differently, a strong rule of law is characterized by effective punishment to transgressors (Oxley and Yeung 2001). In overly politicized and less free states, which lack rule of law, entrepreneurial efforts are diverted away from wealth creation into non-market behavior entailing securing protection from market forces (Campbell and Rogers 2007; Clark and Lee 2005; Kreft and Sobel 2005; Sobel, Clark and Lee 2007). In particular, recognition of contract law is important in producing trust in business transactions (Humphrey and Schmitz 1998; Nichols 1999; Stiglitz and Squire 1998).

In many emerging economies, the rule of law is “often weakly developed” or sometimes “ignored with impunity” (Bratton 2007). Factors related to weak rule of law such as corruption, and the effectiveness of legal system in enforcing contracts act as barrier to entrepreneurship (Sievers 2001). Most obviously, because of ineffective legal enforcement of private property rights, entrepreneurs have to acquire political and administrative protection or depend upon informal norms for security (Yang 2002). A lack of mechanisms related to the protection of intellectual property and discouraging monopolies and unfair trade practices also hinder entrepreneurship (Schramm 2004). Kreft and Sobel (2005: 604) forcefully state:

> Creative individuals are more likely to engage in the creation of new wealth through productive market entrepreneurship. In areas without these institutions, creative individuals are more likely to engage in attempts to capture transfers of existing wealth through unproductive political entrepreneurship.

In the CEE context, while the Baltic States, Poland, Hungary, the Czech Republic, Slovakia and Croatia have been more successful in creating formal institutions, Russia, Belarus, Bulgaria, Moldavia, the Ukraine, Romania, Serbia and Montenegro have been less successful on this front (Zweynert and Goldschmidt 2006). In Romania, for instance, starting a business is difficult. State officials lack accountability; it is almost impossible to sue them; and formal complaints have no effects (OECD 2002) (Also see Table 1a).

Participatory roles

The term "participatory state" captures the extent to which policies and institutions represent the wishes of the members of society (Sobel 1999). In such a state, businesses participate in the national policy making arena through “dialogue, litigation, and mimesis” (Edelman and Suchman 1997). Prior research indicates that business groups can work closely with state agencies to protect their independence and autonomy (Greenwood and Hinings 1996).

In some situations, particularly when business groups are strong, the nation will collaborate with them in rationalizing different activities (Scott 1992, p. 211). Business groups are also involved in a “highly interactive process of social construction”, which influences the practical meaning of a law-in-action (Edelman and Suchman 1997).

Supportive roles

Of equal importance in the discussion of that follows below is the state’s supportive role. In this regard, it is important to note that many emerging economies, new businesses face a host of barriers such as burdens related to tax systems and bureaucracy, absence of relevant commercial laws, ‘dysfunctional’ financial markets and a lack of know-how (The OECD Observer 1999). CEE economies vary widely in terms of the state’s supporting roles. For example, Frye and Shleifer (1997) and Shleifer (1997) provide evidence of the Russian government acting like a "grabbing hand" and discouraging entrepreneurs from investing, while the Polish government does not. Likewise in Romania, starting a business is difficult and time-consuming. There are at least 13 institutions involved in the process (Council of Foreign Investors 2000).

Different theoretical contributions and various empirical studies have led to the accepted view that the government can attack barriers to entrepreneurship related to skills, information, market and infrastructures by legal and non-legal influences. Scholars examining the development of information and communications technology (ICT) industry have identified these influences in the form of new laws, investment incentives, foreign technology transfer, and other supply-push and demand-pull forces (King et al 1994; Montealegre 1999). For instance, Singapore has developed itself as an ICT hub of Asia by providing attractive infrastructure, skilled workers and a stable labor environment which attracted a large number of ICT firms to locate there (Kraemer et al. 1992; Wong 1998). Similarly, strong university-industry linkages and a large pool of highly trained scientists and engineers have driven the development of ICT industries in Israel (Porter and Stern 2001).

Variation in the development of formal institutions across economies

We begin by considering views of some institutional theorists, who refer traditional institutions consisting of custom and limited social networks (intragroup networks) as true forms of institutions (Sjostrand 1992). In some societies, informal networks are more effective than formal laws and regulations in dealing with local problems (Mol and Van Den Burg 2004). Indeed, Gehlen (1980/1957) argued that modem society is increasingly deinstitutionalized.

Scott (2001) has proposed three institutional change mechanisms: institution formation, deinstitutionalization and reinstitutionalization. These mechanisms are described in terms of institutional logics, which are the organizing principles that provide guidelines for actors' behavior (Friedland and Alford 1991). Put differently, such logics create “distinctive categories, beliefs, expectations, and motives and thereby constitute the social identity of actors” (Rao, Monin and Durand 2003).

To put things in context, transition from a centrally planned economy towards a market economy entails enormous changes at the society (The OECD Observer 1999). Most obviously, the creation of formal institutions to support private businesses in CEE economies requires institution formation, deinstitutionalization and reinstitutionalization (Scott 2001).

Institutional researchers argue that formal institutions are associated with and affected by informal institutions (Hayek 1979). North (1996: 344) defines institutions as "formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics" and observes that informal rules provide legitimacy to formal rules (North 1994). Likewise, Axelrod (1997) comments on the relationship between formal and informal institutions:

> Social norms and laws are often mutually supporting. This is true because social norms can become formalized into laws and because laws provide external validation of norms.

The battle to promote market entrepreneurship is about more than just creating market friendly political and economic institutions. In most cases, compared to formal institutions, de-institutionalization and re- institutionalization of social practices, cultural values and beliefs occur very slowly (Clark and Soulsby 1999; Ibrahim and Galt 2002, p. 109; North 1990; Zweynert and Goldschmidt 2006). North (1990: 6) argued that "although formal rules may change overnight as the result of political and judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies". Winiecki (2003) notes in the CEE context:

> .. [T]he expansion of the entrepreneurial private sector was, in turn, dependent on the institutional framework emerging in post-communist transition. And the framework in question consisted not only of the formal rules, general and specific, being introduced, but also of the interaction of the said formal rules with the informal rules. And the latter have been an amalgam of pre-communist customs, beliefs, self-imposed codes of conducts, etc., and new habits acquired during the communist rule in the process of adjusting (often in vain!) to the inconsistent rules of the latter system

In the CEE contexts, institutional and path dependence theorists have observed that formal institutions in the Latin group are more entrepreneurship-friendly compared to those in the Orthodox group. Specifically, three interrelated explanations are given for the difference: (1) The "holistic order" and the "extended order" of the society; (2) The development of elite entrepreneurship; and (3) The concept of strategic decoupling and governments' responses to institutional reform pressures.

"The holistic order" and "the extended order" of the society

A natural question is why the rate of institutional changes varies across economies. Institutionalists and historians have provided a valuable lead into this question. Institutions' propensity to change can arguably be described with two ideal types of social organizations-- "the holistic order" and "the extended, functionally differentiated order" (For review of literature, see Zweynert and Goldschmidt 2006). A holistic society is often characterized by an ideology, mostly in the form of a religion, that "claims validity for all spheres of action and thought" (Zweynert and Goldschmidt 2006). In a holistic society, an action's legitimacy is evaluated on the basis of a "general binding moral prescripts imposed by a superior authority" rather than by an economic logic, a political logic, or a juridical logic (Zweynert and Goldschmidt 2006).

At the highest level of analysis, the heterogeneity in institutional reforms in CEE economies can thus be explained in terms of the degree of religious-secular differentiation. Historically the Orthodox countries in Eastern Europe lacked the religious-secular differentiation that existed in Western Europe (Pipes [1971) 1992, Buss 2003). The political changes in Eastern Europe in the early 1990s initially led to attempts to radically change the formal political and economic institutions. However, in the Orthodox countries, which are closer to the holistic end in the holistic-extended continuum, informal institutions did not change at the same rate as formal institutions (Warner and Daugherty 2004).

The Orthodox tradition viewed entrepreneurship negatively (Gerschenkron 1954) and socialism further reinforced the stereotypes (Kuznetsova 1999; Kalantaridis 2007). Marxist ideology is against the development of service activities where small businesses can flourish, which explains a lack of small businesses in the Soviet Union (Goldman 2006). It is worth noting that while communists in Hungary and Poland encouraged the development of the private sector compared to that in Russia and Romania (Stoica 2004). In sum, institution formation, deinstitutionalization and reinstitutionalization (Scott 2001) related to economic reforms are likely to face resistance in holistic societies.

The development of elite entrepreneurship

Stark (1996) makes an intriguing argument as to why institutional changes needed to promote private businesses are difficult in post-socialist economies: post-socialist transition is not a transition from *plan* to *market* but from *plan* to *clan*. A central feature of the privatization of state enterprises in these economies is that privileged elites converted “limited de facto use and income rights into more de jure alienable rights” (Feige 1997). The essence of Stark’s (1996) argument is thus simple: Elite entrepreneurs take advantage of their positional power to maximize economic rewards. This emphasis on the exploitation of positional power is echoed in the “political capitalism” thesis, which argues that the major winners of the post-socialist transformations are the former nomenklatura (Hankiss 1990; Staniszkis 1991).

Scholars also argue that the development of elite entrepreneurship is more apparent in the Orthodox group than in the Latin group. Put differently, it is suggested that the "political capitalism" thesis might be more appropriate in describing the post-socialist economies in the Orthodox group such as Romania compared to those in the Latin group such as Poland and Hungary (Eyal, Szelényi, and Townsley 1998).

The concept of strategic decoupling and governments' responses to institutional reform pressures

The concept of strategic decoupling can also be very helpful in explaining the differences between the two groups. The basic idea behind strategic decoupling is simple. When actors with conflicting demands opposing one another in terms of their associated direction and risk are to be appeased and served, a proper decoupling of responses may help decision makers retain credibility and minimize cognitive dissonance (George et al. 2006). Decision makers simultaneously utilize different combinations of actions in parallel that reflect their mixed reading of the environment. Different theoretical contributions and various empirical studies have led to the accepted view that the exact nature of decoupling is a function of relative powers of competing organizational and institutional interests (Pfeffer 1981, March and Olsen 1989, Oliver 1991, Westphal and Zajac 1994, 1998, 2001, Zajac and Westphal 1995). These studies provide support for the notion that substantial responses cannot be made to appease actors who diametrically oppose one another. In such cases, the substantive response relates to the threat or opportunity associated with the more powerful actor and the symbolic response relates to the threat or opportunity associated with the less powerful actor or the one on whom the organization is less dependent for survival (George et al. 2006). More generally, if an organization is facing isomorphic pressures from a number of institutional actors, the degree of substantiveness of actions taken to appease a particular actor is positively related to the organization's degree of dependence on the actor.

As noted above, informal institutions are slower to change in the Orthodox group than in the Latin Group (Warner and Daugherty 2004). Moreover, elite entrepreneurs are stronger in the former than in the latter. Speaking of Romania, Stoica (2004) noted that "the former party bosses are alive and, to the despair of many Romanians, well". Romania's relatively slower approach to reform in the 1990s can arguably be attributed to the "blocking tactics" from influential Romanians resisting changes (Ibrahim and Galt 2002; Stan 1997).

Reform pressure facing the government is thus likely to be weaker in the former group than in the latter. While governments in economies in Orthodox group took some symbolic institutional measures (e.g., replacing Soviet-era managers by a new breed of reform-minded managers (Aslund 1999)), these has been a lack of substantive measures.

The differential rate of the development of formal institutions in CEE economies

The above discussion indicates that the development of entrepreneurship-friendly formal institutions is likely to be slower in the Orthodox group than in the Latin group (Table 1a). The central hypothesis is that businesses in economies in the Latin group are likely to perceive the state's role more favorably compared to those in the Orthodox group. More to the point, based on above discussion, the following hypotheses are presented:

H_1: The state's regulatory role is more favorable to private businesses in the Latin group than in the Orthodox group.

H_2: The state's participatory role is more favorable to private businesses in the Latin group than in the Orthodox group.

H_3: The state's supportive role is more favorable to private businesses in the Latin group than in the Orthodox group.

Data and methodology

Our data come from The World Bank Group's World Business Environment Survey (WBES 2000). WBES was administered to enterprises in 80 countries in late 1999 and early 2000. The survey utilized a standard core enterprise questionnaire methodology. Questions in the survey focused on the quality of the investment climate as shaped by domestic economic policy; governance; regulatory, infrastructure, and financial impediments; and assessments of the quality of public services (IFC 2007).

The economies in the Latin group and the Orthodox group are taken from Zweynert and Goldschmidt (2006) and are presented in Table 1b. We have analyzed only economies included in the WBES.

Analysis and findings

This study mainly focuses on question numbers 7-11 and 35 in WBES. We compared formal institutions related to the state's regulatory, participatory and supportive roles in the two groups of economies. Most of the hypothesized effects are statistically significant and in the expected direction.

Regulatory role

We begin by considering governments' regulatory roles in the two groups of economies. Table 2a displays the results for the businesses' perception of their states' regulatory roles in terms of the court systems' efficiency in dealing with business disputes. We took question no. 11 in the WBES for this purpose. It read: "In resolving business disputes, do you believe your country's court system to be." "Fair and Impartial", Honest/Uncorrupt", "Quick", "Affordable", "Consistent", "Decisions Enforced". In the "Always" (1) to "Never" (6) scale, Latin group's average of 3.907 was significantly lower than Orthodox group's average of 4.10 (t = -5.52, p<.0001). This indicates that businesses in the former group perceive their court system more favorably compared to the latter group.

As an alternative measure of the regulatory role, businesses' perceptions of their competitors' compliance with laws are presented in Table 2b. We used Question no. 35 in the WBES to measure this, which read: "Please judge on a four point scale how problematic are the following practices of your competitors for your firm?" In the No Obstacle (1)- Major Obstacle (4) scale, Latin group's average of 2.22 was significantly greater than Orthodox group's average of 2.06 (t = -2.77, p <.01) (Table 2b). The direction of the relationship was thus opposite to our hypothesis. Note, however, that the item non-response rate was very low for this item in the WBES.

Participatory role

We used Question no. 9 and 10 in the WBES to measure the participatory role of the government. Question no. 10 in the WBES read: "When a new law, rule, regulation, or decree is being discussed that could have a substantial impact on your business, how much influence does your firm typically have at the national level of government on the content of that law, rule, regulation or decree?" This question consisted of four items. In the "very influential" (1) to "never influential" (5) scale, Latin group's average of 1.933 was significantly lower than Orthodox group's average of 2.011 (t = -5.52, p<.001) (Table 3a). The t-test led to statistically significant (t = -3.33, p <.001) result, revealing differences between the two groups in terms businesses' participation in the national policy making arena (Table 3a).

Question no. 9 asked to rate "overall perception of the relation between government and/or bureaucracy and private firms". The item: "All in all, for doing business I perceive the state as" was measured in very helpful (1)-very unhelpful (5) scale for the central/national government as well as for the local/regional government. Moreover, the respondents were asked to rate their perceptions of governments at both levels for "now" and "three years ago". Table 3b presents businesses' perception of the relation between government and/or bureaucracy (Central/National level) and private firms "Now". The difference between the two groups was -0.581, which was statistically significant ($t=-11.71$, $p<0.0001$). Similarly, Table 3c presents businesses' perception of the relation between government and/or bureaucracy (Central/National level) and private firms "Three years ago". The difference between the two groups was -0.373, which was statistically significant ($t=-6.88$, $p<0.0001$).

In the same manner, businesses' perceptions of the relation between government and/or bureaucracy (Local/Regional level) and private firms are presented in Table 3d for "Now" and in Table 3e for "Three years ago". The differences between the two groups were statistically significant for "now" (of means = -0.444, $t=-8.23$, $p<0.0001$) as well as "Three years ago" (difference of means = -0..386, $t=-6.76$, $p<0.0001$).

For the central/national government, the difference between "now" and "three years ago" of the average of the overall perception of the relation between central/national government and private firms was -0.028 for the Latin group (Table 3b). This difference corresponded to 862 firms. This indicated a more favorable perception of the relation between government and private firms at the time of the survey compared to three years before the survey in this group. The corresponding difference for the Orthodox group was 0.195 which indicated a less favorable perception of the relation between government and private firms at the time of the survey compared to three years before the survey in this group. This difference corresponded to 910 firms. The corresponding differences for relation between local/regional government and private firms for the two groups were -0.035 (based on 868 responses) and 0.038 (903 responses) respectively for the Latin group and the Orthodox group (table 3c). We also found that t-tests are statistically significant ($t = -5.53$, $p<.0001$ for the central/national government; $t = -2.21$ ($p<.05$ for the local/regional government), revealing differences between the Latin group and the Orthodox group in terms of the perceptions of progress in the three year time period in the relation between the government and private firms.

Supportive role

Question nos. 7 and 8 were used to measure the state's supportive role from the standpoint of private firms. The *q*uestion stated: "Please judge on a four point scale how problematic are these different regulatory areas for the operation and growth of your business". This question consisted of 8 items. In the No Obstacle (1)-Major Obstacle(4) scale, the average for the Latin group was 2.071 and compared to the Orthodox group's average of 2.103 (Table 4a). The difference between the two groups was significant ($t = -2.33$, $p<.05$).

Question no. 8 read: "How often does the government intervene in the following types of decisions by your firm?" This question consisted of 7 items. To provide an indication of how businesses in the two groups differ in terms of their perception of government intervention, the results from table 4b suggest that, in the Always (1)- Never (6) scale, the average for the Latin group was 5.37 and compared to the Orthodox group's average of 5.19. The difference between the two groups was statistically significant ($t = 2.03$, $p<.05$).

Discussion and Implications

In prior research, scholars have suggested that informal institutions affect formal rules (Axelrod 1997; Hayek 1979; North 1994). A related point is that while institutional differences between the Orthodox group and the Latin group were widely noted in the literature (Gerschenkron 1954; Pipes [1971) 1992, Kuznetsova 1999; Buss 2003; Warner and Daugherty 2004), hard statistics were scarce. While there are some studies examining the interrelationships between these institutions (e.g., Stoica 2004), none does so in a way that quite serves the empirical objectives of this study. To the authors' knowledge, these data provide the first comprehensive empirical documentation of the differences. The present study thus fills a large gap in the institutional literature by providing clear and convincing evidence that the contexts provided by informal institutions affect the development of formal institutions.

The findings of this study suggest that Latin countries and Orthodox countries differ in terms of the development of formal institutions to promote private enterprises. A slow rate of the development of formal institutions supporting entrepreneurship has been the most glaring shortcoming of the latter group. The roots of the problem may thus lie partly in the lack of religious-secular difference in the economies.

We have advanced a model that explains how formal institutions promoting entrepreneurship differ across CEE economies. Our findings provide support for the notion that informal institutions influence the degree of generalizeability and replicability of Western political-economic institutions or what (Stark 1992) refers as "designer capitalism". We thus found support for path dependence theory or the market's embeddedness in historical circumstance (Fligstein 1996; Murrell 1992). Put differently, much of the success of transplantation of Western institutions depends on the precise circumstances related to informal institutions.

The analysis of this article also provides some support for the "merchant capitalism" thesis. This thesis suggested that the dominant direction of change in the former Soviet Union would be "backward" or towards a more primitive merchant capitalism rather than a free market-based more advanced capitalism (Burawoy and Krotov 1992). Such changes are also referred as regressive changes. Note that in a regressive change, new instrumentally warranted behaviors are suppressed and additional ceremonially warranted behaviors may be adopted for the suppression (Bush 1994).

Future research

Further theoretical and empirical research is needed to gain a better understanding of changes in formal and informal institutions and relationships between them. The model and perspective developed in this article suggests many exciting directions for future research. This paper focused on formal institutions in CEE economies. Future research is needed to extend extant theory by offering a framework that explores in greater detail the differences in informal institutions in the two groups of economies.

Research conducted in CEE economies has found that environmental factors influence on entrepreneurial morality (Hannafey 2003). Another area of exploration would be to examine how formal and informal institutions influence entrepreneurial attitudes and behaviors.

Finally, future research based on the present framework can be extended to other institutional settings. For instance, researchers could examine how other emerging economies differ in terms of businesses’ perception of regulative, participative and supportive roles of the government.

Table 1a: Some barriers to entrepreneurship in economies in the Orthodox group

Country	**Some barriers to entrepreneurship**
Belarus	o Replacement of Soviet-era managers by ones with a free-market mindset has been slow (Aslund 1999).
Bulgaria	o The pace of reform has been slow. Unlike economies in the Latin group, Bulgarians did not experience the 20th century capitalist production methods and work habits, risks and rewards (Spenner and Jones 1998).
Romania	o Beginning the late 1980s, political elites started converting their positional power for starting businesses (Stoica 2004). o It is suggested that the "political capitalism" thesis might be more appropriate in describing the post-socialist Romania compared to economies in the Latin group (Eyal, Szelényi, and Townsley 1998).
Russia	o The pace of reform on privatization has been relatively slow (Spenner and Jones 1998). o Following the mass privatization, former nomenklatura appointees accounted for two-thirds of the top positions in businesses and the government (Lazarev 2001, 2004).
Ukraine	o "Predatory" actions of state officials hinder rural entrepreneurship (Mandel and Humphrey 2002). o Replacement of many Soviet-era managers by ones with a free-market mindset has been slow (Aslund 1999).

Table 1b: Economies in the Latin group and the Orthodox group

Latin group			**Orthodox group**		
WBES Country code	Country	Sample size in WBES survey	WBES Country code	Country	Sample size in WBES survey
5	Croatia	127	3	Belarus	125
6	Czech Republic	137	4	Bulgaria	125
7	Estonia	132	15	Romania	125
9	Hungary	129	16	Russia	525
12	Lithuania	112	19	Ukraine	225
14	Poland	225			
17	Slovakia	129			

Table 2a: Regulative roles: Perception of the court systems

Latin group				Orthodox group			
	N	Mean	Std. Dev.		N	Mean	Std. Dev.
Croatia	121	4.16	0.910	Belarus	78	3.86	1.289
Czech Republic	92	4.15	0.897	Bulgaria	77	3.90	0.871
Estonia	85	3.31	0.905	Romania	101	3.80	0.929
Hungary	81	3.40	1.137	Russia	416	4.36	0.871
Lithuania	69	4.23	0.763	Ukraine	185	4.21	1.076
Poland	192	4.09	0.776				
Slovakia	100	3.72	0.832				
Latin Group	740	3.907	0.937	Orthodox group	857	4.10	0.991

Table 2b: Regulative roles: Perception of the competitors' compliance with laws

Latin group				Orthodox group			
	N	Mean	Std. Dev.		N	Mean	Std. Dev.
Croatia	87	2.49	0.83	Belarus	74	1.78	0.44
Czech Republic	26	1.85	0.69	Bulgaria	54	2.59	0.85
Estonia	79	1.97	0.67	Romania	178	3.12	1.07
Hungary	48	1.98	0.70	Russia	230	2.02	0.81
Lithuania	38	2.15	0.74	Ukraine	99	2.46	0.84
Poland	102	2.54	0.87				
Slovakia	42	1.95	0.81				
Latin group	422	2.22	0.82	Orthodox group	489	2.06	0.90

Table 3a: Businesses' perception of their involvement in the national policy making arena

Latin group				Orthodox group			
	N	Mean	Std. Dev.		N	Mean	Std. Dev.
Croatia	127	1.94	0.94	Belarus	121	2.24	0.56
Czech Republic	137	2.15	0.89	Bulgaria	125	1.53	0.79
Estonia	132	2.52	0.96	Romania	125	1.70	0.84
Hungary	129	1.57	0.62	Russia	525	2.08	0.87
Lithuania	110	1.69	0.78	Ukraine	223	2.46	1.22
Poland	225	1.89	9.74				
Slovakia	128	1.72	0.83				
Latin group	988	1.933	0.870	Orthodox group	1119	2.011	0.916

Table 3b: Businesses' perception of the relation between government and/or bureaucracy (Central/National) and private firms (Q9) ("Now")

Latin group				**Orthodox group**			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	126	3.17	1.07	Belarus	124	3.68	1.25
Czech Republic	131	3.05	1.04	Bulgaria	124	4.06	1.19
Estonia	118	3.05	1.04	Romania	119	3.66	1.06
Hungary	120	3.09	0.97	Russia	513	4.09	1.04
Lithuania	111	4.34	1.03	Ukraine	223	4.28	1.01
Poland	216	3.35	1.02				
Slovakia	125	3.35	1.23				
Latin group	991	3.45	1.14	Orthodox group	1103	4.03	1.10

Table 3c: Businesses' perception of the relation between government and/or bureaucracy (Central/National) and private firms (Q9) ("Three years ago")

Latin group				**Orthodox group**			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	121	3.14	0.94	Belarus	107	3.43	1.27
Czech Republic	116	3.85	1.11	Bulgaria	104	3.87	1.18
Estonia	110	3.30	1.08	Romania	101	3.57	1.03
Hungary	115	2.90	0.85	Russia	513	3.99	1.13
Lithuania	94	4.23	1.08	Ukraine	223	4.29	1.01
Poland	191	3.32	1.07				
Slovakia	118	3.74	1.03				
Latin group	865	3.46	1.10	Orthodox group	914	3.84	1.13

Table 3d: Businesses' perception of the relation between government and/or bureaucracy (Local/Regional level) and private firms (Q9) ("Now")

Latin group				**Orthodox group**			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	127	2.83	0.92	Belarus	124	3.44	1.31
Czech Republic	130	3.63	1.20	Bulgaria	124	4.02	1.30
Estonia	123	2.98	1.02	Romania	121	3.74	1.09
Hungary	121	2.86	1.01	Russia	515	3.69	1.30
Lithuania	108	4.27	1.02	Ukraine	220	3.66	1.30
Poland	221	3.10	1.02				
Slovakia	123	3.34	1.13				
Latin group	953	3.25	1.08	Orthodox group	1104	3.70	1.23

Table 3e: Businesses' perception of the relation between government and/or bureaucracy (Local/Regional level) and private firms (Q9) ("Three years ago")

Latin group				**Orthodox group**			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	120	3.22	1.13	Belarus	106	3.32	1.30
Czech Republic	116	3.58	1.20	Bulgaria	103	3.95	1.31
Estonia	120	3.23	1.13	Romania	100	3.67	1.09
Hungary	116	2.74	0.99	Russia	419	3.73	1.27
Lithuania	91	4.18	1.07	Ukraine	176	3.54	1.31
Poland	191	3.19	1.01				
Slovakia	114	3.42	1.06				
Latin group	868	3.28	1.12	Orthodox group	904	3.66	1.27

Table 4a: Businesses' perception of regulatory areas for the operation and growth

Latin group				Orthodox group			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	110	2.17	0.60	Belarus	85	2.24	0.50
Czech Republic	98	2.26	0.61	Bulgaria	77	1.95	0.57
Estonia	110	1.75	0.45	Romania	69	2.18	0.57
Hungary	91	1.99	0.53	Russia	313	2.06	0.56
Lithuania	68	2.22	0.52	Ukraine	163	2.34	0.59
Poland	162	2.13	0.58				
Slovakia	94	2.02	0.68				
Latin group	733	2.071	0.593	Orthodox group	707	2.146	0.581

Table 4b: Averages of businesses' perception of government intervention in their decisions

Latin group				Orthodox group			
	N	Mean	S.D.		N	Mean	S.D.
Croatia	96	5.51	0.97	Belarus	54	4.41	1.23
Czech Republic	76	5.43	1.10	Bulgaria	97	5.51	0.97
Estonia	118	5.50	0.72	Romania	67	5.35	0.95
Hungary	67	4.73	1.16	Russia	351	5.380.76	
Lithuania	59	5.51	0.84	Ukraine	123	5.07	1.08
Poland	118	5.58	0.70				
Slovakia	52	4.95	1.17				
Latin group	586	5.37	0.937	Orthodox group	692	5.19	0.947

Note: The averages are based on six items. Responses related to wages were not included in the WBES data.

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Endnotes:

[1] For instance, a survey of new firms in five CEE economies (Poland, Romania, Slovakia, Ukraine, and Russia) indicated that weak property rights were negatively related to firms’ reinvestment of profits despite the availability of bank loans (Johnson, McMillan and Woodruff 2002). Other country-- level studies have shown correlation between secure property rights and aggregate investment level and as well as with economic growth rate (Knack and Keefer 1995; Mauro 1995; Svensson 1998; Acemoglu et al., 2001). It is also important to note that economists are also moving beyond the neoclassical paradigm (e.g., Blanchard 1996) and have advanced alternative approaches such as evolutionary theories (Murrell 1992) to examine these phenomena.

[2] Besley (1995) is an exception, which found a significant link between property rights and investment in firms in Ghana.