INSTITUTIONS AND THE RATE OF FORMAL AND INFORMAL ENTREPRENEURSHIP ACROSS COUNTRIES (INTERACTIVE PAPER)

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Our study examines a largely question in the literature: how does variance in institutional arrangements influence participation in formal or informal entrepreneurship? The size of the informal sector and its tradeoffs with the formal sector, particularly in developing economies, warrants study from the entrepreneurship context. We examine the role of regulatory, cognitive and normative institutional “pillars” across countries in driving the rate of formal and informal entrepreneurship across countries. We develop a set of hypotheses proposing a varied impact of regulatory, cognitive, and normative institutional “pillars” on formal and informal entrepreneurship. Moreover, we hypothesize that the effect of general and entrepreneurship-specific institutions differs.

Method

We use data on new business creation (World Bank’s Entrepreneurship Snapshots), nascent entrepreneurs (Adult Population Survey of the Global Entrepreneurship Monitor) and country measures of regulatory, cognitive, and institutional arrangements (Doing Business Database, World Values Index, World Bank Development Indicators). Our dataset comprises 62 countries with 188 observations over the period 2003–2009.

Using formal entrepreneurship and a novel measure of informal entrepreneurship as our dependent variables, we use a series of linear regression models to examine the impact of the institutional environment. Our key explanatory variables comprise five regulatory (procedures to start a business, total tax rate, time to prepare and pay taxes, time required to enforce a contract, firing cost) three cognitive (mean years of schooling, perceived skills to start a business, perceived opportunities) and three normative (status of entrepreneurship, media attention paid to entrepreneurs, corruption perception) measures reflecting institutional context. We control for economic growth and population size.

Results and Implications

We find the effects of institutions are highly nuanced and that the same institutional arrangements can exert opposing effects on formal and informal entrepreneurship. For example, higher taxes, start-up procedures and firing costs encourage informal entrepreneurship and negatively impact formal entrepreneurship; opportunity perception enhances formal but informal entrepreneurship. The key takeaway from this study is that the same institutions exert different effects on formal versus informal entrepreneurship.

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