A theory of entrepreneurship and institutional uncertainty

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ABSTRACT

Uncertainty and institutions are each vital concepts in entrepreneurship research. However, little work has been done to combine them into a consistent conceptual framework for analyzing the dynamic aspects of entrepreneurial action, uncertainty, and institutional change. Using insights from new institutional economics, we develop a model that explains the institutional uncertainty resulting from conflicts between institutions on different “levels” of social activity. We further explain how entrepreneurs can both cause and mitigate this uncertainty through market and institutional action. Finally, we focus on a special case of institutional uncertainty, “regime uncertainty,” wherein entrepreneurs are left without reliable means to overcome uncertainty in political institutions.

EXECUTIVE SUMMARY

We integrate insights from new institutional economics with theories of entrepreneurship and uncertainty in order to outline a theory of institutional uncertainty. Specifically, we use Oliver Williamson’s hierarchical model of institutional systems as a framework for viewing entrepreneurial action. Williamon’s model consists of four conceptual levels, each of which constitutes a different level of economizing: the top level L1 contains the norms and culture of society; the second level L2 is made up of political regulations and policies; L3 consists of governance, organizations, and long-term contracting; L4 includes the everyday bidding for resources in the market. Institutions are related horizontally and vertically: in particular, higher-level institutions constrain lower levels by formulating “rules” through which lower-level institutions are ordered.

Different theories of entrepreneurship are relevant at each level. For example, Kirzner’s alert entrepreneur, who responds to price discrepancies and thereby corrects entrepreneurial “errors,” appears mainly in L4. At the same time, Schumpeter’s innovative entrepreneur introduces “new combinations” through starting new firms, and therefore acts primarily in L3. Knight’s judgmental entrepreneur, on the other hand, can act in L4 by allocating resources, in L3 by organizing firms, and in L2 by shaping public affairs. However, entrepreneurs can experience extreme difficulty when trying to act in L1. By mapping entrepreneurship theory onto Williamson’s hierarchy, we provide a basis for research on the intersection of entrepreneurship, uncertainty, and institutions. Disaggregating institutions into groups and potential sub-groups allows us to more clearly identify the effects of institutional uncertainty on entrepreneurial action. This is especially true of institutional entrepreneurship, which we conceptualize as a choice entrepreneurs make to reposition their actions either horizontally or vertically in the institutional hierarchy.

So far, most research on institutional entrepreneurship (especially in the Schumpeterian tradition) has focused on innovation while leaving the role of uncertainty aside. We fill this gap by explaining different problems that emerge once uncertainty is allowed to thoroughly permeate the institutional order. Institutional uncertainty exists when entrepreneurs doubt the future compatibility of institutions at different levels. For example, entrepreneurs can be uncertain about whether their everyday trading (L4)
will be compatible with proposed regulatory changes (12). In such cases, entrepreneurs believe that institutions are or will become misaligned or contradictory. Entrepreneurs can usually cope with institutional uncertainty by using a combination of good judgment and institutional entrepreneurship. We focus especially on the changing cost structures entrepreneurs face when confronted with institutional uncertainty, which provide powerful incentives for abiding, evasive, and altering entrepreneurship, and in some cases, entrepreneurial exit.

Abiding action is typical entrepreneurial behavior that legitimizes and strengthens the institutional status quo. Evasive action sidesteps a specific institutional constraint and represents a horizontal relocation to a position less burdened by the relatively high costs of institutional uncertainty. Altering action can be interpreted as a vertical repositioning for the purpose of changing higher-level institutions. If none of these methods appears feasible to the entrepreneur, institutional uncertainty causes her to exit, in other words, to give up entrepreneurial action.

We elaborate this theory by explaining a case in which entrepreneurs are unable to overcome the barriers imposed by institutional uncertainty. Specifically, we apply our framework to the “regime uncertainty” faced by entrepreneurs during the Great Depression and Great Recession, and explain why the rate of entrepreneurship diminished during those crises.

1. Introduction

Entrepreneurship is flourishing as a discipline, and there is every reason to believe it will continue to “party on” in the future (Shepherd, 2015). However, despite rapid growth in entrepreneurship research, many central concepts remain under-theorized and under-applied. This is especially true of uncertainty: although its importance for entrepreneurs was recognized over two and a half centuries ago (Cantillon, 2001 [1755]; Say, 1971 [1803]), the exact role it plays in entrepreneurial decision-making is still debated (McMullen and Shepherd, 2006). The reason for the continuing controversy is that, although uncertainty is frequently mentioned in entrepreneurship studies, data are sparse regarding its nature, types, and time horizons (Bloom, 2014). This in turn means that uncertainty research—despite having made important strides in the past—has a long way to go before resolving some of its most crucial problems. One such involves the question of how uncertainty influences institutions, and vice versa.

Whether social, political, or economic, institutions profoundly affect the entrepreneurial process. Exactly how this happens, however, is not so easily explained, and there is relatively little research on the “institutional conditions that facilitate or hinder entrepreneurial engagement” (Dorado and Ventresca, 2013), especially in regard to uncertainty. In particular, entrepreneurship theory lacks a systematic explanation of how uncertain institutional arrangements affect entrepreneurial decision-making. For example, it is widely held that entrepreneurship can contribute greatly to economic growth and therefore to the well-being of society (e.g., Schumpeter, 1934 [1911]; Baumol, 1986; Audretsch et al., 2006). For this to be the case, however, society’s institutional framework must be conducive to productive entrepreneurship. Without high-quality supporting institutions (e.g., Mehlum et al., 2006), entrepreneurship can be unproductive or even destructive, thereby impairing economic performance and growth (Baumol, 1990). Indeed, it has been shown that the variance in institutional arrangements influences both the rate and type of entrepreneurial activity (Stenholm et al., 2013). The impact of entrepreneurship is therefore more ambiguous than is sometimes thought, as its effects are a function of the quality of institutions (Douhan and Henrekson, 2010).

Importantly, the relationship between institutions and entrepreneurship is not unidirectional; it consists of more than the choice between productive, unproductive, and destructive activity within a given institutional framework. Entrepreneurship can also be directed specifically toward the formal institutional setting itself and toward changing the “rules of the game” (Shepsle, 1989; DiMaggio & Powell, 1991). Entrepreneurial action can take at least three basic forms with respect to any specific institution. Common entrepreneurship abides by the existing institutional order. Where entrepreneurs consider an institution to be unjust or unbenevolent, they can also attempt to evade its influence or act in order to alter the institution by engaging in institutional entrepreneurship (Henrekson and Sanandaji, 2011). In fact, all entrepreneurship is relevant for the development of the institutional framework: abiding action reinforces institutions, evading action challenges their effectiveness by circumventing them (Coyne and Leeson, 2004), and altering action aims to change or replace them by for example political action. Entrepreneurial action and institutions thus influence each other in profound ways (Mutch, 2007; Sewell, 1992), despite criticism that the role of institutional entrepreneurs is overstated (Lounsbury and Crumley, 2007).

However, entrepreneurship is also influenced by institutional uncertainty. Uncertainty is ubiquitous in the institutional environment just as it is in the marketplace, and it poses a series of unique problems for entrepreneurs to wrestle with. We argue that current work presents an incomplete picture of the interaction between entrepreneurship and institutions by overlooking the importance of uncertainty. The overarching questions we address are how uncertainty arises from the institutional environment, and how it affects entrepreneurs’ actions. To answer these questions, we apply Oliver Williamson’s (1998, 2000) hierarchy of institutional levels of economizing. This allows us to distinguish different effects of uncertainty among different categories of institutions. We show how uncertainty is created when entrepreneurs anticipate misalignments, incongruences, or contradictions between institutions on different levels, and how this affects entrepreneurial behavior. Institutional uncertainty changes entrepreneurs’ relative costs of bearing uncertainty in their typical abiding activities. When these costs are high, entrepreneurs have little choice but to evade institutions, alter them through action at a different institutional level, or exit the market. In the former case, entrepreneurs find different ways to do business at the same institutional level, while in the second they change their level of activity by moving upward in the institutional hierarchy. Through abiding, evading, altering, and exiting, entrepreneurs generate feedback to higher-level institutions that encourage adjustment (Elert and Henrekson, 2016). This explains how entrepreneurs and the institutional uncertainties they face contribute to the dynamics of institutional change. However, because entrepreneurs
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