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Institutional deterioration and entrepreneurial investment: The role of political connections

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A B S T R A C T

Although many start-ups struggle to grow partly due to institutional voids in transitioning economies, empirical observations have contradicted this dominant view in the literature in that even with deficient formal institutions many economies (e.g., China) have high rates of entrepreneurship in recent years. To understand this paradox, we propose a politically contingent view of the relationship between the institutional environment and entrepreneurs' reinvestment in their business. Our empirical study of entrepreneurs in China shows that the impact of institutional deterioration on entrepreneurial reinvestment substantially hinges on entrepreneurs' political connections. As such, institutional deterioration does not reduce entrepreneurial reinvestment for all entrepreneurs; rather, when entrepreneurs have political connections they are willing to reinvest in their business despite a weakening institutional environment. Our framework suggests that in an environment perceived as harsh to business, political connections can encourage entrepreneurs to see opportunities for growth. In contrast, entrepreneurs that lack political connections will mainly see threats in a deteriorating institutional environment and thus, limit their business reinvestment.

Executive summary

Research on institutions and entrepreneurship has long argued that "a functional business environment provides positive incentives for entrepreneurs while a weak one is likely to be deleterious" (Estrin et al., 2013 p. 566). However, recent empirical studies, especially those on transitioning economies, have found that even with deficient formal institutions many economies have high levels of entrepreneurial activities and entrepreneurship investment (McMillan and Woodruff, 2002; McMillan and Woodruff, 1999; Zhou, 2013). It is therefore puzzling that in economies like China that are characterized by weak legal infrastructures, high levels of corruption and regulation, and insufficient market intermediaries, that entrepreneurial activities are not as low as expected.

In fact, entrepreneurship in China has been referred to as a paradox since despite having an institutional environment that is unfriendly to business, during the last two decades the country has had one of the world's highest entrepreneurship rates (Ebner, 2014; Eunni and Manolova, 2012; Huang, 2010). Economists are puzzled by how a transitioning economy that supports market

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socialism can produce such a vibrant, entrepreneurial community. They are further puzzled by why entrepreneurship continues to grow in Chinese provinces with a deteriorating institutional environment.

Our study seeks to help solve this puzzle by going beyond the predominant view in the literature that treats institutions as exogenous to entrepreneurship, and instead acknowledging that entrepreneurial opportunities can be institutionally constructed. For example, not only do political and regulative institutions offer rules for the economic market that can spur entrepreneurship, but they themselves should be seen as products in the political marketplace (Buchanan, 1987). Thus, rather than assume that entrepreneurship activities are only motivated by opportunities stemming from economic markets, we argue that opportunities can also be reaped from political markets, especially within those economies where government significantly affects business (Bonardi et al., 2005; Oliver and Holzinger, 2008). Because firms compete in political markets, their connections with political authorities may play an important role in producing opportunities and motivating entrepreneurial reinvestment. Accordingly, we propose a politically contingent model of institutional deterioration and entrepreneurial reinvestment that proposes that institutional deterioration is not universally perceived as a threat that undermines entrepreneurial reinvestment. Rather, when entrepreneurs have political connections that can endow advantages under weak institutions, institutional deterioration can be perceived as an opportunity that promotes entrepreneurs' reinvestment. Our study therefore sheds light on China's entrepreneurship paradox by demonstrating how political connections alter the effect of the institutional environment on entrepreneurs' business reinvestment.

Using national survey data of Chinese entrepreneurial firms, our study reveals a negative relationship between institutional deterioration and reinvestment rate for nonpolitically-connected entrepreneurs. In a striking contrast, institutional deterioration positively affects reinvestment rate for politically-connected entrepreneurs. These results suggest that institutional deterioration is perceived substantially differently (i.e., as offering opportunities or threats) by politically-connected entrepreneurs and those without political connections. Accordingly, political connections appear to have a distinct impact on entrepreneurs' reinvestment in their business in transitioning economies like China.

This study offers several contributions. First, our politically contingent view of the relationship between the institutional environment and business reinvestment in transitioning economies identifies an important boundary condition to our current understanding of the impact of institutions on entrepreneurship. Second, applying research on political ties to entrepreneurship, this study highlights how entrepreneurs' decisions and activities are not solely determined by opportunities in their economic market, but also hinge on their political power and the resources gained from political markets. Due to their heterogeneity in political capital, entrepreneurs are stratified in the political market where their relative advantages or disadvantages will be ultimately channeled into their business. Third, prior empirical analyses on institutions and entrepreneurship mainly use country-level data that shadow the within-country variations and the heterogeneity among entrepreneurial firms. This study directly tackles these issues by capturing the entrepreneurs' perception of the institutional environment. Therefore, our study draws attention to how the political arena can create and sustain advantages for entrepreneurs, thereby explaining differences in how entrepreneurs react to a deteriorating institutional environment.

1. Introduction

Entrepreneurship in China has been characterized as a *paradox*. Although the rule of law, market competition, and business environment are viewed as unfriendly to business, over the last two decades the country has had one of the world's highest rates of entrepreneurship (Ebner, 2014; Eunni and Manolova, 2012; Huang, 2010). Economists are puzzled by how a transitioning economy that supports market socialism can produce such a vibrant, entrepreneurial community. This paradox has led to much interest in studying China's startups (Pistrui et al., 2001; Yang and Li, 2008) and the role of its institutional environment in affecting firm performance (Banalieva et al., 2015; Kshetri, 2007; Peng and Jiang, 2010). It has also led to calls for research to investigate how a weak institutional environment affects entrepreneurs' reinvestment in their business – defined as the percentage of after-tax profits that were reinvested - since the prosperity and growth of SMEs is seen as critical to alleviating poverty and creating jobs in transitioning economies (Bruton et al., 2010; George et al., 2015).

While research has long studied the relationship between institutions and entrepreneurship, this line of inquiry has been reinvigorated in recent years as scholars recognize how a vibrant entrepreneurship community is necessary in developing a middle class and meeting the needs of underserved individuals (Bruton et al., 2013; Hwang and Powell, 2005; Jennings et al., 2013; Puffer et al., 2010; Valdez and Richardson, 2013). Regarding the impact of institutions on entrepreneurship, a longstanding assumption is that "a functional business environment provides positive incentives for entrepreneurs while a weak one is likely to be deleterious" (Estrin et al., 2013, p. 566). Such research assumes that a weak institutional environment forces entrepreneurs to focus more on survival than growth (Smallbone and Welter, 2001). However, recent studies focusing on transitioning economies have found that even with deficient formal institutions, many economies have high levels of entrepreneurial investment and entrepreneurship activities (McMillan and Woodruff, 2002, 1999; Zhou, 2013). Additionally, research tends to assume that the institutional environment is improving in transitioning economies like China, although this is actually not the case (Banalieva et al., 2015). Some provinces in China are experiencing reform reversals and institutional deterioration that are likely to generate uncertainties of rewards from entrepreneurial investment and threaten entrepreneurs' growth aspirations (Banalieva et al., 2015; G. Fan et al., 2007; J.P.H. Fan et al., 2007). It is therefore puzzling that in Chinese provinces with a deteriorating institutional environment characterized by weak legal