

# An Institutional View of Local Entrepreneurial Climate

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This paper proposes a conceptual framework on the role of formal and informal institutional factors at the sub-national level (e.g., city) in shaping the climate conducive for the growth and success of micro, small, and medium enterprises. Extant literature reveals that institutional analyses tend to focus on either formal or informal institutions, in narrow and fragmented ways. Likewise, previous studies focused their analysis on national or country-wide institutional frameworks, ignoring the institutional heterogeneity of regions and cities within a given country. This study attempts to develop an integrated institutional approach at the city-level and stretch the conceptual boundaries of formal and informal institutions as they shape the local entrepreneurial climate—the set of tangible and intangible institutional factors that are shaping the performance of entrepreneurial firms in a geographically and politically defined area such as a city.

**KEYWORDS:** Integrated institutional approach, entrepreneurial climate, micro, small and medium enterprises, city-level

The multidimensional and multilayered construct called entrepreneurship and its conceptual derivations have been getting increased attention as subjects of scientific inquiry across a broad range of disciplines. The foci of extant literature on this subject include understanding entrepreneurship at the individual or entrepreneur level, the enterprise or firm level, or at the external environmental level (Lundstrom & Stevenson, 2005). Many studies, however, take an integrative perspective by considering two or all of these areas of inquiry to better understand a range of issues on the subject.

This paper aims to contribute to further understanding of entrepreneurship by proposing a

conceptual framework of the institutional environment that fosters the growth of micro, small and medium enterprises (MSMEs) at the city, rather than national or regional, level. The interest on MSMEs stems from the fact that these modern-day embodiments of the Schumpeterian “agents of creative destruction” comprise over 98% of total enterprises in the Asia-Pacific region based on the latest Asia Pacific Economic Cooperation (APEC) survey (APEC, 2002). Entrepreneurship, as represented by MSMEs, has long been identified as an engine of economic growth in capitalist societies and an instrument of social transformation in many developing countries (APEC, 2002; Kirby & Watson, 2003; Klein & Hadjimichael, 2003;

Acs, Arenius et. al., 2004; Kreft & Sobel, 2005). Hence, entrepreneurship is being used in this paper to mean the activities of firms categorised as MSMEs.

Extant literature is replete with studies from diverse disciplines discussing the role of the external environment in supporting the emergence of MSMEs. Amongst these studies are the *new wave local economic development framework* (Bartik, 1991), *entrepreneurial environment* (Gnyawali & Fogel, 1994), *British model of local economic development* (Wong, 1998), *entrepreneurial climate* (Goetz & Freshwater, 2001), *city competitiveness* (Magdaluyo, Tecson et. al., 2001), *city investability* (Begg, 2002), *systemic competitiveness* (Esser, Hillebrand et. al., 1995), *investment climate* (World Bank, 2004; Dollar, Hallward-Driemer et. al., 2005), *inner city competitive advantage* (Porter, 1995), plus a wide array of popular business climate polls conducted by various private firms and government agencies.

However, many of these previous studies tend to capture the external environment at the national or country-wide level as it shapes economic productivity and growth as surrogate measures of productivity of business firms, including MSMEs (Ahmadi, 2003; Rodrik, Subramanian et. al., 2004; Dollar, Hallward-Driemer et. al., 2005; Wan, 2005; Welter & Smallbone, 2005). Literature on local economic development, regional science, and economic geography (Wong, 1998; Blakely & Bradshaw, 2002; Wong, 2002; Eberts, 2005) shows the institutional heterogeneity of regions and cities within a given a country. Whilst a national picture of the state of the socio-economic-political environment for business (i.e., business climate) helps in describing the business and investment potentials of a country, it unfairly masks the wide disparities amongst regions and cities within a country. Hence, efforts to stimulate and support entrepreneurship as part of an economic development program depend on a clear understanding of how sub-national economic conditions impact the business performance of entrepreneurs operating in that local business

environment. In their preliminary attempt to measure entrepreneurial climate, Gnyawali & Fogel (1994) conclude that previous studies are deemed fragmented and lacking in focus as they fall short of establishing the explicit link between the needs of entrepreneurs and on how the external environment can help in fulfilling those needs.

Likewise, this paper attempts to characterize the external environment of MSMEs in terms of their institutional dimensions. The basic tenets of institutionalism as applied in entrepreneurship posit that the MSMEs and their activities are embedded in an external environment that is a source of legitimization, rewards/incentives, and constraints (Baum & Oliver, 1992; Hollingsworth, 2002; Parto, 2005). In as much as economic activities are socially instituted (Parto, 2005), institutions are both the “explanantia” and “explanandum” of social phenomena (Groenewegen, Kerstholt et. al., 1995; Grief, 1998).

However, previous empirical studies tend to reduce the concept of institutions into legal and political elements, such as laws, policies, and government programs, as they influence small firms (Henrekson & Johansson, 1999; Henriquez, Verheul et. al., 2001; Veciana, Aponte et. al., 2002; Co, 2004; Rodrik, Subramanian et. al., 2004; Siu, 2005; Vatn, 2005; Wan, 2005; Siu, Lin et. al., 2006). This treatment of institutions is rather too restricted, as will be shown in the following review of the literature on the rich traditions of institutionalism. An incomplete institutional representation is unable to meet the goal of determining the effects of an institutional system on society or a sub-sector of it (Hollingsworth, 2002). It may even produce a distorted view of the system, making policy recommendations short-sighted, shallow, or even distant from or misaligned with real, felt needs. Moreover, propagating a restricted conceptual view of institutions does not serve the sublime purpose of advancing the theoretical understanding of the concept itself.

Another research gap lies on the fragmented nature of previous studies, such that these studies examined only one or a few institutional factors as

they relate to small firms (Veciana, Aponte et. al., 2002; Wattanapruttipaisan, 2002; Wijewardena & De Zoysa, 2003; Gambarotto & Solari, 2005; Tambunan, 2005; Wilkinson, 2006). This study attempts to overcome this fragmentation of empirical evidence by producing an integrated institutional landscape through the development of a model that proposes a relatively comprehensive set of institutional factors suggested by the literature on institutionalism, using an interdisciplinary perspective. The following sections present a brief review of institutional theory, the model of local entrepreneurial climate showing the institutional factors relevant to MSMEs, and the implications associated with the developmental of the model.

#### **THEORETICAL FOUNDATION: INSTITUTIONAL THEORY**

There is a rich body of literature dealing with the role of institutions in shaping human activity in general, and economic activities in particular. The concept of embedded-ness is the underlying assumption in all these institutional analyses (Baum & Oliver, 1992; Hollingsworth, 2002). This concept suggests that entrepreneurship, as manifested by the presence and activities of MSMEs is embedded in an external environment. This environment is the source of legitimization, rewards or incentives and constraints in the activities of MSMEs (Clingermayer & Feiock, 2001). The main paradigm of institutionalism suggests that entrepreneurship as an economic activity is, by itself, an institution that emerged from a wider set of institutions (Hodgson, 1998; Parto, 2005). Hence, institutions are both the “explanantia” (i.e., that which does the explaining) and “explanandum” (i.e., that which is to be explained) of social phenomena (Groenewegen, Kerstholt et. al., 1995; Grief, 1998).

More particularly, the work of Douglas North in the field of new institutional economics significantly influences the framework of this research. North’s main argument suggests that the presence of economic uncertainty makes it costly

for MSMEs to transact. Institutions are formed to reduce this uncertainty by setting the “rules of the game” in the form of formal rules, informal norms, and their enforcement characteristics (North, 1992; North, 2005). Likewise, the same “rules of the game” provide the constraints and incentives that encourage entrepreneurs to switch from unproductive to productive activity, and ultimately improve the general economic well-being of a society (North, 1990). North (2005) repeatedly refers to the non-ergodic economic world and postulated that “*the key to improved performance is some combination of formal rules and informal constraints and the task at hand is to achieve an understanding of exactly what combination will produce the desired results both at a moment of time and over time*”.

Equally relevant is the political science view of institutions in which debates revolve around issues on the role of law in governance, as well as importance of structures, such as political systems (Peters, 1999). The sociological view of institutionalism could well be represented by Selznick’s “natural systems model” (Scott, 2001). Selznick’s theory situates MSMEs in a complex social system implying that the latter’s organizational structure could only be understood by examining the social structures in tandem with its non-rational dimensions, such as the complex informal systems linking social participants (e.g., MSMEs) with one another and with others beyond their boundaries. This view is consistent with the Parsonian cultural-institutional theory (Parsons & Shils, 1951; Scott, 2001). Parson’s theory explains that the value system of an organization is constantly legitimated by its connections to the “main institutional patterns” of its outside environment. This implies that an MSME as an organization acts as a subsystem of a wider social system, which is a source of meaning, legitimation, or higher level support. In short, success of an organization depends on whether it has the necessary support from the wider system.

Furthermore, scholars in the field of organizational theory like Meyer, Rowan, Powell, DiMaggio, Berger and Luckman shed more light

on the role of institutional rules that define the normative structures of organizations and their extra-organizational relations (Meyer & Rowan, 1977; McKinley & Mone, 2003). Conformity to these rules is rewarded with legitimacy, which opens up access to needed societal resources and ultimately leads to what DiMaggio and Powell called “institutional isomorphism”. This view on institutionalism denotes that MSMEs go through the process of institutionalization by constantly seeking legitimacy from their external environment as a prerequisite of organizational survival and longevity.

### **THE NATURE OF INSTITUTIONS**

A review of literature on institutional theory across disciplines such as economics, sociology, and political science reveals a plethora of definitions of institutions. It is important to note that there is no common definition that is accepted either within or across various social sciences (Vatn, 2005). Institutions can be viewed as (a) a pattern of thoughts or actions of some prevalence and permanence, which is embedded in the habits of a group or the customs of a people (Hodgson, 1998; Argy, 2002), (b) social structures (Scott, 2001; Carlsson, 2002), (c) formal organizations, patterns of behaviour, and negative norms and constraints (Coriat & Dosi, 1998), (d) collective action (Parto, 2005), (e) rules (Parto, 2005), (f) beliefs (Elsbach, 2002), and (g) organizations (Hodgson, 2006). North defines institutions as the rules of the game in a society, or formally, as the humanly devised constraints along with their enforcement mechanisms that shape human interaction. Consequently, they structure incentives in human exchange, whether political, social, or economic (North, 1990; North, 1992; North, 2005). Scott (2001) argues that whilst many institutions may be intangible in nature, these institutions evolve and are transported by carriers such as culture and its artifacts, structures, and technologies. These institutional conduits could be argued as the manifestations of the enforcement mechanisms referred to by North.

In developing his theory, North highlights the presence of uncertainty in economic activities. His theory suggests that to reduce uncertainty experienced by MSMEs, an environment that increases information flow amongst the actors is of prime importance. This environment, according to him, is a construct of rules, norms, conventions, and ways of doing things that define the framework of human interaction. North further elaborated by saying that institutions could take the form of formal rules as well as informal norms and their enforcement characteristics (North, 1990). Consequently, North’s theory points out that the quality of these institutions can reduce transaction costs, making economic activities more predictable. North’s theory further explains that the viability, profitability and indeed survival of MSMEs typically depend on the existing institutional matrix. This concept of institutional matrix is a kind of institutional web that governs socio-economic activities and determines the opportunities available for MSMEs. It shows the “institutional thickness” or “local milieu” of a place characterized by the presence of social, economic, and political machineries and practices and efficient contacts between and amongst institutions, mutual awareness and collectivization and corporatization of economic life (Amin & Thrift, 1994; Amin & Thrift, 1995; Raco, 1999).

### **FORMAL AND INFORMAL INSTITUTIONS**

North develops a typology of institutions, namely formal and informal institutions. He defines formal institutions as written policies, laws, and regulations. They also include political rules, economic rules and contracts (North, 2005). North intentionally included political rules because he believes that these rules oftentimes lead to economic rules, although the causality could run both ways. By this he means that rights and contracts are specified by political decision-making, but the structure of economic interests will also influence the political structure. Moreover, North argues that these formal institutions exhibit a hierarchy: “from constitutions, to statute and common laws, to specific bylaws,

and finally to individual contracts". In other studies, these are called *concrete or hard institutions* (Boland, 1992; Hodgson, 1993).

On the other hand, informal institutions are defined by North as codes of conduct, norms of behaviour, and conventions – all these generally emanate from a society's culture (North, 2005). These are mechanisms which run in tandem with formal institutions serving as tools for solving coordination problems. These informal institutions (sometimes referred to as *consensus institutions*) have arisen to coordinate "repeated human interaction" and more specifically consist of extensions, elaborations, and modifications of formal rules; socially sanctioned norms of behaviour; and internally enforced standards of conduct (Boland, 1992; Hodgson, 1993; Fiori, 2002).

### **LOCAL ENTREPRENEURIAL CLIMATE: A CONCEPTUAL FRAMEWORK**

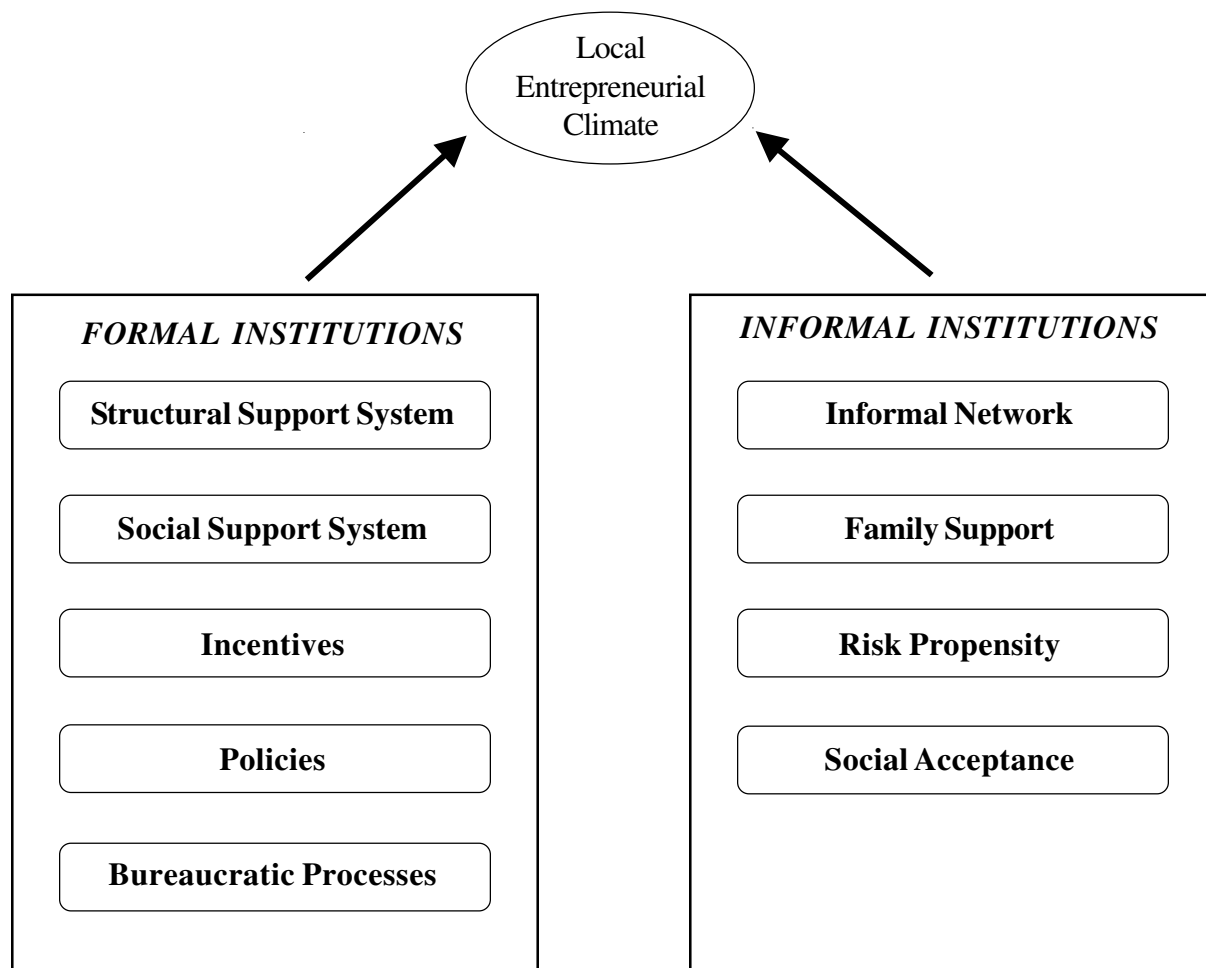
Against this backdrop of rich theoretical foundation of institutionalism, this paper proposes a conceptual framework of institutional thickness that supports the growth, success and sustainability of MSMEs, much akin to the concept of "environmental munificence" (Anderson, Drakopoulou-Dodd et. al., 2000; Anderson & Tushman, 2001; Goll & Rasheed, 2005). This conceptual framework allows "for propositions as well as hypotheses to summarize explanations and predictions regarding the relationships or interactions of variables" (Parsons & Shils, 1951). The use of frameworks in research allows the identification of the elements and the specification of the relationships amongst these elements that the researcher needs to consider for diagnostic and prescriptive analyses (Ostrom, 2005). It allows the researcher to identify, as well as compare, the relevant theories shaping the framework. Furthermore, in developing this conceptual framework, careful consideration of the three requirements for a good "classification system" was observed: (a) development of mutually exclusive and exhaustive categories; (b) capturing meaningful

differences of the objects being classified in a parsimonious manner; and (c) the operationability of the classification scheme (Law, Wong et. al., 1998). Aiding the development of the proposed conceptual framework is the thorough review of existing models and frameworks of business and/or investment climate and city and regional development. Amongst these models and frameworks include investment climate (WorldBank, 2004), inner-city development (Porter, 1995), entrepreneurial environment (Gnyawali & Fogel, 1994), local economic development (Wong, 1998; Wong, 2002), city investability (Begg, 2002), entrepreneurial climate (Goetz & Freshwater, 2001), city competitiveness (Magdaluyo, Tecson et. al., 2001), and systemic competitiveness (Esser, Hillebrand et. al., 1995).

As shown in figure 1, the environment for entrepreneurship, referred to as the local entrepreneurial climate, is shaped by two sets of forces: formal and informal institutions. These two sets of institutions provide the structure of entrepreneurial activities by determining the incentives and constraints of entrepreneurial firms. The framework addresses the dimensions of institutions: structural, process, and incentives (Adams, 1993). In general, these institutional forces shape the playing field of economic activities. The current study attempts to develop a model of a local entrepreneurial climate based on an empirical investigation of these formal and informal institutions.

The concept of an environment for productive entrepreneurship is shown to be a function of three dimensions: economic; political; and socio-cultural environments. Economic environment includes the general wealth of the society, economic stability, as well as capital availability. Political environment includes freedom, property rights, as well as decentralization of political power. Socio-cultural environment includes social and cultural norms, and beliefs (Shane, 2003).

Jackson (2002), on the other hand, defines an entrepreneurial environment as consisting of the contextual environment and dynamic environment. The contextual environment is akin to the economic



**Figure 1. Components of Local Entrepreneurial Climate**

institutional arrangement of North, with a strong emphasis on socio-economic factors, while the dynamic environment takes into account the available technology, information, human resources and finance factors of business operations (Jackson, 2002). These are the major sources of formal and informal institutions, as well as concrete and consensus institutions shaping the institutional thickness of a city from which entrepreneurship is argued to emerge and prosper.

Having identified the various dimensions of environment, the next crucial step is to develop the institutional framework showing the variety of institutions shaping the environment conducive for entrepreneurship. Blakely and Bradshaw (2002) argue that the key to good climate is in determining

what kinds of regulatory and policy tools will facilitate business development for the type of firms that use the locality's asset base.

This section presents the model illustrating the factors that are proposed to constitute a city's *local entrepreneurial climate*. These factors are categorized into two groups: formal and informal institutions. The grouping of these two categories reflect the "institutional framework" as characterized by (Hodgson, 2006) that shows the "institutional thickness" of a city (Amin & Thrift, 1995; Raco, 1999). Consistent with Hollingsworth (2002), this study examines the formal and informal institutions in terms of their influence to a given sector of society which, in this case, refers to the micro, small, and medium enterprises (MSME).

The formal institutions refer to the five multidimensional constructs, namely: structural support system; social support system; incentives; bureaucratic processes; and policies. The informal institutions include informal network, family support, risk propensity, and social acceptance.

## **DIMENSIONS OF LOCAL ENTREPRENEURIAL CLIMATE**

Local entrepreneurial climate is defined as the set of tangible and intangible environmental factors that shape the performance of MSMEs in a geographically and politically defined area such as a city (Gnyawali & Fogel, 1994; Fogel, 2001; Fogel & Zapalska, 2001; Goetz & Freshwater, 2001; Turok, 2005; Welter & Smallbone, 2005). These environmental factors comprise the diverse forms or manifestations of institutions, such that they serve as constraints and/or provide incentives for MSMEs to flourish, shrink or die. They provide the structures of economic transactions occurring between and amongst socio-economic players.

### **FORMAL INSTITUTIONS**

Formal institutions are broadly defined in this study as the set of social, economic, political and legal mechanisms and collective actors that set the rules constraining the behaviour of, and offers incentives that benefit, micro, small and medium enterprises (Hodgson, 1988; North, 1990; Kochhar & David, 1996; Henrekson & Johansson, 1999; Henriquez, Verheul et. al., 2001; Lam, 2003; Hodgson, 2006). Formality implies that there is legal basis in the way a particular institution exerts its influence on an MSME. Formality further implies the explicitness with respect to rules, legal obligations and consequences of these institutions. Explicitness could be expressed in a number of tangible, particularly written, ways, such as charters, proclamations, bylaws, legislation, policies, programs, project, symbols, and a variety of ceremonial displays and rituals which have the force of law. Organizations such as businesses and

trade associations are also considered formal institutions in the context of the product or services they contribute to the economy as a matter of legal obligation by virtue of a contract, license or charter duly recognized by law. This apparently legalistic view of formal institutions stems from the understanding that legal enforceability is a prerequisite for an institutional factor to be considered formal (Co, 2004; Vatn, 2005). Furthermore, the action (or inaction) of the state (i.e. local government unit) has formal institutional weight, as it forms part of the formal administrative-bureaucratic framework through which the functions of the state are disposed. The local government's role in "creating" the physical, legal and social surroundings in which firms operate could be viewed as a "stock" from which firms draw services without making direct payments (Wigren, 1984).

**Structural Support System.** Every economic activity, regardless of scale or magnitude of operation, requires basic infrastructure that is considered a factors to production. Structural support system is defined in this study as *the physical infrastructure and geographic space that aid entrepreneurial business development*. This definition builds on the work of Wong (1998), Gordon (2005), Bingham & Mier (1993), Eberts (2005), Blakely and Bradshaw (2002), and Helmsing (2003), in the fields of modern geography and urbanization, city and regional competitiveness, local economic development, and urban and regional planning. This system includes a city's physical infrastructure, such as roads and road network, transportation system, traffic management, water and power supplies, information and communications technology infrastructure, and waste management system (Gnyawali & Fogel, 1994; Wong, 1998; Hallberg, 1999; Magdaluyo, Tecson et. al., 2001; Begg, 2002). Likewise, the availability of well-defined commercial and industrial areas or zones, as well as the presence of business support services, are considered a strong signal of a positive climate for entrepreneurial business activities (Bartik, 1991;

Skuras, Dimara et. al., 2000; Begg, 2002; Audretsch & Thurik, 2004; Audretsch, 2004). This structural support system aids the firm as it has the capability to increase the supply of other inputs, including information, resulting in lower costs of production (such as flow of skilled labour), and facilitates activities of other firms that are essential in the industry or the value chain (Immergluck, 1993).

**Social Support System.** The city's social support system refers to the *formally instituted social institutions along with its intangible resources forming the "social capital" of the city supporting entrepreneurial development* (North, 1992; Wood, 1996; Reese, 1998; Feindt, Jeffcoat et. al., 2002; Macpherson, 2002; North, 2005) This system complements the structural support system, the combination of which provides the fundamental platform for entrepreneurial growth of the city. This support system is constituted by the following factors: (a) a proactive *local government leadership* with a clear economic vision for the city, and which encourages participation of MSMEs in city development planning, has a clear city marketing plan to attract more tourists and businesses, and all other clear cut efforts to promote MSMEs in the city (Blair, 1995; Wood, 1996; Reese, 1998; Van Den Berg & Braun, 1999; Argy, 2002; Blakely & Bradshaw, 2002; Wallis & Dollery, 2002; Smallbone, 2004); (b) *degree of safety and security* of people and their property (Begg, 1999; Hopkins, 2002; Taylor & Matthew, 2002); (c) *human resource quality* (Acs & Audretsch, 1988; Barber, Metcalfe et. al., 1989; Levy, 1991; Gnyawali & Fogel, 1994; Ward, Duray et. al., 1995; Wong, 1998; Goetz & Freshwater, 2001; Batra & Tang, 2002; Begg, 2002; Zapalska, Perry et. al., 2003); (d) *formal business networks* such as trade or business associations and linkages with other firms in the supply and distribution chains (Barber, Metcalfe et. al., 1989; Peng & Vellenga, 1993; Cooke & Wills, 1999; Huggins, 2000; Lall, 2000; Feindt, Jeffcoat et. al., 2002; McCormick & Atieno, 2002; Wattanapruttipaisan, 2002; Terziovski, 2003;

Kingsley & Malecki, 2004; Rocha, 2004; Gordon & McCann, 2005; Yue-Ming, 2005); and (e) *research and development* manifested by the presence of public or private institutions engaged in R & D including colleges and universities (Sripaipan, 1993; Gnyawali and Fogel, 1994; Wong, 1998; Goetz & Freshwater, 2001; Magdaluyo, Tecson et. al., 2001; Carlsson, 2002; Macpherson, 2002).

**Incentives.** In the Northian institutional context, incentives refer to a set of institutional factors that encourages or supports specific behaviours or activities (in this case, entrepreneurial activities). As North (1990) puts it, formal institutions have two fundamental functions: to discourage unproductive behaviour through the use of rules; and to promote productive behaviour through the use of incentives. These incentives take the form of financial and non-financial business development services and assistance provided by either the government, private sector or both. These incentives that promote entrepreneurship include *financial* (Fogel & Zapalska, 2001; Zinger, LeBrasseur et. al., 2001; Jenssen & Havnes, 2002; Ayyagari, Beck et. al., 2003; Shane, 2003; Audretsch, 2004), *marketing* (Sharma & Fisher, 1997; Mead & Liedholm, 1998; Wren & Storey, 2002; Swierczek & Ha, 2003; Barrios & Barrios, 2004; Arinaitwe, 2006), *production* (Ariss, Raghunathan et. al., 2000; Romijn & Albaladejo, 2002; Visscher, Becker et. al., 2004; Arinaitwe, 2006; Guan, Yam et. al., 2006), *human resource management* (Hadjimanoulis, 2000; Skuras, Dimara et. al., 2000; Jenssen & Havnes, 2002; Audretsch, 2004; Co, 2004), *management development* (Miller & Kirschstein, 1988; Zapalska, Perry et. al., 2003; Visscher, Becker et. al., 2004; Ramsden & Bennet, 2005; Berry & Sweeting, 2006), *export promotion* (Becchetti & Trovato, 2002; Leonidou, 2004; Wilkinson, 2006; Wilkinson & Brouthers, 2006), and *public procurement incentives* (i.e. participation of MSMEs in bidding for government contracts (McGrudden, 2004; DTI, 2005).



**Policies.** The policy framework forms a crucial part of the set of local governance factors to nurture an entrepreneurial climate. Clarity and coherence of policies are crucial in setting the tone for small business development (OECD, 2004). The policies in place which could be reinforcement of a country's national policies, as well as policies indigenous to the city, are important ingredients of this entrepreneurial climate (Gnyawali & Fogel, 1994; Reynolds, Hay et. al., 1999; Lall, 2000; Kirby & Watson, 2003; Lam, 2003; Audretsch, 2004). These are the clear-cut examples of North's concept of formal institutions as "rules of the game" designed to shape the behaviour of economic players.

**Bureaucratic Processes.** Small businesses are likely to have a number of encounters with local government authorities as a matter of legal obligation, such as application or renewal of business registration, permits or licenses. These encounters reveal the level of efficiency, as well as transparency of rules and policies governing the transactions between the business owner and the local authorities (Ollinger & Fernandez-Cornejo, 1998; Ayyagari, Beck et. al., 2003; Turner, 2003; Park, 2006). The length of time involved in these transactions, as well as the necessary degree of complexity, are indicators of the responsiveness of the local governance system to the needs of small businesses. Bureaucratic rigidities are likely to dampen the entrepreneurial spirit of MSMEs as they suffer from unnecessary delays, unofficial fees, as well as frustration.

## INFORMAL INSTITUTIONS

The development of an entrepreneurial climate does not depend solely on the installation of formal institutions. It also requires nurturing the informal institutions that may be as influential as that of the formal legal framework. Despite the lack of legal enforcement mechanisms, such as penalties and sanctions, informal institutions and their enforcement characteristics, including traditions, customs, moral values, religious beliefs, social

conventions, and generally accepted ways of thinking and doing, are able to impose restrictions on the behaviour of individuals belonging to relevant social groups. These informal institutions, or unwritten rules, are created, communicated, and enforced outside officially sanctioned channels (Helmke & Levitsky, 2004). Their enforcement takes place by way of sanctions, such as expulsion from the community, ostracism by friends and neighbours, or loss of reputation (Pejovich, 1999). The current study looks at four forms of informal institutions that the extant literature considers to be influential in shaping the potential, capabilities and activities of entrepreneurs: informal network; family support, risk propensity, as well as social acceptance.

**Informal Network.** Research has identified that the most important business reason that small firms turn to informal networks for assistance is to secure information about their operating environment (Carlsson, 2002; Kopicki, 2002; McCormick & Atieno, 2002; Kingsley & Malecki, 2004; Gordon & McCann, 2005). As MSMEs typically suffer from information asymmetry, this type of network nurtures friendships which provide regular, inexpensive, and swift routes both to customers via referrals (market access) and to reliable marketing information, as ideas are "bounced off" friendly contacts (Feindt, Jeffcoat et. al., 2002). Social networks capture local knowledge and circulate it within the communities, enhancing the knowledge useful for business development.

**Family Support.** The relevance of family influences in small business creation is well-established in the literature (Finnerty & Krzystofik, 1985; Davidsson & Honig, 2003). This study extends the argument that the family support could well nurture existing MSMEs as they navigate through the ocean of business opportunities. The degree to which families welcome and appreciate the idea of business venturing as a career option, as opposed to seeking corporate employment, increases the chances of an individual to be

successful in his/her business undertaking (Plaschka, 1990; Leaptrott, 2005). The influence of the family becomes stronger if entrepreneurship is a family tradition or if there is an entrepreneur family member who serves as a role model (Lundstrom & Stevenson, 2005; Van Auken, Fry & Stephens, 2006). Finally, the family provides further support by expanding the entrepreneur's network and referring formal and informal business contacts (Siu, Lin et. al., 2006).

**Risk Propensity.** Studies have shown that some cultures are more conducive to entrepreneurship than others (Casson 1990; Mueller, 2001). For instance, uncertainty avoidance, as popularized by the work of Hofstede (Hofstede, 1980), is a cultural attribute that has been found to be a strong force influencing the motivations of a society to engage in risky behaviours. The intention to become an entrepreneur and start up a business is characterized as a risky behaviour compared to establishing an employment career with predictable and steady flow of income (Stewart & Roth, 2004; Petrakis, 2005). There is a significant amount of ambiguity and anxiety in one's intention to engage in a business venture, regardless of size. The fear of failure (usually operationalized by an individual's risk aversion) is a particularly critical issue for an entrepreneur, due to the small separation between business and personal risk in an entrepreneurial venture (Watson & Robinson, 2003). In this case, entrepreneurship can be characterized as requiring a fair degree of tolerance to ambiguity, a locus of control that is more internal than external, as well as a willingness to take risks that are relatively well calculated (Shabbir & Di Gregorio, 1996; Pitt & Kannemeyer, 2000; Fielden & Dawe, 2004). This indicates that willingness to take on risks is an important variable determining the success of small business owners.

**Social Acceptance.** Closely related to risk propensity is the level of "social acceptance" for venturing into a business as a career (Jackson & Rodkey, 1994). Birch et al (1991) argue that

tolerance and recognition of new and different people doing new and different things are hallmarks of entrepreneurs starting and growing companies. Likewise, De (2001) in Lundstrom and Stevenson (2005) underscores the importance of social acceptance of entrepreneurship and highlights the need to nurture the associated "social capital" in order to increase the likelihood of a potential entrepreneur to start a business. It has been shown that the higher the level of acceptance of entrepreneurship, the higher the level of propensity to engage in business ventures in a given society (Shane, 2003). By extension, the higher the level of support of an MSME and its products or services from the local community, the higher the chance of success of the business. Furthermore, social praise for entrepreneurs and social prestige and status that entrepreneurs receive can act as important non-pecuniary rewards for entrepreneurship, and therefore affect the opportunity cost of becoming or succeeding as an entrepreneur (Gifford, 1998).

## CONCLUSION

The development of the conceptual framework showing the institutional dimensions of a city's local entrepreneurial climate serves as the springboard on which further research is grounded. Based on the preceding discussion, three main propositions could be drawn. First, the presence of these formal and informal institutions defines the local entrepreneurial climate of a city. The more pronounced their presence, the more favourable the climate will be. Second, formal and informal institutions exert different, but equally similar levels of, influence in shaping the local entrepreneurial climate. Third, in as much as these two types of institutions are complementary, one can further argue that the absence of one reduces the positive influence of another.

The utility of this proposed framework depends on subsequent research examining these propositions and the overall validity and reliability of the framework. One basic challenge is to

determine the sources of data that will be used in gauging the presence or absence of these institutions. Another key challenge is determining how to establish the link between local entrepreneurial climate and entrepreneurship, particularly as the latter relates to the economic performance of MSMEs and cities. One approach would be to investigate the presence of these institutions and link these results with some indicators of aggregate economic performance of a city. Another approach is to determine if the framework correlates with the performance of MSMEs.

Another issue deals with the challenge of operationalizing the constructs under each category. Since one goal of proposing this research framework is to develop an integrated institutional approach to defining local entrepreneurial climate, the need to establish content validity is essential, such that all relevant factors are given due consideration. Construct validity is of paramount concern if the goal is to ensure that the model depicting local entrepreneurial climate is the closest approximation of reality. To check the possibility that constructs under each category of institutions overlap with each other, discriminant validation may be of help, depending on the type of measures or data that will be gathered. Moreover, a significant portion of the relevant literature that formed the basis of conceptual framework development has a Western context; future empirical investigations may be geared towards determining the generalizability of the framework in the context of non-Western countries, particularly amongst the developing countries in the Asia Pacific region. Even then, there is a further need to validate if this model of local entrepreneurial climate is generalizable across cities in one given country.

Furthermore, empirical investigation may include the role of the public and private sectors in fostering a positive entrepreneurial climate. For instance, a question may be asked regarding the kind of government-business relationship required in pursuit of such entrepreneurial climate. What would be its implication in terms of the praxis of management in both the government and business

sector? In as much as MSMEs are institutions themselves, they cannot be taken as passive beneficiaries of an entrepreneurial climate. Hence, investigating the role that MSMEs play in shaping such a climate may also be of interest for research and policy-making purposes.

The proposed conceptual framework is an attempt at deconstructing the conventional notions of institutions by providing a synthesis of the various strands of institutionalism as a school of thought cutting across disciplines. It extends the typical conceptual definitions of institutions and provides opportunities to establish their relevance in creating a local entrepreneurial climate. Finally, the conceptual framework provides the basis on which to further test the theoretical assumptions regarding the role of institutions in promoting entrepreneurship, in particular, and MSME and economic development, in general.

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