

CRONYISM AND ENTREPRENEURSHIP:
AN INTERNATIONAL ANALYSIS OF THE
INFLUENCE OF CRONYSIM ON COUNTRY LEVEL
PRODUCTIVE AND UNPRODUCTIVE
ENTREPRENEURSHIP

By

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Abstract: Cronyism or the practice of favoritism based on network connections represents a strong informal institution or rule of the game in many countries. This study adopts Baumol's model of productive, unproductive, and destructive entrepreneurship to explain how the prevalence of cronyism in a country encourages unproductive entrepreneurial behaviors and discourages productive entrepreneurial behaviors in that country. Analysis of data for 132 countries provides empirical supports for cronyism's direct positive and negative effects on, respectively, unproductive and productive entrepreneurship. Also, results indicate that cronyism's direct effects on both types of entrepreneurship are mediated through cronyism's influence on the levels of institutional trust and market competition in each country.

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CHAPTER I

INTRODUCTION

Since at least the 1930s, when Schumpeter proposed his creative destruction hypothesis and defined entrepreneurship as activities that involve different types of innovation, entrepreneurship has been generally framed as a positive phenomenon in societies. Such positive bias toward entrepreneurship is mainly because of its known positive effects on economic development and prosperity in a country (e.g. Reynolds, Hay, & Camp, 1999; Zacharakis, Shepherd, & Bygrave, 2000). However, more recently, scholars have noticed that entrepreneurship does not always include innovations in productive ways as Schumpeter suggested (new product, new process, new supply, new market, and new organizing method), but can also include innovations in unproductive forms, including “innovations in rent-seeking procedures, for example, discovery of a previously unused legal gambit that is effective in diverting rents to those who are first in exploiting it” (Baumol, 1990, p. 897).

Research on factors that promote entrepreneurship in a society, especially in its productive forms, has attracted significant attention in different fields of knowledge, including economics, sociology, and entrepreneurship scholarship (e.g. Sobel, 2008). A major research stream in this area is the study of institutions and their influence on entrepreneurial efforts within different societies (North, 1990; Scott, 1995;

Acemoglu, 1995). Institutions are rules of the game that constrain or promote certain types of behaviors and interactions among people in a society (Hira & Hira, 2000). Hence, institutions can encourage/discourage people to engage in productive or unproductive forms of entrepreneurial behaviors (Baumol, 1990; Murphy, Shleifer, & Vishny, 1991). For example, Sobel (2008) demonstrates that better institutional frameworks (e.g., more secure property right regime, more balanced and fair judicial system, stronger contract enforcement, etc.) promote productive entrepreneurship (higher venture capital investments, higher rate of patents, faster rate of sole proprietorship growth, and higher establishment birth rates) and reduce unproductive entrepreneurship activities (lobbying activity and legal quality/lawsuit) within different states of the US.

Prior research has mostly focused on effects of formal institutions (written rules, regulations, laws, etc.) on productive entrepreneurship (Bruton, Ahlstrom, & Li, 2010). Secure property rights, fair judiciary systems, strong enforcement agencies, and efficient tax codes are a few examples of formal institutions that are known to have positive effects on the level of productive entrepreneurship in a country. In contrast, with exception of national culture, research on effects of other informal institutions (social norms, beliefs, values, etc.) on entrepreneurship, especially in its unproductive forms, has attracted much less attention among scholars (Bruton et al., 2010). This study seeks to contribute in filling these gaps of knowledge by explaining how cronyism, as an understudied informal institution, influences the level of people's involvement in both productive and unproductive forms of entrepreneurship in a country.

Cronyism refers to the act of favoritism among members of a network based on their connections and mostly at the expense of outsiders. More accurately, cronyism as a practice

refers to “a reciprocal exchange transaction where party A shows favor to party B based on shared membership in a social network at the expense of party C's equal or superior claim to the valued resource.” (Khatri, Tsang, & Begley, 2006, p. 62). Cronyism refers to both private favoritism and public favoritism (government-business relationship). Private favoritism happens in a purely private domain between two parties (for example, in an organizational setting between managers and employees), however, public power is at stake in public favoritism, meaning that, one party abuses public power to give/receive favors to/from another party, possibly at the expense of a specific third party or public interest (Li, 2009). Once cronyism becomes a dominant practice in a business context, it functions as a strong informal institution, either as a cognitive belief (the common/safe path for success) or as a normative belief (how things are getting done around here).

Prevalence of cronyism in a context leads to the emergence of an economic system, called crony capitalism, in which business performance depends on political connections rather than market forces (Holcombe, 2013; Sobel & Graefe-Anderson, 2014). In a crony capitalism system, cronyism, especially in its public form between bureaucrats and businesses, is a dominant business practice and “those close to the political authorities who make and enforce policies receive favors that have large economic value” (Haber, 2002, p. xii). Therefore, connected economic players have unfair advantages over their un-connected competitors. In other words, in such an economic system, ‘what firms do’ is much less important than ‘whom firms know’ (Guseva, 2007). In extreme cases of crony capitalism, using networks to acquire resources and access opportunities is not just a supporting factor for business performance, but the only way for achieving business goals, such that without

benefiting from cronyism the survival of a firm is quite unlikely. This is described as the “downside of social networking” (Khatri, Tsang, & Begley, 2003).

Cronyism is considered as the “downside of social networking” (Khatri et al., 2003) not only because of its tendency to constrain success paths in a society, but also because it restricts the opportunities for building ‘right networks’ to certain individuals and groups within a society. Cronyism mostly happens based on relations such as kinship or friendship that are not available to everyone in a society. Hence, crony capitalism’s problem is that having the ‘right networks’ is excessively important for business performance (such that it cannot be substituted by anything else), and that not everybody has an equal chance to build those ‘right networks’. Consequently, cronyism leads to an unfair access of certain groups of people to resources and opportunities in a business context, at the expense of other people who cannot or do not participate in this favor seeking/offering game.

Cronyism was first used in a political context in 1952 by a New York Times’ journalist to describe Truman administration’s act of appointing employees within the official postal administration, based on friendships rather than qualifications (Turhan, 2014). Yet, cronyism did not attract scholars’ attention until it was recognized as one of the major causes of the economic crisis and fall of the East Asian economies in mid 1990s (e.g. Rasiah, 1998; Wade, 1998; Henderson, 1999; Enderwick, 2005). Hence, it has not been until recently that economists started to investigate the economic consequences of cronyism in different contexts (e.g. Haber, 2002; Kang, 2002; Enderwick, 2005; Khatri et al., 2006; Holcombe, 2013). In management scholarship, there are very few studies that have focused on cronyism (e.g. Khatri et al., 2006), however, there are numerous studies on political connections and

networking that help to form a basic understanding about cronyism's effect on organizational performance.

Prior research findings indicate that cronyism has a wide range of economic consequences. Cronyism's effects are different based on the level of analysis and time frame. At the organizational level, most scholars have studied the effects of political connections on firms' performance, with underlying assumption that political connections lead to favoritism. The general belief is that having political connections benefits firm's overall performance, especially when firms are small and at the earlier stages of their development (e.g. Li & Zhang, 2007; Li, Meng, Wang, & Zhou, 2008; Xin & Pearce, 1996; Zhou, 2013). However, cronyism's long-term effects are uncertain and can be even detrimental to firm's performance. Firm's engagement in cronyism undermines its ability to plan for the long-term and diverts its efforts to political rent seeking instead of developing sustainable core competencies and competitive advantages (Enderwick, 2005; Tahoun, 2014).

Similarly, cronyism's economic effects are different for countries at different stages of development, such that, cronyism may have some short-term benefits for countries at earlier stages of development, but its cost increases significantly in the long-run as countries become more developed (Shleifer & Vishny, 1994). In developed economies, cronyism slows down the economic growth by restricting economic freedom, producing barriers to entry, increasing lobbying efforts, and disrupting market competitions (Smith & Sutter, 2012). However, in developing countries, cronyism is often considered as a pragmatic second best solution to government's credible commitment problem (making sure that government will not usurp private property rights while it has the right to distribute and protect private

property right) and makes economic growth possible in the short term (Aligica & Tarko, 2014).

Additionally, cronyism has several social and political consequences. Cronyism is a major cause for higher levels of income inequality in a society since it transfers wealth to connected elites at the expense of the public (Walder, 2002). This wealth redistribution leads to deadweight loss¹ in a society as it increases rent seeking behaviors, such that, what elites gain is much less than what the public lose (Mitchell, 2013). Moreover, widespread cronyism makes unfairness pervasive, promotes narrow self-interest among citizens, and undermines ethical standards in a society. Hence, widespread cronyism increases different types of corrupt behaviors in a society and exhaust people's trust in fairness and functionality of the system (Anokhin & Schulze, 2009).

Cronyism promotes political authoritarianism by suppressing political competitions and aligning countries' resources to support the status quo (Morck & Yeung, 2004). Once cronyism has become a widespread practice, businesses find no better option than to engage in political rent seeking, "self-interested dealings between the political and business elites" (Morck & Yeung, 2004, p. 391), and gain profit through politicians' favoritism in exchange for supporting those politicians to stay in power (Holcombe, 2013). Consequently, politicians and favored businesses get locked into a situation of mutual dependency, called mutual hostage problem, in which, change by one part threatens the position of the other part (Enderwick, 2005).

¹-Deadweight loss, also known as excess burden or allocative inefficiency, refers to costs to society resulted from market inefficiencies. Deadweight loss happens when supply and demand are out of equilibrium.

A quite understudied consequence of cronyism at the country level is its effect on entrepreneurial activities. Several scholars posit that the most destructive effect of cronyism is its tendency to discourage corporate restructuring and innovative economic behaviors (e.g., Enderwick, 2005). However, there is no study that delves deep into the relationship between cronyism and entrepreneurship at the national level and tests how widespread cronyism influences entrepreneurial activities in different countries. The main focus of this research is to investigate how the degree of prevalence of cronyism in a society influences entrepreneurship in that society.

This study aims to investigate the effects of cronyism on entrepreneurial behaviors and explain how cronyism influences entrepreneurship at national level. In other words, this research strives to find answers for two major questions: 1) how does the degree of prevalence of cronyism in a country influence the level of productive/unproductive entrepreneurship in that country? 2) How do the levels of market competition and institutional trust mediate the relationship between cronyism and productive/unproductive entrepreneurship within a country? For this purpose, I adopt an institutional perspective (North, 1990; Scott, 1995) and build my theoretical explanations based on Baumol's (1990) model of productive, unproductive/destructive entrepreneurship.

Productive Entrepreneurship (PE) refers to activities that increase the innovativeness, adaptability, and dynamicity of an economy, and create wealth for entrepreneurs and their society (Baumol, 1990; 1996; Sobel, 2008; Douhan & Henrekson, 2008). Examples include product/service innovations, business model innovations, commercialization of new technologies, and establishment of new firms. In contrast, Unproductive Entrepreneurship (UE) refers to unproductive innovative activities that mostly destroy wealth in an economy

and results in positive returns for certain individuals at the expense of other individuals and society (Baumol, 1990; 1996). Examples include rent seeking activities such as lobbying efforts, organized crimes, lawsuit abuse, and other types of redistributive activities (North, 1990; Baumol, 1990; 1996; Douhan & Henrekson, 2008).

Baumol's (1990) main thesis is that rules of the game, institutions, determine the rewards for involvement in productive and unproductive entrepreneurship efforts in each context and people choose to engage in productive or unproductive entrepreneurship by considering the relative return that each type of entrepreneurship provides for them. Based on this framework, this study explains how widespread cronyism acts as an informal rule of the game that influence the reward structure for economic activities in a country and encourages individuals in a country to get involved in unproductive entrepreneurship and discourages them from involvement in productive entrepreneurship (Murphy et al., 1991).

Moreover, this study suggests two mediators for the direct relationships between cronyism and productive/unproductive entrepreneurial activities in a country. Cronyism leads to different types of entry barriers for non-favored firms to the benefit of favored firms. Connected firms strive to make it more difficult for would-be competitors to enter the market, and they are often favored by receiving monopoly powers or other types of privileges to stay ahead of others in the market (Mitchell, 2013). Such lack of market-based competition in a business context decreases the incentives for involvement in PE and promotes UE. Therefore, market competition is one mediator for direct link between cronyism and productive/unproductive entrepreneurship at national level.

The other factor that mediates the direct relationship between cronyism and productive/unproductive entrepreneurship is institutional trust. Institutional trust refers to the “wide-spread confidence that office holders and others who are directly and indirectly party to a transaction will, regardless of their identity, impartially and fairly enforce the rules that govern exchange” (Anokhin & Schulze, 2009, p. 3). Prevalence of cronyism among businesses and between businesses and governments hurts credibility of the parties involved (Mitchell, 2013). Through repeated interactions with businesses and government, potential entrepreneurs learn the rules of the game and whether they can count on fairness and neutrality of institutions or if they need to engage in cronyism if they want to achieve their goals. Therefore, prevalence of cronyism leads to citizens’ skepticism about the ability and intention of market institutions to reliably and neutrally enforce trade rules. Lack of trust in institutions drives a country’s individuals away from PE toward UE, since they strive to ensure that they can reap the benefits of their own talents.

The study utilizes secondary data from multiple sources to build appropriate measures for its desired constructs. These data sources include: Global Competitiveness Index reported by World Economic Forum (Sala-I-Martin et al., 2010), Worldwide Governance Indicators developed by World Bank Groups (Kaufmann, Kraay, & Mastruzzi, 2010), World Bank Group Entrepreneurship Survey (WBGES), World Development Indicators developed by World Bank Groups, and Corruption Perception Index reported by Transparency International (Lambsdorff, 2008). The results of SEM analysis on data from 132 countries provide strong support for most parts of the study’s conceptual model. The study finds empirical support for the direct negative effect of cronyism on PE, direct positive effect of cronyism on UE, and mediated paths from cronyism to PE/UE through institutional trust.

However, the results indicate that market competition mediates the influence of cronyism on PE, but fails to support the mediated path between cronyism and UE through market competition.

Understanding the effects of cronyism on entrepreneurship at national level is important because of the significant implications of productive and unproductive entrepreneurship for countries' economic growth and prosperity. Cronyism increases unproductive entrepreneurial efforts, which can suppress productive entrepreneurial activities and lead to more cronyism. Therefore, once countries fall into the "idea trap" of cronyism, as a pragmatic way of getting business done, their private and public resources becomes locked into the system and they become entangled in a reinforcing vicious cycle that is able to destroy or obliterate the whole economy of a country in the long run.

Consequently, scholars need to study cronyism, its antecedents and consequences at different levels of analysis, and mechanisms through which it works, so that they can suggest effective solutions to limit the practice of cronyism in a business context. This study is one of very few studies that recently focused on the issue of cronyism. The study contributes in this area of knowledge by providing a comprehensive overview of cronyism's literature and developing a research model that elaborates on relationships between cronyism and entrepreneurial activities in a national context.

This study has several theoretical and practical contributions. Firstly, it contributes to recent body of research that is forming around the issue of cronyism. This study is among the very first studies that present a comprehensive overview of the literature on cronyism and highlight areas that require more attention by researchers. For example, research on

antecedents of cronyism in a business context has attracted very little attention. This study reviews this literature and suggests a novel institutional framework that can be implemented by future researchers to investigate different antecedents of cronyism in a society. Moreover, this research suggests a new way to measure cronyism, which can be implemented in future research to study the consequences of cronyism. The study uses a measure of the ‘perception of cronyism’ and argues why perception of cronyism is an appropriate proxy to measure the level of cronyism in a country (Smith & Sutter, 2012).

Moreover, this research contributes to our knowledge about entrepreneurship policy and how rules of the game determine the allocation of resources to productive or unproductive entrepreneurial efforts in national context. It explains how widespread cronyism changes the reward structure in a society and encourages individuals to engage in unproductive efforts instead of productive ones. This is among very few studies that aim to provide empirical support for Baumol’s (1990) model of productive, unproductive, and destructive entrepreneurship (e.g. Sobel, 2008). In addition to clarifying cronyism’s effect on allocation of entrepreneurship in a society, this study also explains how cronyism reduces the supply of entrepreneurship in a society through its negative effects on entrepreneurial motivation and intention in a country.

Additionally, this study contributes to the previous literature on the effects of networks on entrepreneurial activities. For more than three decades, scholars have emphasized the positive role of networking for business performance. The general consensus is that having social networks (whether dense networks of strong ties or sparse networks of weak ties with many structural holes) provides competitive advantages for firms and supports entrepreneurial growth in almost every context (Burt, 1992; Coleman, 1988, 1990; Singh,

Hills, Hybels, & Lumpkin, 1999). More recent findings even suggest that social networks can substitute for the lack of well-functioning formal institutions, especially in developing countries' context (e.g. Puffer, McCarthy, & Boisot, 2010). However, there are relatively very few studies on the “downside of social networking” or cronyism (Khatri et al., 2003). A study of cronyism highlights the fact that prevalence of certain types of networking activities can be detrimental to productive entrepreneurship efforts in the society as a whole.

Finally, this research's findings inform and warn policy makers and businessmen about the negative consequences of cronyism for long term economic growth and prosperity of a society. Moreover, it provides them with an understanding of how these effects take place. Therefore, they are better able to restrict the practice of cronyism by setting appropriate policies and corporate governance structures that protect against cronyism. For instance, based on this study's arguments, development of programs and enforcement of policies that aim to promote market competitions and institutional trust among citizens can help avoid some of the negative consequences of cronyism.

In the following chapters, first, a comprehensive overview of the literature on cronyism is provided. Then, the study's theoretical frameworks and hypotheses are discussed in the third chapter. The fourth chapter explains the study's methodology and analysis. Finally, the study's results and limitations are discussed in the fifth chapter.

CHAPTER II

REVIEW OF LITERATURE

Crony derives from the Greek word ‘Khronios’ (long-lasting) and means “a close friend or companion” (Oxford dictionary). In 19th century, cronyism was used to refer to the ability and willingness to establish friendships, however, later on in 1952 in the USA, a New York Times journalist used cronyism in a political context to describe Truman administration’s act of appointing employees within the official postal administration, based on friendships rather than qualifications (Turhan, 2014). Consequently, cronyism began to be used in political conversations and perceived as favoritism based on friendship.

Currently, cronyism is defined as either a relational or a structural phenomenon (Aligica & Tarko, 2014). As an interpersonal or relational phenomenon, cronyism is a practice that refers to “a reciprocal exchange transaction where party A shows favor to party B based on shared membership in a social network at the expense of party C's equal or superior claim to the valued resource.” (Khatri et. al., 2006, p. 62). In simple words, cronyism is a practice of favoritism based on social ties. Oxford dictionary defines cronyism as “the appointment of friends and associates to positions of authority, without proper regard to their qualifications” (Oxford dictionary). Cronyism as a practice is contrary to meritocracy.

As a structural or systemic phenomenon, cronyism refers to an economic system “in which those close to the political authorities who make and enforce policies receive favors that have large economic value” (Haber, 2002, p. xii). In other words, cronyism describes an economic system in which business success depends on political connections rather than market forces (Holcombe, 2013; Sobel & Graefe-Anderson, 2014). Such a system is also called ‘Crony Capitalism’. In crony capitalism, private firms build and leverage their social networks with politicians to influence public power to their own advantages (Smith & Sutter, 2012). Cambridge dictionary defines crony capitalism as an “economic system in which family members and friends of government officials and business leaders are given unfair advantages in the form of jobs, loans, etc.” (Cambridge dictionary). In simple words, crony capitalism is an economic system in which cronyism is a common practice.

In this chapter, I further elaborate on these two interpretations of cronyism. Next, I explain about distinction between cronyism and other similar concepts, including, rent seeking, and corruption. Then, different forms of cronyism and its major antecedents and consequences are discussed.

Cronyism as a practice

Table 1 presents several definitions for cronyism as a practice. As a practice, cronyism refers to “a reciprocal exchange transaction where party A shows favor to party B based on shared membership in a social network at the expense of party C's equal or superior claim to the valued resource.” (Khatri et. al., 2006, p. 62). Based on this definition, an exchange of favor between two parties is considered to be cronyism once

that favor satisfies four criteria: “(1) there must be no immediate return of the favor or explicit agreement to return it (2) something of value must be given (3) the parties must share membership in a social network (4) it must come at a third party's expense.” (Khatri et al., 2006, p.70).

Table 1 – Example Definitions of Cronyism

Cronyism as a relational phenomenon (Cronyism as a practice)
The appointment of friends and associates to positions of authority, without proper regard to their qualifications (Oxford dictionary)
The unfair practice by a powerful person (such as a politician) of giving jobs and other favors to friends (Merriam – Webster dictionary)
The situation in which someone important gives jobs to friends rather than to independent people who have the necessary skills and experience (Cambridge dictionary)
A reciprocal exchange transaction where party A shows favor to party B based on shared membership in a social network at the expense of party C's equal or superior claim to the valued resource (Khatri et. al., 2006, p. 62).
Preferential treatments that members of a network receive due to their social ties and not because of their qualifications (Begley et al, 2010, p. 282)
Favoritism shown by the superior to his or her subordinate based on their relationship, rather than the latter’s capability or qualification, in exchange for the latter’s personal loyalty (Khatri, & Tsang, 2003, p. 289)
Favoritism resulting from personal relations and social networks (Turhan, 2013, p. 296)
A description of the phenomenon of the exercising of authority in a manner that favors friends or associates at the expense of merit (whatever is merit in the relevant context) (Mazumdar, 2008, p.2)

The major theme among different definitions of cronyism is ‘favoritism based on network connections’. In other words, cronyism is preferential treatment that members of

a network receive due to their social ties and not because of their qualifications (Begley, Khatri, & Tsang, 2010). Cambridge dictionary describes cronyism as “the situation in which someone important gives jobs to friends rather than to independent people who have the necessary skills and experience” (Cambridge dictionary). Consequently, cronyism can be defined as the “downside of social networking” (Khatri et al., 2003), since it produces unfair advantages for members of a specific network over others. Banfield (1958) explains about Southern Italy and Sicily, in which the high importance of family loyalty would reinforce the practice of cronyism by forcing people to offer illegal favors and preferential treatments to their families. Similarly, Tonoyan and her colleagues (2010) posit that reciprocity norms and loyalty to the members’ interest in bonding networks such as kinship that tend to exclude outsiders, promote cronyism.

Cronyism as a practice may occur at any context between any two connected members of a network. However, one can differentiate between cronyism that involves private favoritism and cronyism that involves public favoritism (government-business relationship) (Li, 2009). An example of cronyism that involves private favoritism is cronyism at an organizational setting, which is a “favoritism shown by the superior to his or her subordinate based on their relationship, rather than the latter’s capability or qualification, in exchange for the latter’s personal loyalty” (Khatri & Tsang, 2003, p. 289). Cronyism that involves private favoritism happens in a purely private domain between two private parties, possibly at the expense of a third private party. In contrast, in cronyism that involves public favoritism, public power is at stake (Li, 2009), meaning that, one party abuses public power to give/receive favors to/from another party, possibly at the expense of a specific third party or public interest. The cronyistic relationships

between government officials and their businessmen cronies are typical examples of public favoritism and are typically the main concern of people in a society when they discuss cronyism.

Khatri et al. (2006) adopted social exchange theory (Emerson, 1972; 1981) to suggest four different variants of cronyism. Based on social exchange theory, motives and relative powers of the parties involved in an exchange relationship influence the dynamics of the exchange (Emerson, 1972; Molm & Cook, 1995). Khatri et al. (2006) suggest that four different types of cronyism can happen in different combinations of two kinds of motives, instrumental or relational, and two types of power relationships, peer or hierarchical, of parties involved in cronyism. Instrumental cronyism is primarily motivated by task, utilitarian and self-interest factors, as opposed to relational cronyism that is instigated by relationship, affection, and loyalty-based factors. Each of these two motives may exist in cronyism that either happens between two parties with the same level of power, peers, or two parties with an imbalanced power relationship, hierarchical.

Cronyism as a system (or Crony Capitalism)

Cronyism as a system, often called crony capitalism, refers to an economic system “in which those close to the political authorities who make and enforce policies receive favors that have large economic value” (Haber, 2002, p. xii). Oxford dictionary defines crony capitalism as “an economic system characterized by close, mutually advantageous relationships between business leaders and government officials” (Oxford dictionary). So often in the media, crony capitalism is used as an umbrella term to refer to a system comprised of a loose collection of related phenomena, such as political favoritism,

family-based corporate governance, corruption, collusion, "the old boys club", oligarchy, etc. (Mazumdar, 2008). However, as presented in Table 2, the major theme in most definitions of crony capitalism is the fact that cronyism, especially in the form of public favoritism, is the dominant practice in such a system. In other words, while generally speaking crony capitalism may represent a system that includes a group of related phenomena, its differentiating point is the fact that cronyism is the main practice in crony capitalism, which then promotes other related phenomena. These related phenomena are discussed later as major consequences of cronyism.

Table 2 – Example Definitions of Crony Capitalism

Crony Capitalism as a structural phenomenon (Crony Capitalism as a system)
An economic system characterized by close, mutually advantageous relationships between business leaders and government officials (Oxford dictionary)
Economic system in which family members and friends of government officials and business leaders are given unfair advantages in the form of jobs, loans, etc. (Cambridge dictionary)
A term describing an economy in which success in business depends on close relationships between business people and government officials. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks, or other forms of state interventionism (Wikipedia)
A description of capitalist society as being based on the close relationships between businessmen and the state. Instead of success being determined by a free market and the rule of law, the success of a business is dependent on the favoritism that is shown to it by the ruling government in the form of tax breaks, government grants and other incentives (Investopedia)
A system in which success in business is determined by political connections rather than market forces ... when the normal consumer-driven profit-and-loss signals in an economy are significantly distorted through government-granted favors. (Sobel & Graefe-Anderson, 2014, p. 1, p. 10)
<i>[A system]</i> in which those close to the political authorities who make and enforce policies receive favors that have large economic value (Haber, 2002, p. xii)

A form of capitalism that restricts the allocation of economic resources and opportunity to a country's privileged elite or politically connected cronies [<i>friends</i>] (Enderwick, 2005, p. 117)
An economic system in which the adjudication of commercial disputes as well as the allocation of resources are generally made to favor those who have a close relationship with political leaders or government officials (Wei, 2001, p. 16)
A derogatory or derisive description of the illegitimate use (or abuse) of public authority to favour businessmen or business firms who have close relations with those exercising that public authority. (Mazumdar, 2008, p.3)
State incumbent generation of uneven distribution of property rights in favor of a few politically-selected firms as a tactic to retain their political power beyond mere self-enrichment (Adly, 2009, p.8)

Aligica & Tarko (2014) suggest that crony capitalism is a distinct type of rent seeking society, in addition to the other types of rent seeking societies discussed in the literature, namely, classic mercantilism, real life socialism, and state capitalism. They argue that in crony capitalism rent seeking structure is legitimized by a populist ideology, which is quite different than the ideologies that legitimize other types of rent seeking societies (religion and military concerns in mercantilism, utopian socialism in real-life socialism, and nationalism in state capitalism). They explain that pragmatism is the main legitimizing rhetoric for crony capitalism in which institutions suggest that cronyism is an efficient, “middle of the road”, way of getting things done (Aligica & Tarko, 2014).

Whether to agree with such categorization or not, I submit that the main characteristic of crony capitalism, meaning the practice of cronyism, is inevitably present in any society to some extent. The fact is that public policies mostly emerge from a collective decision making process in which several stakeholders, including businessmen and government officials' cronies, are influential and have the ability to bias the process to their own benefit (Arshed, Carter, & Mason, 2014). Moreover, governments are not

“omniscient benevolent dictators” who can access unbiased information in every context and set fair rules and enforce them unequivocally in every situation (Holcombe, 2013). Therefore, policy makers’ and government bureaucrats’ decision making can be partially biased by their social networks, either directly through their relationships or indirectly through biased information they get from people who are connected to them.

Such a biased decision making process can result in the emergence of policies/decisions that discriminate against some actors and favor others, meaning that, some degree of crony capitalism is inevitable in any context. However, other institutions are able to either suppress or promote this inevitable level of cronyism in a context. From an economic perspective, the important factor is how much the level of cronyism distorts competitive market forces and determines economic success in a business context. In a purely crony capitalism system, profitability of a business highly depends on its political connections (Sobel & Graefe-Anderson, 2014). Businesses have no choice but to engage in cronyism, especially with government officials, to survive (Holcombe, 2013). The more the business performance in a certain society depends on engagement in cronyism, the more crony capitalistic that society is.

Concluding marks

In this dissertation, the word ‘cronyism’ is used to refer to the practice of cronyism, an exchange of favor between two parties based on their connection at the expense of a third party, and the term ‘crony capitalism’ is used to refer to an economic system in which cronyism is a common practice. An economic system is considered pure crony capitalism if its business performance in that system highly depends on

engagement in cronyism. Once consequences of cronyism are discussed in the following sections, it becomes clear that other characteristics attributed to crony capitalism originate from prevalence of cronyism as a widespread practice in crony capitalism.

Finally, an important point about the definition of cronyism needs to be highlighted here. Cronyism is favoritism based on social ties. Therefore, a practice of cronyism includes both favoritism and connection. In prior research, scholars have studied cronyism but mostly labeled it either favoritism or connection (e.g. Fisman, 2001; Faccio, Masulis, & McConnell, 2006; Franck & Rainer, 2012; Zhou, 2013). However, in most cases they assumed that one implies the other, meaning that, connection result in favoritism and favoritism happens through connections.

For instance, Zhou (2013) investigates the effects of political connections on entrepreneurial reinvestments in China. He defines politically connected firms as “those whose largest owners are closely related to at least one current government official” (Zhou, 2013, p. 302) and posits that firms with political connections enjoy higher levels of reinvestments because of their facilitated access to resources and opportunities and their highly protected property rights. In fact, this is an investigation of cronyism’s effect on entrepreneur’s ability to secure reinvestments, but labeled as a political connection study that assumes connections result in favoritism.

This interpretation of cronyism as the simultaneous existence of favoritism and connection in practice is in line with Khatri et al.’s (2006) four criteria for cronyism definition: “(1) there must be no immediate return of the favor or explicit agreement to return it (2) something of value must be given (3) the parties must share membership in a

social network (4) it must come at a third party's expense.” (Khatri et al., 2006, p.70). Having a connection satisfies criterion (3) and favoritism, defined as “the practice of giving unfair preferential treatment to one person or group at the expense of another” (Oxford Dictionary), fulfills the other criteria. (1) In favoritism the party who receives a favor is not obligated to return it immediately in a specific way, even if he is expected to somehow compensate for it in future. Otherwise, it is not described as a favor. (2) Obviously favoritism provides some valuable advantageous for receiver of the favor, which makes it unfair to others. (4) Favoritism, at least, violates people's right to benefit from fair, impartial, and equitable treatments in society. The following sections discuss how such a sense of unfairness constrains people’s ambitions and diverts societies’ talents toward unproductive entrepreneurial behaviors (Baumol, 1990). Therefore, to decide whether a practice is cronyism or not, one needs to look for existence of both favoritism and connection in that practice.

One last point on definition of cronyism is that the connection between two parties can be based on any type of social relations, such as family, friendship, ethnicity, ideology, religion, workplace, or any other grouping category (Khatri et al., 2003). Therefore, cronyism includes different types of favoritism, such as, ethnic favoritism (Favoritism based on same ethnicity), political favoritism (favoring others based on their similar political view), or family favoritism (also called nepotism referring to employment of relatives and family members in same organization (Ford & McLaughlin, 1986)).

In next section, differences between cronyism and two similar concepts are discussed to further clarify the concept of cronyism.

Cronyism and similar concepts

There are few other concepts in the literature that have large overlaps and are often confused with cronyism. Here, the two most similar concepts to cronyism are considered to explain the distinction between them and cronyism. Table 3 summarizes the main differences between cronyism and these other concepts, namely, rent seeking, and corruption.

Table 3 – Cronyism and Similar Concepts

Relation to similar concepts	
Rent-seeking	<ul style="list-style-type: none">• Cronyism involves rent seeking activities, however, there are many other types of rent seeking activities that do not involve exchange of favors.
Corruption	<ul style="list-style-type: none">• Cronyism is mostly legal, however, corruption is always illegal.• Cronyism is socially expected/accepted in many countries, however corruption is socially rejected everywhere.• Cronyism can promote different types of corrupt behaviors and a corrupt context provides a suitable circumstance for cronyism

Cronyism and rent seeking - Some authors simply consider cronyism “as a morally loaded synonym for rent-seeking (e.g. Krueger, 2002)” (Aligica & Tarko, 2014, p. 158). However, these two concepts are quite different, yet related. “Rent” is defined as “that part of the payment to an owner of resources over and above that which those resources could command in any alternative use” (Buchanan, 1980, p. 3). It is clear that an act of favoritism produces rents for some parties who can then seek those rents for gaining economic values over what they normally can get absent such favors. Therefore,

cronyism is a practice through which some types of rents are produced and certain types of rent seeking behaviors are promoted. In other words, cronyism can be considered as one type of exchange relationships in which rent seeking occurs. However, rent seeking behaviors take many different forms and occur in several other types of exchange relationships that are not involved with exchange of favors between two parties. Also, as discussed, cronyism may have a more general meaning and refer to an economic system (crony capitalism) that mainly associates with rent seeking behaviors, but its meaning is not constrained to just rent seeking.

Cronyism and corruption - Corruption is defined as an exchange relationship that involves abuse of public power for private ends, such that it influence the allocation of resources in a context (Macrae, 1982). Hence, cronyism, especially in the form of public favoritism, can be considered as one type of corruption in many context (e.g. Li, 2009). However, generally speaking this is not always the case as the boundaries between corruption and cronyism are dependent on cultural norms (Wei, 2001). A government official's act of favoritism toward a family member is considered as a corrupt behavior in the western cultures; however it is expected/suggested as an ethical obligation in some eastern cultures.

Moreover, unlike cronyism, corruption is illegal almost everywhere. Cronyism is very tricky as it is difficult, if not impossible, to accuse someone of being involved in cronyism. Parties involved in cronyism try to hide it or justify their exchange of favor by many other reasons, such as public interest or consumer protection rationales (Smith & Sutter, 2012). That is why there are no court or indictment records on cronyism and it is considered to be a legal practice.

Finally, crony capitalism is a system that is associated with different types of corruption (Haber, 2002). Tonoyan et al. (2010) suggest that countries in which economic players exploit their close networks, such as kinship or friendship networks, in business to compensate for lack of formal institutions are very prone to different types of corruption, since they offer environments that attribute social values and honors to involvement in corrupt behaviors. In other words, cronyism promotes other types of corruptions in a society. For instance, un-connected individuals strive to compensate for their lack of connection by offering bribes to government officials and receive preferential treatments that their connected competitors benefit from because of their connections. Moreover, widespread corruption in a business context promotes people's propensity to engage in cronyism (Smith & Sutter, 2012). Consequently, cronyism promotes different types of corrupt behaviors and a corrupt context provides a suitable circumstance for cronyism. That is why crony capitalism is known for prevalence of both, cronyism and corruption, and the vicious reinforcing cycle between them.

Different forms of cronyism

Cronyism occurs in different forms. In the developed economies' context, cronyism mostly happens in the form of larger firms lobbying with the government for setting certain laws or regulations that benefit them. In contrast, in the developing economies' context, cronyism takes the form of business owners getting governmental contracts or acting beyond the law based on their personal relationships with politicians. In other words, in developed countries with rule of law, such as US, cronyism is a way to build entry barriers for not-favored businesses and reduce competition for favored ones, while in less developed countries with low levels of institutional developments such as

South American states, cronyism is a mechanism to secure private property rights through making implicit partnerships between the owners of property rights (favored business) and those who have the power to confiscate them (bureaucrats) (Aligica & Tarko, 2014).

In general, cronyism is complementary to formal economy in developed countries, meaning that favored firms get advantageous to participate in the formal economy (Aligica & Tarko, 2014). For instance, cronyism occurs in the form of lobbying, revolving doors between government official and industries they regulate, donations to political campaigns and favored charities, occupational licensing, and so forth (Smith & Sutter, 2012). However, in developing countries, cronyism is a complement to the informal economy, meaning that favored firms get advantageous to remain in the shadow economy and act beyond the law (Aligica & Tarko, 2014). For example, businessmen draw on their relationships, governed by reciprocity norm “You help me, I help you” (Ledeneva, 1998, p. 185), to find shortcuts in formal procedures. Arranging privileged conditions for getting loans, postponing tax payments, jumping off the queues for acquiring required licenses, speeding up bank operations, and settling business disputes at court are few examples of different forms of cronyism in developing countries (Tonoyan et al., 2010).

In conclusion, any type of privileges granted by government to businesses can be delivered through public cronyism (government-business). Examples include preferential subsidies, monopoly or quasi-monopoly grants, protection from international competition by means of tariffs and licenses, regulatory privilege, loan guarantees, tax privileges, bailouts, expected bailouts, and noncompetitive bidding (Mitchell, 2012). Examples of

private cronyism include "the old boys club" or "the golden circle", hiring friends and families, promoting incompetent connected personnel, preferential payments and treatments to close colleagues, or any other types of favoritism that occur between two private parties in the business context (Turhan, 2013).

Cronyism: Antecedents

Scholarly investigation of the antecedents of cronyism has attracted very little attention in the literature (Khatri et al., 2006). However, there are several factors at different levels of analysis that influence occurrence of cronyism in a context. For instance, at the micro-level, individuals' values and ethical standards influence their propensity for engagement in cronyism. At the meso-level, networks' characteristics and norms affect their members' tendency to get involved in cronyism. At the macro-level, government, history, and institutional frameworks can influence individuals' involvement in cronyism within a society. Here, a brief review of micro-, meso-, and macro-level antecedents of cronyism is offered.

Micro-level antecedents of cronyism

Individuals' basic desire to be members of different social groups and need to enhance their sense of belonging encourage them to get involved in cronyism (Khatri et al, 2006). A bureaucrat who favors a friend's firm over other firms, not only believes that his/her friend will reciprocate appropriately in a later time, but also gains positive affect from offering that favor to his/her friend and strengthening their friendship. However, this is not always the case, as people's cognitive beliefs and ethical values determine how they feel about engagement in cronyism. For instance, for someone who believes "the

end justifies the means” (Machiavellianists), cronyism would be a perfect practical option (Tonoyan et al., 2010), while for someone who believes in fair business practices, engagement in cronyism would be a red line.

Meso-level antecedents of cronyism

As mentioned earlier, cronyism is also described as “downside of social networking” (Khatri et al., 2003). Network characteristics, such as the basis (family, friendship, nationality, etc.) and strength of ties, influence the level of cronyism among network members. For instance, Begley et al. (2010) discussed how intra- and inter-network competitions in clique networks, group of strong ties, and entrepreneurial networks, group of weak ties, positively influence the level of cronyism within these networks. Moreover, they posit that network type, clique vs. entrepreneurial, moderate the positive effects of network competitions on the level of cronyism, such that, inter-network competition promotes cronyism more in cliques rather than entrepreneurial networks and intra-network competition leads to more cronyism within entrepreneurial networks compared to clique networks. Additionally, networks that are formed based on cultural bonding characteristics, such as *guanxi* in China (Khatri et al., 2006), *blat* in Russia (Ledeneva, 1998), and *Wasta* in Arab countries (Barnett, Yandle, & Naufal, 2013), instigate the occurrence of cronyism among their members.

Macro-level antecedents of cronyism

Prior research on cronyism has mostly focused on country-level analysis (e.g. Haber, 2002; Kang, 2002; Johnson & Mitton, 2003). Hence, macro-level antecedents of cronyism have attracted the most attention among scholars. Among all the other factors,

government is the main focus of scholars as they believe cronyism, especially in its public form, is an inevitable by-product of a big government (Holcombe, 2013). A big government offers a wide range of privileges and interruptive policies that provide a fertile context for cronyism (Mitchell, 2013). In addition to government, culture is another major antecedent of cronyism at the macro-level (Khatri et al., 2006). In general, certain cultural norms, such as norms of reciprocity and loyalty (Banfield, 1958), and cultural characteristics, such as collectivism and power distance (Turhan, 2013), promote people's tendency to engage in cronyism within a society.

Moreover, scholars extensively highlighted the path-dependent nature of societies' institutions and economic systems (Zingales, 2009). Prevalence of relationship-based economic activities as opposed to rule-based ones, for example in Asia or Latin America, is rooted in the country's history (Zhou, 2013). In other words, countries' institutional configurations can be seen as a result of their history (Loveridge, 2006). For instance, Barnett et al. (2013) posit that "Wasta can be traced to as far back as the 14th century. Ibn Khaldun points to the importance of a connection with the ruler in determining one's profit (Spengler, 1964)" (p. 42). Similarly, Morck & Yeung (2004) describe family governance and control over a country's corporate assets, which promote cronyism in a country, as a residue of history. Zingales (2009) also attributes the differences between American capitalism and other types of capitalism that are more cronyistic, to several historical factors specific to the US. For example, Zingales (2009) highlights that American capitalism developed at a time when the government spending in the economy was very low, less than 7 %, compared to other modern capitalist countries that emerged after World War II when government spending was about 30% in

Western European countries. He also posits that “in America, unlike much of the rest of the West, democracy predates industrialization ...this created a public with high expectations, unlikely to tolerate evident unfairness in economic policy. It is no coincidence that the very concept of anti-trust law — a pro-market but sometimes anti-business idea — was developed in the United States.” (Zingales, 2009, p. 25). Therefore, factors that cause people in specific regions of the World to be more or less prone to engage in cronyism, may originate from the history of those regions and the people who have been living there in prior centuries.

Institutional theory offers an appropriate perspective to discuss antecedents of cronyism in different countries (North, 1990; Scott, 1995). An institutional perspective is able to capture the effects of current and historical factors that influence individuals’ tendency to get involved in cronyism within a country’s context. Institutions are rules of the game in each society that determine the incentives for engagement in different kinds of activities (Hira and Hira, 2000). Institutions are either formal (written rules, regulations, laws, etc.) or informal (social norms, beliefs, values, etc.) (North, 1990). Baumol (1990, 1993) suggests that the rules of the game at each society determines people’s pay off for engagement in productive, unproductive, or destructive entrepreneurial behaviors. Improper institutional frameworks degrade incentives to engage in productive economic activities and instead encourage people to engage in rent seeking behaviors, such as cronyism. Robinson & Acemoglu (2012) refer to such institutions as extractive institutions, as opposed to inclusive institutions, which encourage people to extract benefits from the others rather than to get involved in productive entrepreneurial activities that produce wealth for themselves and society.

In following sections, certain characteristics of a country's institutional framework that influence the level of cronyism at national level are highlighted. Since the main focus of this dissertation is an investigation of cronyism's implications for entrepreneurship at national level, I chose to focus on cronyism's consequences. However, empirical analysis of cronyism's antecedents is also an insightful research stream that needs further attention. The framework that is explained here, is an appropriate model for studying the antecedents of cronyism in future studies.

Formal Institutions - A significant body of research has formed around the notion that institutional environments may have different types of imperfections that can persist for several reasons, which discourage socially acceptable behaviors and creating unique challenges for firms and the society (e.g. Khanna & Palepu, 1997). Institutional imperfections refer to the aspects of societies' institutional environments that hinder or fail to support efficient and fair business practices, and ultimately the attainment of societal needs and goals, even when the intent exists for the institutions to do so. Once the institutional arrangements are such that cronyism (seeking and offering favors) pays off more than productive economic efforts, it is more likely that people invest in cronyism instead of productive economic activities (Aligica & Tarko, 2014). Here, a few types of institutional imperfections, namely, institutional voids, institutional weakness, institutional inefficiency, and institutional uncertainty, are suggested as antecedents of cronyism.

Institutional void means absence, paucity or insufficient development of formal institutions, especially market supporting institutions and intermediaries that help to build a fair competitive business context (Khanna & Palepu, 1997). There are several examples

of Institutional voids that promote cronyism in a society. Capitalism calls for the existence of several types of formal institutions, such as independent judiciary, autonomous specialists, market supporting intermediaries, national agencies, a professional public service, a free media, and an active civil society, that are required as a check and balance systems to resolve government's credible commitment problem – making sure that government will not usurp private property rights while it has the right to distribute and protect private property rights (Haber, 2002). Absence or insufficient development of each of these institutions can trigger the rise of crony capitalism. For instance, in developing countries' business context, lack of sophisticated financial assessment institutions leads to a system in which bank officials offer loans to businesses based on subjective measures or relationships, which nurture a suitable context for cronyism. Consequently, the higher levels of cronyism in developing countries in contrast with developed countries can be attributed to higher levels of Institutional voids in these contexts.

Institutional weakness refers to the limited authority, whether in terms of scope, power, regulatory capacity, and/or dominance, of institutions to enforce codified rules. Institutional weakness simply means the poor status of “rule of the law” in a country. Once property rights are weakly protected and there are weak institutional limits and safeguards to what government can do in a country, cronyism appears as a solution for businessmen to make partnership with the government and build an overlap between their self-interest and government's interests to protect themselves against weak property rights, insufficient contract laws, and arbitrary enforcement of business regulations (Tonoyan et al., 2010). Bureaucrats also get involved in cronyism to gain business elite's

support and secure their power position. As rule of law and protection of property rights get stronger in a region, the influence of political connections on business performance decreases (Zhou, 2013). Furthermore, institutional weakness let political interest groups grow, solidify, and establish their power relationships in a society and secure favors for themselves through their connections (Olson, 1982).

Institutional inefficiency refers to misallocation of resources and distortions of incentives by burdensome institutions that undermine efficient market transactions overall. A few examples of such Institutional inefficiencies include overwhelming taxation, burdensome regulatory frameworks for starting and managing a business, extensive license requirements and so on. Once government imposes unjustified costs through taxation and regulations to businesses, they have no other choice but to actively engage in political processes and participate in crony capitalism for their survival (McChesney, 1987). Moreover, inefficient policies produce rents and promote cronyistic efforts for capturing those rents. Regulatory capture theory (Stigler, 1971) explains how regulations end up benefiting regulated economic actors in the long run instead of serving the public interest. Once certain regulations are set, economic players adjust their behaviors in the short run, but in long run start developing relationships with regulatory agencies to influence them and ultimately capture value from those relationships at the cost of public, which means burdensome regulations lead to more opportunities for cronyism.

Institutional uncertainty refers to conditions in which too much discretion is left to individuals and organizations as to how to set legitimate goals and operate in socially acceptable ways, either due to conflicting institutions, ambiguous policies, complex rules,

or overlapping procedures. Political discretion is one example of institutional uncertainty which grants politicians the right to use their own subjective criteria to make decisions about favoring some over the others in uncertain situations (Holcombe, 2013). Cronyism rises once government officials have too much discretion over how to use their power in decisions related to the private sector (Henderson, 2012). Institutional uncertainty also allows businessmen to be able to collude with bureaucrats more easily and circumvent rules and regulations at their own benefit and at the public's expense (Douhan, & Henrekson, 2008).

Informal Institutions - National culture is one of the main categories of informal institutions within every country that influence individuals' tendency for involvement in cronyism. Culture reflects social values, beliefs, and preferences within a national context (Hofstede, 1991). Therefore, it can shape individuals cognitive beliefs and values for or against the involvement in cronyism. Cultural norms guide how and when individuals are expected to favor others or reciprocate their previous favoritism. Prior research suggests that cronyism is more likely to happen in a vertical rather than horizontal culture (Khatri et al, 2006). In a vertical culture with higher power distance among members of society, people accept authorities' power more readily and compete for gaining their favors as a secure way to gain advantage over others. Also, those in power feel a critical need to secure their power position through favoring connected individuals in exchange for their loyalty. However, in horizontal cultures it is more likely that the parties, whose interests are hurt by acts of favoritism, speak up and receive support from others; as such acts violate the principle of equality in these cultures.

Individualism and collectivism are cultural characteristics that are extensively used to describe national cultures. Prior research suggests that individualistic values work against promotion of cronyism in a country (Khatri et al., 2006). In an individualistic culture, people act as autonomous entities independent of others and have their own personal goals which may or may not overlap with other people's goals. Individualistic people emphasize task achievements even at the expense of relationships and therefore are less probable to get involved in cronyism which requires them to favor others with anticipation for future reciprocation. Hence, it is reasonable to believe that cronyism is relatively less prevalent in countries with individualistic cultures.

In contrast, collectivism dimension of national culture can be described in two different dimensions (House et al., 2004; Taylor & Wilson's, 2012). An in-group collectivism dimension, called familism or localism, which reflects the level of "pride in, and loyalty to, small groups such as family, organization, circle of close friends, etc." (Taylor & Wilson, 2012, p. 238) and an institutional collectivism, called patriotism or nationalism, which reflects "the degree to which organizational and societal institutional practices encourage and reward collective distribution of resources and collective action" (House et al., 2004, p. 12). Capitalism's institutions promote beliefs about a shared economic nationalism in which "the economic fate of the individual is seen as related in an abstract fashion to that of the nation-state" (Loveridge, 2006, p. 119). Nationalism as the main legitimizing tool in a capitalist system rejects the idea of localism and degrades the value of cronyism, which is basically favoring the interests of specific local groups, such as family or friends, over national interest (Aligica & Tarko, 2014). Describing Wasta in Arabic societies as "an implicit social contract, typically within a tribal group,

which obliges those within the group to provide assistance (favorable treatment) to others within the group” (p. 41), Barnett et al. (2013) posit that “where tribal ties dominate national interests, a social convention (like *wasta*) that favors the interests of tribal members above national interests is likely to be viewed as both logical and virtuous” (p. 44). Similarly, prior research found higher levels of corruption and nepotism in countries with higher familistic cultures (Lipset & Lenz, 1999). Therefore, the strength of nationalism is an underlying informal institution in a society that influences individual’s level of national identity positively and his/her general tendency to get involved in cronyism negatively. In contrast, it seems reasonable to believe that individuals in familistic cultures would be more inclined to favor their local network’s in-group member over other members of society.

Cronyism: Consequences

Unlike antecedents of cronyism, its consequences have been a main focus of prior research. Indeed, cronyism is well known as a major cause of the economic crisis and fall of East Asian economies in mid 1990s even after enjoying high rates of economic growth for some decades (e.g. Rasiah, 1998; Wade, 1998; Henderson, 1999; Enderwick, 2005). Scholars have examined effects of cronyism across many countries and industries. Consequently, there is a wide range of cronyism’s effects that are discussed in the literature.

For example, Enderwick (2005) discusses four main categories of cronyism’s costs, including, allocative inefficiencies (dominance of family business structure with poor governance, firm’s excessive diversification and short term bias due to fear of

political changes), dynamic inefficiencies (low rates of innovation and technical change, impediments to corporate restructuring), corruption and high transaction costs (specially as it discourages foreign investments and hurts small firms), and problems of social and political stability (mutual hostage situation between politicians and business leaders) (Enderwick, 2005). Similarly, Mitchel (2012) describes nine types of costs associated with government privileges that are often granted through cronyism, including, monopoly costs, productive inefficiencies (X-inefficiencies), inattention to consumer desires, rent-seeking, distributional effects, unproductive entrepreneurship, loss of innovation and diminished long-run economic growth, macroeconomic instability, and diminished legitimacy of government and business (Mitchel, 2012). In the following sections, the major consequences of cronyism are highlighted and grouped in three categories: social, political, and economic consequences.

Social consequences of cronyism

Cronyism is one major factor that contributes to higher levels of income inequality in a society by distributing wealth to elites at the expense of public and especially the poor (Walder, 2002). Cronyism enables a few families, special interest groups, or government cronies to receive unfair advantages over other economic players in a society and get facilitated access to resources and opportunities that allow for the accumulation of wealth (Zhou, 2013). In fact, crony capitalism can be identified as the concentration of control over a large part of a country's resources and corporate assets in hands of few families and groups (Morck & Yeung, 2004; Singh & Zammit, 2006). Moreover, dynamism of cronyism, the exchange of favors between government and family business groups, exacerbates inequality in a society and prevents unconnected

individuals from obtaining wealth and moving up in society (Loveridge, 2006). Low levels of social mobility and inequality in a society leads to major social costs including the promotion of corruption and higher crime rates.

Additionally, cronyism promotes lobbying efforts and cartel activities in a society, which often lead to the promotion of corruption as well as influence the evolution of attitudes and culture within a society (Smith & Sutter, 2012). Once cronyism becomes a widespread business practice in a society, it provides rationale for more people to engage in cronyism and other corrupt business practices, which undermines ethical standards in that society (Tonoyan et al., 2010). In such a society, if an entrepreneur is unable or unwilling to seek or offer favors, he is considered as a failure rather than an ethical businessman. Tonoyan et al., (2010) suggest that countries in which economic players exploit their close networks, such as kinship or friendship networks, in business to compensate for lack of formal institutions, meaning that cronyism is a common practice there, are very susceptible to different kinds of corruption since in those countries social values and honors are attributed to involvement in corrupt behaviors.

Finally, cronyism leads to deadweight loss in a society, since it produces barriers to entry and reduces competition in an industry, which leads to lower level of total sales in the industry compared to situations where competition is high. Hence, gains of favored firms in an industry are less than the losses of the non-favored ones. In such circumstance, consumers and society as a whole becomes worse off (Mitchell, 2013). Cronyism affects consumer welfare negatively, since consumers cannot access high quality products/services that they would have been able to benefit from in a competitive market. They even may end up paying higher prices for lower quality products/services

that are offered to them by favored firms (Thierer & Skorup, 2013). Overall, these effects end up lowering people's trust in societal institutions, including the government and businesses, which promote narrow self-interest among people and undermine their contribution in improvement of their society (Khatri et al., 2006; Mitchell, 2013).

Political consequences of cronyism

Pervasiveness of cronyism in a system, builds a political market for connections, in which connections to different power positions have different prices that firms are willing to pay in hope of the future favors that they can receive through those connections (Fisman, 2001). For instance, i Vidal, Draca, & Fons-Rosen (2012) found that lobbyists who have connection to a US senator lose 24% of their revenues once that senator leaves office. Just being connected to someone in power signals the ability to receive favors and gain abnormal advantageous. Acemoglu et al. (2013) found that firms captured a 6% abnormal return if they were connected to Timothy Geithner one day after announcement of his nomination for Treasury Secretary in November 2008. Obviously, such returns was not because of favoritisms that those firms could receive in that one day, but because of people's positive perceptions about future favors that they can receive through their connections to Treasury Secretary. Additionally, market value of political connections results in a revolving door (movement of government officials into lobbying industry or businesses that they used to serve) between government and business (i Vidal et al., 2012).

Cronyism promotes political authoritarianism by suppressing political competitions and other appropriate institutions that support democratic processes (Morck

& Yeung, 2004). Once cronyism is a common practice, businesses often have no choice but to engage in cronyism and gain profit through politicians' favoritism and, in exchange, support those politicians to stay in power (Holcombe, 2013). Therefore, politicians and favored businesses get locked into a situation of mutual dependency, mutual hostage problem, in which, change by one part threatens position of the other part (Enderwick, 2005). In such a system, both parts have a short term focus at the expense of long-term benefits to society. Consequently, politicians set rules and policies that lead to maximum political support for themselves, and businesses strive to benefit from politicians' favoritism as long as they are in office (Becker, 1983).

Economic consequences of cronyism

Cronyism is known to have a wide range of economic consequences; however, these effects are different based on the level of analysis and time frame. At the organizational level, most scholars studied effects of political connections on firm's performance, with underlying assumption that political connections lead to favoritism. In general, having political connections benefits a firm's overall performance, especially when the firm is small and at the earlier stages of their development (e.g. Li & Zhang, 2007; Li et al., 2008; Xin & Pearce, 1996; Zhou, 2013). However, cronyism's long-term effects are uncertain and can be even detrimental to firm performance as it undermines firm's ability to plan for the long-term and diverts its efforts to political rent seeking instead of working on its core competencies and building sustainable competitive advantages (Enderwick, 2005; Tahoun, 2014). The same patterns are true at the societal level. Cronyism's effects are known to be different for countries at different stages of development, such that, cronyism may have some short-term benefits for countries at

earlier stages of development, but the costs become progressively higher in the long-run as countries become more developed (Shleifer & Vishny, 1994).

Organizational-level economic consequences - At the organizational level, cronyism provides strong protection of property rights and facilitated access to resources and opportunities for politically connected firms, especially in under-developed regions, in which lack of formal institutions are substituted by cronyism (Zhou, 2013). There are numerous empirical findings from developed and developing countries that suggest firms with political connections enjoy higher financial performance in market as they either receive or at least are perceived to receive favors through their connections (e.g. Acemoglu et al., 2013; Faccio, 2006; Faccio, Masulis, & McConnell, 2006; Fisman, 2001; Chen, Parsley, & Yang, 2013; Borisov, Goldman, & Gupta, 2013; Hill, Kelly, Lockhart, & Van Ness, 2013). For instance, Cooper and his colleagues (2010) report positive future stock-market returns for companies that had higher contributions to US political campaigns from 1979 to 2004. Similarly, Claessens, Feijen, & Laeven (2008) found that politically connected firms with higher campaign contributions in Brazil enjoy higher stock performance and easier access to bank finance.

In contrast, there are studies that either fail to find any significant effects between firm's political connections and its performance (e.g. Fisman et al., 2012) or suggest that politically connected firms underperform compared to unconnected firms (Faccio, 2010; Duchin & Sosyura, 2012). For instance, Tahoun (2014) documents that politically connected firms enjoy easy access to government contracts, however, once they lose their connections, firm performance suffers drastically and they underperform other firms. Similarly, Faccio (2010) shows that favored firms' accounting performance are lower

compared to others. Also, Duchin & Sosyura (2012) report that investments in connected firms underperform investments in other firms, meaning that connected firms suffer from investment inefficiencies. Sobel & Graefe-Anderson (2014) show that favors toward connected firms end up benefiting the firms' managers rather than the firms' performance.

In conclusion, I submit that cronyism influences firms' performance more favorably when firms are smaller and at the early stages of their development, especially in regions with less developed institutions (Peng & Luo, 2000; Zhou, 2013). In such a context, cronyism helps new ventures to overcome the liability of newness and survive in competition with larger firms. However, as firms grow, they are required to focus on developing their core competencies to gain sustainable competitive advantage in the long term. Dependence on cronyism distracts firm's investments in building its own capabilities, wastes its resources in political games, and makes it short-sighted (Enderwick, 2006). Consequently, although cronyism may provide firms with short-term financial incentives, it endangers their long-term profitability and survival. Moreover, costs associated with engagement in cronyism surpass its benefits for firms as institutional frameworks develop in a context, since more developed institutions have more checks and balances against involvement of agents (bureaucrats and businessmen) in cronyism (Shleifer & Vishny, 1994; Zhou, 2013). Therefore, firms in less developed countries benefit more from engagement in cronyism compared to their counterparts in developed countries. The next chapter explains how cronyism leads to firm's ignorance to develop its dynamic and innovative capabilities, which is a major long-term disadvantage of depending on cronyism (Baumol, 1990).

National-level economic consequences - Similar to organizational level consequences, cronyism has different effects in countries that are in different stages of economic development. In developed economies, cronyism slows down economic growth by restricting economic freedom, producing barriers to entry, increasing lobbying efforts, and disrupting market competitions (Smith, & Sutter, 2012). However, in developing countries, cronyism is often considered as the second best solution to government's credible commitment problem and makes economic growth possible in the absence of political stability and the rule of law (Aligica & Tarko, 2014).

Crony capitalism rises in response to government's credible commitment issue (Haber, 2002). Businesses need to make sure that government is not able to usurp their property right, while it has the right and power to distribute and protect property rights in society (Enderwick, 2005). Capitalism's solution to this issue is a "limited government" accompanied with several other institutions, such as independent judiciary, central and local governments, autonomous specialists, national agencies, a professional public service, a free media, and an active civil society, to check and balance the system. However, it is costly, complex, and a long process to develop such institutions in a society, and few countries in the world have managed to develop institutional frameworks close to capitalism's ideal model. Consequently, crony capitalism rises as a practical alternative to make 'doing business' possible in absence of developed formal institutions (Aligica & Tarko, 2014). Cronyism is the second best solution that fulfills both businesses' and government's interests through building partnerships between them.

Therefore, in the short term, cronyism helps with the process of doing business and economic growth; however, in the long term, as countries transition to higher stages

of economic development and fail to develop their institutions, cronyism's costs dominate its benefits and it becomes detrimental to both doing business and economic growth (Morck, Wolfenzon, & Yeung, 2005; Singh & Zammit, 2006; Zhou, 2013). Once cronyism has persisted as a major practice in a country for a long period of time, its consequences cause the economic system subject to different types of inefficiencies and failures that endanger well-being of the system (Loveridge, 2006; Li, 2009). For instance, Wei (2001) posits that cronyism is a signal of the potential for a financial crisis as it causes a country to be more dependent on volatile international capital flows (e.g. international bank loans) and undermines its ability to attract less volatile capital flows (e.g. foreign direct investment). Ideally, countries need to avoid the destructive effects of widespread cronyism in their economic development path and build their institutions such that businesses transition from network-based strategies to market based strategies as countries' economic systems evolve (Loveridge, 2006; Li, 2009; Barnett et al., 2013).

Prevalence and persistence of cronyism as a major business practice leads to different types of inefficiencies, allocative and dynamic or X-inefficiencies (Leibenstein, 1966; Enderwick, 2005). Favoritism toward government cronies leads to the misallocation of resources and concentrates corporate assets into the hands of a few connected families and groups in a country (Morck & Yeung, 2004). Cronyism results in the persistence and dominance of poor forms of corporate governance, such as family business governance, that are mostly inefficient in adopting new methods of organization and production (Loveridge, 2006; Barnett et al., 2013). Different forms of cronyism produce barriers to entry for new firms, which shield inefficient protected industries that have no comparative advantage (Enderwick, 2005). Moreover, cronyism reduces market-

based competitions among firms. Lack of competitive forces in the market place allows businesses not to do their best and not to push themselves to develop efficient business practices/ routines as hard as they would push in a competitive context. This is generally called X-inefficiency (Leibenstein, 1966), which is one major cost of cronyism in a business context (Mitchell, 2013).

Finally, the most destructive effect of cronyism is its tendency to discourage corporate restructuring and innovative economic behaviors (Enderwick, 2005). Cronyism produces economic rents, promotes rent seeking behaviors, and discourages wealth creation through productive entrepreneurship (Baumol, 1990). Morck & Yeung (2004) found that family control over a country's resources is associated with less innovation and more political rent seeking, which is the "self-interested dealings between the political and business elites" (p. 391) (see also, Morck, Stangeland, & Yeung, 1998). Similarly, Lenway, Morck, & Yeung (1996) used data from US steel firms to show that trade protections, so often granted through cronyism, decrease the incentives to innovate and discourage engagement in the Schumpeterian process of creative destruction for firms. I argue that cronyism almost always has negative influences on innovation and productive entrepreneurship and this is why as countries transition through different stages of economic development, namely, factor-driven stage, efficiency-driven stage, and innovation-driven stage, cronyism's costs become more pronounced compared to its benefits. Cronyism's negative effects on innovation and productive entrepreneurship at the national level are the main focus of this research. I use Baumol's (1990) model of productive, unproductive/destructive entrepreneurship to discuss about these effects in next chapter.

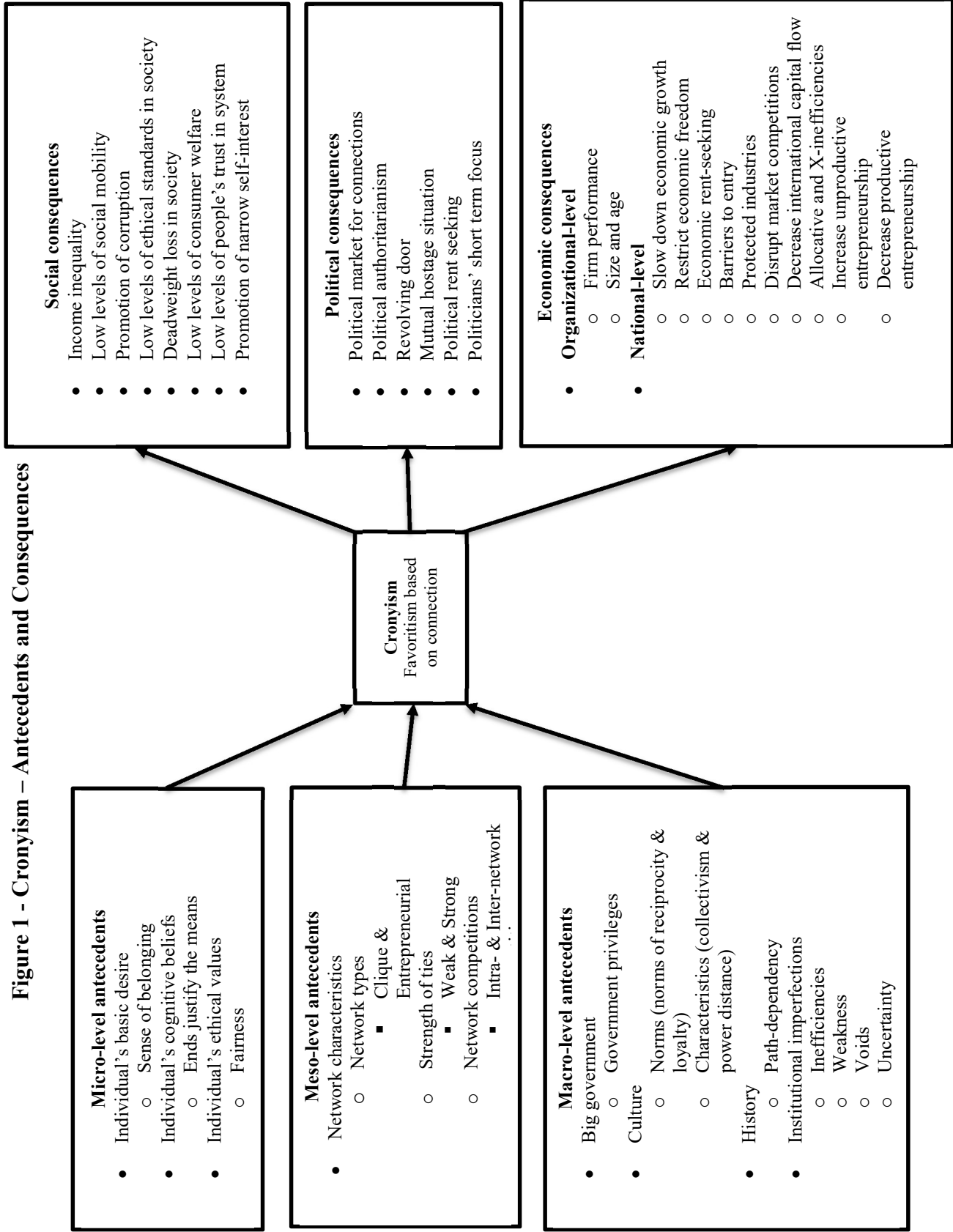
One last important point about the consequences of cronyism in a country is that cronyism causes more cronyism (Holcombe, 2013). Once people see a practice, such as cronyism, becomes widespread in a context, they invest in adopting that practice more easily and at a faster rate, even if it's illegal or prohibited (Tonoyan, et al., 2010). Moreover, cronyism's consequences and antecedents are very much inter-dependent, meaning that its consequences can instigate its antecedents. That's why crony capitalism is known as a complex combination of cronyism's consequences and antecedents. Countries that fall into the "idea trap" of crony capitalism will have their private and public resources becomes locked into promotion of such system, and will fall into a reinforcing vicious cycle that is able to destroy or obliterate the whole economy of a country in the long run.

Figure 1 is an illustration of the antecedents and consequences of cronyism in prior research, which is briefly discussed in this chapter.

Productive and Unproductive Entrepreneurship

Ever since Schumpeter proposed his creative destruction hypothesis in the 1930s and defined entrepreneurship as activities that involve different types of innovations (new product, new process, new supply, new market, and new organizing method), entrepreneurship has been at the center of scholars' attention because of its positive effects on economic development and growth (Reynolds et al., 1999; Zacharakis et al, 2000). However, recently scholars have pointed out that entrepreneurship does not necessarily include innovations in productive ways as Schumpeter originally suggested, but can also comprise of different types of unproductive innovations, including

Figure 1 - Cronyism – Antecedents and Consequences



“innovations in rent-seeking procedures, for example, discovery of a previously unused legal gambit that is effective in diverting rents to those who are able and willing to exploit them.” (Baumol, 1990, p. 897). Therefore, it is important to make a distinction between productive and unproductive entrepreneurship when antecedents and consequences of entrepreneurship are investigated.

Productive Entrepreneurship (PE) refers to activities that increase the innovativeness, adaptability, and dynamicity of an economy, and create wealth for entrepreneurs and their society (Baumol, 1990; 1996; Sobel, 2008; Douhan & Henrekson, 2008). Examples include product/service innovations, business model innovations, commercialization of new technologies, and establishment of new firms. These activities are also called productive market entrepreneurship as they are considered to be legal, legitimate, and typical activities within market (Folsom, 1991; Sobel, 2008).

In contrast, Unproductive Entrepreneurship (UE) refers to unproductive innovative activities that mostly destroy wealth in an economy and results in positive returns for certain individuals at expense of other individuals and society (Baumol, 1990; 1996). Examples include innovation in rent seeking activities such as lawsuit abuse (finding new ways to sue people) by lawyers, discovering new ways of securing money for elections by lobbyists, Gerrymandering (manipulating district boundaries to create partisan advantaged districts), Swindling, and etc. (North, 1990; Baumol, 1990; 1996; Douhan & Henrekson, 2008). These activities are also called unproductive political entrepreneurship as they often happen through manipulation of political and legal processes and aim to circumvent institutional frameworks, without necessarily an explicit

violation, to transfer wealth to those who are involved in such activities (Folsom, 1991; Sobel, 2008; Douhan & Henrekson, 2008).

In economic term, productive entrepreneurship shifts the production possibility frontiers (PPF) outward, while unproductive entrepreneurship shifts PPF inward in a society (Coyne & Leeson, 2004). PPF represents the maximum possible economic output of a society, given all the available inputs (resources, labors, raw materials, etc.).

Productive entrepreneurs introduce innovative recombination of resources; hence they make it possible to reach higher levels of output using the available inputs. However, unproductive entrepreneurs redistribute resources in innovative inefficient ways to their own benefits, such that their acts decrease the maximum possible output for a society given their available inputs (Coyne et al., 2010).

Baumol's model

Baumol's model explains how individuals choose to engage in productive or unproductive entrepreneurship within a certain context (Baumol, 1990; 1993; 1996). Baumol's main thesis is that people choose between involvement in productive and unproductive entrepreneurship by considering the relative return that each one provides for them. Relative return of productive and unproductive entrepreneurship is determined by the rules of the game, institutions, in each context and signals potential entrepreneurs how attractive is to pursue each path. In other words, Baumol describes a utility maximization model that potential entrepreneurs use to choose between involvements in productive vs. unproductive entrepreneurship (Sobel, 2008).

In his seminal paper, Baumol (1990) discusses several instances throughout the history of mankind in different societies in which relative rewards to different types of entrepreneurial activities determined the pattern of entrepreneurial efforts in that context. For example, he explains how the rules of the game degraded the pursuit of wealth through productive business activities in ancient World. Additionally, he explains about a story of a man in ancient Rome that lost his head because of inventing unbreakable glass and turning it over to the emperor in hopes of reward. Overall, Baumol concludes that “it is the set of rules and not the supply of entrepreneurs or the nature of their objectives that undergoes significant changes from one period to another and helps to dictate the ultimate effect on the economy via the allocation of entrepreneurial resources.” (Baumol, 1990, p. 894).

Murphy et al. (1991) echoed Baumol’s model by demonstrating how relative return of involvement in productive vs. unproductive efforts influences allocation of a country’s most talented individuals among different activities. They posit that talented individuals aspire to capture the rents derived from their talents in most promising ways and enter occupations that reward them with reasonable return for their talents. They present empirical evidence that shows “occupational choice depends on returns to ability and to scale in each sector, on market size, and on compensation contracts.” (Murphy et al., 1991, p. 503). In countries that rent seeking rewards talent more than entrepreneurship does, talented individuals choose to study law degrees more often than they choose to study engineering (Magee, Brock, & Young, 1989; Murphy et. al, 1991).

Since the presentation of Baumol’s idea in 1990, there have been several studies that further developed and discussed Baumol’s model of productive, unproductive, and

destructive entrepreneurship (e.g. Baumol 1990; 1993; 2002; Boettke, 2001; Boettke & Coyne, 2003; Coyne & Leeson, 2004; Kreft & Sobel, 2005; Ovaska & Sobel, 2005). As a prominent example, Sobel (2008) tests Baumol's model and provides strong empirical support for this model in the US. Sobel (2008) examines the relationship between the measures of quality of institutions in different states and the level of productive and unproductive entrepreneurship in those states. He finds that better institutional frameworks (more secure property right regime, more balanced and fair judicial system, stronger contract enforcement, etc.) promote productive entrepreneurship (higher venture capital investments, higher rate of patents, faster rate of sole proprietorship growth, and higher establishment birth rates) and reduce unproductive entrepreneurship (lobbying activity and legal quality/lawsuit).

In sum, Baumol's model explains that the rules of the game determine rewards to productive vs. unproductive entrepreneurship in any context and the relative return to those activities influence allocation of resources to productive vs. unproductive entrepreneurship in that context. Murphy et al., (1991) clarifies Baumol's model by explaining how such relative returns influence allocation of talents within a country between productive and unproductive occupations. They also demonstrate how allocation of countries' talents between productive vs. unproductive entrepreneurship is related to their economic growth rate. Those countries in which the rules of the game encourage individuals to adopt unproductive occupations over productive ones, suffer from slower rates of economic growth (Magee et al., 1989; Murphy et. al, 1991). Therefore, it is crucial to understand how the rules of the game determine payoff for productive and unproductive entrepreneurship in a certain context.

Institutions as rules of the game

Baumol's model is built upon the notion that the rules of the game determine relative return to engagement in productive vs. unproductive entrepreneurship in each society (Baumol, 1990). As discussed earlier, "institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." (North, 1990, p. 3). These institutions are either formal (written rules, regulations, laws, etc.) or informal (social norms, beliefs, values, etc.) (North, 1990). Institutions, as the rules of the game, constrain or promote certain types of behaviors and interactions among players, entrepreneurs or organizations, in a society (Hira & Hira, 2000). Therefore, formal and informal institutions are major determinants of entrepreneurial activities in a certain context, since they govern the relative, pecuniary and non-pecuniary, return of entrepreneurial activities, including both PE and UE (Acemoglu, 1995).

Research on institutions' effects on entrepreneurial behaviors has attracted extensive attention within entrepreneurship and institutional economics discipline (e.g. Puffer, et al., 2010; Gohmann, 2012; Boudreaux, 2014). Examples of institutions that promote PE and discourage UE include the rule of law, secure property rights, strong contract enforcement, free trade, efficient tax codes, fair and transparent business practices, and so on. Sobel (2008) posits that institutions that are measured by economic freedom index² (Gwartney & Lawson, 2005) are "precisely those institutional structures

2- Economic freedom index measures institutions' quality in ten categories, namely, property rights, freedom from corruption, fiscal freedom, government spending, business freedom, labor freedom, monetary freedom, trade freedom, investment freedom, and financial freedom.

that should lower the return to unproductive entrepreneurship, promoting productive entrepreneurship over unproductive entrepreneurship” (Sobel, 2008, p. 645). Acemoglu & Robinson (2012) refer to such institutions as inclusive institutions, those institutions that help produce wealth for individuals and society, as opposed to extractive institutions, those that help elites to extract wealth for themselves at the expense of others and society.

One major type of institution that determines relative payoff for involvement in productive vs. unproductive entrepreneurship in a country is entrepreneurship policy (Minniti, 2008). There are several studies that have investigated the effects of government policy and programs on the level of entrepreneurial behaviors within different countries (e.g. Brenner, 1987; Minniti, 2008; Lee, Yamakawa, Peng, & Barney, 2011; Herrera & Sánchez-González, 2013). However, whether government’s entrepreneurship policies and programs increase or decrease the rewards for productive entrepreneurship more than the rewards for unproductive entrepreneurship is an important research question that is yet to be answered (Capelleras, Mole, Greene, & Storey, 2008; Norrman & Bager-Sjögren, 2010). Here, I submit that those policies and programs that are very much dependent on subjective judgements of bureaucrats and leave room for occurrence of cronyism will end up promoting UE over PE, even though this may be contrary to the original purpose of designing those policies and programs (Fei, Guliang, & Young, 2012).

Cronyism and Entrepreneurship

There are several arguments that suggest cronyism discourages productive entrepreneurship in a society (Singh & Zammit, 2006; Loveridge, 2006). This study

adopts Baumol's model and institutional theory to argue how the prevalence of cronyism as a routine business practice discourages PE and encourages UE in a country.

The main thesis here is that once cronyism becomes a routine business practice in a context, it functions as an informal institution, either as a cognitive belief (the common path to success) or as a normative belief (how things are getting done around here), that increases the reward for unproductive entrepreneurship and decreases the return to productive entrepreneurship (Baumol, 1990). Hence, cronyism plays the role of an informal rule of the game that promotes allocation of country's talents and other resources to UE, at the expense of driving them away from PE. Moreover, cronyism not only influences allocation of entrepreneurial talents between productive and unproductive efforts, but also decreases the supply of entrepreneurial talents by decreasing individuals' motivations and intentions for entering entrepreneurship field.

The main argument here may seem contradictory to a strong body of research in entrepreneurship discipline that suggest the positive effects of informal networks promote entrepreneurial behaviors, especially, in contexts of developing countries that suffer from different types of institutional imperfections (e.g. Xin & Pearce, 1996; Puffer et al., 2010). The main argument there is that informal networks, such as Guanxi in China or Blat in Russia, and advantages derived from them for entrepreneurs, including favoritism and support, substitute for negative effects of imperfections that exist in formal institutional structures in those countries and help entrepreneurs to achieve their goals. This dissertation does not reject these findings but aims to study this phenomenon at a higher level of analysis. In other words, I acknowledge that having informal networks helps an entrepreneur to pursue his goals at individual/organizational level, but I posit

that once having informal networks becomes a key success factor, and maybe the only success factor, in a country, then the level of productive entrepreneurship efforts is influenced negatively at the national level.

Cronyism promotes unproductive entrepreneurship

Social, political, and economic consequences of cronyism are reviewed in the second chapter of this study. As discussed, several of those consequences can either include unproductive efforts (e.g. promotion of corruption and destruction of customer welfare) or promote antecedents of unproductive efforts (e.g. degrading ethical standards and promoting narrow self-interest). The clearest influence of cronyism on unproductive entrepreneurship in societies occurs through promoting economic and political rent seeking behaviors. An act of favoritism based on connections (cronyism) produces rents for parties involved in cronyism and encourages rent seeking activities to capture those rents. These activities can be either economic rent seeking to get access to economic resources and opportunities or political rent seeking to achieve political power and influence.

Cronyism encourages economic rent seeking in a society. Firms that engage in cronyism are able to secure resources and support from government through their connections. For instance, Li (2002) demonstrates that credit assistance programs significantly benefit targeted entrepreneurs at the cost of non-targeted entrepreneurs. He finds that total productive entrepreneurial activities are reduced because of these programs (Li, 2002). Similarly, Zhou (2013) shows that politically connected entrepreneurial firms receive entrepreneurial reinvestments easier and more often than

other firms. Moreover, prior research have made it clear that politically connected firms are more likely to receive favors and be bailed out in case of economic crisis than their similar non-connected competitors (e.g. Faccio et al., 2006; Blau, Brough, & Thomas, 2013).

Most of government-supported programs and policies, especially in imperfect institutional contexts, fail to define clear objective standards for targeting firms. Hence, their performance depends on bureaucrats' subjective evaluations of entrepreneurial firms' performance and other criteria. It is obvious that in such condition, connected firms are favored and receive better subjective evaluations, meaning that cronyism plays a significant role in deciding who receives the support and preferential treatment (Fei et al., 2012). For instance, Chen et al. (2012) posit that in China, entrepreneurs who used to be members of legislative bodies or act as government advisers can easily obtain preferential treatments and support from the government.

Therefore, firms that engage in cronyism and capture the economic rents resulted from it, have access to resources and opportunities that are not available to those who choose not to engage in this kind of rent seeking behaviors. These unfair advantages and benefits that result from cronyism reduce the rewards for productive entrepreneurial efforts and increase the return for engagement in rent seeking activities that capture the economic rents resulted from cronyism. Hence, firms are encouraged to reallocate their resources such that they can seek more rents through cronyism (Baumol, 1990). The more the firms adopt cronyism as a business practice to secure economic rents in a society, the more legitimized and necessary it becomes for other firms to seek economic

rents through engagement in cronyism in that society (Tonoyan et al., 2010; Holcombe, 2013)

Cronyism also promotes political rent seeking, “self-interested dealings between the political and business elites” (Morck & Yeung, 2004, p. 391). As discussed earlier, cronyism is an exchange of favors between two parties, which provides the involved parties with unfair advantages over a third party or public (Khatri et al., 2006). Hence, cronyism promotes narrow self-interest among citizens of a country which drives talents away from productive activities toward unproductive or even destructive political rent-seeking behaviors such as lobbying with politicians, or cultivating favor with bureaucrats (Murphy et al., 1991; 1993). In the politicians-entrepreneurs relationships, politicians favor entrepreneurs and provide them with economic rents in exchange for the entrepreneurs’ political supports and economic contributions to political campaigns. Once the exchange of favors (cronyism) becomes a common practice in a country, politicians and entrepreneurs are mutually dependent on each other and strive to preserve the status quo irrespective of the welfare costs to society (Enderwick, 2005; Douhan & Henrekson, 2008).

In a mutual hostage condition between politicians and entrepreneurs, politicians have de jure power because of their positions in the political institutions, while entrepreneurs have de facto power because of their possession of resources in the country (Acemoglu & Robinson, 2006). Therefore, entrepreneurs strive to leverage their de facto power through political rent seeking activities such as lobbying efforts to either change institutions or change institutions’ functions to their own advantage (Douhan & Henrekson, 2008). In other words, cronyism is a major practice through which

entrepreneurs get involved in political rent seeking activities and change institutions or their functions to benefit them. The more prevalent the cronyism becomes in a country, the more necessary it is for entrepreneurs to engage in political rent seeking activities to secure economic rents for themselves and prevent potential harm to their business because of other entrepreneurs' lobbying or lawsuit efforts (Holcombe, 2013).

Finally, as mentioned earlier, cronyism is not considered as a corrupt practice everywhere, however, it promotes other types of corrupt behaviors in any society. For instance, un-connected entrepreneurs who cannot benefit from cronyism, strive to compensate for their lack of connection by offering bribes to bureaucrats in exchange for preferential treatments that their connected competitors benefit from because of their connections. Moreover, cronyism influences the culture, attitude, and ethical standards of a society by promoting lobbying and cartel activities, which make citizens insensitive to unfairness, suppress social mobility, and increase inequality (Smith & Sutter, 2012). In such a society, if an entrepreneur is unable or unwilling to seek or offer favors, he is considered as a failure rather than an ethical businessman. Tonoyan et al., (2010) suggests that countries in which economic players exploit their close networks, such as kinship or friendship networks, in business to compensate for lack of formal institutions, meaning that cronyism is a common practice there, are very susceptible to different kinds of corruption because in those countries social values and honors are attributed to involvement in corrupt behaviors rather than fair transparent business practices. Therefore, prevalence of cronyism leads to occurrence of other types of corrupt and unproductive entrepreneurial efforts in a country.

Overall, the above discussion indicates that widespread cronyism in a country increases the rewards to unproductive entrepreneurial efforts, such as economic rent seeking, political rent seeking, and other corrupt behaviors, in that country. Hence, cronyism makes it more attractive for individuals in a country to engage in UE. Therefore, there is a positive relationship between the level of cronyism in one country and the level of unproductive entrepreneurship in that country.

Hypothesis 1: There is a positive relationship between prevalence of cronyism in a country and level of unproductive entrepreneurship in that country.

Cronyism reduces productive entrepreneurship

The highest cost of cronyism in a country is its destructive effect on productive entrepreneurship, including corporate restructuring and innovative economic behaviors (Enderwick, 2005). As discussed earlier, cronyism's consequences can be different for countries at different stages of development, such that, cronyism may have some short-term benefits for countries at earlier stages of development, but its cost become more pronounced in the long-run as countries' institutions become more developed and it becomes more difficult for both entrepreneurs and bureaucrats to seek and offer favors (Shleifer & Vishny, 1994). Acemoglu et al. (2012) posit that there are two possible growth paths for developing countries that have extractive institutions: 1) to allocate resources to high productive activities that are controlled by the elites (e.g. Barbados, Soviet Union), meaning, to leverage cronyism in certain industries to instigate growth, 2) when elites feel relatively secure in their positions they may wish to let the emergence of relatively inclusive institutions under their control (e.g., South Korea under General Park,

China today). However, they add, that this growth path is not at all sustainable since it does not allow for creative destructions that change the status quo for elites and politicians. Therefore, I submit that while cronyism may have some positive growth implications in early economic development stages, it almost always has negative effects on productive entrepreneurship and innovation in countries. This explains why as countries transition through different stages of economic development, namely, factor-driven stage, efficiency-driven stage, and innovation-driven stage, and their growth becomes more dependent on productive entrepreneurship, cronyism's cost becomes more highlighted than its benefits.

This section elaborates on how cronyism influences both allocation and supply of productive entrepreneurship in a destructive way. There are two major arguments here. First, cronyism changes pecuniary and non-pecuniary aspects of the reward structure of involvement in productive and unproductive entrepreneurial efforts in a society such that individuals reallocate their resources away from PE to UE (Baumol, 1990; Murphy et al., 1991). Second, cronyism decreases the supply of productive entrepreneurship by debilitating individuals' motivations and hopes for entrepreneurial success in a country.

Cronyism and diversion of resources away from PE - As discussed in previous sections, cronyism increases the payoff for unproductive entrepreneurship in a society and attracts individuals to political and economic rent seeking. This implies that cronyism drives talents and resources away from productive entrepreneurship in a society, since the same abilities and talents that can be used in productive ways, are encouraged by cronyism to be invested in unproductive practices (Murphy et al., 1991). In fact, the real social cost of rent seeking includes opportunity cost of resources that could be

implemented to productive entrepreneurship, but are wasted in unproductive entrepreneurship (Sobel & Garrett, 2002).

Moreover, cronyism leads to long term deadweight loss for a society through promoting rent seeking activities. Acemoglu (1995) posits that:

“the existence of rent-seeking creates a negative externality on productive agents... In a dynamic setting, allocations of past generations as well as expectations of future allocations influence current rewards and the society may get trapped in a ‘rent-seeking’ steady state equilibrium... more rent-seeking in the society reduces the return both to entrepreneurship and rent-seeking... When an agent chooses rent-seeking, he influences the relative rewards of the current generation but since he will be an active rent-seeker for a number of periods to come, he also influences the relative rewards to future generations.” (Acemoglu, 1995, p. 17, 18).

Acemoglu (1995) claims that countries get locked into an “underdevelopment trap” in which rent seeking behaviors are reinforced at the expense of productive entrepreneurship. This is in line with the discussion of cronyism’s vicious reinforcing cycle offered earlier in this study. Countries that fall into “idea trap” of cronyism, as a pragmatic way of getting business done, eventually find their private and public resources locked into such system that a reinforcing vicious cycle of cronyism is able to destroy or obliterate the whole economy of a country.

Prior research includes empirical evidence on the negative association of rent seeking and productive entrepreneurship. For instance, Morck & Yeung (2004) found

family control over country's resources, which implies more cronyism, is associated with less innovation and more political rent seeking. Similarly, Morck et al. (1998) found that countries with more signs of political rent seeking have fewer self-made entrepreneurs and spend less on innovation (also have more concentrated capital structure that implies more cronyism). Additionally, Murphy et al. (1993) define public rent seeking as "either redistribution from the private sector to the state, such as taxation, or alternatively, from private sector to government bureaucrats that affect the fortunes of the private sector, which takes the forms of lobbying, corruption, and so on." (Murphy, et al., 1993, p. 412) and distinguish it from private rent seeking that takes "the form of theft, piracy, litigation, and other forms of transfer between private parties" (Murphy, et al., 1993, p. 412). They argue that public rent seeking is particularly harmful to innovation, since innovators are more dependent on government supplied goods, such as, permits, licenses, property right protections and so on, than established firms (Bardhan, 1997).

There are two major reasons that make cronyism's effects on rent seeking detrimental to productive entrepreneurship. First, cronyism makes governmental programs and policies ineffective or even destructive for reallocating resources toward productive entrepreneurship. For instance, it is shown that government's credit guarantee policy is associated with less R&D investments and innovation (Oh, Jeong-Dong, Heshmati, & Gyoung-Gyu, 2009). Similarly, Lenway et al. (1996) used data from US steel firms to show that trade protections, so often granted through cronyism, decrease incentives for innovation and engagement in the Schumpeterian process of creative destruction for firms. In fact, more cronyism is associated with more governmental supporting programs and bigger government size, which is shown to be inversely related

to entrepreneurial entry within different countries (Aidis, Estrin, & Mickiewicz, 2012). One major reason for this ineffectiveness is the destructive role that connected firms play in policy formulation and execution processes through cronyism and their political rent seeking behaviors (Arshed et al., 2014).

The second reason that makes cronyism's effect on rent seeking detrimental to productive entrepreneurship is that more involvement in unproductive entrepreneurship means less investment on productive entrepreneurship capabilities. Once firms get involved in cronyism they start to invest more on how to be a better rent seeker instead of investing on building their innovative capabilities. In other words, cronyism makes entrepreneurs short term oriented and unwilling to plan for investments on building long term competitive advantages and involvement in innovative processes that generally have uncertain long term rates of return (Enderwick, 2005). As an empirical evidence for this claim, Su, Xie, & Wang (2015) demonstrate that more political networking is associated with lower levels of entrepreneurial orientation in firms (Lumkin & Dess, 1996).

Cronyism and reduction of PE supply - In a crony capitalism system, political connections are the main success factors and individuals have less incentive to engage in productive entrepreneurial behaviors (Cook & Barry, 1993; Smith & Sutter, 2012). For instance, in Italy, Zingales (2009) posits that entrepreneurs find innovation in markets as not the best way to make money as 80 percent of Italian managers believe that "knowledge of influential people" is the most important factor for financial success. Obviously, in such an economic system that connections and favors determine the winners, individuals are unable to capture rents from their own talents if they want to pursue productive entrepreneurship (Murphy et al., 1991). Therefore, they either choose

unproductive entrepreneurship or forget about entering entrepreneurship and the self-employment sector.

Cronyism promotes unfair and inefficient employment practices in labor market (Ponzo & Scoppa, 2010). Once unqualified labor forces obtain jobs and preferential treatments based on their connections, qualified unconnected labor forces are either left out of the market or are offered positions that are not suitable for their profile and cannot motivate them to engage in productive entrepreneurship within their organizations (Prendergast & Topel, 1996; Illoong, 2006). In other words, once cronyism becomes a widespread practice even at the organizational level and managers favor connected employees regardless of their performance, it discourages corporate entrepreneurship efforts by other employees. Additionally, in crony capitalism, since organizations see fewer incentives for productive entrepreneurship in the market, they do not reward their employees for involvement in corporate entrepreneurship activities. Therefore, in crony capitalism, individuals lose motivation for engagement in productive entrepreneurship both within and outside existing firms, since, firstly, it may not pay off if they cannot find the right connections and appropriate support from powerful individuals within or outside their firms, and secondly, if it pays off, their property rights are not guaranteed and they cannot reap the benefits of their own talent (Murphy et al., 1991). Griffiths, Kickul, & Carsrud (2009) found that stronger perceptions of government corruption are associated with lower entrepreneurial intentions.

Widespread cronyism can also lead to inefficiencies in a country's educational system as it debilitates students' motivation for developing cognitive skills that are required for engagement in productive entrepreneurship (Coco & Lagravinese, 2014).

Students have no incentives to prepare themselves for entrepreneurship once they cannot see its benefits in their future. In fact, widespread cronyism signals to them to not bother with entrepreneurship and encourages them to take on governmental positions that give them higher levels of job security and power to participate in the game of exchanging favors in the society (Acemoglu & Verdier, 1998). Therefore, cronyism attacks the entrepreneurship supply in a society by framing it as an unrewarding and uncontrollable career path.

Entrepreneurial entry and new venture development is by nature an uncertain and challenging process. However, to understand why cronyism makes that process excessively unpredictable and uncontrollable, one needs to consider the additional complications that cronyism produces for entrepreneurial entry and venture development. As discussed earlier, cronyism affects new and small businesses that are usually the champions of innovation in their countries, more severely than established firms, because they are challenged with resource scarcity and liabilities of newness. Resource scarcity makes it very difficult for small businesses to participate in political rent seeking and public policy efforts that are the norm in a crony capitalism system. Therefore, considering new and small firms' special needs to acquire new licenses and permissions for their activities from the government, inability to take part in political games and play by rules of the game in crony capitalism, makes it extremely difficult for small firms to survive and become profitable (Cook & Barry, 1993).

Another factor that makes it more difficult to start and grow a new venture in a crony capitalism system is that in general small ventures do not have access to the 'right networks'. Aidis, Estrin, & Mickiewicz (2008) explain that: "the strong ties between

businesses and state administration in the Russian economy seems to provide greater opportunities for existing entrepreneurial insiders to develop new ventures rather than newcomers taking the plunge of establishing start-ups. Moreover, entrepreneurial outsiders who have attempted to break into the web of business–government relations but failed are less likely to try again” (Aidis et al, 2008, p. 657). Similarly, Aidis & Adachi (2007) found that networks between business firms and government officials are very important for business survival and new ventures without such connections are more likely to fail. Therefore, having prior personal ties with powerful individuals in business and the government is a major determinant of venture performance in crony capitalism (Peng & Luo, 2000).

Empirical evidence suggests that prior social networks help individuals to decide whether they can start a successful business or not. For instance, Román, Congregado, & Millán, (2013) found that having a self-employed relative affects individuals’ decision to become self-employed as they can count on benefits such as inside information or referrals once they are in business. Similarly, Glasser (2004) and Djankov, Qian, Roland, & Zhuravskaya (2006) posit that prior social networks play a significant role in explaining productive entrepreneurship in Russia and China. For example, in Russia, having a father who used to be a member of the communist party increases the chance of becoming an entrepreneur. Lack of such networks indicates less chance for cronyism, which discourages individuals from starting a new business.

One last point needs to be clarified here. There is little doubt that having social networks (whether dense networks of strong ties or sparse networks of weak ties with many structural holes) provides competitive advantages and helps entrepreneurial success

in almost every context (Burt, 1992; Coleman, 1988, 1990; Singh et al., 1999). However, a crony capitalism context is different in two major ways. First, once cronyism is a dominant practice in a context, then benefiting from certain types of networks is not just a supporting factor for success, but is the only way for success and without it, survival of firms are quite unlikely. Second, in crony capitalism, there is not equal opportunity for everybody to build the ‘right networks’ since many of those networks are based on individuals’ characteristics (family, friendship, ethnicity, etc.) that individuals either have or do not have, and if not they hardly can earn them. Therefore, the problem with crony capitalism is that having the ‘right networks’ is excessively important for success (such that it cannot be substituted by anything else), and not everybody has an equal chance to build those ‘right networks’. This is why cronyism is described as “downside of social networking” (Khatri et al., 2003).

Overall, above discussion indicates that widespread cronyism has several destructive effects on supply and allocation of resources to productive entrepreneurship within countries. Therefore, I hypothesize that:

Hypothesis 2: There is a negative relationship between prevalence of cronyism in a country and level of productive entrepreneurship in that country.

Market competition as a mediator

Market competition refers to the extent to which competitive forces (e.g., rivalry among existing firms, threats of new entry, threats of substitute products/services, and bargaining power of suppliers/customers) impact firms’ behaviors and determine performance in a business context. An important conclusion of above discussion about

unique difficulties of starting a business in crony capitalism is that cronyism breeds different types of entry barriers for new firms. Parties involved in cronyism make it more difficult for new competitors to get into the game, so that they can keep their status quo power unthreatened. In fact, building entry barriers for non-favored firms to the benefit of favored firms is one major function of cronyism even in developed countries (Aligica & Tarko, 2014).

Moreover, connected firms strive to marginalize competitive forces and disrupt market dynamics through their political rent-seeking and lobbying efforts. Favoritism provides connected firms with benefits in terms of monopoly powers, tax reliefs, preferential funding, protective regulations, and other types of privileges that allow them a competitive edge in serving the market (Mitchell, 2013). Therefore, promotion of cronyism weakens competitive market forces and leads to the lack of market competition and the emergence of several favored business groups controlled by elites (Maman, 2002; Rose–Ackerman, 2008).

The absence of market competition leads to the presence of rents in markets, which promote innovative rent seeking behaviors by both bureaucrats and businesses to exploit those rents. Ades & Di Tella (1999) posit that “less competition means firms enjoy higher rents, so that bureaucrats with control rights over them, such as tax inspectors or regulators, have higher incentives to engage in malfeasant behavior[s]” (Ades & Di Tella, 1999, p. 982), such as corruption and other forms of unproductive entrepreneurship. In perfect competition, firms exhaust their resources to keep up with their competitors and they have no excess resources/profits to invest in unproductive and corrupt efforts such as lobbying and bribing (Bliss & Di Tella, 1997). Hence, high

competition reduces the return on such unproductive rent seeking behaviors (Ades & Di Tella, 1999; Emerson, 2006).

As discussed, cronyism can produce excessive regulations that undermine market competition. Such uncompetitive markets encourage individuals to get involved in unproductive and corrupt efforts to find shortcuts and ways to bend the rules and evade costs of regulations (Holcombe, 2013). For instance, Djankov et al. (2002) examined entry regulations in 85 countries and reported that nations with more regulative entry barriers have more corruption and larger informal economies, indicating in less competitive contexts, excessive entry regulations promote unproductive and corrupt economic activities. Regulatory capture theory (Stigler, 1971) explains how regulations fail to serve public interest and end up benefiting regulated economic actors in the long run. Once certain regulations are set, economic players adjust their behaviors in the short term, but in the long term they develop relationships with regulatory agencies and get involved in unproductive entrepreneurial efforts to influence regulations and capture value at the expense of the public. Therefore, highly regulated uncompetitive markets promote unproductive entrepreneurship.

Additionally, lack of competitive forces allow favored business groups to be able to survive and flourish even without doing their best and pushing themselves to develop efficient business practices/routines as hard as they would push in a competitive context. In the absence of competition, firms' payoffs for investment in innovation and productive entrepreneurship are negligible and they do not see the need for such investments (Singh & Zammit, 2006). This is generally called X-inefficiency (Leibenstein, 1996) and results in existence of protected industries that reward poor firm performance. For instance,

Lenway et al. (1996) investigated US steel firms' performance and surprisingly reported that "high past R&D spending is negatively correlated with stock price changes when [trade] protection is announced, and positively correlated with subsequent exit from the industry" (p. 410), indicating that trade protection in the US steel industry, which undermines competitive forces, decreases incentives of productive entrepreneurship.

Low market competition, resulting from the prevalence of cronyism, endangers consumer welfare significantly, since consumers do not have access to high quality products/services that they would have had in a competitive market. They even may end up paying higher prices for lower quality products/services that are offered to them exclusively by favored firms (Thierer & Skorup, 2013). In contrast, enhanced competition makes firms more efficient and innovative and serves consumer welfare as they are offered innovative products and services at more reasonable prices (Rey, 1997; Dutz, Ordober, & Willig, 2000).

In a competitive market firms are forced by their existing competitors to be proactive and have higher rates of product/process innovations to maintain pace with competition. Higher threats of new entries and substitutes make firms in a competitive environment more competitively aggressive toward potential new rivalries and act more entrepreneurial to keep their competitive positions in the market. This is called "Red Queen" competition, in which firms that are exposed to more intense market competition adopt a more innovative approach compared to those that are exposed to less intense market competition (Barnett Sorenson, 2002; Barnett & McKendrick, 2004). Baumol (2004) posited that the Red Queen effect is the most important development mechanism in Capitalistic societies. Derfus and her colleagues (2008) explain that:

“Red Queen can be seen as a contest in which each firm’s performance depends on the firm’s matching or exceeding the actions of rivals. In these contests, performance increases gained by one firm as a result of innovative actions tend to lead to a performance decrease in other firms. The only way rival firms in such competitive races can maintain their performance relative to others is by taking actions of their own. Each firm is forced by the others in an industry to participate in continuous and escalating actions and development that are such that all the firms end up racing as fast as they can just to stand still relative to competitors.” (Derfus, Maggitti, Grimm, & Smith, 2008, p. 61)

Higher levels of competitions and lower levels of entry barriers are beneficial to both revolutionary and evolutionary productive entrepreneurship (Dutz et al., 2000). Once new firms can enter more easily, they are willing to undertake radical innovative initiatives to gain a competitive position in the market and such threats of new entry make existing firms take more evolutionary productive entrepreneurship to avoid losing their market power. Additionally, higher competition means that entrepreneurs have better access to high-quality suppliers and supporting business services, which provide them stronger support and incentives to engage in productive entrepreneurship.

In sum, the above discussion indicates that cronyism in a country leads to lower levels of competitions in the country’s local markets, which then increases the level of unproductive entrepreneurship and decreases the level of productive entrepreneurship in that country. Hence, I hypothesize that:

Hypothesis 3(a): The positive relationship between cronyism and unproductive entrepreneurship is partially mediated by market competition, such that, a high level of cronyism reduces market competition which then, in turn, increases the level of unproductive entrepreneurship at national level.

Hypothesis 3(b): The negative relationship between cronyism and productive entrepreneurship is partially mediated by market competition, such that, a high level of cronyism reduces market competition which then, in turn, decreases the level of productive entrepreneurship at national level.

Institutional trust as a mediator

As discussed earlier, prevalence of cronyism among businesses and between businesses and governments hurts the credibility of both sides (Mitchell, 2013). Through repeated experience with businesses and the government, potential entrepreneurs learn about rules of the game and whether they can count on fairness and neutrality of institutions or if they need to be involved in cronyism to be successful. Once cronyism is a dominant practice, it promotes exchange of unfair favors and advantages between the government and businesses. Cronyism also increases the level of political rent-seeking activities and circumvention of laws and regulation by connected entrepreneurs. Consequently, people lose confidence in the ability and intention of the government and market institutions to reliably and neutrally enforce trade rules, or simply they lose their trust in institutions (Anokhin & Schulze, 2009).

Institutional trust refers to “wide-spread confidence that office holders and others who are directly and indirectly party to a transaction will, regardless of their identity,

impartially and fairly enforce the rules that govern exchange” (Anokhin & Schulze, 2009, p. 3). It represents the level of trust that people have in the satisfactory performance of institutional environment, including formal and informal institutions (Welter & Smallbone, 2006). Entrepreneurs’ trust in institutions may include different aspects, such as confidence in effective management of institutions, or trust in credibility of decision makers, or confidence in functionality and usefulness of the institutions (De Clercq & Dakhli, 2009). Institutional trust is shown to have a positive relationship with people’s well-being in general (Hudson, 2006) and entrepreneurs’ loyalty to ethical standards in particular (De Clercq & Dakhli, 2009). Institutional trust is essential for occurrence of efficient transactions within a market economy as it enables entrepreneurs to get into transactions with partners, whom they have little information about, without much concern about opportunism from partners (Raiser, 1999).

Institutional trust is different than interpersonal trust, and is defined as an agent’s personal confidence that another agent will behave in a way that is expected (Williamson, 1993). Interpersonal trust is a result of a history of repeated interactions among particular individuals or knowledge about certain individuals’ reputation, however, institutional trust precedes such interactions and helps individuals to interact in the first place without prior knowledge about each other’s reputation (Luhmann, 1988; Rus & Iglíč, 2005). In other words, institutional trust “generalizes beyond a given transaction and beyond specific sets of exchange partners” (Zucker, 1986, p. 63) and serves as a foundation that facilitates the development of interpersonal trust among citizens (Rose-Ackerman, 2001).

A mixture/balance of both types of trust, interpersonal and institutional, is required for promoting efficient and innovative economic transactions in a country

(Welter & Smallbone, 2006). However, cronyism can disrupt the mixture/balance of both types of trust in a society and consequently constrain economic activities in that context. Interpersonal trust among certain groups of individuals is the basis for practicing cronyism. An exchange of favor between two parties happens based on their interpersonal trust and the belief that the party who receives the favor will reciprocate in an appropriate way in the future. Hence, interpersonal trust initiates cronyism, which undermines people's trust in fairness and functionality of the system, or their institutional trust. Low levels of institutional trust in a society prevents individuals from doing business with unknown others and building interpersonal trust with new people through their interactions. Therefore, cronyism disrupts the mixture/balance of both types of trust in a society by decreasing institutional trust in a context, which makes it more difficult for agents to engage in interactions that help to build interpersonal trust with new individuals, and increasing people's reliance on those with whom they have interpersonal trust, which leads to more cronyism and reinforcement of the same disruptive mechanism.

As Baumol (1990) suggests, once potential entrepreneurs find institutions to be effective and fair in supporting them and facilitating their paths to achieve their goals, they would prefer to follow legitimate rather than illegitimate paths toward accomplishment of their goals. However, "when people perceive institutional arrangements as unfair and arbitrary, they may feel alienated from the social structure in which they are embedded and therefore consider socially accepted norms as less instrumental to accomplish their personal goals" (De Clercq & Dakhli, 2009, p. 481). Hence, people who do not have trust in the functionality and impartiality of institutions to

provide supporting resources and valuable opportunities for citizens, are prone to discount their ethical standards and use their talents to find innovative illegitimate ways for fulfilling their self-interest (Dakhli & De Clercq, 2004; De Clercq & Dakhli, 2009). Therefore, low levels of institutional trust promote unproductive entrepreneurship that rewards individuals who seek their own interest at the expense of society.

Additionally, absent institutional trust, high transaction costs limit the scale and scope of economic trade and thus hinder economic growth and investment in productive entrepreneurship (Anokhin, & Schulze, 2009). Higher levels of institutional trust facilitate the development of arms-length exchanges and enable entrepreneurs to expand their scope of interactions by helping them to choose from a wider pool of economic partners. Rus & Iglič (2005) studied small- and medium-sized firms in Slovenia and Bosnia- Herzegovina to understand how the level of entrepreneurs' institutional and interpersonal trust influences their choice of governance mechanisms. They found that in Slovenia "the use of institutional trust as a basis for a governance mechanism may lead to increased economic performance of companies due to the inclusive nature of sociability patterns and tie formation since institutions generalize trust beyond a specific set of exchange partners." (Rus & Iglič, 2005, p. 371). In contrast, in Bosnia- Herzegovina "the use of interpersonal trust may limit economic potential due to its reliance on strong ties embedded within cohesive groups marked with closure." (Rus & Iglič, 2005, p. 371). Lack of institutional trust promotes doing business based on alternative foundations such as kinship, or ethnicity, which are not only restrictive for existing entrepreneurs, but also as discussed earlier, promotes cronyism and makes it more difficult for potential

entrepreneurs who do not have access to such networks (gunaxi, blat, etc.) to enter to the entrepreneurship sector (Puffer et al., 2010; Aidis et al., 2008).

In presence of high institutional trust, not every business transactions is required to be regulated by contracts and government interference, which leads to lower transaction costs for entrepreneurs and higher returns to productive entrepreneurship (Baumol, 1990). Therefore, high levels of institutional trust signal that relative rewards for productive entrepreneurship are high and secured, and encourage individuals to invest in productive entrepreneurship. Once individuals are confident that their property rights are secured and are less afraid to get hurt by governments' and businesses' opportunistic behaviors and unfair practices, they find more incentives to get involved in innovation and productive entrepreneurship. For instance, institutional trust is known to play a significant role in the expansion of online businesses and electronic markets such as Ebay or Craigslist (Patnasingam, Gefen, & Pavlou, 2005).

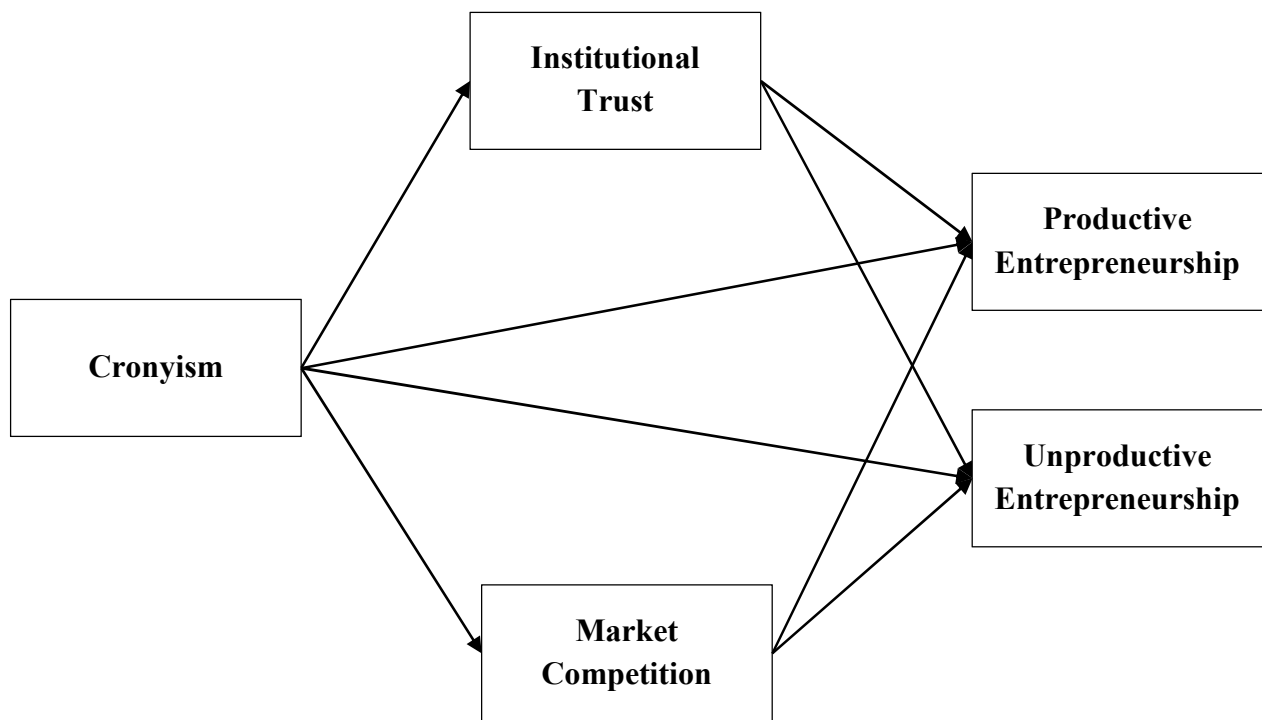
Overall, the theory presented here indicates that higher levels of cronyism in a country decreases the level of institutional trust among citizens, which then leads to higher levels unproductive entrepreneurship and lower levels of productive entrepreneurship in that country. Therefore, I hypothesize that:

Hypothesis 4(a): The positive relationship between cronyism and unproductive entrepreneurship is partially mediated by institutional trust, such that, a high level of cronyism reduces institutional trust which then, in turn, increases the level of unproductive entrepreneurship at national level.

Hypothesis 4(b): The negative relationship between cronyism and productive entrepreneurship is partially mediated by institutional trust, such that, a high level of cronyism reduces institutional trust which then, in turn, decreases the level of productive entrepreneurship at national level.

Figure 2 shows the study's research model that explained in this section.

Figure 2 - Research Model



CHAPTER III

METHODOLOGY

Data

This study collects secondary data from several different sources to analyze its conceptual model. These data sources include: Global Competitiveness Index reported by World Economic Forum (Sala-I-Martin et al., 2010), Worldwide Governance Indicators developed by World Bank Groups (Kaufmann, Kraay, & Mastruzzi, 2010), and Corruption Perception Index reported by Transparency International (Lambsdorff, 2008). In following sections, these data sources are briefly explained and the measures borrowed from each data source are described.

Global Competitiveness Index (GCI)

A majority of this study's measures are adopted from the GCI that was developed and reported by the World Economic Forum (WEF) for more than a decade.

Competitiveness is defined as “the set of institutions, policies, and factors that determine the level of productivity of an economy, which in turn sets the level of prosperity that the country can earn” (The Global Competitiveness Report 2015, p. 4). Hence, the GCI represents key factors that determine economic growth and a country's level of present and future prosperity. GCI combines 114 country-level indicators that are grouped into 12 pillars: institutions, infrastructure, macroeconomic environment, health and primary

education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation.

GCI includes statistical data from a variety of legitimate data sources (internationally recognized agencies such as, International Monetary Fund (IMF), United Nations Educational, Scientific and Cultural Organization (UNESCO), and World Health Organization). Also, in many cases that require more qualitative assessments or the data is not available, GCI indicators are derived from the Executive Opinion Survey, which is a global annual survey that has been conducted by the WEF for the last 40 years. The Executive Opinion Survey is a national survey of representative samples of executives in more than 140 countries (on average 100 executives from different sectors in each country), which produces average national scores on different topics for each country. The Executive Opinion Survey's methodology has been validated throughout the years with the help of Gallup's survey experts. Scholars have extensively adopted these average national scores in studies that are published in top management and entrepreneurship journals (e.g. Wan & Hoskisson, 2003; Ho & Wong, 2006; Shaner & Maznevski, 2011; Stenholm, Acs, & Wuebker, 2013).

World Governance Indicators (WGI)

This is a World Bank's research dataset that summarizes assessments of quality of governance in different countries. The WGI is based on data from 31 data sources that report perceptions of governance among large numbers of survey respondents and experts worldwide. The data is gathered from a variety of survey institutes, think tanks, non-governmental organizations, internationally-recognized organizations, and private sector

firms. A detail explanation of WGI methodology is offered by Kaufmann, Kraay, & Mastruzzi (2010).

Kaufmann et al. (2010) define governance as “the traditions and institutions by which authority in a country is exercised. This includes (a) the process by which governments are selected, monitored and replaced; (b) the capacity of the government to effectively formulate and implement sound policies; and (c) the respect of citizens and the state for the institutions that govern economic and social interactions among them.” (Kaufmann et al., 2010, p. 4). Based on this definition, they construct six measures of governance, namely, Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. WGI offer annual national scores on each of these six measures for more than 200 countries in a time frame between 1996 and 2013. These scores have been extensively used in prior studies published in top management and entrepreneurship journals (e.g. Jandhyala, 2013; Kim & Li, 2014; Saeed, Yousafzai, & Engelen, 2014; Sun & Im, 2015).

Corruption Perception Index (CPI)

The CPI is a widely used proxy for measurement and comparison of the level of corruption among different countries. CPI has been reported by Transparency International for more than a decade and contains scores on how corrupt the public sector of a country is perceived to be (Lambsdorff, 2008). CPI is a composite index that combines data on perception of corruption in different countries from a variety of surveys and assessments of corruption by internationally-recognized organizations (e.g., World Bank’s Country Policy and Institutional Assessment, Transparency International’s Bribe

Payers Survey). Similar to other data sources described above, CPI is also extensively adopted by scholars in studies that appear in top management and entrepreneurship journals (e.g., Aidis, Estrin, & Mickiewicz, 2008; McMullen, Bagby, & Palich, 2008; Gohmann, 2012; Payne, Moore, Bell, & Zachary, 2013).

Measures

Based on the theoretical definition of each construct, the three most appropriate available variables in the previously described datasets were chosen to form reflective latent constructs that are able to capture variability of the study’s desired concept at the country level. In this section, final measures for each construct are described. Table 4 summarizes these measures, their definitions, scales, and data sources.

Table 4 - Measurement Variables

#	Measurement variables (definition, scale, source)
Cronyism	
1	<p><i>Favoritism in decisions of government officials</i></p> <ul style="list-style-type: none"> In your country, to what extent do government officials show favoritism to well-connected firms and individuals when deciding upon policies and contracts? [1 = always show favoritism; 7 = never show favoritism] <p><i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i></p>
2	<p><i>Favoritism in appointing managers</i></p> <ul style="list-style-type: none"> In your country, who holds senior management positions? [1 = usually relatives or friends without regard to merit; 7 = mostly professional managers chosen for merit and qualifications] <p><i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i></p>
3	<p><i>Undue influence on judiciary system</i></p>

	<ul style="list-style-type: none"> In your country, to what extent is the judiciary independent from influences of members of government, citizens, or firms? [1 = heavily influenced; 7 = entirely independent] <i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i>
Market Competition	
1	<p><i>Intensity of local competition</i></p> <ul style="list-style-type: none"> In your country, how intense is competition in the local markets? [1 = not intense at all; 7 = extremely intense] <i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i>
2	<p><i>Effectiveness of anti-monopoly policy</i></p> <ul style="list-style-type: none"> In your country, to what extent does anti-monopoly policy promote competition? [1 = does not promote competition; 7 = effectively promotes competition] <i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i>
3	<p><i>Extent of market dominance</i></p> <ul style="list-style-type: none"> In your country, how would you characterize corporate activity? [1 = dominated by a few business groups; 7 = spread among many firms] <i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i>
Institutional Trust	
1	<p><i>Government effectiveness</i></p> <ul style="list-style-type: none"> Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. [ranges from -2.5 (weak) to 2.5 (strong)] <i>Source: World Bank, World Governance Indicators</i>
2	<p><i>Rule of law</i></p> <ul style="list-style-type: none"> Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement,

	<p>property rights, the police, and the courts, as well as the likelihood of crime and violence.</p> <p>[ranges from -2.5 (weak) to 2.5 (strong)]</p> <p><i>Source: World Bank, World Governance Indicators</i></p>
3	<p><i>Regulatory quality</i></p> <ul style="list-style-type: none"> Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. <p>[ranges from -2.5 (weak) to 2.5 (strong)]</p> <p><i>Source: World Bank, World Governance Indicators</i></p>
Productive Entrepreneurship	
1	<p><i>Capacity for innovation</i></p> <ul style="list-style-type: none"> In your country, to what extent do companies have the capacity to innovate? <p>[1 = not at all; 7 = to a great extent]</p> <p><i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i></p>
2	<p><i>Company spending on R&D</i></p> <ul style="list-style-type: none"> In your country, to what extent do companies spend on research and development (R&D)? <p>[1 = do not spend on R&D; 7 = spend heavily on R&D]</p> <p><i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i></p>
3	<p><i>PCT patent applications</i></p> <ul style="list-style-type: none"> Number of applications filed under the Patent Cooperation Treaty (PCT) per million population <p><i>Source: World Economic Forum, Global Competitiveness Report, adopted from Organization for Economic Co-operation and Development (OECD), Patent Database</i></p>
4	<p><i>New business density</i></p> <ul style="list-style-type: none"> New businesses registered (the number of new limited liability corporations registered in the calendar year) divided by population. <p>[New business registrations per 1,000 people ages 15-64]</p> <p><i>Source: World Bank Group Entrepreneurship Survey (WBGES)</i></p>

5	<p><i>High-technology exports</i></p> <ul style="list-style-type: none"> • High-technology exports are products with high R&D intensity, such as in aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery. <p>[High technology exports as % of all manufactured exports]</p> <p><i>Source: World Bank, World Development Indicators, adopted from United Nations, Comtrade database</i></p>
6	<p><i>Research and development expenditure</i></p> <ul style="list-style-type: none"> • Expenditures for research and development are current and capital expenditures (both public and private) on creative work undertaken systematically to increase knowledge, including knowledge of humanity, culture, and society, and the use of knowledge for new applications. R&D covers basic research, applied research, and experimental development. <p>[R&D expenditure as % of GDP]</p> <p><i>Source: World Bank, World Development Indicators, adopted from United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute for Statistics</i></p>
7	<p><i>Researchers in R&D</i></p> <ul style="list-style-type: none"> • Researchers in R&D are professionals engaged in the conception or creation of new knowledge, products, processes, methods, or systems and in the management of the projects concerned. Postgraduate PhD students (ISCED97 level 6) engaged in R&D are included. <p>[Researchers in R&D per million people]</p> <p><i>Source: World Bank, World Development Indicators, adopted from United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute for Statistics</i></p>
8	<p><i>Technicians in R&D</i></p> <ul style="list-style-type: none"> • Technicians in R&D and equivalent staff are people whose main tasks require technical knowledge and experience in engineering, physical and life sciences (technicians), or social sciences and humanities (equivalent staff). They participate in R&D by performing scientific and technical tasks involving the application of concepts and operational methods, normally under the supervision of researchers. <p>[Technicians in R&D per million people]</p>

	<p><i>Source: World Bank, World Development Indicators, adopted from United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute for Statistics</i></p>
Unproductive Entrepreneurship	
1	<p><i>Control of corruption</i></p> <ul style="list-style-type: none"> Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. <p>[ranges from -2.5 (weak) to 2.5 (strong)]</p> <p><i>Source: World Bank, World Governance Indicators</i></p>
2	<p><i>Corruption Perception Index (CPI)</i></p> <ul style="list-style-type: none"> The CPI score represents how corrupt a country's public sector is perceived to be. <p>[A scale of 0-100, where 0 means that a country is perceived as highly corrupt and a 100 means that a country is perceived as very clean]</p> <p><i>Source: Transparency International, Corruption Perception Index</i></p>
3	<p><i>Irregular payments and bribes</i></p> <ul style="list-style-type: none"> Average score across the five components: In your country, how common is it for firms to make undocumented extra payments or bribes in connection with (a) imports and exports; (b) public utilities; (c) annual tax payments; (d) awarding of public contracts and licenses; (e) obtaining favorable judicial decisions? <p>[1 = very common; 7 = never occurs]</p> <p><i>Source: World Economic Forum, Global Competitiveness Index, adopted from Executive Opinion Survey</i></p>

Cronyism (Independent Variable)

Objective measurement of cronyism at a national level is a difficult task. The parties who are involved in cronyism seek to hide it or justify it as best for the public interest, consumer protection, or other types of rationales for favoring some people over others. If parties who are involved in cronyism want to deny their participation in cronyism, no one can definitively accuse them that they favor someone else based on

their connection and in hope of future compensations. This is why cronyism is not illegal and there are no court or indictment records for it. Therefore, it is vital for researchers to develop appropriate proxies that enable them to capture the variability of cronyism.

Prior research on cronyism has used different proxies to measure cronyism, such as concentration of country's assets in hands of small groups, inattention to consumer needs in business contexts, stock-market event analysis for investigation of the effects of political connections on stock prices, capital structure of state capitols, or campaign contributions by political action committees (Smith & Sutter, 2012). While each of these proxies represent different consequences of cronyism and are able to capture the level of cronyism in a country to some extent, this study adopts a different approach by using citizen's 'average perception of prevalence of cronyism' as an effective measure of cronyism in a country.

Baumol (1990) posits that individuals choose to engage in productive versus unproductive entrepreneurship by comparing rewards they gain in each path. This indicates that individuals decide to engage in certain activities based on their subjective evaluation of rewards that they can earn in each type of activity. Therefore, individuals' perception about prevalence of cronyism and its importance for success influence their subjective evaluations of relative return to productive versus unproductive entrepreneurship. In other words, it is indeed individuals' perception of cronyism that influences their judgment and choice of behavior rather than any other reliable objective measure of cronyism, meaning that perception of cronyism is an appropriate measure to study cronyism's effects on people's behavior.

In line with this reasoning, Smith & Sutter (2012) also suggest that perception of cronyism is an appropriate measure for the level of cronyism, since “in fact, just the perception of cronyism can inhibit business formation, [and] distort the allocation of entrepreneurial talent” (p. 25). Similarly, Illoong (2006) points out that it is ‘perceived favoritism’ within an organization that decreases organizational members’ motivation for innovation and effective contributions to the organization. Therefore, I submit that a measure of the perception of cronyism is an appropriate proxy for capturing the variability of prevalence of cronyism in different countries.

To form a construct that is able to measure the level of cronyism’s perception in different countries, three variables from GCI are selected. These variables are all adopted from WEF’s Executive Opinion Survey.

- ***Favoritism in decisions of government officials***
 - In your country, to what extent do government officials show favoritism to well-connected firms and individuals when deciding upon policies and contracts?
[1 = always show favoritism; 7 = never show favoritism]
- ***Favoritism in appointing managers***
 - In your country, who holds senior management positions?
[1 = usually relatives or friends without regard to merit; 7 = mostly professional managers chosen for merit and qualifications]
- ***Undue influence on judiciary system***
 - In your country, to what extent is the judiciary independent from influences of members of government, citizens, or firms?

[1 = heavily influenced; 7 = entirely independent]

The first variable measures the extent to which people perceive that cronyism exists in the government sector, the second variable measures people's perception of the prevalence of cronyism in the private sector, and finally, the third variable is a proxy for people's perception of how much cronyism exists in the judiciary system. Overall, the latent reflective construct that is identified by these three measures is able to strongly capture variability of the average perception of prevalence of cronyism within a country.

Market Competition (Mediator)

The current study is interested in the general level of competition in country's different local markets. In other words, the extent to which market dynamics/forces (e.g., rivalry among existing firms, threats of new entry, threats of substitute products/services, bargaining power of suppliers and customers) influence firms' behaviors and determine business performance in different markets. Executives' common perception of how different local markets in a country are governed by market competitive forces (market-based competition among the economic players) and free of non-market-based dynamics (e.g. governmental interferences, monopoly power, etc.) can capture the variability of general market competition within a country.

Common perception about the level of market competition in a country signals potential entrepreneurs about the fairness of competition in that country and the level of uncompetitive forces that challenge them once they are in business. It is indeed the entrepreneurs' perceptions of the quality of market competition that influence their choice of behavior (productive versus unproductive entrepreneurship). Therefore, this

study adopts the three most theoretically fit measures from the list of GCI's indicators for goods market efficiency at country-level. These measures include:

- ***Intensity of local competition***

- In your country, how intense is competition in the local markets?

[1 = not intense at all; 7 = extremely intense]

- ***Effectiveness of anti-monopoly policy***

- In your country, to what extent does anti-monopoly policy promote competition?

[1 = does not promote competition; 7 = effectively promotes competition]

- ***Extent of market dominance***

- In your country, how would you characterize corporate activity?

[1 = dominated by a few business groups; 7 = spread among many firms]

Institutional Trust (Mediator)

Institutional trust is defined as a “wide-spread confidence that office holders and others who are directly and indirectly party to a transaction will, regardless of their identity, impartially and fairly enforce the rules that govern exchange” (Anokhin & Schulze, 2009, p. 3). Hence, to measure institutional trust, this study adopts three governance measures from WGI that are proxies for “(b) the capacity of the government to effectively formulate and implement sound policies; and (c) the respect of citizens and the state for the institutions that govern economic and social interactions among them.” (Kaufmann et al., 2010, p. 4). The reflective latent construct formed by these three governance indicators is able to strongly capture variability of institutional trust

(considering its above mention definition) in different countries. These indicators include:

- ***Government effectiveness***

- Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

[Ranges from -2.5 (weak) to 2.5 (strong)]

- ***Regulatory quality***

- Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

[Ranges from -2.5 (weak) to 2.5 (strong)]

- ***Rule of law***

- Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

[Ranges from -2.5 (weak) to 2.5 (strong)]

Productive Entrepreneurship (Dependent Variable)

Prior research used different proxies to measure the level of Productive Entrepreneurship (PE) at the national level. Stenholm et al. (2013) reviewed different

measures for country-level entrepreneurial activities in prior studies and explained that these measures are either based on aggregation of self-reports of randomly selected individuals in a country (e.g., OECD data on self-employment, or GEM data on self-employment or early stage entrepreneurial activities) or records from business registries (e.g., World Bank Group Entrepreneurship Survey (WBGES), or OECD Comparable Entrepreneurship Data for International Analysis-COMPENDIA). This study adopts a mixed approach to ensure the robustness of its results.

Firstly, the three most theoretically fit measures of productive entrepreneurship are chosen from the variables that are suggested by GCI as indicators of innovation pillar at the country-level. This option provides the study with higher sample size and stronger statistical power. The reflective latent construct formed by these three measures is able to account for variability of innovation capacity in a country. These three measures include:

- ***Capacity for innovation***
 - In your country, to what extent do companies have the capacity to innovate?
[1 = not at all; 7 = to a great extent]
- ***Company spending on R&D***
 - In your country, to what extent do companies spend on research and development (R&D)?
[1 = do not spend on R&D; 7 = spend heavily on R&D]
- ***PCT patent applications***
 - Number of applications filed under the Patent Cooperation Treaty (PCT) per million population

Additionally, to insure robustness of the study's results about productive entrepreneurship, the study adopts a few other common measures, including, *new business density* (as a proxy for entrepreneurial new entry), *high-technology export* (as a proxy for high-technology innovation capacity), *R&D expenditure* (as a proxy for investment on PE), *Researchers in R&D* (as a proxy for encouraging labor force to engage in PE rather than UE), and *Technicians in R&D* (as a proxy for encouraging labor force to engage in PE rather than UE). These variables are adopted from World Bank Group Entrepreneurship Survey (WBGES) and World Bank Group's World Development Indicators, which are both extensively used in studies that appear in top level management and entrepreneurship journals (e.g., Jandhyala, 2013; Stenholm et al., 2013; Kim & Li, 2014).

Unproductive Entrepreneurship (Dependent Variable)

Unlike productive entrepreneurship, prior research fails to suggest appropriate proxies that are able to measure the level of unproductive entrepreneurship within a country³. In fact, it is very difficult to build an objective measure of unproductive entrepreneurship that is able to capture how often individuals in a country come up with innovative ways of redistributing wealth to themselves at the expense of society. These efforts are mostly under the radar and unproductive entrepreneurs do not publicize their efforts. Also, there are rarely court records for a majority of these efforts, since they are not considered as illegal activities per se, but innovative ways to bend legal procedures.

3- The only proxy that is used by very few studies for this purpose, is the level of a country's talents that enter into law/legal studies and businesses, instead of engineering and science careers (e.g. Murphy et al., 1991; Sobel, 2008).

This study examines the level of a country's corruption as a proxy for measuring unproductive entrepreneurship. Unproductive entrepreneurship is mostly categorized under the rubric of corruption and perceived as corrupt behaviors by the general population. Therefore, average perception of the level of corruption in a country can be a proxy for measuring the level of unproductive entrepreneurship. I certainly acknowledge that this is a serious limitation of this study and not all types of corruption (e.g., bribery) are unproductive entrepreneurship, but as explained, there is no better alternative proxy available at this point. Hence, this study forms a reflective latent construct as a proxy for unproductive entrepreneurship using these three corruption variables from WGI, GCI, and CPI:

- ***Control of corruption***

- Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

[Ranges from -2.5 (weak) to 2.5 (strong)]

- ***Irregular payments and bribes***

- Average score across the five components: In your country, how common is it for firms to make undocumented extra payments or bribes in connection with (a) imports and exports; (b) public utilities; (c) annual tax payments; (d) awarding of public contracts and licenses; (e) obtaining favorable judicial decisions?

[1 = very common; 7 = never occurs]

- ***Corruption Perception Index (CPI)***
 - The CPI score represents how corrupt a country's public sector is perceived to be.

[A scale of 0-100, where 0 means that a country is perceived as highly corrupt and a 100 means that a country is perceived as very clean]

Measurement Model

The data sources adopted in this study provide data for multiple years. Hence, the first step to build the study's measurement model is to choose a base year for analysis. Two factors are considered for making this decision, first, statistical power (sample size), and second, probable effects of World's 2008-2009 financial crisis. Based on these two considerations, the year 2011 is chosen as the base year for analysis. Moreover, as a common suggested practice for examination of causal paths, a one year lag is considered between different layers of the study's conceptual model, meaning that, data analysis is performed with IV's data for 2011, mediators' data for 2012, and DVs' data for 2013.

The next step to test for reliability and validity of the study's measures is to build the study's measurement model and run Confirmatory Factor Analysis (CFA). For this purpose, the study used maximum likelihood estimation with Proc Calis procedure in SAS Enterprise Guide 7.11. A CFA model that includes the study's five latent constructs and three observed measures for each construct was built. The study chose to keep only three best measures for each construct to insure model convergence considering the study's relatively small sample size and high numbers of tested relationships. As a common practice, all constructs' variances were set to one to run CFA.

Table 5 shows final list of observed measures for each construct, standardized factor loadings and their t-values ($t > 2$, $p < 0.05$), Cronbach Alpha, Composite Reliability (CR), and Average Variance Extracted (AVE) for all constructs and their observed measures. All Cronbach Alpha and CR values are higher than 0.80 and exceed their suggested thresholds, respectively, 0.70 and 0.60, which provide strong support for reliability of the measures (Bagozzi & Yi, 2012). Moreover, all loading factors are significant and higher than 0.80, which insure convergent validity of each construct's measures. Moreover, AVE values for all latent constructs are higher than 0.75 and larger than each construct's shared variance with other constructs, which satisfy discriminant validity of constructs (Fornell & Larcker, 1981).

Table 5 - Measurement Model (CFA Results)

Latent Constructs' Measurement Items	Loading (t – value)
Cronyism (Cronbach Alpha=0.92, CR=0.84, AVE=0.81)	
• Favoritism in decisions of government officials	0.88 (39.96)
• Favoritism in appointing managers	0.89 (44.92)
• Undue influence on judiciary system	0.93 (63.27)
Market Competition (Cronbach Alpha= 0.93, CR=0.83, AVE=0.77)	
• Intensity of local competition	0.83 (27.39)
• Effectiveness of anti-monopoly policy	0.92 (52.19)
• Extent of market dominance	0.88 (37.66)
Institutional Trust (Cronbach Alpha= 0.98, CR=0.86, AVE=0.94)	
• Government effectiveness	0.98 (200.6)

• Rule of law	0.98 (258.2)
• Regulatory quality	0.94 (90.72)
Productive Entrepreneurship (Cronbach Alpha=0.95, CR=0.85, AVE=0.86)	
• Capacity for innovation	0.99 (160.0)
• Company spending on R&D	0.97 (133.1)
• PCT patent applications	0.82 (27.71)
Unproductive Entrepreneurship (Cronbach Alpha=0.98, CR=0.86, AVE=0.94)	
• Control of corruption	0.99 (701.8)
• Corruption Perception Index (CPI)	0.99 (573.8)
• Irregular payments and bribes	0.92 (65.62)

The measurement model's goodness of fit is investigated through chi-square statistics, a set of relative fit indices, and a set of absolute fit indices. Chi-square test is almost always significant in studies with highly restricted models and large sample sizes, hence, other tests are explored to examine the measurement model's goodness of fit. Prior research suggests that a chi-square/DF ratio below 5 indicate an acceptable level of fit between model and data (Hooper, Coughlan, & Mullen, 2008). This ratio (Chi-square/DF = 257.82/80) equals 3.22 in this case, which meets the recommended threshold. Moreover, values for a commonly used absolute fit index (Standardized Root Mean Square Residual (SRMR) = 0.03) and relative fit indices (Comparative Fit Index (CFI) = 0.95, Non-normed Fit Index (NNFI) = 0.93), which are less sensitive to sample size (Bentler, 1990), indicate acceptable fit between the model and the data. In conclusion, the above results provide strong support for the study's measurement model validity and reliability.

Table 6 presents the constructs' descriptive statistics. Since data is gathered from several datasets that each have different scales, all measures are standardized (mean = 0, SD = 1) to make comparison both clear and possible. All variables are coded in positive direction (higher cronyism values indicate less perception of cronyism, and higher UE values indicate less prevalence of UE). The final sample size for the analysis is 132, meaning that the study includes data for 132 countries worldwide. The study's sample includes a variety of developed, transition, and developing economies from all regions/continents of the world.

Table 6 - Descriptive Statistics

	Mean (SD)	Min (Max)	Cronyism	Market Competitio n	Institutiona l Trust	Productive Entrep.
Cronyism	0 (0.93)	-1.93280 (2.36418)	1			
Market Competition	0 (0.92)	-1.95396 (2.11717)	0.82	1		
Institutional Trust	0 (0.98)	-1.75648 (2.02678)	0.83	0.77	1	
Productive Entrep.	-0.01 (0.95)	-1.20230 (3.34265)	0.77	0.77	0.76	1
Unproductiv e Entrep.	0.01 (0.98)	-1.41462 (2.28055)	0.89	0.74	0.94	0.75

N=132, All correlations are significant at $p < 0.001$

Conceptual Model

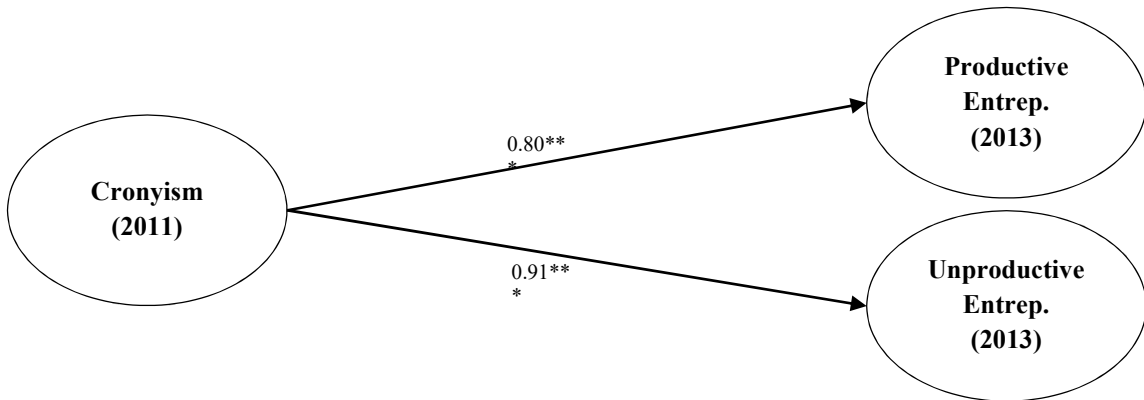
Structural Equation Modeling (SEM) is the analytical method that this study uses to test its hypotheses. SEM is an appropriate choice for this study because of its ability to analyze reflective latent constructs and trace multiple mediation paths simultaneously in

theoretical models. The study builds its conceptual model in two incremental stages to better understand the quality and strength of its hypothesized direct and mediated paths.

In first stage, SEM analysis tests for direct effects of cronyism on PE and UE.

Figure 3 shows this model. Model's goodness of fit indices indicate acceptable level of fit between this model and data (Chi-square/DF = 3.85, SRMR = 0.03, CFI = 0.96, NNFI = 0.94). Cronyism has a positive significant relationship with UE ($\beta = 0.91$, p-value < 0.001), meaning that, lower perception of cronyism leads to less engagement in unproductive entrepreneurship. This finding provides strong support for H1. Also, there is a significant negative relationship between cronyism and PE ($\beta = 0.80$, p-value < 0.001), indicating that, lower levels of cronyism promote higher levels of PE. This finding provides strong support for H2. In conclusion, these findings support our theory for direct effects of cronyism on UE and PE.

Figure 3 – SEM Results for Direct Paths



Chi-square=96.43, Chi-square DF=25, Chi-square/DF=3.85, SRMR=0.03, CFI=0.96, NNFI=0.94

(P <.05 *, P<.01 **, P<.001 ***), N=132

*All variables are coded in positive direction, meaning that, higher values of cronyism and unproductive entrepreneurship variables, respectively, indicate lower levels of cronyism and unproductive entrepreneurship in a country.

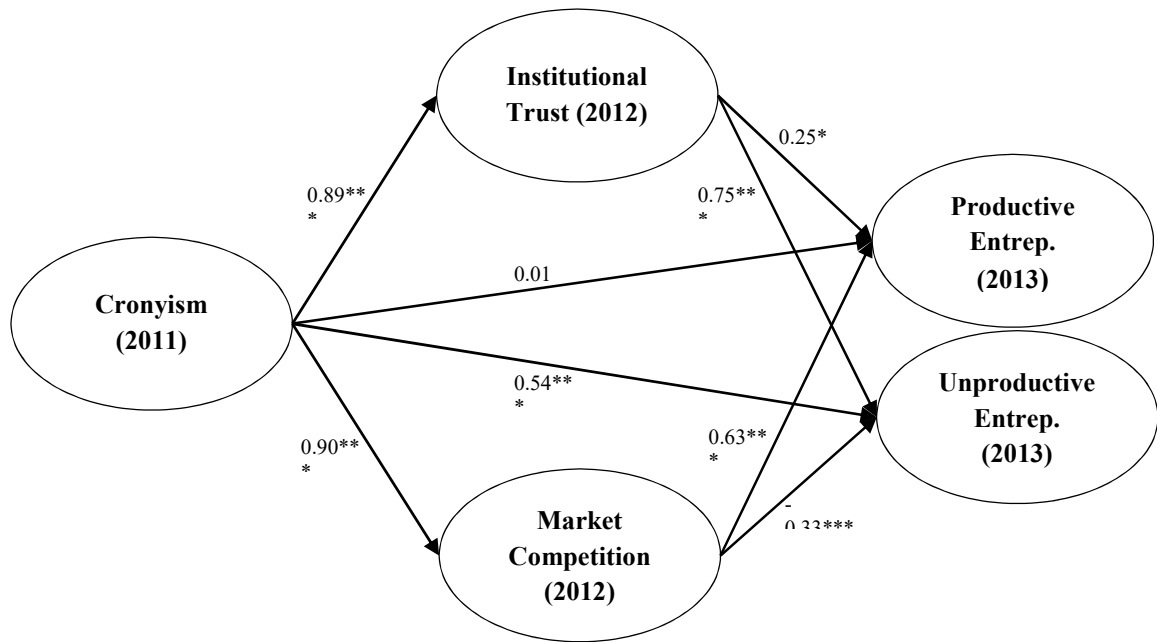
In the second stage, mediators are added to the previous model to test for mediation paths. The second model also indicates adequate fit with data (Chi-square/DF = 3.15, SRMR = 0.03, CFI = 0.94, NNFI = 0.93). The results show that the direct effect of cronyism on UE is still significant ($\beta = 0.54$, p -value < 0.001). However, cronyism's direct effect on PE fades away once mediators are added to the analysis ($\beta = 0.01$, n.s.), which indicates that this path is fully mediated through the study's suggested mediators. As shown in Figure 4, cronyism significantly influences market competition ($\beta = 0.90$, p -value < 0.001), and market competition affects PE ($\beta = 0.63$, p -value < 0.001). Similarly, cronyism significantly affects institutional trust ($\beta = 0.89$, p -value < 0.001), and institutional trust influences PE ($\beta = 0.25$, p -value < 0.05). These results indicate that lower levels of cronyism within a country leads to higher levels of market competition and institutional trust in that country, which both promotes higher levels of PE. These findings provide strong support for H3(b) and H4(b), respectively. In conclusion, the above results show that cronyism has a significant negative influence on PE, and this influence is fully mediated through its negative effects on market competition and institutional trust.

The results from second SEM analysis indicate that market competition does not mediate the cronyism's effect on UE. While the relationship between cronyism and market competition is negative ($\beta = 0.90$, p -value < 0.001), the relationship between market competition and UE appears to be positive ($\beta = -0.33$, p -value < 0.001). This finding means that lower cronyism promotes market competition, and higher market competition leads to higher UE. This is exactly opposite to the study's theory that

suggests lower market competition leads to higher UE. In other words, the analysis results fail to support H3(a). This finding is further discussed in next chapter.

Finally, results of the second SEM analysis provide strong support for H4(a). Cronyism has a negative significant relationship with institutional trust ($\beta = 0.89$, p-value < 0.001), and institutional trust has a significant negative relationship with UE ($\beta = 0.75$, p-value < 0.001). This means that lower levels of cronyism in a country promote higher levels of institutional trust, which then leads to lower levels of UE in that country. In other words, positive effects of cronyism on UE is partially mediated through its negative influence on institutional trust.

Figure 4 – SEM Results for Direct and Mediated Paths



Chi-square=258.58, Chi-square DF=82, Chi-square/DF=3.15, SRMR=0.03, CFI =0.94, NNFI =0.93

(P <.05 *, P<.01 **, P<.001 ***), N=132

*All variables are coded in positive direction, meaning that, higher values of cronyism and unproductive entrepreneurship variables, respectively, indicate lower levels of cronyism and unproductive entrepreneurship in a country.

Robustness Tests

Several robustness tests were performed to echo the validity of the above described results. Firstly, two subject matter experts' surveys were conducted to investigate content validity of the study's measures (Hinkin, 1995; Schriesheim et al., 1993). As a common practice, the study used two samples of 20 PhD students and 20 undergraduate senior students to investigate the extent to which these samples agree that the study's measures can meaningfully reflect the construct they are intended to measure (Hill, White, & Wallace, 2013). Both samples were offered a task in which they would read the definition for each construct and its corresponding measures, and then determine whether they believe that each of the measures reflect the construct's meaning or not. Appendix 1 present the template for the study's subject matter experts' survey and Table 7 represents the results.

Table 7 – SME Survey Results (n=20 per each sample)

Measurement variable	Agreement Rate (%) PhD Students	Agreement Rate (%) Senior Students
Cronyism	92	83
• Favoritism in decisions of government officials	95	100
• Favoritism in appointing managers	100	70
• Undue influence on judiciary system	80	80
Market Competition	92	88
• Intensity of local competition	95	100
• Effectiveness of anti-monopoly policy	90	80
• Extent of market dominance	90	85

Institutional Trust	90	80
• Government effectiveness	90	80
• Rule of law	90	85
• Regulatory quality	90	75
Productive Entrepreneurship	75	87
• Capacity for innovation	75	95
• Company spending on R&D	75	85
• PCT patent applications	75	80
Unproductive Entrepreneurship	78	82
• Control of corruption	80	85
• Corruption Perception Index (CPI)	60	80
• Irregular payments and bribes	95	80

As shown in Table 7 most of the study's measures satisfy the suggested threshold level of 80% in both samples (Hill, Kern, & White, 2014), meaning that majority of the samples' participants believe that the study's measures appropriately reflect the meaning of constructs they are intended to measure. An important exception here is PhD students' rating for measures of productive entrepreneurship, which received 75% agreement rate. While this is not a major shortcoming (75% compared to 80% threshold), the study adopts other common proxies for measurement of productive entrepreneurship at country level to address this concern and insure that the study's main findings are valid.

Consequently, several regression models are analyzed to further investigate validity of results for the main focus of the study, meaning the relationship between cronyism and productive entrepreneurship (H2). For this purpose, the study considers five other proxies for measuring country-level productive entrepreneurship, including,

new business density (number of new business registered divided by population), R&D expenditure (as % of GDP), researchers in R&D (per million people), technicians in R&D (per million people), and high technology exports (as % of all manufactured exports). The relationship between cronyism and these other proxies for PE are investigated using regression analysis to find further support for H2.

Table 8 – Robustness Tests Regression Analysis

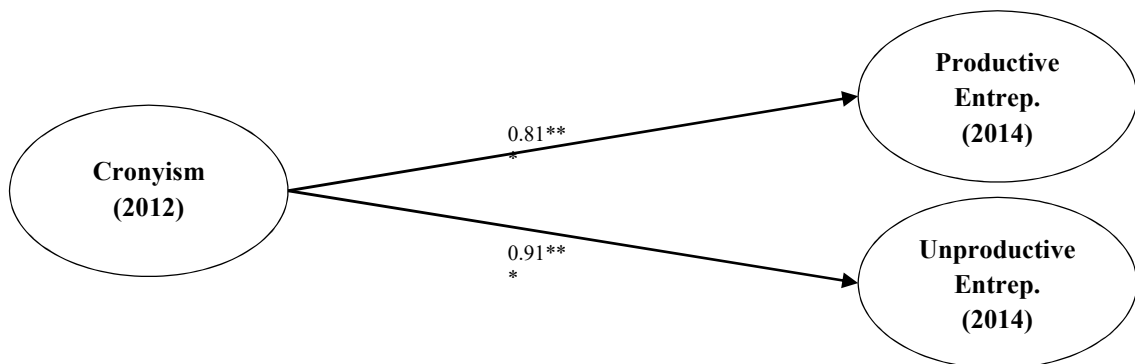
Variables	New Business Density (2012)		R&D expenditure (2013)		Researchers in R&D (2013)		Technicians in R&D (2012)		High Technology Exports (2013)	
	β	S.E.	β	S.E.	β	S.E.	β	S.E.	β	S.E.
Cronyism (2011)	0.34** *	0.10	0.63** *	0.11	0.67** *	0.12	0.46**	0.15	0.36** *	0.10
R²	0.12		0.40		0.45		0.21		0.13	
Adjusted R²	0.11		0.39		0.44		0.19		0.12	
F	11.67***		35.74***		36.58***		10.89**		15.92***	
N	90		55		46		43		112	

The results of five regression models, shown in Table 8, support that cronyism has a negative significant influence on PE (using multiple proxies), meaning that lower levels of cronyism is associated with higher levels of PE. There is at least a one year lag (two years when data available) between cronyism data (IV) and PE proxies (DVs). All regression coefficients (β s) are significant ($p < 0.01$) and their values range from 0.34 to 0.67, indicating cronyism's strong effects on PE. According to these regression models, the level of cronyism is able to explain, respectively, 11%, 39%, 44%, 19%, and 12% of variance in PE, when new business density, R&D expenditure, researchers in R&D,

technicians in R&D, and high technology exports are used as PE proxies (R-square for regression models). Overall, these results provide further strong support for H2, and shows that cronyism’s negative influence on PE is robust for different proxies of PE.

Additionally, SEM analysis are performed with the base year of 2012, meaning that, cronyism’s data for 2012, mediators’ data for 2013, and DVs’ data for 2014. The results of this two-stage SEM analysis indicate that the study’s results are fairly robust even with the change of the year in the analysis. As shown in Figure 5 and Figure 6, goodness of fit and path coefficients’ results for these new models (2012 → 2013 → 2014) are similar to the results of the study’s main models (2011 → 2012 → 2012), which indicate that the hypothesized relationships are robust throughout different years.

Figure 5 – Robustness Test Results for Direct Paths

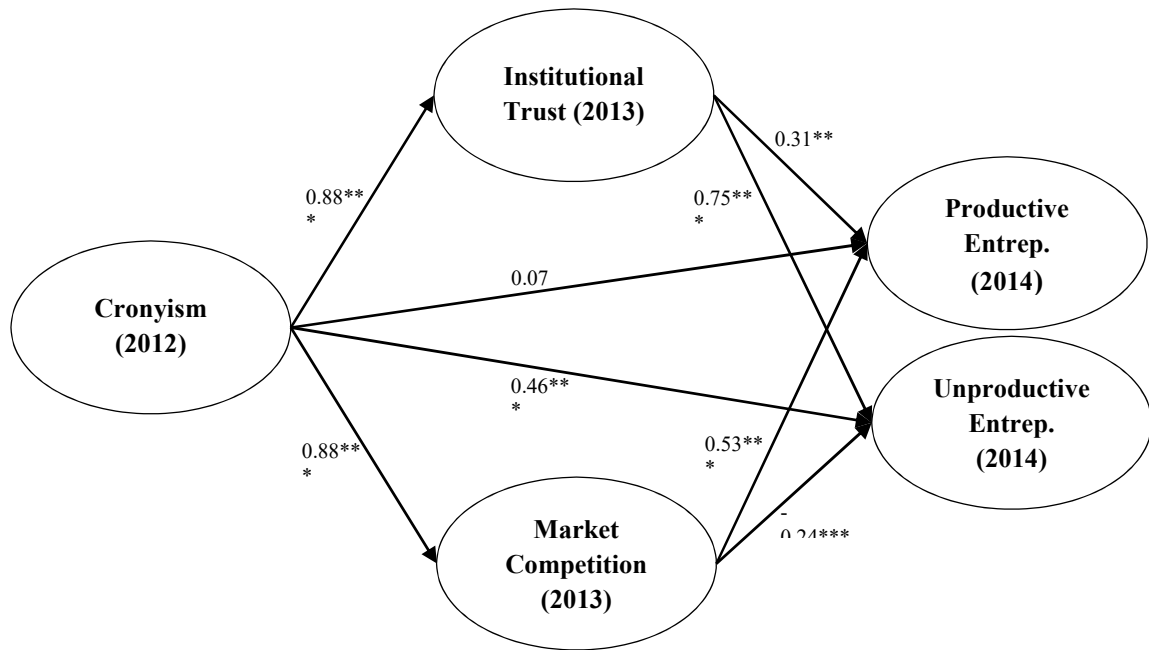


Chi-square=128.93, Chi-square DF=25, Chi-square/DF=5.15, SRMR=0.04, CFI =0.94, NNFI =0.92

(P <.05 *, P<.01 **, P<.001 ***), N=135

*All variables are coded in positive direction, meaning that, higher values of cronyism and unproductive entrepreneurship variables, respectively, indicate lower levels of cronyism and unproductive entrepreneurship in a country.

Figure 6 – Robustness Tests Results for Direct and Mediated Paths



Chi-square=307.13, Chi-square DF=82, Chi-square/DF=3.75, SRMR=0.04, CFI =0.93, NNFI =0.92

(P <.05 *, P<.01 **, P<.001***), N=134

*All variables are coded in positive direction, meaning that, higher values of cronyism and unproductive entrepreneurship variables, respectively, indicate lower levels of cronyism and unproductive entrepreneurship in a country.

CHAPTER IV

FINDINGS

This study strives to clarify how the levels of productive and unproductive entrepreneurship are impacted by the prevalence of cronyism in a country. For this purpose, the study adopts Baumol's (1990) model of productive, unproductive, and destructive entrepreneurship and explains how the prevalence of cronyism undermines productive entrepreneurship and promotes unproductive entrepreneurship in a society. The study posits that cronyism as a practice becomes institutionalized in a context and functions either as a cognitive (common/safe path for success) or as a normative (how things are getting done around here) institution to influence individuals' choice of behavior. In Baumol's words, prevalence of cronyism changes the rules of the game such that they reward unproductive entrepreneurship more than productive entrepreneurship in a society.

Additionally, this study suggests two mechanisms through which cronyism impacts productive and unproductive entrepreneurship. Market competition and institutional trust are two mediators that this study focuses on to explain how the prevalence of cronyism in a country discourages productive entrepreneurship and encourages unproductive entrepreneurship. The study argues that prevalence of cronyism dampens market competition and exhausts people's trust in institutions, which both, lack

of market competition and institutional trust, decrease productive entrepreneurship and increase unproductive entrepreneurship in a society.

Empirical analysis of the study's hypotheses is performed on data from 132 countries using reliable secondary data sources, including the Global Competitiveness Index reported by World Economic Forum (Sala-I-Martin et al., 2010), the Worldwide Governance Indicators developed by World Bank Groups (Kaufmann, Kraay, & Mastruzzi, 2010), the World Bank Group Entrepreneurship Survey (WBGES), the World Development Indicators developed by World Bank Groups, and the Corruption Perception Index reported by Transparency International (Lambsdorff, 2008). The study's sample includes underdeveloped, developing, emerging, and developed countries from all regions of the world, which assures generalizability of the study's findings.

Analysis results strongly support all hypothesized relationships, except for mediating role of market competition in cronyism-unproductive entrepreneurship relationship. More specifically, empirical findings indicate that the prevalence of cronyism has a negative relationship with productive entrepreneurship and this relationship is fully mediated through cronyism's negative effects on market competition and institutional trust. Also, the prevalence of cronyism has a positive relationship with unproductive entrepreneurship, which is partially mediated through cronyism's negative influence on institutional trust and institutional trust's negative influence on unproductive entrepreneurship. In contrast to this study's hypothesis, market competition does not mediate cronyism's relationship with unproductive entrepreneurship. Instead, the results show that market competition has positive relationship with unproductive entrepreneurship, contrary to what is hypothesized in this study.

This study argues that prevalence of cronyism results in entry barriers and protective regulations in favor of connected firms which undermines market competition. Also, the lack of market competition produces rents and leaves firms with excessive resources that they can invest in rent seeking behaviors, meaning that, less competitive markets promote more unproductive entrepreneurial behaviors to extract different types of rents in these markets. Consequently, the study hypothesizes that prevalence of cronyism decreases market competition, which then leads to promotion of unproductive entrepreneurship. However, the empirical results indicate market competition has a positive relationship with unproductive entrepreneurship, meaning that a decrease in market competition leads to lower levels of unproductive entrepreneurship.

An overview of the literature on relationship between market competition and corruption is useful to understand these findings, especially considering that this study uses a corruption measure as a proxy for unproductive entrepreneurship. Prior research suggests that this relationship is a complex phenomenon that depends on various factors, including reasons for strength of market competition and specific nature of corruption (Bliss & DiTella, 1997; Alexeev & Song, 2013). For instance, “corruption based on the extraction of existing rents that are due to some artificial (non-technological) limits on competition is likely to flourish in less competitive environments. Also, if competition is weak due to excessive regulation, then it might be associated with greater corruption that is promoted by this regulation.” (Alexeev & Song, 2013, p. 6). However, “corruption that reduces firms’ costs is likely to be promoted by product market competition.” (Alexeev & Song, 2013, p. 6). Therefore, the influence of market competition on corruption varies in different contexts.

Regardless of the fact that this study uses a corruption measure for unproductive entrepreneurship, the same arguments apply to the relationship between market competition and unproductive entrepreneurship. In other words, the nature of this relationship depends on reasons for lack/presence of market competition and specific types of/motives for unproductive entrepreneurship. For example, as discussed, low levels of market competition due to governmental barriers can promote unproductive entrepreneurial efforts, such as political rent seeking or lobbying, (negative relationship between competition and UE), however, when market competition is high because of natural market competitive forces it can motivate firms to engage in unproductive entrepreneurial efforts, such as tax evasions or law suits, that lead to cost-advantageous for firms (positive relationship between competition and UE). Therefore, the nature of market competition's effects on unproductive entrepreneurship is mostly an empirical issue and differs based on varying contextual factors that influence these variables, and also different proxies that are used to measure them (Alexeev & Song, 2013).

This study contributes to prior research on cronyism in several ways. Firstly, the study provides the first comprehensive review of this literature. This review highlights the multi-level nature of this body of research. It suggests that cronyism is a multi-level phenomenon with micro-, meso-, and macro- level antecedents, and has social, political, and economic consequences at different levels of analysis. Consequently, a wide range of theoretical frameworks and empirical methods can be adopted to examine cronyism-related research questions.

The study focuses on country-level of analysis and chooses an institutional theory perspective to study cronyism. It conceptualizes cronyism as an informal institution

(whether cognitive or normative) in a society, which is a new addition to prior literature. Conceptualization of cronyism as an informal institution in a context provides a rich set of institutional theory related frameworks and arguments for researchers interested in studying cronyism. For instance, this research adopts Baumol's (1990) model of productive and unproductive entrepreneurship and explains how cronyism, as an informal rule of the game, encourages unproductive entrepreneurship at the expense of discouraging productive entrepreneurship.

Moreover, this study suggests a new approach for measuring cronyism by building a measure of 'average perception of prevalence of cronyism' within a context. The study argues that difficulties of making objective judgment about occurrence of cronyism suggest that perception of cronyism can be an appropriate proxy for measuring cronyism (Smith & Sutter, 2012). A significant contribution of this study is to build a measure of perception of cronyism at country-level as a proxy for the degree of prevalence of cronyism within a country.

This study reports a national score for the level of cronyism in countries included in the study's sample based on measures adopted from World Economic Forum's Global Competitiveness report and validated through confirmatory factor analysis. These scores and countries' ranks based on their cronyism scores are presented in Table 9. While these cronyism scores have large significant correlations with countries' GDP per capita (0.72, $P < .0001$) and global competitiveness scores (0.83, $p < .0001$), it is very difficult to conclude that countries' level of cronyism depends on any single factor, like the level of economic development, or wealth. For instance, the existence of developing countries such as Qatar (9), Saudi Arabia (17), and Bahrain (20), scoring higher than developed

countries such as the US (32), France (34), and Italy (88), in the ranking proposes interesting anomalies that call for future research on country-level antecedents and consequences of cronyism. This study's initiatives to develop this measure of cronyism at country-level facilitate and instigate future research in this area.

Table 9 – Ranking of Countries Based on the Level of Cronyism

Rank	Country	Country Code	Cronyism Score (2011)
1	Sweden	SWE	2.364179
2	New Zealand	NZL	2.273711
3	Denmark	DNK	2.085018
4	Finland	FIN	1.946829
5	Norway	NOR	1.923706
6	Netherlands	NLD	1.904489
7	Switzerland	CHE	1.833269
8	Singapore	SGP	1.820654
9	Qatar	QAT	1.673596
10	Canada	CAN	1.620512
11	United Kingdom	GBR	1.599568
12	Australia	AUS	1.531966
13	Japan	JPN	1.519187
14	Germany	DEU	1.512528
15	Ireland	IRL	1.428579
16	Luxembourg	LUX	1.34825
17	Saudi Arabia	SAU	1.282473
18	Chile	CHL	1.222948
19	Rwanda	RWA	1.204371
20	Bahrain	BHR	1.141683
21	Iceland	ISL	1.141239
22	Belgium	BEL	1.130987

23	Israel	ISR	1.080697
24	Barbados	BRB	1.015316
25	Estonia	EST	1.005816
26	United Arab Emirates	ARE	0.995422
27	Austria	AUT	0.983584
28	Oman	OMN	0.957466
29	Malaysia	MYS	0.947081
30	Botswana	BWA	0.919324
31	Gambia	GMB	0.77832
32	United States	USA	0.733328
33	Brunei	BRN	0.712244
34	France	FRA	0.694248
35	Uruguay	URY	0.512542
36	Sri Lanka	LKA	0.457333
37	South Africa	ZAF	0.426747
38	Costa Rica	CRI	0.41414
39	China	CHN	0.349385
40	Malta	MLT	0.312363
41	Cyprus	CYP	0.276932
42	Namibia	NAM	0.263492
43	Mauritius	MUS	0.228364
44	Montenegro	MON	0.22503
45	Malawi	MWI	0.168124
46	Indonesia	IDN	0.133135
47	Spain	ESP	0.132495
48	Poland	POL	0.122626
49	Kuwait	KWT	0.110098
50	Brazil	BRA	0.063254
51	Ghana	GHA	0.041553

52	Thailand	THA	-0.01289
53	India	IND	-0.01854
54	Cabo Verde	CPV	-0.03352
55	Trinidad and Tobago	TTO	-0.07222
56	South Korea	KOR	-0.08162
57	Jordan	JOR	-0.09397
58	Lithuania	LTU	-0.10131
59	Tanzania	TZA	-0.11538
60	Zambia	ZMB	-0.13219
61	Jamaica	JAM	-0.14427
62	Hungary	HUN	-0.15244
63	Portugal	PRT	-0.18002
64	Latvia	LVA	-0.21335
65	Zimbabwe	ZWE	-0.22114
66	Morocco	MAR	-0.22428
67	Czech Republic	CZE	-0.22987
68	Cambodia	KHM	-0.2383
69	Iran	IRN	-0.24071
70	Nigeria	NGA	-0.30257
71	Guyana	GUY	-0.30609
72	Suriname	SUR	-0.31038
73	Georgia	GEO	-0.32648
74	Peru	PER	-0.32842
75	Albania	ALB	-0.33118
76	Egypt	EGY	-0.33252
77	Vietnam	VNM	-0.3718
78	Pakistan	PAK	-0.37407
79	Swaziland	SWZ	-0.37803
80	Mexico	MEX	-0.3789

81	Azerbaijan	AZE	-0.37994
82	Colombia	COL	-0.38018
83	Turkey	TUR	-0.41522
84	Philippines	PHL	-0.42407
85	Ethiopia	ETH	-0.4274
86	Cameroon	CMR	-0.47256
87	Nepal	NPL	-0.50672
88	Italy	ITA	-0.53027
89	Honduras	HND	-0.53836
90	Benin	BEN	-0.53943
91	Uganda	UGA	-0.53974
92	Kenya	KEN	-0.54251
93	Bosnia and Herzegovina	BIH	-0.54404
94	Greece	GRC	-0.5753
95	Romania	ROM	-0.62724
96	Armenia	ARM	-0.64734
97	Senegal	SEN	-0.64735
98	Guatemala	GTM	-0.64891
99	Croatia	HRV	-0.66381
100	Mozambique	MOZ	-0.68841
101	Timor-Leste	TLS	-0.72153
102	Bangladesh	BGD	-0.72941
103	Macedonia	MKD	-0.74095
104	Bulgaria	BGR	-0.75038
105	Lesotho	LSO	-0.76506
106	Ecuador	ECU	-0.76808
107	Bolivia	BOL	-0.77451
108	Kazakhstan	KAZ	-0.8063
109	El Salvador	SLV	-0.81503

110	Argentina	ARG	-0.83613
111	Russia	RUS	-0.86105
112	Mali	MLI	-0.86671
113	Burkina Faso	BFA	-0.87723
114	Moldova	MDA	-0.88434
115	Madagascar	MDG	-0.88993
116	Côte d'Ivoire	CIV	-0.96624
117	Mongolia	MNG	-0.98732
118	Panama	PAN	-0.9974
119	Lebanon	LBN	-1.03406
120	Ukraine	UKR	-1.05799
121	Serbia	SCG	-1.10358
122	Venezuela	VEN	-1.12227
123	Kyrgyzstan	KGZ	-1.13284
124	Algeria	DZA	-1.16571
125	Dominican Republic	DOM	-1.22114
126	Paraguay	PRY	-1.24479
127	Nicaragua	NIC	-1.25702
128	Burundi	BDI	-1.29246
129	Chad	TCD	-1.32333
130	Mauritania	MRT	-1.36065
131	Haiti	HTI	-1.38677
132	Yemen	YEM	-1.9328

Lastly, this study suggests two mechanisms through which cronyism influences productive and unproductive entrepreneurship. In the case of productive entrepreneurship, it appears that market competition and institutional trust are able to fully mediate negative effects of cronyism. While the full mediation results can be due to

this study's specific choice of variables and measures, it may also indicate that other mediators for cronyism-productive entrepreneurship link mediate this relationship through either of the two major mechanisms explained here. Overall, these results underscore the importance of these mechanisms for investigating cronyism's effects on other country-level outcomes in future research.

In addition to contributions to cronyism research, this study also contributes in filling research gaps at intersections of entrepreneurship with institutional theory and network theory. Prior research mainly focused on studying the effects of formal institutions, such as property rights and contract enforcement laws, on productive entrepreneurship and falls short in studying the effects of informal institutions on productive entrepreneurship (Bruton et al., 2010). This study explains how cronyism, as an understudied informal institution, creates differences in the levels of productive entrepreneurship within countries that may even have more or less similar formal institutions. Hence, this study highlights the importance of considering the effects of informal institutions on productive entrepreneurship and encourages scholars to focus on this understudied area of research.

Moreover, for many years entrepreneurship has been generally framed as a positive phenomenon by scholars because of its known positive effects on economic development and prosperity in societies (e.g. Reynolds et al., 1999; Zacharakis et al., 2000). Such a positive bias toward the entrepreneurship related phenomenon is still dominant in entrepreneurship scholarship, despite calls for paying attention to the dark sides of entrepreneurship at different levels of analysis (e.g. Baumol, 1990; Hmieleski, & Lerner, 2013). This study is one of the few empirical research studies that focuses on

unproductive entrepreneurship at macro-level and provides support for Baumol's (1990) model of productive, unproductive, and destructive entrepreneurship (e.g. Murphy et al., 1991; Sobel, 2008). This study's theoretical arguments and empirical findings advance our knowledge about unproductive forms of entrepreneurial behaviors and highlight a critical need for future scholarship in this area.

Finally, the study highlights an important gap of knowledge at the intersection of entrepreneurship and network theory, which requires scholars' further attention. For many years, scholars focused on studying positive roles of networking for entrepreneurial entry and business performance. Having social networks (whether dense networks of strong ties or sparse networks of weak ties with many structural holes) is known to provide competitive advantages for firms and supports entrepreneurial growth in almost every context (Burt, 1992; Coleman, 1988, 1990; Singh et al., 1999). Recent findings even suggest that social networks can substitute for lack of well-functioning formal institutions, especially in the developing countries' context (e.g. Puffer et al., 2010). In contrast, there are relatively very few studies on the "downside of social networking" or cronyism in management and entrepreneurship scholarship (Khatri et al., 2003).

This study demonstrates that prevalence of certain types of networking activities, called cronyism, can be detrimental to productive entrepreneurship in a society as a whole. In other words, this study does not reject scholars' general belief that having informal networks helps an entrepreneur to pursue his goals at the individual/organizational level, but it further clarifies that once having informal networks becomes an excessively important success factor for businesses in a country, then the level of productive entrepreneurship is influenced negatively at the national level. Hence,

this current research focuses on negative effects of too much networking for entrepreneurship and business, which is an understudied area of research.

CHAPTER V

CONCLUSION

Implications for Policy Makers and Entrepreneurs

Entrepreneurship policy makers aim to set the rules of the game in a country such that they promote the supply and allocation of resources to productive entrepreneurship. This study explains how cronyism can suppress these goals by decreasing supply of resources to productive entrepreneurship through undermining individuals' entrepreneurial intentions, also by promoting allocation of resources to unproductive entrepreneurship through changing reward structure in a society. Therefore, policy makers need to find ways to fight against cronyism and its destructive effects on entrepreneurship policies and programs.

Policy makers are required to set policies that decrease opportunities for occurrence of cronyism in a business context. For instance, developing more transparent procedures with rules that leave less room for subjective judgments of officials who enforce these rules can reduce the level of preferential treatments for connected individuals (Fei et al., 2012). Moreover, policy makers need to focus on suppressing two mediating mechanisms suggested in this study in order to weaken the effects of cronyism on productive entrepreneurship. Based on this study's findings, setting and enforcing

policies that strengthen market competitions and attract citizens' trust in fairness and functionality of the system are effective ways to hamper the negative effects of cronyism on productive entrepreneurship.

Additionally, entrepreneurs need to consider the destructive long term effects of engagement in cronyism. While involvement in cronyism can benefit entrepreneurs in the short term, it has major costs for them in the long term. Most importantly, entrepreneurs' reliance on preferential treatments they receive through their connections makes them short term oriented and unwilling to plan for investments on developing sustainable competitive advantages that help them to survive in the long run (Enderwick, 2005). In other words, entrepreneurs who have access to favors through their connections get distracted from investing in their own core competencies and ultimately suffer from their incompetence in the long-term, especially in cases of connection terminations or major political changes that destroy their connections' value (Duchin & Sosyura, 2012; Tahoun, 2014; Su et al., 2015).

Moreover, once an entrepreneur participates in cronyism and seeks rents through favors, his rent seeking behavior not only produces a negative externality on productive entrepreneurs, but also reduces the return to rent seeking in his society (Acemoglu, 1995). In other words, an entrepreneur's involvement in cronyism may seem to have short term benefits for the individual entrepreneurs, but in long term it contributes to changing reward structure in the society and reduces the return to both productive and unproductive entrepreneurship for current and future generations. Consequently, when entrepreneurs decide to participate in cronyism, they need to consider that they contribute

in making entrepreneurship, both productive and unproductive, less rewarding in society as a whole, which ultimately hurts themselves as well as other citizens.

Future Research Directions

Scholarly research on cronyism, especially in management and entrepreneurship disciplines, is in its infancy stage. Although prior research on political connections' influence on firm's performance tangentially informs scholars about some of the firm-level consequences of cronyism (e.g. Zhou, 2013), there are still wide areas of research on cronyism-related phenomenon that remain untouched. Most importantly, the cronyism concept requires more theoretical clarifications and empirical investigations. So far, very few studies, including this one, focused on clarifying the concept of cronyism and its different types in the literature (e.g. Khatri et al. 2006; Henderson, 2012; Holcombe, 2013). However, further theoretical development and understanding in this area would be limited without the proper definition of this concept and clarification of its boundaries.

This study conceptualizes cronyism as an informal institution in a society. Future research is required to explain how the practice of cronyism becomes institutionalized in a context and what other factors, including other formal/informal institutions, accelerate/strengthen the institutionalization of cronyism in a context. In other words, our knowledge about (micro-, meso-, and macro-level) antecedents of cronyism is very limited and more scholarship is required to understand why cronyism is more prevalent in some contexts than others. The multi-level multi-disciplinary nature of these antecedents enable scholars from different areas of knowledge (e.g. psychology, sociology, economics, politics) to be able to establish fruitful research streams in this area.

A few examples of research questions for future studies on the antecedents of cronyism include: what individual characteristics increase the propensity of individuals to engage in cronyism? What is the relationship between individuals' ethical standards and their propensity for engagement in cronyism? What organizational characteristics can promote organizational members' involvement in cronyism within firms? How do firms' degrees of familiness influence the occurrence of cronyism within those firms? What social norms and values promote cronyism in a society? How do different types of institutional imperfections in countries influence their level of cronyism?

Similarly, cronyism's consequences require more scholarly attention. Cronyism has a variety of social, political, and economic consequences, which calls for multidisciplinary research streams that aim to examine cronyism's relationships with these consequences and investigate the mechanisms through which cronyism influence its outcomes. However, the empirical investigations of cronyism-related phenomenon is limited until future research focuses on the development of appropriate measurement tools for capturing variability of cronyism in different contexts.

A few examples of questions that future researchers may choose to focus on for investigation of cronyism's effects and outcomes include: What types of emotional and behavioral reactions do different individuals have when they are victims or witnesses of cronyism? What is the relationship between the prevalence of cronyism in a context and individuals' entrepreneurial intentions and aspirations? How does the occurrence of cronyism within organizations influence firm-level outcomes? How do effects of intra-organizational cronyism on firm's performance change over time? How do economic consequences of cronyism change over time as a country passes through different stages

of economic development? What is the relationship between the prevalence of cronyism and the level of social inequality in different societies?

Additionally, unproductive entrepreneurship is an understudied area of research. It is quite surprising that entrepreneurship scholarship have been so focused on productive forms of entrepreneurship that its unproductive forms have remained understudied for more than three decades. Future research is required to investigate the relationship between productive and unproductive forms of entrepreneurship, their similarities and differences, and the motives for unproductive entrepreneurship at different levels of analysis. However, advancement of our knowledge about unproductive entrepreneurship depends heavily on future researchers' attempts to firstly clarify its definition, boundaries, and different types, and secondly, develop appropriate measurement tools to capture its variability at different levels of analysis.

A few examples of research questions for future research on unproductive entrepreneurship includes: How can prior knowledge on productive entrepreneurship and rent-seeking behaviors increase our understanding about unproductive entrepreneurship? What individual characteristics increase the propensity of individuals involvement in unproductive entrepreneurship rather than productive entrepreneurship? How do individuals' motives differ for involvement in unproductive entrepreneurship compared to productive entrepreneurship? Do most entrepreneurs engage in some level of both types of entrepreneurship? If yes, how do they balance their resource investments on productive and unproductive entrepreneurship? What firm-level capabilities and characteristics promote firm-level unproductive entrepreneurial behaviors? What firm-

level factors influence firms' allocation of resources between productive and unproductive entrepreneurial behaviors?

In conclusion, this study encourages a wide variety of future research on both cronyism and unproductive entrepreneurship, as both concepts have attracted negligible attention in prior management and entrepreneurship research. Hence, there are significant gaps of knowledge in both areas, which urge future scholarships.

Limitations

This study's data is based on perceptual measures adopted from reliable secondary data sources. Several reasons make this choice of perceptual measures appropriate for the study's purpose. Firstly, perceptions matter as people's choice of behavior/action is based on their perceptions of reality, rather than the objective reality itself (Kaufmann et al., 2010). For instance, citizens choose to engage in unproductive rather than productive entrepreneurship based on their perceptions of return to each path. Similarly, institutional trust is based on people's perceptions of fairness and functionality of the system, rather than its objective fairness and functionality. Secondly, in cases such as corruption, unproductive entrepreneurship, and cronyism, perceptual measures are appropriate alternatives to other available objective measures, since by definition there is no objective record for these types of activities (e.g., Lambsdorff, 2008). For instance, as discussed previously, no one can be accused of committing cronyism in a court, and unproductive entrepreneurs mostly strive to perform their actions under the radar.

Finally, in cases such as formal institutions or market competition, some objective or fact-based data may be available, however such data often captures de jure notion of

the desired variables, rather than de facto reality, which is captured by perception data (Kaufmann et al., 2010). For instance, ‘on the books’, entry barriers (e.g. measured by number of required licenses and permissions) can determine de jure level of market competition, which can be quite different than, ‘on the ground’, de facto level market competition that is perceived by an entrepreneur who considers entering that market. Overall, use of perceptual measures is strongly defensible in this study, especially considering its country-level of analysis. However, concerns about probable imprecision of perceptual measures and existence of different types of biases in perceptual databases are undeniable. This study acknowledges this limitation and encourages future researchers to examine similar relationships using objective proxies to the extent possible.

Additionally, using corruption measures as proxies for unproductive entrepreneurship is a clear limitation of this study. Prior research fails to suggest appropriate objective proxies for measurement of unproductive entrepreneurship. Also, to the author’s knowledge, perception-based measures of unproductive entrepreneurship are not available. Hence, this study uses the level of country’s perceived corruption as a proxy for measuring the level of unproductive entrepreneurship. Unproductive entrepreneurial behaviors are mostly perceived as corrupt behaviors by the general population; however, not all types of corrupt behaviors (e.g., bribery, embezzlement) are unproductive entrepreneurship. Therefore, this is a serious limitation of this study, which urges future researchers to develop/adopt more accurate proxies for measuring unproductive entrepreneurship in their studies.

Finally, low sample size and inadequate number of available years in current data did not allow this study to investigate longitudinal models or implement panel data analysis. However, this area of knowledge would significantly benefit from longitudinal analysis of these variables to understand how the level and influence of cronyism on entrepreneurship changes over time within countries. Considering that World Economic Forum and World Bank Groups release new version of the data used in this study every year, I strongly encourage future scholars to revisit these data sources and assess the possibility of performing longitudinal analysis in this area.

Concluding marks

For several decades, management scholarship have mostly focused on networking and its positive effects on entrepreneurial behaviors and business performance. However, scholars have rarely acknowledged negative effects of the prevalence of too much networking, or the downside of networking, in a business context. The current study highlights this issue by conceptualizing cronyism as an informal institution that is able to discourage productive entrepreneurial behaviors and encourage unproductive ones. Whenever individuals offer unfair favors to members of their networks at the expense of non-members, they contribute in disrupting market competitions, destroying people's trust in the system, and ultimately developing a system in which connections play critical roles for achievement of goals rather than qualifications and hard work. Such an unfair economic system generally is called crony capitalism.

Countries that fall into the “idea trap” of cronyism, as a pragmatic way of getting business done, find their private and public resources locked into a crony capitalism

system in long run. As cronyism become more institutionalized it leads to more cronyism and ultimately these countries fall into a reinforcing vicious cycle that is able to destroy/obliterate their whole economy. This is an ‘underdevelopment trap’ that many countries are locked in currently (Acemoglu, 1995). Therefore, it is vital that scholars initiate more research on cronyism to understand and identify its antecedents, consequences, and mechanisms through which it is reinforced. I hope future research form a rich body of knowledge that is able to offer practical suggestions for policy makers and entrepreneurs on how to fight against the “idea trap” of cronyism in societies and contribute in building favor-free and fair business contexts. This research is a step forward in this direction.

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