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How Cronyism Undermines Innovation and Entrepreneurial Productivity

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Favoritism may make it easier to get things done, especially in difficult business environments. But as cronyism increases, productive entrepreneurship falls and more entrepreneurial activity shifts toward profiteering without creating value.

Imagine you are launching a new business. A friend offers to help you skip the line to obtain the necessary permits, gain access to a loan, or secure a valuable contract. Nothing illegal, of course...just an advantage that comes from having a well-connected friend. Would you accept the help?

In much of the world, personal relationships are a key and even unavoidable part of doing business, often overriding other criteria including merit. Yet relying on connections can create a difficult tradeoff. While connections can help entrepreneurs more effectively navigate complex systems, they can also help create or perpetuate a business environment where success depends more on who entrepreneurs know rather than capabilities or merit.

The tension illustrated in this scenario lies at the heart of cronyism, defined as the shared norms and understandings that legitimize the exchange of favors among connected parties, resulting in the prevalence of preferential treatment based on personal relationships (e.g., family members, friends, and political allies) rather than merit. Cronyism is a pervasive informal institution across many societies, shaping access to contracts, licenses, financing, employment, promotions, and other valuable opportunities and resources. Unlike corruption, which involves the abuse or violation of formal rules for private gain, cronyism is embedded in enduring social relationships and norms that operate within, alongside, or around formal institutions (e.g., rules, regulations).

Consequently, its various manifestations, such as nepotism or securing regulatory advantages, are often legal, socially accepted, and deeply ingrained in business and political life. Although the prevalence and forms of cronyism vary across countries, relationship-based favoritism exists to some degree in every society, making cronyism an institutional reality that entrepreneurs, managers, and policymakers cannot ignore.

What We Wanted to Understand

Cronyism has both potential benefits and costs across contexts. On the one hand, it can support economic activity by serving as a pragmatic way of getting things done. Relationship-based exchanges can reduce uncertainty, build trust, facilitate business coordination, and expedite regulatory processes, particularly where formal institutions are weak or underdeveloped. On the other hand, cronyism can distort competition, weaken market discipline, and reduce incentives to respond to customer needs, ultimately harming consumers and overall market efficiency.

If cronyism can both help entrepreneurs navigate difficult environments and undermine merit-based competition, how does it shape the kind of entrepreneurship that emerges? Does it help entrepreneurs identify and exploit novel opportunities to create new businesses and offerings, or does it discourage innovation and redirect entrepreneurial effort toward securing personal advantages and redistributing wealth without generating new value for society?

What We Studied

To understand how cronyism shapes entrepreneurship, we examined both the quantity and quality of entrepreneurial activity across countries. Entrepreneurship quantity refers to the amount of entrepreneurial activity in a country, and entrepreneurship quality reflects whether those activities are focused on innovation and growth. In addition, because strong legal institutions are often viewed as a safeguard against cronyism, we investigated whether the rule of law moderates the effect of cronyism on both the quantity and quality of entrepreneurship.

To examine these relationships, we used established international indicators that capture the prevalence of different types of entrepreneurial activity at the country level. Productive entrepreneurship (i.e., entrepreneurial activity that creates new value through innovative offerings) was measured by the prevalence of opportunity-motivated entrepreneurship: people pursuing entrepreneurship to increase their income or independence rather than because they lack other employment options. We also looked at indicators of innovation and growth, including patent applications, new product introductions, and entrepreneurs expecting to create at least six jobs within five years. In contrast, unproductive entrepreneurship focuses on capturing or redistributing existing value for private gain, often at the expense of society. We measured that by the prevalence of necessity-driven entrepreneurship—people pursuing entrepreneurship because they lack better employment alternatives—along with indicators of unethical firm behavior and the costs that crime imposes on businesses. To assess the quality of entrepreneurship, we measured entrepreneurial productivity by comparing the prevalence of productive versus unproductive entrepreneurship within each country.

Cronyism was measured using executives' perceptions of favoritism in both government and business. Specifically, we examined the extent to which government officials favor well-connected firms and individuals in policy and contracting decisions and whether senior management positions tend to go to qualified professionals or to relatives and friends regardless of merit. Finally, the rule of law was measured using institutional quality indices that reflect the strength of legal enforcement, property rights protection, and constraints on arbitrary governance. We analyzed data from 98 countries between 2010 and 2017, comprising 482 country-year observations.

What We Found

Our findings show that cronyism is associated with both the quantity and quality of entrepreneurship across societies. As cronyism increases, productive entrepreneurial activity declines while unproductive entrepreneurial activity rises. Cronyism is also negatively related to the quality of entrepreneurship. Our research indicates that as cronyism increases, entrepreneurial effort shifts away from innovation and value creation toward survival and rent-seeking activities: pushing for tariffs or regulations that eliminate the competition, using monopoly power to dramatically raise prices, and other profiteering activities that don't create value.

Surprisingly, and contrary to expectations, the negative relationship between cronyism and entrepreneurship quality is stronger in countries with a stronger rule of law. This suggests that when cronyism is deeply embedded, stronger legal and regulatory systems not only fail to protect against the harmful effects of favoritism on entrepreneurial productivity but may also create more opportunities for entrepreneurs to leverage formal institutions for private advantage.

Implications for Entrepreneurs

Our findings suggest that entrepreneurs should think carefully about the source of their competitive advantage. Although no single entrepreneur can transform an institutional system alone, every entrepreneur can choose whether to compete primarily through capabilities or connections. These choices not only shape the long-term resilience of individual firms but also collectively influence the entrepreneurial environment in which businesses compete.

In many business environments, relying on connections to obtain permits, financing, contracts, or regulatory relief may appear efficient and sometimes even necessary. However, overreliance on relationship-based favoritism carries significant long-term costs. What begins as a useful shortcut can eventually become a dependency. Entrepreneurs should pay attention to warning signs that personal connections are becoming a substitute for capabilities. These signs may include winning opportunities primarily because of relationships, relying on informal influence to solve recurring business problems, prioritizing network maintenance over customer value creation, or becoming dependent on a

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small group of connected individuals for access to critical resources. Such advantages can appear valuable in the short run but often become liabilities as conditions change. Moreover, as more entrepreneurs choose to rely on relationships to gain advantages, these practices become increasingly normalized, reinforcing a vicious cycle that creates a business environment in which connections matter more than capabilities. Over time, this shifts the reward structure away from value creation and reduces the returns to entrepreneurial activity for current and future entrepreneurs.

A more sustainable strategy is to build firms around business capabilities rather than privileged access. Entrepreneurs who invest in innovation, product quality, operational excellence, and merit-based hiring develop advantages that are more resilient to political change, shifting alliances, and institutional uncertainty. While resisting cronyism may involve short-term sacrifices, it strengthens the firm's long-term competitiveness and contributes to a healthier entrepreneurial environment in which success is driven by value creation rather than favoritism.

Implications for Policymakers

One of the most surprising findings from our study concerns the interaction between cronyism and the rule of law. Rather than weakening the negative effects of cronyism, stronger formal institutions sometimes appear to amplify them. Every new law or regulation introduces procedures and discretion that, in environments where relationship-based favoritism is deeply entrenched, can become opportunities for connected actors to advance their own interests.

Licensing requirements offer a clear example. While licensing is intended to improve quality and oversight, complex approval processes can increase the value of personal connections. Well-connected individuals or firms may receive faster approvals, informal guidance, or exemptions, while others face delays, uncertainty, or higher costs. In these settings, stronger regulation does not necessarily curb the harmful effects of cronyism. Instead, it can inadvertently increase the value of personal connections relative to competence.

Policymakers should view formal and informal institutions as complementary rather than independent. Put simply, changing the rules may not be enough. Policies that work well in one country may produce very different outcomes elsewhere, because informal norms and relationship-based practices shape how formal rules are interpreted and enforced. Likewise, legal reforms designed to promote fairness can be adapted or exploited by well-connected actors if the underlying culture of favoritism remains unchanged. Consequently, strengthening the rule of law should be accompanied by efforts to reshape the informal institutions that sustain cronyism. Alongside legal and regulatory reforms, policymakers should invest in transparency, civic education, public awareness, and initiatives that reinforce meritocracy, accountability, and ethical business practices. Lasting institutional reform requires not only better laws but also changes in the shared norms and expectations that determine how those laws operate in practice.

Explore the Research

Soleimanof, S., Payne, G. T., Moore, C., & Rutherford, M. W. (2025). Cronyism, Rule of Law, and Entrepreneurship: A Country-Level Examination. *Journal of Management*.

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