

**Understanding informality across developing and advanced economies:**

**Case studies of African and Caribbean entrepreneurs in Newark, NJ**

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**Abstract:** While much of the informal sector literature looks at the less developed or developing country context, the motivations for transitioning from formal to informal, and vice versa, are similar for entrepreneurs in advanced countries. Entrepreneurs across both types of economies use informality to leverage social networks against unemployment and marginalization. Although one can seemingly expect similar motivations despite different institutional environments, differences in context may cause variation in the processes used to make business choices. Additionally, research shows that the informal sector's impact on economic and social conditions differs according to the economy's level of development. However, informal sector research lacks comparison of entrepreneur characteristics and behaviors across different institutional environments; in particular, the differences created by the institutional contexts of developing versus advanced economies. As such, this paper will compare studies that focus on advanced economic contexts against those that are still developing to see any variation across variables and constructs according to the differences in these contexts. Such comparison will identify areas of opportunity for further development in either context. To further study these differences, a second paper uses a multiple case studies approach with grounded theory analysis to profile the way African and Caribbean immigrant entrepreneurs navigate a different institutional environment than their home country and their business choices as formal or informal entrepreneurs. The context of the study is Newark, New Jersey, which is a constrained urban environment, as this is where a majority of immigrant entrepreneurs start their business after migration to an advanced economy. Combining the contributions of this paper and the second paper from my research will build theory for identifying immigrant entrepreneur processes within both formal and informal sectors.

**Keywords: Informal sector, African entrepreneurs, Caribbean entrepreneurs, developing and advanced economies**

The stable market environment of developed countries, created by increases in legal institutions, protects economic transactions and participation (Williamson, 2000). The pursuit of an identified purpose or a new opportunity pushes entrepreneurs to mobilize resources and leads to the birth of new organizations (Aldrich & Ruef, 2006). In an environment with many institutional protections and guarantees, entrepreneurs are encouraged and can be confident in making good use of the prosperity that arises from organizational foundings (Aldrich & Ruef, 2006). However, entrepreneurs in most less developed countries do not have the same confidence in their legal and economic national institutions. Although government regulations for business development in less developed countries are meant to protect and encourage markets, the regulations tend to be very restrictive and overbearing, making it more difficult for the entrepreneurs to formally start a business; much less to maintain it. The difficulties posed by institutional factors in less developed countries hamper the processes relevant to organizational foundings. This is only one of the reasons that entrepreneurs start unregistered businesses in the informal sector, in order to bypass regulations.

Literature that reviews the development of urban enterprises account for the social, political, and economic barriers to market that entrepreneurs have to overcome in order to foster local growth (Angel, 1980; Robinson, 2007). Regulatory barriers play a major role as a deciding factor for entering entrepreneurship, but can also minimize the effects of individual characteristics, including business skills and social networks (Ardagna & Lusardi, 2008). However,

[p]olitical factors can manifest as specific policy actions that reduce bureaucratic barriers and corruption, ensure fair practices, or provide grants and funding to support entrepreneurial opportunities and promotion programs...Governments can also promote entrepreneurship through an explicit entrepreneurship promotion framework or strategy (Robb, Valerio, & Barton, 2014).

One such development strategy that governments have used to stimulate formal business growth through entrepreneurship is urban enterprise zones, which have garnered a great deal of attention from scholars (Bondonio & Engberg, 2000). More recent literature has recognized that one cannot discuss formal markets comprehensively without talking about its intersection with informality (McGahan, 2012). Informal economy literature notes that when in a context with high regulatory and economic barriers, businesses that operate under the radar of registration primarily represent necessity-driven entrepreneurship (Robb et al., 2014). For urban enterprises with growth goals, informality can pose financial and legal hindrances (Robb et al., 2014).

The informal economy has gained fresh traction in development economics, representing at least half of the economic transactions that take place in a majority of countries (McGahan, 2012). With increases in the socio-economic impact of the informal sector came a necessary increase in research attention on its participants within the economic and sociological fields (De Soto, 1989; ILO, 1985; Leonard, 2000; World Bank, 1989). Although these fields have used entrepreneurship and organization theories to explain venture creation, operation and performance in a variety of informal contexts, management research continues to lag behind. McGahan (2012) reviewed informal transactions in the field of management, which are primarily discussed through lens that analyze the boundaries of the firm using such theories as transaction cost, more recently extended and termed organizational economics (Argyres & Zenger, 2012; Williamson, 1975, 1985), property rights and governance (De Soto, 1989), the resource-based view (Godfrey, 2011; Penrose, 1959), stakeholder theory (Porter & Kramer, 2011; Prahalad, 2004), labor economics and capacity development (Baum & McGahan, 2012), disruptive technologies and creative processes (Bhattacharyya, Khor, McGahan, Dunne, Daar, & Singer, 2010; George, McGahan, & Prabhu, 2012), institutional entrepreneurship and reform

(Greenwood & Suddaby, 2006; North, 1990; Rosser, Rosser, & Ahmed, 2000), and organization legitimacy (Godfrey, 2011; Webb, Tihanyi, Ireland, & Sirmon, 2009).

To encourage more interdisciplinary scholarship, the Academy of Management dedicated an entire conference to developing a more comprehensive research paradigm on the informal economy (Bruton, Ireland, & Ketchen, 2012). In introducing the research that arose from the symposium, Bruton, Ireland, and Ketchen (2012) called for “examination of the firms and managers in institutional settings where informal firms dominate.” Further, after a cursory review of the existing literature, the authors specifically request that researchers look at “motivations that cause a firm to transition from informal to formal” sectors (Bruton et al., 2012). This paper will compare studies that focus on advanced economic contexts against those that are still developing to see any variation across variables and constructs according to the differences in these contexts. Such comparison will identify areas of opportunity for further development in either context. To further study these differences, a second paper uses a multiple case studies approach with grounded theory analysis to profile the way African and Caribbean immigrant entrepreneurs navigate a different institutional environment than their home country and their business choices as formal or informal entrepreneurs. The context of the study is Newark, New Jersey, which is a constrained urban environment, as this is where a majority of immigrant entrepreneurs start their business after migration to an advanced economy. Combining the contributions of this paper and the second paper from my research will build theory for identifying immigrant entrepreneur processes within both formal and informal sectors.

The first part of this paper will go through a general overview of the state of literature on the informal sector. Then, I will take a more specific look at how conditions of the informal sector impact development and separate concepts found in the literature according to emerging

or advanced economies. Finally, I offer propositions that seek to build comparisons of entrepreneur characteristics and behaviors across different institutional environments; in particular, the differences created by the institutional contexts of developing versus advanced economies.

### **INFORMAL ECONOMY LITERATURE, THUS FAR**

While much of the informal sector literature looks at the less developed country context, the motivations for transitioning from formal to informal, and vice versa, are similar for entrepreneurs in developed countries. Yet, entrepreneurs across both types of economies use informality to leverage social networks against unemployment and marginalization, positioning informality as a “social and historical process, rather than a separate sector or economy,” (Leonard, 2000). Difficulties posed by institutional factors in developed countries, such as zoning laws, hamper the processes relevant to business registrations. As an economist, Portes (1994) looked at excessive and burdensome government policies and laws, which nascent entrepreneurs assess before starting a business. Business registration difficulties and high tax costs also provide incentives to start a company in the informal sector in order to bypass regulations (Grosh & Somolekae, 1996). Research also finds that while burdensome regulations decreases entrepreneurship rates, surprisingly administrative considerations that entrepreneurs assess when starting a business are found to be unrelated to the startup process (van Stel, Storey, & Thurik, 2007; van Stel & Stunnenberg, 2006). Further, informal self-employment is still on the rise even in countries that have made major adjustments to their business administrative policies and now provide incentives for formal registration (Webb et al., 2009). Expansion of the

informal sector even where institutional barriers decrease indicates that there must be other factors at work that influence the entrepreneur's perceptions and decision making.

Organizational behavior research on human resources have identified trust in the government and institutional system as an important motivational factor in entrepreneurial decision making, heavily influencing whether or not the entrepreneur chooses the informal sector over the formal sector (Maloney, 2004; Rosser et al., 2000). Mixing social and institutional theory, scholars have pointed to the rise of informal networks to provide legitimacy (North, 1990) and resources for firms operating in the informal sector (Khavul, Bruton, & Wood, 2009). However, firms in the informal sector have also been noted to attain legitimacy also by mimicking the standards set by formal firms (Godfrey, 2011). While the demand for informal products and services is high, processes that would help to increase the revenue growth of informal firms require formalization or "the adoption of regulatory frameworks" (McGahan, 2012).

Literature on the informal sector has identified various factors as motivation for firm owners to maintain informal operations. Amongst the factors are interdependence with the formal economy and conditions of the government, market and population, as well as geographic access, and job variety. In order to access low-wage labor populations and discounted markets, firms target certain locations, which also lead to a mixed clustering of both formal and informal firms (Sassen, 1994). When looking at the ways the regulated economy is intertwined with informality, formal firms and immigrant communities stand out as providing a major part of the demand for informal goods and services (Sassen, 1994).



## **Significance of the Informal Economy on Development**

Extant literature captures the debate on whether the informal economy benefits country development. Notwithstanding the differing views of scholars, the effect of the informal economy on development actually depends on the dynamic interaction involving supply and demand factors. Development trends in emerging economies are significantly linked to entrepreneurship, which supply and demand factors drive. Thus, discussing how supply and demand factors operate within, and subsequently effect, the informal economy and development is important.

Dating back to the 1970s, the debate on the informal economy's benefits to economic development was sparked by Hart's (1973) article on informal employment in Ghana, which brought to the forefront the need for scholarly research that contrasted both the formal and informal sectors' impact on development (Leonard, 2000). Liberals and international organizations argued for a beneficial economic impact of informal enterprises (ILO, 1985; De Soto, 1989; World Bank, 1989). Whereas, socialists garnered a more negative forecast regarding the inability of informal enterprises to increase economic development based on the restrictive nature of capitalist ideals (Portes and Sassen-Koob, 1987; Castells and Portes, 1989). To date, neither side has won the debate as both have empirically shown the positive and negative effects of the informal economy on development. However, the dominance of the informal economy, alongside formal sectors proves that informality is not going anywhere and requires more research as a result.

Development in economies that have a mix of formal and informal economic activity is driven by economic, political, and social factors, experiencing heterogeneity through varying levels. Economically, informal economy entrepreneurs often earn their living off of subsistence

farming incomes, street or market trade, housing construction, or other personal service jobs (Blades, Ferreira, and Lugo, 2011). Politically, developing countries with large informal economies typically have weak central governments and either a lack of institutions or have ancient institutions that do not work efficiently for a number of reasons, including corruption (Meagher, 2007). The social conditions that plague the population include lack of social security and policies for professional safety standards (Blades et al., 2011). The lag in improvement in these three areas highlights the need for further study on the informal economy's impact on development.

Informal economy heterogeneity is long acknowledged as affecting the way informal economies are defined. Exclusion or inclusion of certain factors from the definition of informal economy dictates how an informal sector's impact on development is measured (Mead and Morrisson, 1996). Further, defining informality across multiple countries becomes harder based on heterogeneity within informal sectors (Mead and Morrisson, 1996). Informal sector heterogeneity is traditionally categorized according to performance and capital levels, expressed as a dichotomy (Hart, 1972). Studies that look at performance in West Africa's informal economy group entrepreneurs according to top performers and survivalists categories (Grimm, Knorringa, and Lay, 2012). Heterogeneity in the West African informal sector has also looked at capital levels, returning interesting findings. Surprisingly, entrepreneurs are able to pull extraordinary marginal capital returns when they are using extremely low capital stock levels (Grimm et al., 2012). Grimm, Knorringa, and Lay (2012) expand the scope of informal economy heterogeneity studies to include another group of entrepreneurs, which they aptly name constrained gazelles. Identifying the groups that factor into the heterogeneity within informality

helps create more targeted informal sector policy measures according to the three groups of entrepreneurs and their different earning potentials.

Another important factor to tease out when discussing informal sectors is the nature of the economy the informal sector is located in, meaning whether you are dealing with a developed versus a developing economy. The economy's nature will also be a cause of informal sector heterogeneity. However, while there is much heterogeneity between developed and developing informal economies, entrepreneurs in both economies similarly use informality as a coping strategy (Leonard, 2000). Specifically, entrepreneurs across both types of economies use informality to leverage social networks against unemployment and marginalization, positioning informality as a "social and historical process, rather than a separate sector or economy," (Leonard, 2000, p. 1082).

Regulatory and enforcement issues around supply-side and demand-side factors tend to negatively affect economic development (Palmade, 2005). Economic development is supported by social policies that advance demand-side factors, whereas supply-side policies are more likely to lead to market distortions (Palmade, 2005). Looking first on supply-side factors, policy studies normally focus on supply variables such as education, training, savings, and credit (Thomas, 1995). However, informal economy studies reviewing supply-side factors focus mostly on the labor supply mobility (Maloney, 2004; Funkhouser, 1997). Labor mobility between sectors, especially the formal and informal sectors, is important because both sectors pull from the same labor supply, yet have differing demands for employment (Galiani & Weinschelbaum, 2012). As such, where employment demands for the formal sector become too stringent, the informal sector's ability to take in the unemployed is seen as beneficial (Leonard, 2000; ILO,

1985). Yet, it is the formally employed workers that are found to engage in just as much informal activity as the unemployed workers (Leonard, 2000).

## **INFORMAL SECTOR CONCEPTS FOR EMERGING AND DEVELOPED/ADVANCED ECONOMIES**

The informal sector's impact on economic and social conditions differs according to the economy's level of development (Schneider, Buehn, and Montenegro, 2010). As a result of the informal sector's link to development, the largest informal sectors are found in emerging economies.<sup>1</sup> Emerging economies are defined as,

“low-income, rapid-growth countries using economic liberalization as their primary engine of growth . . . [and] fall into two groups: developing countries in Asia, Latin America, Africa, and the Middle East and transition economies in the former Soviet Union and China” (Hoskisson, Eden, Lau, and Wright, 2000).

Emerging economies are marked by difficulties with establishing strong market institutions, high levels of risk and uncertainty, inadequate infrastructures, lack of skilled labor, burdensome market regulations, and insufficient capital markets (Hoskisson, et al., 2000). Such emerging economy challenges tend to push low-income enterprises out of the formal sector and into informality in order to remain sustainable (London & Hart, 2004). According to the World Bank (2013), the informal sector represents between 1/5 - 4/5 of non-agricultural employment in developing economies. As of 2007, emerging economies in the Sub-Saharan Africa, Europe and Central Asia regions had the largest informal sectors (Schneider, Buehn, & Montenegro, 2010).

On the opposite end of the economic spectrum, characteristics of developed economies include strong institutions, increased regulations, larger pools of skilled labor, and modern infrastructure and technology systems. In 2010, developed economies accounted for 65.8% of

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<sup>1</sup> Used interchangeably with developing economies.

nominal GDP worldwide (IMF, 2011). Of that amount, about 18% of GDP represents the informal economy (Schneider, et al., 2010).

Economic and social impact studies on the informal sector have been very narrow in scope. Most use emerging markets as the field of study. Positive impacts of the informal sector on emerging economies are seen in job creation and generation of income (World Bank, 2013). However, the social impact of the informal sector in emerging economies is often negatively reflected in concerns of health equity and health-associated expenditures from occupational injuries and diseases (Nastiti, Prabaharyaka, Roosmini, & Kunaefi, 2012). Since informal enterprises avoid the costs of occupational insurance and other forms of social protection guaranteed by national labor codes, informal workers bear the brunt of occupational injuries in the form of healthcare costs and even lost wages.

The informal sector also has a significant economic and political impacts in developed economies. Particularly in developed economies, the size of the informal sector is significantly impacted by regulations, the unemployment rate, and improved economic conditions (Schneider, et al., 2010). Other studies that look at established markets mostly explore issues of criminality within the informal sector. A smaller portion of the literature looks at the dichotomy between the positive innovation arising from informal firms in developing countries and how those innovations disrupt established firms in developed countries (McGahan, 2012).

The negative impact of informality is more easily seen in developed economies. Institutional structures are undermined by informal sector operations. Short term benefits will eventually be outweighed by long run harm to existing institutions. For developing economies, the informal sector is found to stagnate long term growth and prevents these countries from reaching their true economic potential. A developing country's economic heights can be limited

by negative externalities and distortions created by large informal sectors (Leal Ordóñez, 2013) (Leal Ordóñez, 2014). In one particular example, Macias and Cazzavillan (2009) present the evolution of Mexico's informal economy, concluding that the failure of government policy to reign in the informal sector has left a large segment of enterprises on the unproductive fringe of the economy. Taking their conclusion one step further by looking at the effects of taxation policy enforcement, Leal Ordóñez's (2014) study found that Mexico's labor productivity and output under complete enforcement would increase by 19% in a baseline model and by 34% in a monopolistic competition model.

The informal sector in many emerging markets is on its way to spiraling out of control. In emerging economies, the informal sector, thus far, has proven to have a more beneficial impact than harmful one. As a result of its beneficial impact, scholars support policies aimed at providing incentives to conduct business in the informal sector, rather than policies with punitive implications. However, these incentives will only lead to more entrepreneurs starting businesses in informal economy, rather than adhering to regulations. Governments will have a very difficult time closing the flood gates once it has been opened to get entrepreneurs to make a switch to more formalized operations.

### **Processes of Informal Entrepreneurship**

Entrepreneurship theory on the informal sector mainly assesses the process of entrepreneurship and how different factors regarding the entrepreneur can influence the process. Entrepreneurship theory is often concerned with performance or growth measures as positive outcomes. However, literature that looks at informal entrepreneurship dissects the process as contributing to a more negative side of entrepreneurship. When viewed in a negative light, the informal economy conjures "images of illegality, shadowiness, exploitation, evasion and

lawlessness” (Khavul et al., 2009). Portes and his coauthors point to the negative side of informal entrepreneurship as symptoms of ineffective governance and poverty (Castells & Portes, 1989; Portes & Haller, 2005). Whereas, Smallbone and Welter (2001) and Szelenyi (1988) highlight the good in the negative and reference the informal sector as the “site of, as well as seedbed for, entrepreneurship” (Williams, 2009). Statistics further verify that a large amount of economic transactions happen in the informal sector (Webb et al., 2009).

The entrepreneurial process in the informal economy tends to be used as a coping mechanism and a tool to exploit legitimate opportunities where one otherwise would not have had the means. The entrepreneurial process includes “entrepreneurial alertness, opportunity recognition, opportunity exploitation, and decisions concerning growth” as the usual stages that entrepreneurs go through when they are trying to grow their business (Webb et al., 2009). The transformations in business activity that may occur within each of these stages will look different between necessity entrepreneurs, who normally do not seek growth, and opportunity entrepreneurs, who are more growth-oriented.<sup>2</sup> Institutions set the boundaries between where formal business activities end and informal, but legitimate business activity begins (Webb et al., 2009). Volery (2007), citing Rath and Kloosterman (2002), characterizes the use of informality as a competitive strategy triggered by a great “temptation to apply informal practices with respect to taxes, labor regulations, minimum wages and employing children and immigrant workers without documents.” When making decisions concerning growth, the entrepreneurial

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<sup>2</sup> According to the Global Entrepreneurship Monitor’s 2004 Executive Report, “Individuals participate in entrepreneurial activities in order to exploit a perceived business opportunity, (referred to as opportunity entrepreneurship), or because all other employment options are either absent or unsatisfactory, (referred to as necessity entrepreneurship). GEM 2004 data show that three in five (65 percent) of those involved in entrepreneurial endeavors around the world are opportunity entrepreneurs, while two in five (35 percent) are necessity entrepreneurs. . . . The opportunity entrepreneurs tend to be more dominant in the high-income countries while necessity entrepreneurship is prevalent in low income countries” (p. 13). Acs, Z. J., Arenius, P., Hay, M., & Minniti, M. 2004. 2004 executive report. In M. Hancock (Ed.), *Global entrepreneurship monitor*. Babson Park, MA: Babson College & London Business School.

process is key to the informal entrepreneur as it helps them navigate an institutional environment that lacks necessary support mechanisms.

*Proposition 1a. Qualitative studies that track the narratives of informal entrepreneurs across different contextual environments, including advanced versus developing markets are more likely to capture nuances in the entrepreneurial process.*

Entrepreneurship theory recognizes various categories of entrepreneurs in the informal economy that extend beyond necessity or opportunity. Webb et al. (2009) identifies growth-oriented entrepreneurs, as well entrepreneurs seeking to supplement their incomes or change their lifestyle. Salary-substitute or lifestyle entrepreneurs would have much smaller operations than growth-oriented entrepreneurs (Webb et al., 2009). The category that an entrepreneur belongs to is determined by their context. Maloney (2004) further identifies informal entrepreneurs as “the “informal salaried,” those working in microenterprises without protections, and women in various modalities of informal work.” Maloney’s categories hint at the flexibility of the labor force – to go back and forth between formality and informality (Webb, Bruton, Tihanyi, & Ireland, 2013). Yet, even with such employment flexibility, most still choose the informal sector as a result of the institutional context. Thus, identifying the types of entrepreneurs that operate in the informal economy is important to understanding the reasons for choosing the context, where there is the possibility of operating formally.

*Proposition 1b. Creating typologies that match types and characteristics of informal entrepreneurs according to institutional context will build strong frameworks for explaining any variations in the entrepreneurial process used by informal entrepreneurs.*

The type of entrepreneurial activity that exists in the informal sector has also been categorized in various ways, primarily according to whether or not the activity is legal and/or



legitimate. The entrepreneurial activity can be further described according to the means – how the activity is produced, and the ends – the actual product or service that results from the entrepreneurial activity. Thus, various combinations according to the legality and legitimacy of the means used to produce a product or service and the legality and legitimacy of the ends can be created (Webb et al., 2013). Such descriptions and groupings of entrepreneurial activity can help to identify the incentives that can influence an entrepreneur to move from the informal to the formal sector, as well as improve enforcement of formal regulations (Webb et al., 2013).

Informal entrepreneurial activity is also categorized by the kind of business operated, with the family business dominating the informal sector (Khavul et al., 2009). Industry sector also plays a role in understanding the entrepreneurial process involved in informal business operations. The majority of informal entrepreneurs are often operating in the service sector interfacing primarily with final users, instead of business to business transactions (Williams, 2009). The final categorization within types of entrepreneurial activity looks at whether the operation is fully formal or partially informal (Williams, 2009).

Finally, I turn to how skillsets, gender and relationships, factors directly related to the entrepreneur, affect the entrepreneurial process in the informal sector. Not surprising, “about 80% use the skills, tools and/or social networks directly related to their current or previous formal employment and/or employment-place in their off-the-books business ventures” (Williams, 2009). Gender also influences the opportunity exploitation stage as more women were found to have informal enterprises out of necessity, whereas the enterprises operated by men were more likely to be formal and operated for opportunistic reasons (Williams, 2009). Further, relationship ties are found to affect the process that entrepreneurs use to establish their business.

*Proposition 2. Using the narratives and typologies will enable scholars to develop a pedagogical continuum along which informal entrepreneurs move, integrating a nuanced analysis of their status of formality, type of entrepreneurial activity, kind of business operated, industry sector and demographic characteristics.*

## **Conclusion**

Informal sector and entrepreneurship literatures are the major fields examined in this paper. While each field has developed over the last three decades, the literatures are ripe with areas where an interdisciplinary approach and further development would be useful. Through propositions, the paper outlines important areas for developing more rigorous constructs in the informal sector field through an entrepreneurship approach, focusing on immigrant entrepreneurs. I provided a general overview of the state of literature on the informal sector. Then, I took a more specific look at how conditions of the informal sector impact development and separate concepts found in the literature according to emerging or advanced economies. My review of these fields is intended to identify relevant constructs to be used during future research. Finally, I present my propositions and the appropriateness of exploring particular research methods.

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