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**Exit, Acceptance, and Voice—The Choice of the Informal Entrepreneur**

**ABSTRACT**

The informal economy represents 50-75 percent of all non-agricultural employment in developing nations. This necessitates an investigation on how informal entrepreneurs make decisions and the consequences of these decisions on their community. When do informal entrepreneurs choose to either exit, voice, or remain loyal in the informal economy? What consequences does this decision have on business and economic development in the entrepreneur’s community? This paper applies Hirschman’s typology to informal entrepreneurs to explore how the entrepreneur’s level of informality, the formalizing institutions, and social and human capital affect the decision-making process of an informal entrepreneur.

**Keywords:**

Informal Economy, Formalization, formal economy, economic development, entrepreneurship

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Shan-Zhai, a mobile phone company in China, began illegally in the Chinese informal economy. After finding overwhelming success in the informal economy, Shan-Zhai effectively organized, mobilized support, and lobbied the Chinese government until regulations changed to allow Shan-Zhai to operate formally (Lee & Hung, 2014). This one informal venture grew large enough to successfully voice their disgruntlement and eventually change Chinese regulations regarding mobile phones, allowing Shan-Zhai to legalize their enterprise and enjoy the benefits of formal protections from the Chinese government (Lee & Hung, 2014).

 In Zambia, informal market vendors represent traditionally marginalized members of society—people who do not have large resources at their disposal or the wealth to maintain a lobbying effort. Yet, the Zambia National Marketeers Association (ZANAMA) organized and created pressure on the Zambian government to alter regulations regarding market vendors (Larsen, 2013). These relatively poor market vendors in the informal economy organized together and created a collective channel for voice to change the regulatory institutions of Zambia to protect informal entrepreneurs from exploitive police enforcement (Larsen, 2013).

 Both small case studies are examples of informal entrepreneurs organizing to put concerted pressure on formal institutions in vastly different political, cultural and geographical circumstances. Shan-Zhai was a single dominant informal firm with many resources at their disposal. ZANAMA was a collective of informal entrepreneurs with few resources available. Yet, in both cases, these informal entrepreneurs organized, voiced their displeasure, and effectively bettered their circumstances by changing the formal institutions in their state either through individual, or collective action. Utilizing voice risked everything these entrepreneurs had built illegally. Why would informal entrepreneurs risk so much to try and change the institutional framework?

 The informal economy accounts for 50 to 60 percent of all economic activity in developing nations, and approximately 10 to 20 percent in developed nations (Lee & Hung, 2014). Yet, not all informal entrepreneurs engage in organizational activism to ensure protection of their informal ventures. Why do some informal entrepreneurs, like Shan-Zhai or ZANAMA, organize and lobby to change their institutional environment, while other informal entrepreneurs do not?

 Participants in an environment where the organization or institutions are failing have three choices—exit the environment, remain resigned to the status quo, or voice their disagreement in effort to better the situation (Hirschman, 1970). This research applies Hirschman’s typology to the informal economy to understand how and why the entrepreneur in the informal economy will choose to exit, voice, or maintain the status quo in the informal economy. In this situation, exit is either formalization, emigration, or quitting, while voice is organizing for institutional change, and acceptance involves taking no action to change the situation. This new context for Hirschman’s typology creates an interesting lens to investigate informal entrepreneurial behavior.

 This paper applies theoretical framework of exit, acceptance, and voice to the informal economy. It begins by outlining a new conceptualization of the informal economy and then lays out the main choices for informal entrepreneurs. The entrepreneur’s choice is affected by four primary independent variables: formalizing institutions, location of the entrepreneur on the continuum of informality, social, and finally human capital. The following section then proposes various hypotheses on how these independent variables affect the decision of the informal entrepreneur followed by a discussion.

## **The Informal Economy Conceptualized**

The formal economy is comprised of regulated economic units and protected workers inside the formal regulatory environment. The regulatory environment is comprised of government policies, laws, and regulations (Chen, 2006: 83). The formal economy includes all economic activity that is observable and regulated by official governance mechanisms (Guha-Khasnobis et al., 2006). Since it is based on the rules and regulations of the state, the formal economy is considered legitimate, based primarily upon sociopolitical legitimacy granted by the state (Aldrich & Fiol, 1994). Entrepreneurs in the formal economy are entitled to all rights under the laws of the state and can access all formal institutions that enforce and protect those rights. With formalization comes protection from the state, which allows entrepreneurs to grow and expand their enterprises (North, 1990).

Opposite the formal economy is the informal economy, which is economic activity outside the jurisdiction of formal state institutions and their protections. The informal economy’s boundaries are not as clear as the formal economy’s boundaries (Venkatesh, 2006). There is a debate among scholars about how the formal and informal economies are linked and separated. How the two economies are linked primarily determines the boundaries and definitions of the formal versus informal economy. The three primary schools of thought concerning the informal economy are the dualist, structuralist, and legalist views; each of these are discussed briefly below.

The dualist school was inspired by the Lewis Model, created in 1954 to describe the “informal sector.” The “informal sector” was agrarian, traditional in nature, and full of surplus (i.e., untapped) labor supply (Lewis, 1954). This sector was outside and separate from the modern industrial, formal sector. Economic development in this view is achieved when the surplus labor of the informal sector transitions into the formal sector. In this view, informality was separate from formality, creating a dichotomous view of the formal versus informal economy as depicted in Figure 1. Informal units and or activities have few if any linkages to the formal economy, and thus act autonomously (Setheuraman 1976). This complete separation of the two economies created the dualist perspective of the informal economy. Dualists assume that the informal sector is inherently poor, as they represent agrarian untapped labor that has yet to be incorporated into the modern, industrial area (Lewis, 1954; Godfrey, 2011). This assumption of poverty is a defining characteristic of the dualist view and is also a major limitation of the dualist view. A further limitation of this view is that it cannot account for entrepreneurs moving between the formal and informal economy freely, or for entrepreneurs who are semi-formal or semi-informal as the marketplace is dichotomous dictating they be in one market or the other. Furthermore, dualists do not allow for leakage of formal entrepreneurs back into the informal economy. Rather modernization pressures workers to flow into the formal economy.

Figure 1: Dualist View

 Despite the view of Dualism, Keith Hart in 1973 saw that the Lewis Model did not hold in all cases. Instead, he noted that most economies contained several bidirectional flows and interactions between the formal and informal economies within a state (Hart, 1973). This work spurred the structuralist perspective of the informal and formal economy, wherein the two economies are intrinsically linked (Chen, 2006). Structuralists view informality as a feature of labor-capital relations, with more informal labor being supplied and supported by formal capital (Fortuna and Prates, 1989). This school imagines a formal core economy with an informal periphery economy as depicted in Figure 2 (Maloney, 1999; Godfrey, 2011).

Figure : StructuralistView

This view anticipates the exploitation of labor by capital, explaining the persistence of the informal economy (Godfrey, 2011). The structuralist view assumes that informality is a constraint upon certain segments of society and that the relationship between labor and capital is exploitive as capital subjects labor to informality. This assumption is a limitation of the structuralist view. Informality is a constraint upon exploited labor rather than as a choice. Therefore, structuralists would see very little leakage of the formal economy into the informal economy because the barrier is a conscious, power-based vehicle of oppression.

 The final view regarding the relationship between formal and informal economy is the legalist one. This view argues that informal work arrangements are a response to over-regulation by government bureaucracies (Becker, 2004). Legalism therefore focuses on the policy, regulatory, and institutional reasons why individuals might choose formality or informality (Godfrey, 2011). This notion is similar to the dualist perspective, wherein the economy is seen as dichotomous—composed of separate formal and informal marketplaces as depicted in Figure 3.

 However, legalists differ from dualists in that they see informality arising primarily from institutional preferences and arrangements rather than as surplus labor yet to be incorporated into modern economic activity (Godfrey, 2011). Legalists also differ from structuralists in their conception of informality, which they see as a free choice rather than an imposed constraint (Godfrey, 2011).

Figure : Legalist View

According to legalists, if institutions and incentives exist to encourage formality and also remove barriers to formalization, then more entrepreneurs will choose to formalize (Godfrey, 2011). Therefore, the legalists have a unique view of the informal economy—entrepreneurs and their enterprises may choose to be formal, or informal. Informality is not dictated by social standing, lack of opportunity or capital, or any other imposed constraint. The barrier between the formal and informal economy is permeable, with movement occurring at the margin to benefit the firm. However, the limitation to this view, is similar to the major limitation of the dualist school—this view cannot take into account entrepreneurs occupying a middle space of semi-informality or formality. It mandates a clear distinction between formality and informality and does not leave space in-between the two for entrepreneurs to operate.

 While all three schools have their own value, none are fully complete. Structuralists view the informal economy and formal economy as linked and continuous, but as exploitive and an enforced constraint. Dualists and legalists see the informal economy as dichotomous, either an enterprise is formal or informal, but can never be both or occupy someplace in between. Yet, characteristics from each school of thought do occur in the real world. This paper re-conceptualizes the linkages between the formal and informal economy, represented by Figure 4 below.

Figure 4: Continuum of Formality

 This new conceptualization views the informal and formal economy as continuous, with a large area of overlap as informality blurs into formality. This model represents a continuous view of the economy, where the line between formality and informality is not straightforward or entirely recognizable. On the other hand, participants who are further away from the overlap between the formal and informal economy appear more dichotomous and separate—black and white, formal versus informal. From the periphery, this fits the assumptions of the dualist and or legalist perspectives—where one is either in the informal, or formal economy. But in the gray area where the informal transitions to the formal, there is considerable overlap, making it more difficult to ascertain whether an entrepreneur is fully formal or informal. In Figure 5, the Continuum of Formality is compared to frim size. The dualist and structuralist view see informality as a constraint of the impoverished or resource poor. Both views focus on the clusters of informality, small firms that are further to the left on the continuum. These views see as firms increase in size, and relative wealth, then they will transition into the formal economy, representing the cluster on the figure labeled formality. Yet, there are many firms who lie outside this scope, who are very large, yet informal or visa versa very small yet formal. These outliers are largely ignored cases in these two schools. As legalists see the barrier between formality and informality as permeable, they can account for outliers. However, none of the three prevailing schools can account for the semi-formal cluster, wherein firms have some aspects of formality, but are not entirely formal regardless of firm size. This new conceptualization of the continuum of formality can account for all cases represented in Figure 5.

Figure 5: Continuum of Formality Vs. Size of Firm

 This new conceptualization of the informal economy allows for a new definition of the informal economy. This new designation includes transactions and activities where the state neither provides protection, nor receives a “cut” (Centeno and Portes, 2006: 26-27), but where illegal processes or arrangements may still be used to create legal or legitimate goods and services (Chen, 2006). In this way, the informal economy is “conducted by unregistered firms or by registered firms but hidden from taxation” (Porta & Shleifer, 2008). The activities of an informal economy “[include] those actions of economic agents that fail to adhere to the established institutional rules or are denied their protection” (Feige, 1990), as well as “all income-earning activities that are not regulated by the state in social environments where similar activities are regulated” (Castells & Portes, 1989).

 This definition bridges together various parts of the three perspectives to show that there are parts of the formal/informal economy that are dichotomous (i.e., either a firm is registered or not, paying taxes or not, and operating adhering to the institutional rules of the formal economy or not), while other parts remain more blurred and continuous. The degree of legality is dependent on the processes or arrangements used to produce the goods and services. A firm can be operating semi-legally, completely legally, or illegally. This new model allows for a continuum of informality/formality while also allowing for some respects that appear more dichotomous. With this conceptualization in place, this research now looks to inefficiencies in the informal economy that can affect informal entrepreneurs.

## **Inefficiencies in the Informal Economy**

 The informal economy can be efficient for some entrepreneurs in some circumstances. While the informal economy is unregulated by formal institutions, it may be highly regulated by substitute informal institutions that can provide their own services to informal entrepreneurs (Skousen and Mahoney, 2016). Many ventures, including “lifestyle ventures” (Williams, Shaw, & Greenwood, 1989), can exist and prosper in the informal economy. However, the informal economy cannot always substitute for formal benefits. In most cases, the decision to exit the informal economy and register for the formal comes when either the entrepreneur seeks further legitimacy and therefore other intangible benefits (e.g. trust and reputation) or on the other hand when entrepreneurs need to gain access to benefits from formal institutions (e.g. credit, property rights, training) that informal substitute institutions cannot provide (Skousen and Mahoney, 2016). Therefore, this paper looks to inefficiencies in the informal economy arising when the substitute informal institutions can no longer provide the necessary tangible or intangible benefits to growing entrepreneurs. Furthermore, the informal economy is subject to changes made in the formal economy. Small formal changes can drastically alter the efficiency of conducting business in the informal market by disrupting and altering informal substitute institutions. When the informal economy proves inefficient either by the growth of a venture and necessary obtainment of new resources only conferred to formal enterprises, or by changes made in the formal economy making informal activity less efficient, entrepreneurs must react to either ensure continued growth or survival. This section describes these inefficiencies motivating entrepreneurial choice.

Although not necessarily criminal, informal entrepreneurs act outside the law, forfeiting all protections guaranteed by formal economic institutions, including the protections of property rights, contract enforcement, and access to capital markets amongst other economic benefits. Informal firms are unable to take full advantage of the “legal, financial, and marketing benefits that, in principle, the judicial, banking, and economic systems of its country offer” (Zinnes, 2009: vii). Access to these formal benefits, while maybe not necessary to every venture, can be instrumental in aiding business ventures in scale. Due to their informality, off-the-record entrepreneurs cannot enforce contractual agreements as easily as formal entrepreneurs (Porta & Shleifer, 2008). For this reason, business relationships in the informal economy must be grounded primarily on social, not legal, contracts (London and Hart, 2004: 352). This makes contract enforcement extremely difficult for informal entrepreneurs and can leave them financially vulnerable. This increase in transaction costs can be detrimental to growth of informal ventures. At some point, due to the inability to access and take advantage of formal economic institutions and guaranteed protections, informal entrepreneurs may face barriers to growth (Marcouiller & Young, 1995). These barriers to growth stem not only from lack of property right protections and exclusion from formal economic institutions, but also from the inability to grow a more stable professional network in the informal economy.

Informal activity takes place largely in personal and intimate contexts, based on the nature of the personal ties between participants (Gaughan and Ferman, 1987: 16). Informal entrepreneurs use their personal ties to create social networks, allowing them to conduct business without a formal structure in place (Peng, 2003). This system however, typically limits business to locally based transactions in a limited geographic area, because trading must take place through face-to-face relationships between friends, relatives, or acquaintances (Henry, 1987: 140). The reputation of the entrepreneur, created through repeated transactions, is especially important here, since the trust that helps establish credible business commitments is founded on it. Local, informal enterprises that focus only on known social groups may see few gains to formalization. However, informal entrepreneurs seeking to expand may exhaust their informal networks and will not continue growing their enterprise outside their geographic region without assistance (North, 1991). To grow his enterprise to the next level, the entrepreneur will need to have the protection of property rights to transact with others outside his social networks (North, 1991). Continued growth involving transactions with new trading partners is only possible in a system of established and enforced property rights (North, 1991). Without protection of property rights and contract enforcement, the risks associated with expanding past reputational currency are too high.

    Informal entrepreneurs also have significant restraints in accessing public goods and finance, which can further stunt their ability to grow an enterprise (Porta & Shleifer, 2008). Informal entrepreneurs are far less likely to have access to reliable electrical connection, computers and other technology hardware, and are less likely to use email to communicate with clients; overall, informal assets tend to be of a much lower-quality when compared to formal counterparts (Porta & Shleifer, 2008). Other public goods, such as the judiciary system and rule of law, are also not accessible to informal entrepreneurs because of their illegal status. Conflicts cannot be arbitrated using the judicial system, and protections are not guaranteed. Informal firms are more likely than formal ones to experience theft and have no way to pursue recompense from the perpetrators (Porta & Shleifer, 2008). Some informal entrepreneurs can substitute informal services for public goods, using their own generators or contracting with local gangs for protections. However, these illicit methods are very costly, and many informal entrepreneurs and startup ventures cannot afford the extra cost. Furthermore, these measures can increase the risks of acting informally.

The restricted access to public goods also impacts the availability of financial resources, which acts as another barrier to growth. Oftentimes, to push a business to the next level, a further injection of capital is necessary. Being informal excludes enterprises from formal capital markets (Porta & Shleifer, 2008). As a result, informal entrepreneurs do not have the same ability to raise funds as their formal counterparts, making it difficult to continue growing. These barriers to growth show how the informal economy fails to support growth-oriented entrepreneurs.

These barriers to growth assume efficiency in the formal economy however, which is not necessarily the case. Plentiful studies demonstrate that not all formal institutional environments are entirely efficient (XXXX). In some nations, the benefits of formalization mentioned above do not exist due to the extreme inefficiencies or corruption of the formal institutional environment (XXX). Therefore, while there may exist some barriers to growth in the informal marketplace, (Marcouiller & Young, 1995), this is not the only factor that may create inefficiencies in the informal economy. The formal institutions in and of themselves maybe contributing to the inefficiencies of the informal economy.

The informal economy is especially vulnerable to changes made in formal economic institutions. When there are changes in the formal economy, the informal economy can be affected, and the results can potentially make business harder for informal entrepreneurs. The exogenous shock to the informal economy may also create an impetus for entrepreneurs to change their business operations due to newly created inefficiencies in the informal marketplace.

The informal economy has inefficiencies, due to barriers restricting growth or to exogenous changes in the formal economy. Therefore, there is a need to capture what happens when the informal economy can no longer support an informal entrepreneur. When informal entrepreneurs are pushed to action, they may decide either to exit the informal economy, remain in the inefficient informal economy, or attempt to change their circumstances.

## **Options for Informal Entrepreneurs**

When the informal economy can no longer support an informal entrepreneur, that entrepreneur has three primary choices—exit, voice, or loyalty. Per Hirschman, “under any economic, social, or political system (including informal ones), individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior” (Hirschman, 1970: 1). No matter how successfully basic institutions have been initially devised, over time, actors will fail to live up to the norms and expectations of these institutions, causing inefficiency and stagnation (Hirschman, 1970). When this occurs, actors within these systems have three options: to exit the situation entirely, to maintain the status quo and resign to their current situation, or to use their voice to create change.

This research will extend this basic theoretical framework to the informal economy, where the organization in question is the informal economy itself. As an “organization,” the informal economy fails to allow entrepreneurs unlimited growth opportunities. As outlined previously, informal entrepreneurs face several barriers to growth. Furthermore, as formal policies change, it can create new obstacles for informal entrepreneurs that necessitates their action. At these points, the entrepreneur must act to exit, resign to their situation, or voice their disagreement.

## **Exit**

 The idea of exit is dependent on the concept of dualistic informal/formal economies—one is either a formal or an informal entrepreneur, but cannot be both. Exit, per Hirschman, operates within the realm of economics—if a product is lower in quality, a participant will exit that organization and find a new organization with a higher quality product (Hirschman, 1970). In this case, the informal entrepreneur is the participant and the informal economy is the organization; entrepreneurs exit when the informal economy does not provide adequate support. Exit is guided by Adam Smith’s invisible hand and is a clean action: an actor either exits or does not, letting the market justify their actions (Hirschman, 1993). However, exit is only possible if there are other options available to the actor. Exit indirectly and unintentionally can cause the deteriorating organization to improve its performance as exit can be a form of feedback for the organization, but this feedback is not as direct as voice (Hirschman, 1993).

There are three forms of exit in this paper’s model—entrepreneurs can choose to exit the informal economy for the formal one in the home country, emigrate to a new country, or quit the marketplace altogether. In this paper, formalization is the process of registering the enterprise to bring it into compliance with the formal laws and institutions of the state. Exit via formalization occurs when the informal entrepreneur transitions into a formal designation, and shifts their business to the formal marketplace.  This requires the informal entrepreneur to go through all registration processes, and to be in compliance with the rules and regulations guarding the formal economy.

Emigration occurs when the informal entrepreneur leaves their home country to enter either the informal or formal economy of a new country. Emigrative action is categorized as one type of exit, because this research is only interested in the change effects on the country of origin. Emigration affects the formal institutions of the entrepreneur’s home country regardless of whether the entrepreneur enters the formal or informal economy in their new country.

After formalization and emigration, there is a third possible type of exit, where an entrepreneur “quits” and leaves the marketplace entirely. This could include the decision to become an employee of another business (either in the formal or informal economy), to enter the criminal economy, to pursue education, or to quit the informal economy for other reasons. Essentially, this form of exit occurs when an informal entrepreneur decides to no longer be an informal entrepreneur, but does not choose to formalize their business venture.

While the paper acknowledges the other two types of potential exit, this research will only focus on exit as formalization. Formalization is a primary concern for development, policy making, and state management, and is therefore the focus of this study (ILO, 2007).

## **Acceptance**

Acceptance is the inaction to either engage in voice, or to exit, but rather to maintain the status quo and continue informally. In Hirschman’s typology, loyalty represents two separate concepts—either feelings of attachment to an organization that increases cost for exit, or as a third option of choosing neither exit, nor voice (Hirschman, 1970; Hirschman, 1993). This research looks at the concept of loyalty as inaction to voice or exit. Therefore, this research will use the term acceptance rather than loyalty to describe this third choice of remaining informal and continuing the status quo. Acceptance, like exit, is also dependent on a dichotomous view of the formal/informal economy; in this choice, either the informal entrepreneur remains informal and therefore “accepts” their position in the informal economy, or he does not.

Acceptance is essentially a choice based on expediency, an attempt to avoid trouble and maintain survival (Williamson, 1975). Acceptance occurs when the informal entrepreneur maintains the status quo by keeping their heads down, staying small, and not fighting the institutional environment. They do enough to survive and get by without risking trouble from authoritative figures. They may not necessarily feel attached to the informal economy, despite its failings—but they are fearful of the alternatives, or they believe there are no viable alternatives. When the price for exiting or the price for voice is deemed too high, informal entrepreneurs instead will choose acceptance.

Out of the three choices, exit and acceptance are clearly defined for the informal entrepreneur. It is easy to determine if an informal entrepreneur has exited or not, and if they have taken no action to voice for change or not. Pure exit and pure acceptance therefore are easily identifiable. Voice, by comparison, is harder to define and qualify.

## **Voice**

Voice lies within the “political realm” and is graduated with a wide spectrum of available actions (Hirschman, 1970: 16). Voice occurs when actors attempt to change the practices, policies, and or outputs of an organization or institution (Hirschman, 1970). Unlike exit, voice includes an entire spectrum of actions with various degrees of intensity. Voice is any attempt to “change, rather than escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge… or through various types of actions and protests” (Hirschman, 1970: 30). Voice can be “quiet” or “loud,” depending on the action of the entrepreneur.  As voice occurs anytime the entrepreneur seeks to change the circumstance, voice is broad and can encompass many actions.

Voice can be individual or collective in nature. When it is an individual act, it may not be as powerful in inducing change, but it still fits the definition of voice. Collective action may garner greater results in creating change, but it is also subject to free riders (Olsen, 1975). Voice can also be horizontal or vertical in nature. Vertical voice occurs when the entrepreneur speaks out to superiors, addressing those in charge in order to petition for transformation. Horizontal voice implies talking to friends, neighbors, and or colleagues in an effort to enact change laterally (O’Donnell, 1986). In any form, voice is used to enact change, whether it be direct, or indirect to achieve a preferred state for the actor. It involves some action on the external regulative institutions with the result of change in behavior or conditions in those institutions.

Unlike exit or acceptance, the idea of voice requires the conceptualization of the formal/informal economy as a continuum, for voice can occur to change both formal and informal economic institutions. Entrepreneurs can act to change the informal institutions they are a part of, or alternately, transform formal institutions. For example, if there is an informal arrangement for paying rent to occupy a certain space, informal entrepreneurs can seek to alter that informal arrangement. Or in a formal setting, if there is a regulatory change in the formal economy that makes the informal economy less efficient, informal entrepreneurs can use voice to change those formal regulations to make either transitioning into the formal economy easier, or make business in the informal economy easier and more attractive.

Voice can also take place via formal, or informal channels. In some instances, informal entrepreneurs can crossover into the formal economy and register as unions, while legal organization can take formal, legal action to enact changes in the informal marketplace. These crossovers between formal and informal markets is only possible when the informal economy and formal economy are continuous. The conceptualization presented by this research of one continuous informal economy and formal economy with significant overlap is therefore vitally important to understanding voice and how it operates for informal entrepreneurs.

Voice is embodied in institutional work, or“[the] broad category of purposive action aimed at creating, maintaining, and disrupting institutions” (Lawrence & Suddaby, 2006). Theory on institutional work focuses on change and the purposeful practices of actors, called institutional entrepreneurs (DiMaggio, 1988).  The foundation of this work is based on the work of DiMaggio, (1988), who reintroduces individual agency into institutional theory as a way to understand how new institutions arise and are changed. Institutional entrepreneurs are actors who seek to change political, economic, legal or cultural institutions to advance their social interests (DiMaggio, 1988). As actors enact agency, institutions are altered. Furthermore, institutional entrepreneurship is the “study of informal economic activity precisely because it focuses on the processes that give rise to the regulatory framework for legitimacy and thus formality” (McGahan, 2012).

As the informal economy grows, the power of informal entrepreneurs grows, leading to increased exposure (Lee & Hung, 2014). Yet, institutional entrepreneurship is difficult in the informal economy due to increased risk that their illegal activity will become visible to authorities. Shan-Zhai, a mobile phone company in China, began illegally in the Chinese informal economy. After years of growing and finding success, this company engaged in institutional entrepreneurship that ultimately led to institutional change in China’s formal economy, allowing Shan-Zhai and other mobile phone companies to legally exist and sell products in China (Lee & Hung, 2014). Similarly, in Zambia, the street vendors created a union of marketeers, ZANAMA, to effectively voice their concerns and appeal to the government for further rights and protections for informal entrepreneurs (Larsen, 2013). In cases like these, voice occurs through institutional entrepreneurship that begins in the informal market, and the goal of such action is institutional change.

Voice can include a number of different actions in between voice and acceptance, and typically occurs whenever an entrepreneur seeks to change their circumstances. It can take the form of individual informal entrepreneurs reaching out to powerful stakeholders in an attempt to create change, or it could take the shape of collective action in institutional entrepreneurship. The vast spectrum of voice makes it both interesting, and challenging to qualify.

Voice in this application also may lead to exit. Traditionally, exit and voice, in Hirschman’s typology, are seen as opposite reactions to the situation of inefficient institutions (Hirschman, 1970). They are mutually exclusive—either the participant exits or voices. Yet in this case, if entrepreneurs are successful with voice and create regulatory or institutional change that now allows for formalization, they may then choose to exit the informal economy for the formal. Furthermore, when informal entrepreneurs are engaging in formal channels of voice, it moves the entrepreneurs closer to formality, changing their location on the spectrum of informality and perhaps making formalization more of a reality. In this way, there is overlap between exit and voice in this application to the informal economy that is vastly different than other applications of this framework.

Now that the three choices, exit, acceptance, and voice, have been laid out, this research will investigate the factors that leads to one of these three choices. In the following section, formalizing institutions, the entrepreneur’s location on the continuum of informality, social and human capital, will be more fully discussed.

## **Independent Variables**

### *Formalizing Institutions*

Formalizing institutions guide entrepreneurs from the informal to the formal economy, creating a gateway through which entrepreneurs must pass in order to join the formal economy. Institutions are social systems that have “regulative, normative, and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life” (Scott, 2014). From this definition, this research creates a new terminology, “formalizing institutions.” Formalizing institutions are the rules, regulations, norms, and cultural cognitive elements that create the process for entering the formal economy. Formalizing institutions not only guard entrance to the formal economy, but also act as a signal of the state regarding the formal economy and its requirements.

This institutional framework has both formal and informal components. Formal institutions are embodied in things such as codified law, regulations, constitutions, and their supporting apparatuses (North, 1990). Specifically, formal institutions are state bodies including courts, legislatures, bureaucracies, and state enforced rules, including constitutions, laws, and regulations (Helmke & Levitsky, 2004). Hence, formal institutions are largely viewed as “legitimate” as they come from the recognized authority to make law, the state (Bruton et al., 2012).  Formal institutions outline possible, socially acceptable actions in a society. These norms are deemed socially acceptable because of the perceived legitimacy of formal institutions emanating from the state as third party enforcement of these legitimate, behavioral norms.

In contrast, informal institutions are societal norms, values, beliefs, cultures, and customary practices, making informal institutions more abstract and lest concrete (North, 1990).  Specifically, informal institutions encompass “civic, religious, kinship, and other ‘societal’ rules and organizations” (Helmke & Levitsky, 2004). The main difference between formal and informal institutions are the levels of social acceptability and the degree of bureaucracy in the institutional environment (Bruton et al., 2012). Informal institutions are self-enforcing whereas formal institutions are enforced by a third party, most oftentimes the state (Knight, 1992). This third party enforcement leads to the greater perceived legitimacy of formal institutions. Nevertheless, there can still be perceived legitimacy in informal institutions. Sometimes informal actions enjoy greater degrees of legitimacy than the formal institutions in that community (Bruton et al., 2012).

The formal aspect of formalizing institutions encompasses all the state institutions that allow citizens to access the rights and protections guaranteed in law, namely the procedures officially required for an entrepreneur to start up and or operate a business (World Bank Group, 2016a). This includes actions such as obtaining necessary licenses and permits for the business, completing any required notifications to the state, and verifications for the company and its employees with relevant state authorities (World Bank Group, 2016a). These formalizing institutions guarding the start-up phase of a business include the requirements to meet regulation for legally starting a business, as well as the bureaucracy to fulfill all legal obligations and registrations as a formal enterprise. Essentially, the formal side of formalizing encompasses the rules and then the organizations that fulfill and enforce these rules, including organizations such as the police, judiciary, and other enforcement agencies.  Other parts of the formal side of formalizing institutions include registering property, getting credit, determining how to pay taxes and at what rate, enforcing contracts, and setting up rules for resolving insolvency (World Bank Group, 2016a). These components of formalizing institutions are based on the World Bank Group’s Doing Business Index, which seeks to measure the ease of doing business in individual countries (World Bank Group, 2016a). These components are commonly administered and created on a local level, and this means most formalizing institutions are formed by local governments that administer property rights outlined in state law and constitutions. This formal side of formalizing institutions is tangible and easy to measure, and may involve specific procedures, such as how many steps it takes for an entrepreneur to legally establish a business venture (De Soto, 2000).

The formal side of formalizing institutions is typically characterized by its complexity. This complexity refers to how many state prescribed steps there are to the formalizing process. This is measured by looking closely at the procedural side of formalizing institutions—the number of steps, official time, and costs that a start-up must bear to operate legally in the formal economy (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002).  The regulations regarding business entry are the first component of formalization and can either promote or impede the formalization process. As the regulations regarding entry increase in number and difficulty, adding to the time, effort and cost required to complete the procedures, the overall price tag of formalization multiplies and entrepreneurs are discouraged from joining the formal marketplace.

When formalizing institutions are overly complex, many entrepreneurs are unable to overcome the barriers to enter the formal economy and instead choose to remain informal. This complexity can deter many entrepreneurs from entering the formal economy due to the perceived cost. On the other hand, formalizing institutions can be simple and inclusive, creating incentives and opportunities for joining the formal marketplace, creating a level playing field, and rule of law on universal principles (Acemoglu & Robinson, 2012). Furthermore, when formalizing institutions are simple and inclusive, official constraints limit the power of all representatives who oversee the formalizing process, ensuring the system is more objective and fair in enforcing the rule of law.

The informal side of formalizing institutions includes any practices that lead to differential treatment of entrepreneurs and undermine the equanimity of the marketplace. Corruption is anything from preferential treatment due to personal connections, to outright bribery to overcome the cumbersome formal state institutions guarding venture creation. These informal practices can make it harder, or conversely, make it easier to enter the formal economy.

Corruption, the informal side of formalizing institutions, represents extractive institutions that create incentives and opportunities for a few while denying those same benefits to the general population, creating large barriers to entry, and tilting the playing field in the absence of rule of law (Acemoglu & Robinson, 2012). The extractive informal side of formalizing institutions includes corruption, bribery, and asymmetrical enforcement of rule of law that can create an unequal playing field and diminished opportunity for those in the informal economy.

When regulations are overly complex or when corruption is rife, it logically makes sense for entrepreneurs to choose not to enter the formal economy. If participation in formal institutions means arbitrary institutional extortion, then participation is costlier than noncompliance, pushing entrepreneurs to the informal economy (Godfrey, 2011). Furthermore, high levels of distrust (which result from conspicuous corruption) are a key motivational force pushing entrepreneurs into the informal rather than formal economy (Maloney, 2004). If citizens do not believe that they can access the formal economy and its associated rights, then they will not attempt formality in their business ventures. The lack of rule of law and asymmetrical enforcement, which characterize corrupt formalizing institutions, again close the gateway for informal entrepreneurs to access the formal economy and the rights that it embodies.

Complex and corrupt formalizing institutions reflect the inefficient regulations and the poorly managed bodies that were created to enforce rule of law. In a system marked by both inefficiency and fraud, informal entrepreneurs must pass through both complexity and corruption to enter the formal economy and enjoy the benefits of formality, including guarantees and protection of property rights, contract enforcement, and capital markets.

Yet, formalizing institutions are only a part of the equation that influences whether an entrepreneur chooses to exit, remain loyal, or voice. Where an entrepreneur is located on the “continuum of informality” is also vitally important.

### *Location on the Continuum of Informality*

Where an entrepreneur operates on the continuum of informality largely determines their ability to choose exit, acceptance, or voice.

 If an entrepreneur is on the far periphery of informality, with little to no overlap with the formal economy, it will be incredibly difficult for her to choose anything but exit or acceptance. Yet, the entrepreneurs who operate with overlap with the formal economy have more choices at their disposal.

 Location on the spectrum is measured by the level of informality for a business venture and the entrepreneur. Specifically, the level of informality is measured by the degree of overlap with the formal economy, measured by the level of access and contact that informal enterprises have with formal institutions. Where an entrepreneur physically situates and operates her business is the first component, creating her location on the spectrum. For example, entrepreneurs who reside and operate in rural areas, with little to no access to formal institutions, are more likely to be further towards informality on the continuum of informality. Living in isolation from formal institutions does not allow for a high degree of overlap, limiting their access to formality. From their perspective, the informal economy does appear more dichotomous as they are unable to see the continuum and overlap between the formal and informal economy. But those who reside in rural areas while operating their businesses in urban zones have a much higher degree of overlap with the formal economy, and are thus much closer to the formal economy on the spectrum. How the business operates may also be a factor. Businesses that are operated in the home may be limited in ability to openly conduct business or market for their product, which could lead to more isolation (Skousen and Mahoney, 2016). Finally, those who live and operate in urban areas and have frequent interactions and access to formal institutions will likely be the closest to the formal economy on the spectrum. Although accessibility is likely to be higher the closer the entrepreneur gets to metropolitan area, there may be some populations who live and operate in urban zones and still have no interaction with formal institutions. This could include those who operate from within the home and do not participate on the open market, but rather only on word of mouth (McPhearson and Liedholm, 1996; Skousen and Mahoney, 2016). Therefore, where an entrepreneur lives and operates her business are not the only determinants of her location on the continuum of informality.

 Access to formal institutions is also affected by the level of formality found in the enterprise. Is the enterprise registered with any formal institutions? Are they paying any sort of taxes to a formal institution? Are they complying and reporting all or just some business activity to the government? All of these are measures of the level of informality/formality of the business venture itself.

 Location is also determined by what kind of ties the entrepreneur has in the formal economy. For example, does their spouse, child, family member, close friend work in a formal company? Does the entrepreneur himself have a second job in the formal economy? What other close connections does the entrepreneur have in the formal economy? The more overlap an informal entrepreneur has with the formal economy, the more likely they are to be closer on the spectrum to formality rather than wholly informality.

 As an informal entrepreneur moves on the continuum of formality towards the right and formalization, there are more potential benefits to formalizing. Lifestyle ventures, those that are not seeking to scale, may not see benefits of formalization as they do not experience the growing pains of inefficiencies in the informal economy. However, as enterprises grow and interact more with the formal institutions, there may be increased pressure for the unregistered entrepreneur to conform to formal institutions and move into formality (Skousen and Mahoney, 2016; Webb et al., 2009). As entrepreneurs transact with more formal partners and interact more frequently with formal institutions, the chances of detection and the potential for being shut down increases (Skousen and Mahoney, 2016). Therefore, as the entrepreneur interacts more with formal institutions, the risk of losing their livelihood increases, increasing the pressure to conform with legal requirements.

 These links lead to the discussion of the next independent variable affecting an informal entrepreneur’s choice to exit, remain loyal or voice—social capital.

### *Social Capital*

Social capital is an “accumulation of various types of social, psychological, cultural, cognitive, institutional, and related assets that increase the amount (or probability) of mutually beneficial cooperative behavior” (Uphoff, 2000: 216). Most economic behaviors are embedded in social networks (Granovetter, 1985). As a result, social capital plays a significant role in accessing information, creating social cohesion, bettering civic engagement, reducing opportunistic behavior between trading partners, reducing transaction costs, providing insurance against risk and uncertainties, and so on (Bhandari and Yasunobu, 2009).

This variable focuses on the connections of the entrepreneur to social capital, including familial ties, political ties, military ties, and other forms of social capital, such ethnic affiliation. Family is defined as, two or more persons “related by blood, marriage, or adoption” (Bureau, 2000). Familial ties are especially important when an entrepreneur has family members with resources that can be exploited by the entrepreneur (e.g., connections to formalizing institutions). Political ties are the personal and institutional linkages between the focal enterprise and government authorities (Sun, Mellahi, & Thun, 2010), including any personal or institutional linkage between the entrepreneur and a politician, a government agency, or a government representative. Military ties are defined as personal or institutional linkages between the focal enterprise and military authorities (Hiatt & Sine, 2016).

Social capital is about who the entrepreneur knows and can potentially utilize in overcoming overly burdensome formal regulations to enter the formal economy, or alternatively to overcome obstacles that prevent their stay in the informal economy. In many cases, the entrepreneur can use informal ties and social capital to enter the formal economy, disregarding some (or all) state regulations, bureaucracy and paperwork that are prescribed by the state in order to establish a formal business enterprise. Social capital can also play a role in enabling entrepreneurs to stay in the informal economy while navigating around formal institutions. Finally, social capital increases social cohesion in communities and can increase likelihood for civic action and or political participation (Bhandari and Yasunobu, 2009). This can also increase the likelihood of success for that civic action or political participation.

### *Human Capital*

 In addition to who an entrepreneur knows, it is important to account for what he knows. Researchers have long argued that human capital attributes, such as education, experience, knowledge and skills, are a critical resource for entrepreneurs and entrepreneurial success (Florin et al., 2003). Human capital is defined as the skills and knowledge that individuals acquire through investments in schooling, on the job training, and other types of experience (Becker, 1964). Human capital for this paper will be measured not only by educational achievement, but of relevant experience for the entrepreneurial venture. Relevant experience includes previous entrepreneurial experience. If a person has opened several businesses and/or has been an entrepreneur for many years, he has learned many of the tricks of the trade to become a more efficient entrepreneur (Shane and Venkatraman, 2000). On the other hand, there is also industry experience. Being an employee for a firm within the same industry as the new entrepreneurial venture also teaches the individual entrepreneur how to be efficient in a specific industry. Industry related experience is also important in measuring the human capital of the informal entrepreneur.

        As informal entrepreneurs face inefficiency in the informal economy as an organization, imposing barriers to venture growth, it is the formalizing institutions, the entrepreneur’s location on the informality continuum, along with social and human capital, that act as the primary determinants for informal entrepreneurial behavior. These external and internal forces influences an entrepreneur to choose either exit, acceptance, or voice. The next section lays out the hypotheses of this research for the different combinations that lead to exit, acceptance, or voice.

## **Hypotheses**

*H1a-The location of the informal entrepreneur on the continuum of informality is the primary determinant between resignation on one hand, and exit or voice on the other.*

 Exit is only a viable option of there is a substitute choice available. Informal entrepreneurs who do not have overlap with the formal economy and are on the far side of the continuum do not have the available option of exiting to the formal economy. With no opportunity to overlap and enter the formal economy, this leaves resignation and voice. Yet, voice is extremely difficult for these isolated informal entrepreneurs. Therefore, resignation is more likely for these informal entrepreneurs on the far side of the informality continuum—without overlap and crossovers with the formal economy, exit and voice are extremely rare and difficult.

*H1b-Resignation occurs more for entrepreneurs with low social, and or human capital.*

 Those without social networks that can help overcome other shortcomings have little choice in their future, leaving resignation as a default choice.

*H2a-After looking to location on the spectrum, formalizing institutions are the key deciding variable for exit.*

 After looking at location of the informal entrepreneur on the informality continuum, the next primary deciding factor is the state of formalizing institutions.  If these institutions are not complex or corrupt, then exit via formalization is most likely. However, when institutions are complex or corrupt, then exit is less likely since this indicates that the formal economy does not incentivize formalization.  Therefore,

*H2b-When formalizing institutions are overly complex or corrupt, exit is less likely to occur unless the informal entrepreneur has high social capital or human capital that can overcome the voids in the formalizing institutions.*

 Institutional voids are insufficiencies in the institutional environment (Ricart, Enright, Ghemawat, Hart, & Khanna, 2004). If formalizing institutions are overly complex or corrupt, then they exhibit institutional voids. Human and or social capital can help an entrepreneur overcome these voids and formalize despite the institutional voids that exist in this process. Social capital is important in overcoming these voids. If a family member or friend can help the informal entrepreneur expedite the process, or bypass corruption or complex bureaucracy, then formalization is still a possibility. Yet, for those without high levels of social and or human capital, formalization is less likely. Under these circumstances of high level of corruption and or complexity in formalizing institutions with low levels of social or human capital, regardless of the entrepreneur’s location on the spectrum, the choice will most likely be resignation.

*H3a-Voice is more likely to occur in places with significant overlap between the formal and informal economy as entrepreneurs use both formal and informal means of creating change.*

 Voice in this research requires informal entrepreneurs to have linkages with the formal economy. Voice oftentimes requires formal channels for creating change and is oftentimes focused on changing formal institutions. This is difficult to accomplish for the isolated informal entrepreneur.

*H 3b: Voice is likely to occur when formalizing institutions are complex, but not overly corrupt.*

The cost of coordination in the already illegal shadow environment of the informal economy is incredibly high. The organization involved in institutional entrepreneurship would bring undue attention to informal entrepreneurs. Therefore, it is less likely to occur if informal entrepreneurs do not believe that change will occur. Informal entrepreneurs will have more cause to believe in possible institutional change if at least some of the formal institutions are considered inclusive, either political or economic institutions (Acemoglu & Robinson, 2012). Inclusive institutions can be mildly corrupt, but not entirely corrupt. If there are some inclusive institutions, then there is an avenue for voice to be heard and for change to occur, giving cause for informal entrepreneurs to believe that their engagement in voice will cause effective change.

*Proposition 3c: Voice is more likely to occur for entrepreneurs with higher levels of social and human capital.*

 Individual voice is more likely to occur for informal entrepreneurs with higher levels of human capital. It is difficult to know how to create better circumstances for the entrepreneur without prior experience. Collective voice is more likely for entrepreneurs with higher levels of social capital. Collective action takes networking and commitment from others involved in the project.

*Proposition 3d: After engaging in voice to change formal regulations, if successful, informal entrepreneurs may then engage in exit via formalization.*

Oftentimes the goal of voice for informal entrepreneurs is to seek change in the institutions guarding the formal economy. If these entrepreneurs are successful in institutional entrepreneurship and do create regulatory change, then they may then exit the informal economy and formalize.

## **Discussion**

    Current academic literature on this topic focuses on failing aspects of formalizing institutions—how levels of complexity affects the size of the informal economy or how the level of corruption affects the formalizing process. Yet, the conceptualization of the informal economy is usually dichotomous, looking at one economy versus the other. It does not take into consideration the location of an entrepreneur on the continuum of informality, what ties and overlaps he has with the formal economy that may alter his decision to formalize or not. The location of an entrepreneur on the spectrum of informality is critical to understanding the deeper story behind the entrepreneur’s decision to remain informal, formalize, or seek institutional change. This paper also adds a new dependent variable: the choice that informal entrepreneurs make. This brings agency into the institutional framework (DiMaggio, 1988), treating informal entrepreneurs as agents rather than pawns on an institutional chess board.

This theoretical framework also brings up interesting questions about what affects an entrepreneur’s choice to exit, voice, or resignation. Is complexity more of a determining factor on entrepreneurial choice, or is corruption in formalizing institutions? Meaning, in what circumstances do the informal aspects of the formalization process, corruption, outweigh the complexity? How do informal entrepreneurs utilize their social capital and engage in corruption to formalize? Why does this occur? How does an entrepreneur’s linkages to the formal economy affect this decision?

This research also brings up further questions about the second half of the story concerning what occurs after the choice is made. What are the effects of the entrepreneur's choice on the overall institutional environment of the country? Specifically, what effect does voice have on the overall institutional framework of the state? Can informal entrepreneurs create institutional change?

   This paper lays out a framework to assist in analyzing the decision-making process for informal entrepreneurs. The individual decisions of informal entrepreneurs have consequences on their communities, their institutional environment, and the state. Voice can have a powerful effect on the institutional environment of the state. While much of the literature posits informality as coexistent with poverty and survival based necessity, this is not always the case. There are innovative, ingenious entrepreneurs operating informally who can grow and create a sustainable enterprise, but for a variety of reasons choose to avoid formalization. In many of these cases, a lack of access to institutional rights such as property rights, capital markets, and contract enforcement create barriers to formal growth. These entrepreneurs are capable of voicing and creating institutional change. Investigating voice for informal entrepreneurs and how voice enables informal entrepreneurs to interact with the state creates a new component to institutional change theory, adding further knowledge to this evolving body of literature.

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