

YOU SAY ILLEGAL, I SAY LEGITIMATE: ENTREPRENEURSHIP IN THE INFORMAL ECONOMY

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The entrepreneurial process drives economic activities in the formal economy; however, little is known theoretically about how the entrepreneurial process works in the informal economy. To address this theoretical gap, we employ a multilevel perspective integrating entrepreneurship theory (microlevel) with institutional (macrolevel) and collective identity (mesolevel) theories to examine the role institutions and collective identity play in the recognition and exploitation of opportunities in the informal economy. Additionally, we explore factors that influence the transition to the formal economy.

Societies are composed of groups that often have different opinions about what is socially acceptable (Bickford, 1999; Rokeach, 1973). Contrasting norms, values, and beliefs are the source of these differences. When concerned with salient issues, the groups that form as a result of individuals' coalescence around different norms, values, and beliefs often become large. The Prohibition era and the civil rights movement in the United States, for example, led to protracted struggles between large groups of supporters and antagonists. Currently, large groups in society with different norms, values, and beliefs are struggling to reach agreements about socially acceptable positions regarding several issues, including immigration, balancing individuals' civil liberties and national security, and society's role in protecting the environment.

Each individual in a society may not actively participate in defining social acceptability about issues such as those mentioned above; however, all citizens are affected by the outcomes of interactions between groups with different views (Davis & Silver, 2004). Moreover, when large groups in a society disagree about what is socially acceptable relative to salient issues, one group's norms, values, and beliefs may eventually become the basis of laws and

regulations (Scott, 1995), but this set of laws and regulations may differ from the laws and regulations that would be the product of another large group's norms, values, and beliefs (Weber, 1978). Because of these differences, a gap often exists between what some large groups in a particular society understand to be *legal*—as specified by laws and regulations—and what they consider to be *legitimate*—as specified by norms, values, and beliefs (Dowling & Pfeffer, 1975; Scott, 1995). This type of gap is important in that when a large group defines social acceptability more broadly than is specified by established laws and regulations, members of that group may consider what is deemed illegal to be legitimate.

Of interest to us is the fact that a gap (or variance) between what is legal in a society and what some large groups consider to be legitimate in that society allows an informal economy to emerge. Drawing from different social disciplines (e.g., anthropology, economics, and sociology), we define the informal economy as the set of illegal yet legitimate (to some large groups) activities through which actors recognize and exploit opportunities (Castells & Portes, 1989; Feige, 1990).¹ In this context an opportunity is the poten-

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¹ The *irregular*, *underground*, *shadow*, and *illegal economy* are terms others use to describe what we label the *informal economy*. Our definition of the informal economy is generally consistent with definitions used in anthropology, economics, and sociology research (e.g., Castells & Portes, 1989; Feige, 1990).

tial to create more efficient or effective means—that is, production/distribution—and/or ends—that is, goods/services (Casson, 1982).

A significant amount of activity takes place in the informal economy, suggesting its theoretical and practical importance. Schneider (2002) estimated that informal economy activities account for approximately 17 percent of gross domestic product (GDP) in developed economies and approximately 40 percent of GDP in developing economies. The International Labour Organization (2002) offered similar statistics. The associated societal costs are also significant. For instance, the U.S. Department of Justice (2006) has estimated the annual costs of counterfeit goods at \$250 billion and 750,000 lost jobs. Revenues lost from uncollected taxes on counterfeit goods and unlicensed services and the costs of curbing these activities by means of regulation, inspection, and/or enforcement are examples of additional costs resulting from activities in the informal economy (Fadahunsi & Rosa, 2002).

Here we argue that entrepreneurial activities taking place in the informal economy fall within informal institutional boundaries (i.e., norms, values, and beliefs of large groups in a society) but outside formal institutional boundaries (i.e., laws and regulations). By default, entrepreneurial activities outside formal institutional boundaries are illegal. The illegality of these activities surfaces because the means and/or ends employed do not comply with the mandates of laws (e.g., not adhering to labor laws) and regulations. However, some groups may deem these activities to be socially acceptable/legitimate when they are consistent with those groups' norms, values, and beliefs. Trader tourism (Konstantinov, 1996), activities involving undocumented workers (Raijman, 2001; Villar, 1994), and music/software piracy (Givon, Mahajan, & Muller, 1995) are examples of activities taking place in the informal economy that are illegal but legitimate for some groups. Informal economy entrepreneurs acting illegally rely on the legitimacy that comes by operating within informal institutional boundaries to exploit opportunities and operate their ventures outside formal institutional boundaries.²

² Institutional theorists refer to *both* formal and informal institutions as conferring legitimacy. For the purposes of our arguments, we refer to activities with respect to formal institutions as *legal* or *illegal* and activities with respect to informal institutions as *legitimate* or *illegitimate*.

As in the formal economy, different types of entrepreneurs (e.g., those seeking to replace their current income, those desiring a certain lifestyle, and those committed to growing their ventures) compete in the informal economy. Because of the scale of their operations compared to salary-substitute and lifestyle entrepreneurs, we focus on growth-oriented entrepreneurs (i.e., individuals who continuously seek substantial growth for their ventures; Miller, 2005). Growth-oriented entrepreneurs use an entrepreneurial process as the foundation for growing their ventures. Entrepreneurial alertness, opportunity recognition, opportunity exploitation, and decisions concerning growth are the stages commonly associated with the entrepreneurial process (Bygrave & Hofer, 1991; Kirzner, 1979). We develop theoretical arguments examining the entrepreneurial process in the informal economy and the ability of some entrepreneurs to thrive outside formal institutional boundaries.

We draw from three theoretical levels to develop our arguments. To describe the contextual nature of the entrepreneurial process, we integrate microlevel (individual), macrolevel (institutional), and mesolevel (group) effects. We use institutional theory to explore the boundaries around the formal and informal economies and to explain why entrepreneurs are able to recognize and exploit opportunities in the informal economy. In short, because formal institutions condemn the exploitation of a set of opportunities by deeming them illegal (Jepperson, 1991; Scott, 1995), a realm of opportunities exists for entrepreneurs willing to operate outside formal institutional boundaries. Based on collective identity theory (Lounsbury & Glynn, 2001; Polletta & Jasper, 2001) at the meso level, we show how entrepreneurs rely on cooperative groups to recognize and exploit opportunities in the informal economy. These cooperative groups form through a shared identification with similar others or through a shared disidentification with formally institutionalized practices. The collective identity theory lens suggests how and why informal economy entrepreneurs create and access factor and product markets that substitute for the lack of support from formal institutions.

Several theoretical contributions and policy implications result from our work. First, integrating different social disciplines to explain the use of the entrepreneurial process in the informal economy contributes to an emerging

theory of entrepreneurship (Phan, 2004). Second, we enhance institutional theory by describing how opportunities arise within the informal economy, as well as why entrepreneurs can effectively pursue some of those opportunities. In doing so we answer calls for multidimensional perspectives regarding institutions (Glynn, Barr, & Dacin, 2000). Third, we contribute to identity theory by describing how an entrepreneur's collective identity facilitates opportunity recognition and exploitation in the informal economy. Finally, from a policy-making perspective, we inform efforts taken to develop policies that (1) more effectively encourage entrepreneurs to use the entrepreneurial process in the formal economy and (2) influence entrepreneurs' transitions from the informal economy to the formal economy.

First, we establish the theoretical context for our arguments at the micro, meso, and macro levels. We then form propositions to discuss how institutional incongruence and weak enforcement of formal institutions enable the entrepreneurial process in the informal economy, how collective identity facilitates opportunity recognition and exploitation in the informal economy, and what the influences are that affect the transition from the informal to the formal economy. We conclude by discussing the implications of our work for research and policy.

THEORETICAL BACKGROUND

The Entrepreneurial Process

The entrepreneurial process's activities unfold in stages: entrepreneurial alertness, opportunity recognition, opportunity exploitation, and decisions concerning growth (Bygrave & Hofer, 1991; Shane & Venkataraman, 2000). These activities are the source for realizing an opportunity's potential. Entrepreneurial alertness refers to an individual's ability to recognize opportunities. Opportunity recognition may occur as a flash of spontaneous superior insight (Kirzner, 1979); alternatively, entrepreneurs sometimes recognize opportunities after taking what can be a lengthy amount of time to evaluate ideas concerning specific market needs (Sarason, Dean, & Dillard, 2006). Opportunity exploitation refers to activities entrepreneurs pursue to gather, bundle, and leverage new and existing resources in order to develop more efficient means and/or ends (Sir-

mon, Hitt, & Ireland, 2007). Entrepreneurs sustain their venture's growth by leveraging the same opportunity in additional markets and/or by leveraging different opportunities in the same market.

Institutions and an entrepreneur's collective identity affect the entrepreneurial process (Aldrich & Fiol, 1994; Polletta & Jasper, 2001; Sine, Haveman, & Tolbert, 2005). We use institutional theory to describe how institutions affect the use of the entrepreneurial process in the informal economy. Following this, we discuss how collective identity facilitates access to both factor (e.g., financial capital, labor, material, etc.) and product markets for the informal economy entrepreneur.

Institutional Boundaries of the Informal Economy

Legality and legitimacy. Legitimacy is "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" (Suchman, 1995: 574). As socially constructed reflections of laws, regulations, norms, values, and beliefs, institutions "negatively constrain action, define opportunity, and facilitate patterns of interactions" (Clemens & Cook, 1999: 445). That is, institutions confer legitimacy to sanctioned opportunities to promote socially acceptable actions (Jepperson, 1991). By sanctioning some opportunities, institutions simultaneously specify a set of unsanctioned opportunities.

Scholars have developed various typologies of institutions (Aldrich & Fiol, 1994; North, 1990; Scott, 1995).³ North's (1990) well-established typology divides institutions into formal and informal dimensions. *Formal institutions* refer to laws, regulations, and their supporting apparatuses (enforcement agencies, regulatory bodies, etc.). Through a wide range of mechanisms such

³ Scott's (1995) categorization includes regulatory, normative, and cognitive institutions. Aldrich and Fiol (1994) distinguish sociopolitical (which essentially combines Scott's regulatory and normative) and cognitive institutions. North (1990) provides a third typology, distinguishing formal (regulatory) and informal (normative and cognitive) institutions. The distinction between formal laws/regulations and values, norms, and beliefs establishes the informal economy's context.

as enforcement, incentives, and precepts (Suchman, Steward, & Westfall, 2001), formal institutions establish the boundaries of entrepreneurial activities. *Informal institutions* refer to norms, values, and beliefs that define socially acceptable behavior. Informal institutions encourage conformity with social groups' shared norms, values, and beliefs (Aldrich & Baker, 2001).

Despite distinguishing the two dimensions, scholars have yet to examine the effects of the potential incongruence between what formal and informal institutions define as legitimate. Glynn et al. noted that "ignoring the dimensionality of legitimacy . . . can be costly in terms of over or underestimating the attention given to the variable expectations and power of key constituents" (2000: 730). As laws, regulations, and supporting apparatuses, formal institutions embody the values, norms, and beliefs of certain large groups in society. For these large groups, formal and informal institutions are congruent. Because of dispositional characteristics, personal experiences, and contextual elements, however, individuals differ in their norms, values, and beliefs (Meglino & Ravlin, 1998). Therefore, some large groups in society may come to hold notions of what is legitimate that conflict with formal institution's prescriptions. In fact, entire communities, enclaves, and other identity-based groups can adhere to norms, values, and beliefs that conflict with the laws and regulations specified by formal institutions (Safran, 2003). Formal and informal institutions are, thus, incongruent for these large groups.

We assert that the informal economy exists because of the incongruence between what is defined as legitimate by formal and informal institutions. "Legitimacy" is commonly used in the literature to describe the prescriptions of both formal and informal institutions; however, using the word in this manner can create ambiguity for those seeking to study the difference between formal and informal institutional requirements. Therefore, we explicitly refer to opportunities as being *legal* or *illegal* (as specified by formal institutions) and *legitimate* or *illegitimate* (as specified by informal institutions). The legal/illegal distinction captures prescriptions guiding economic activities that have been formalized and codified in laws and regulations that govern society. Our use of the terms *legitimate* and *illegitimate* more narrowly captures

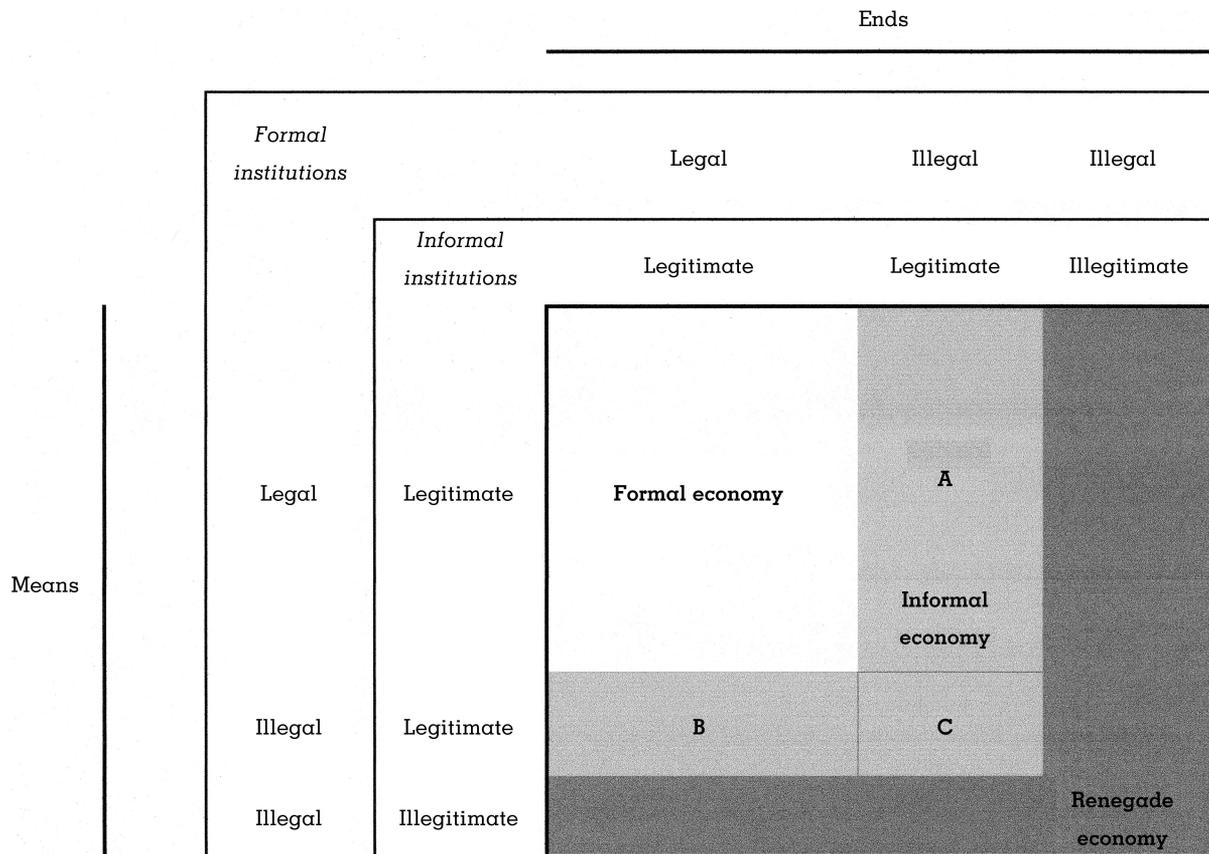
prescriptions for social acceptability based on only norms, values, and beliefs of large groups in society, disregarding prescriptions of laws and regulations. In other words, the means and/or ends of an opportunity can be assigned classifications of both legality and legitimacy. By "means," we refer to the factors and processes directly involved in the production of finished goods and services. Factors include raw materials, labor, and other inputs; processes parallel Porter's (1985) conceptualization of primary activities, such as inbound logistics, operations, outbound logistics, marketing and sales, and service. By "ends," we refer to the output (goods or services) produced by the venture. Combinations of legal/illegal and legitimate/illegitimate means and ends create three sectors of the economy (see Figure 1).

The formal economy. As suggested in Figure 1, entrepreneurs exploiting legal and legitimate means to produce legal and legitimate ends operate in the formal economy. Formal economy entrepreneurs create new combinations of knowledge as the foundation for exploiting recognized opportunities but seek to conform to established formal and informal institutions (Zimmerman & Zeitz, 2002), even perhaps at the expense of increased efficiency (DiMaggio & Powell, 1983).

The renegade economy. In some cases means and ends can be illegal and illegitimate. Therefore, opportunities outside both formal and informal institutional boundaries lack any necessary level of legal support and social acceptability. We refer to the set of activities taken to exploit illegal and illegitimate opportunities as the *renegade economy*.

As an important distinction between the renegade and informal economies, we limit our analysis of legitimacy to that conferred by large groups in society supporting a given set of norms, values, and beliefs. Drug cartels, bank robberies, and dog-fighting syndicates are examples of activities occurring in the renegade economy. The broader society does not confer legitimacy to such activities (Johnson, Dowd, & Ridgeway, 2006). Although lacking social acceptability, some renegade economy activities can grow substantially. The renegade economy is an intriguing research context; however, analyzing how renegade economy activities grow through such mechanisms as addiction, coercion, and secrecy is outside our scope.

FIGURE 1
Institutional Categories of Entrepreneurial Activities



The informal economy. The informal economy couples illegality with legitimacy. Drawing from our earlier discussion, *the informal economy contains the activities to recognize and exploit opportunities occurring outside formal institutional boundaries but within informal institutional boundaries.* For example, an alert entrepreneur in the informal economy may use illegal yet legitimate means (e.g., undocumented workers) to produce legal, legitimate products (e.g., residential homes, farm output). Although means and ends in the informal economy are illegal (as specified by formal institutions), some large groups in a society consider them to be legitimate.

Entrepreneurial activities in the informal economy fall into three categories (see Figure 1). Case A represents the combination of illegal yet legitimate ends with legal and legitimate means. Therefore, concerns for Case A revolve around the good or service itself, not its production. Examples here include pirated software

and counterfeit products. The means associated with making copies of compact discs or counterfeit products are not illegal; however, the ends produced by those means are illegal. Selling drugs with medicinal purposes that have regulatory approval in other countries but not in a focal country is another example of Case A activities. A product-specific example here is using ozone to sterilize a patient's mouth when completing dental procedures. Although illegal in the United States, ozone for dental procedures is legal in parts of Europe. Thus, some large groups in the United States may view the use of ozone as legitimate because of its medicinal value and acceptance in other countries.

Case B combines legal and legitimate ends with illegal yet legitimate means, such as employing undocumented workers. While undocumented workers may provide services similar to those of documented workers, they may be willing to accept lower wages and work without benefits—conditions that increase operational

efficiency. Ignoring emission requirements during manufacturing processes is another example of Case B. Although producing a legal product, entrepreneurs can again improve efficiency by avoiding engineering, construction, and certification costs associated with fulfilling emission requirements.

Case C combines both means and ends that are illegal yet legitimate. Using undocumented workers to produce counterfeit products is an example of this type of entrepreneurial activity.

While some individuals engage in the informal economy because certain factors (e.g., lack of requisite financial capital, discrimination) bar their entry into the formal economy (Pessar, 1995; Raijman, 2001), others, even those who are affluent, may also opt to enter the informal economy (Williams, 2006). Affluent individuals may find the informal economy attractive because of their business acumen, motivations to increase wealth, and access to the resources needed to exploit illegitimate opportunities (Cloward, 1959). Regardless of socioeconomic factors, focusing on the growth motivation of informal economy entrepreneurs highlights processes germane to our arguments. Specifically, to recognize and exploit opportunities in the informal economy, growth-oriented entrepreneurs proactively seek to take advantage of institutional incongruence and weak enforcement of the formal institution's laws and regulations. Additionally, because of their need for resources, growth-oriented entrepreneurs operating in the informal economy are highly dependent on their collective identity (Portes & Haller, 2005).

Collective Identity and the Entrepreneur in the Informal Economy

Because they lack access to the resources and to the markets available within the boundaries of formal institutions, informal economy entrepreneurs may rely on cooperative groups as substitutes for formal channels and markets. Collective identity, which refers to the common bond tying individuals to a group (Polletta & Jasper, 2001), is one way cooperative groups form between entrepreneurs and others. Identification refers to an individual's cognitive, moral, or emotional attachment to a group based on similar attributes (Nahapiet & Ghoshal, 1998). For example, identity may form around values, behaviors, or general attributes

such as one's race or cultural background (O'Reilly & Chatman, 1986).

Ethnic enclaves, perhaps the most salient and studied collective identities in society (Pessar, 1995; Raijman, 2001), are concentrations of firms within a generally defined location that are owned and operated by workers from the same ethnic background and serve the ethnic and/or broader community (Portes & Jensen, 1989). Identification within ethnic enclaves or other groups creates an environment conducive to entrepreneurial activities in the informal economy, partly because the group substitutes for formal institutions (Sanders & Nee, 1987; Wilson & Portes, 1980). For example, Portes and Sensenbrenner (1993) illustrated this role of collective identity with the presence of informal loan operations granting credit to entrepreneurs in a community of primarily illegal Dominican immigrants in New York City (also see Aldrich & Zimmer, 1986). This community ostracized entrepreneurs who failed to repay their loans, limiting the entrepreneurs' access to different factor markets. Similarly, the employees of Spanish-language radio stations in South Florida and private "security services" in other ethnic communities maintain strong collective identities (Portes & Sensenbrenner, 1993).

Other attributes that meaningfully highlight a salient norm, value, or belief may also be the foundation for a collective identity. Regardless of the focal attribute, individuals often define themselves and others within social categories and perceive a positive contribution to their own identity by belonging to a group of others with similar attributes (Dutton, Dukerich, & Harquail, 1994; Turner, 1975). Individuals sharing a common identity cooperate with each other and compete with those who do not share the same attributes (Ashforth & Mael, 1989). Moreover, to support their group's collective identity, individuals are motivated to act, even in the face of great personal risk (Akers, Krohn, Lanza-Kaduce, & Radosevich, 1979). Such actions are explained by "interaction in or [being] under the influence of those groups which control individuals' major sources of reinforcement and punishment and expose them to behavioral models and normative definitions" (Akers et al., 1979: 638).

Through discourse, informal economy entrepreneurs are able to create common identities with potential investors, employees, suppliers,

and customers and to mobilize collective action (Lounsbury & Glynn, 2001). Discourse refers to differing modes of communication, such as conversation, text, pictures, and symbols (Grant, Keenoy, & Oswick, 1998). For example, entrepreneurs sometimes tell stories to increase cultural alignment with and support for their venture. Stories facilitate identity formation by "emphasizing the distinctiveness of the new venture through a focus on identifying its unique characteristics" and "by stressing the normative appropriateness of the new venture by identifying its symbolic congruence" with other individuals' commonly shared attributes (Lounsbury & Glynn, 2001: 551). Furthermore, recursive discourses allow individuals to establish their role within a group or network (Robichaud, Giroux, & Taylor, 2004), their expectations of membership, and the meanings of the collective identity within the context of previous discourse. In this way a set of standards guiding behavior is established (Burke, 1991). In turn, a collective identity can create a cognitive awareness of why the venture in the informal economy exists, of identity-imposed norms or rules guiding the venture's activities, and of mechanisms enabling success in factor and product markets (Lawrence, Hardy, & Phillips, 2002).

A MULTILEVEL FRAMEWORK OF THE ENTREPRENEURIAL PROCESS IN THE INFORMAL ECONOMY

Based on the theoretical context given here, we develop propositions specifying the relationships among institutions, collective identity, and the entrepreneurial process in the informal economy. Napster, which was a growth-oriented entrepreneurial venture that Shawn Fanning established in the informal economy (Green, 2002), is the primary example we use to illustrate our arguments. A software-based venture that developed peer-to-peer file-sharing capabilities, Napster allowed the transfer of hundreds of millions of song files among "pirating" users who paid no royalties to music companies or artists. Napster's business model resulted in facilitating infringement of existing copyright law through the venture's software. Some analysts believe that Napster's success contributed to a downturn in the music industry—a downturn from which the industry is still recovering (Chaffin, 2007; Schuman, 2007).

Incongruence Between Formal and Informal Institutions

Entrepreneurial alertness generally increases the recognition of opportunities (Kirzner, 1979). Research on microlevel processes in entrepreneurship supports this relationship; however, we suspect that institutions play a role in this relationship as well. Specifically, we describe incongruence between formal and informal institutions as exerting an important effect on entrepreneurs' recognition of opportunities in the informal economy.

The boundaries established by formal institutions prescribe preferred methods for conducting entrepreneurial activities in a society (Suchman et al., 2001), which, in turn, allow for legality and its benefits (e.g., reputation effects, reduced transaction costs, etc.) to be procured by ventures adhering to such methods. Differences in institutional boundary conditions arise when formal and informal institutions send different signals about the acceptability of certain means and/or ends as the foundations for entrepreneurial activities. We label these differences *institutional incongruence*. Increasing institutional incongruence magnifies the gap between what is legal and what is legitimate.

Napster's launch demonstrates an entrepreneur's decision to take advantage of institutional incongruence. Long before Napster, copyright laws specified the property rights for the music industry and its artists. Although Napster facilitated copyright law infringement, the company experienced phenomenal growth. Napster was a "catalyst for the normative reconceptualization of copyright in society" (Green, 2002: 799). Various norms, values, and beliefs (informal institutions) contradicted copyright laws (formal institutions), legitimizing Napster. For example, some individuals believed that (1) the courts were wrong to target Napster given other available, nontargeted avenues for piracy (CD burners, blank tapes, etc.); (2) Napster introduced diverse music to consumers, actually helping many artists; and (3) Napster allowed users to sample music before purchasing CDs (Merriden, 2001).

Most often, the type of incongruence that is relevant to our arguments arises from formal institutions that are more restrictive than what informal institutions deem socially acceptable.

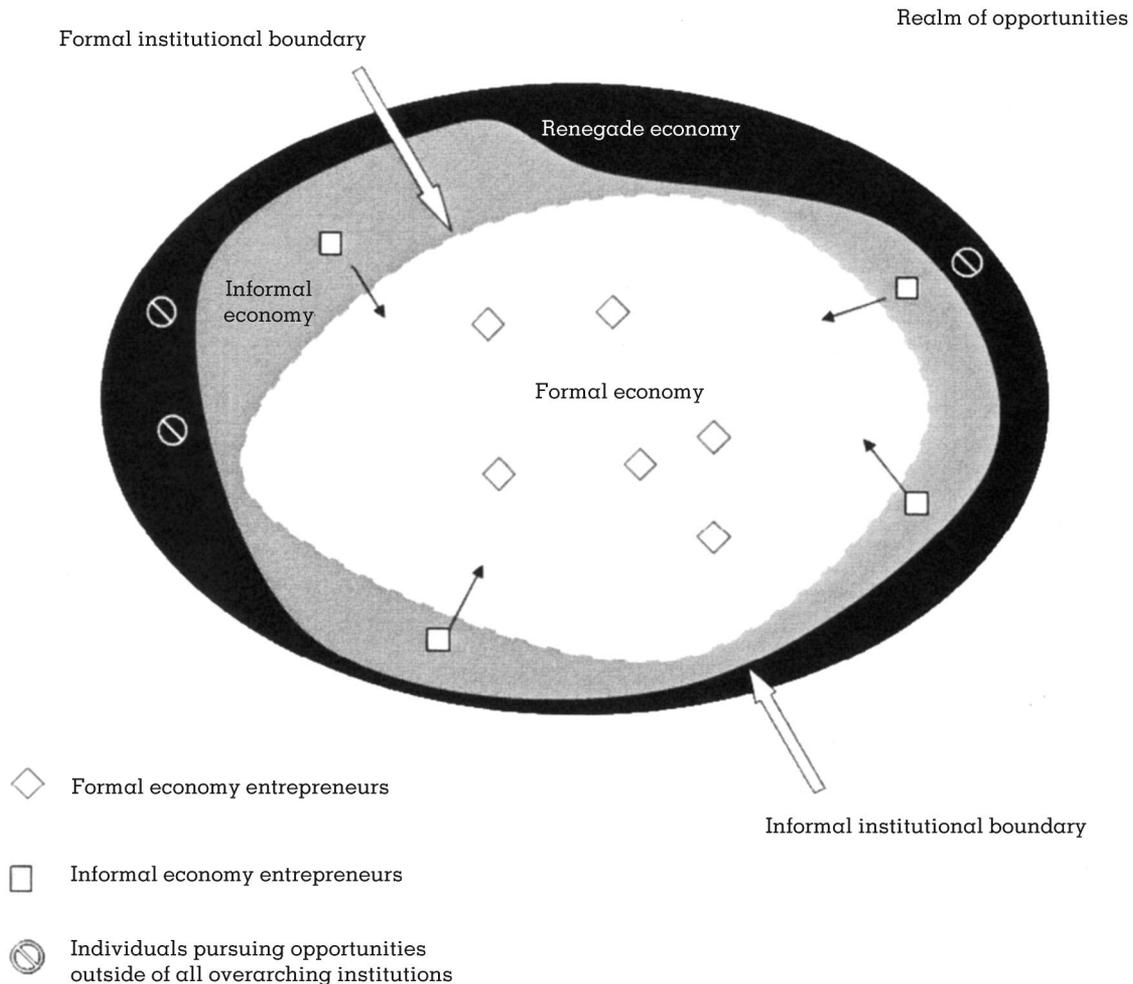
We demonstrate this relationship in Figure 2, where the outermost boundary represents the overall realm of opportunities available to entrepreneurs. The white region corresponds to opportunities available to entrepreneurs within the formal economy. The gray region represents the informal economy, while the black region represents the renegade economy. The boundaries between the formal and informal economies are dynamic and shift over time. As formal and informal institutions change, the level of their congruence changes as well. Increased incongruence increases opportunities, whereas decreased incongruence decreases opportunities in the informal economy (i.e., the gray space).

At least two factors explain change in the formal institutional boundary. First, legislative

efforts to acknowledge and accept new technologies and services shift the formal institutional boundary outward, transitioning opportunities from the informal to the formal economy. For example, Sellin (1963) described how the conception of the lottery in the United States, currently found in the formal economy, was once part of the informal economy. As laws became more tolerant of lotteries, formal institutions grew more congruent with informal institutions. Second, interest groups may lobby successfully for shifts in regulations that align formal institutions with certain groups' norms, values, and beliefs (Aldrich & Fiol, 1994; Suchman et al., 2001). Currently, for example, some are lobbying for legalizing the use of marijuana for medicinal purposes.

One can assume that entrepreneurs are alert to legitimate opportunities. The lack of legiti-

FIGURE 2
Locus of the Formal, Informal, and Renegade Economies and Their Participants



macy implies that there are comparatively small markets for the entrepreneurs' goods or services. Entrepreneurs are not alert to (or at least do not consider in depth) opportunities they deem as unacceptable. Because of institutional incongruence, entrepreneurs have different perspectives on legitimacy. When informal institutions guide entrepreneurs' perceptions of legitimacy more strongly than do formal institutions' prescriptions, the entrepreneurs become alert to opportunities in the informal economy.

As the benefits of using the means and ends to conduct entrepreneurial activities dictated by formal institutions decrease, alert entrepreneurs may recognize more opportunities in the informal economy. Despite being illegal (as defined by formal institutions), institutional incongruence allows legitimate opportunities in the informal economy and increases the chance that alert entrepreneurs will recognize these opportunities. Therefore, we suggest the following.

Proposition 1: Institutional incongruence strengthens the relationship between entrepreneurial alertness and opportunity recognition in the informal economy.

While effective institutions may reliably regulate social action without the need for collective mobilization or consistent intervention (Clemens & Cook, 1999; Jepperson, 1991), entrepreneurs may recognize opportunities in the informal economy when formal and informal institutions are incongruent. However, institutional incongruence is a necessary yet insufficient condition for explaining entrepreneurial activities in the informal economy. Additionally, weak enforcement of formal institutions is a precursor for exploiting opportunities in the informal economy.

Weak Enforcement of Formal Institutions

Institutional theorists consider the stability of formal institutions to be a function of surveillance or enforcement power (Scott, 1995). The state's enforcement of formal regulations is *third-party enforcement*. Ideally, third-party enforcement implies neutrality, costless measurement of contracts, and costless enforcement (North, 1990). In reality, though, enforcement costs are substantial, particularly as the number and complexity of laws and regulations in-

crease. To enforce all activities effectively, the costs could possibly exceed the value created by the desirable activities.

Entrepreneurs exploit opportunities in the informal economy by taking advantage of the imperfections in the enforcement of laws and regulations. Although formal institutions not linked with enforcement may discourage some entrepreneurs from developing their products, the potential for additional wealth through increased efficiency or effectiveness encourages other entrepreneurs to exploit recognized opportunities in the informal economy.

A number of imperfections contribute to weak enforcement of formal institutions, including the fact that a significant portion of enforcement tends to concentrate on the activities and outcomes of prominent firms or industries. Targeted enforcement increases awareness of violations and is viewed as an effective method of setting an example for other ventures that violate formal institutions. However, targeted enforcement also allows the activities of smaller entrepreneurial ventures to continue undeterred.

Other imperfections surface owing to the enforcement methods agents have available. Enforcement agents are often visible manifestations of the formal institutions. As such, entrepreneurs in the informal economy benefit from the ability to exploit opportunities outside the purview of these enforcement agents. Bornstein (2001) described the Palestinian-Israeli border as a constraint regulating the flow of products and workers. Road checkpoints and patrols severely limit the flow of Palestinians to their businesses and jobs in Israel. Therefore, tens of thousands of Palestinians merely avoid these visible obstacles by undertaking clandestine off-road crossings into Israel (Bornstein, 2001). A similar source of imperfection surfaces when one set of formal institutions obstructs agents from enforcing other formal institutions. More specifically, laws defining privacy and civil rights may limit the detection and termination of informal economy activities.

Self-interested motives and negligence of formal institutional agents may further undermine efforts to control deviant behaviors. Bribery often fulfills the motives of self-interested institutional agents. Some institutional agents may also lack the expertise or desire needed to enforce regulations guiding economic activities. Finally, the values of institutional agents may

align with those of the informal economy entrepreneur, leading the agents to believe that enforcing more restrictive formal institutions is not worthwhile or necessary.

The weak enforcement of copyright laws was a major contributor to Napster's growth. The internet provides a global marketplace with an enormous number of vendors. Because of its size, most informal economy entrepreneurs operating on the internet are not visible to enforcement agents (Zimmerman, 2006). But Napster's growth eventually became its source of demise. The music industry targeted Napster and its customers in a series of lawsuits. As noted, however, targeted enforcement controls the major violators but allows smaller entrepreneurial ventures to escape detection and possible punishment. While the music industry targeted Napster, numerous imitators established similar operations (*The Economist*, 2002).

Proposition 2: Weak enforcement of formal institutions strengthens the relationship between opportunity recognition and opportunity exploitation in the informal economy.

Entrepreneurs in the informal economy may be effective not only at taking advantage of weak enforcement of formal institutions but also at maintaining a strong market position for their venture's products. They may do so by leveraging cooperative groups based on the formation of a collective identity to broker factors of production their venture needs to continue operating.

Collective Identity and Opportunity Recognition in the Informal Economy

Individuals define themselves within a system of social categories based on numerous attributes, including norms, values, and beliefs (Turner, 1975). Whether an individual is born a member or joins a group later, others within that group reinforce the individual's perspectives. A confluence of geographic, cultural, and other factors and events can characterize the unique historical context through which a collective identity forms. The collective identity strengthens over time as the group behaves in ways to protect and reinforce its defining characteristics in the face of broader contextual changes (Polletta & Jasper, 2001). Furthermore, the norms, values, and beliefs that develop in the collective

identity of such groups can differ from the prescriptions put forth by formal institutions.

As a valuable social source of information to its members, a group's collective identity can increase its members' ability to recognize opportunities (Ozgen & Baron, 2007; Singh, 2000). More specifically, through membership in a collective identity that is outside formal institutions, individuals may recognize opportunities through three types of valuable experiential knowledge: (1) knowledge that a market of opportunities exists outside formal institutions, (2) knowledge of collective identity members' needs and customer problems, and (3) knowledge of how to serve the needs of the collective identity (Shane, 2000).

To elaborate, institutional incongruence creates opportunities in the informal economy (as specified in Proposition 1). However, an individual's membership in a collective identity attunes the individual to these opportunities and to the existence of a market with actors possessing similar norms, values, and beliefs that can be served. Individuals sharing a collective identity also may be more capable of understanding the group's needs and desires. Given members' specific group knowledge formed through consistent interaction and discourse with the group (Yu, 2001), alert individuals become aware of the group's specific needs that cannot be served through formal economy activities. Because individuals who are not members of such a collective identity do not participate in the everyday interactions of the group, they do not possess key sources of knowledge needed to identify relevant opportunities for the collective identity (Gaglio & Katz, 2001). Finally, members of a group also understand the mechanisms to effectively engender identification with the group and to create factor and product markets (Bletzer, 2003), allowing these members to understand how to serve the collective identity.

Napster is an interesting example of how a collective identity facilitated an entrepreneur's recognition of an opportunity. Fanning was a student at Northeastern University when he recognized the opportunity that developed into Napster. He and other students were using earlier versions (e.g., Scour) of music-downloading programs. Alert to others' complaints about outdated and empty links to song files, Fanning recognized an opportunity to develop software that would automatically update links as users logged onto the internet with the program run-

ning. The group's music-loving collective identity was the basis of the recognized opportunity (Menn, 2003), manifesting through Fanning's knowledge of a potential online market for music by internet users, the issues undermining current methods of accessing music online, and how to develop a better service for this market segment.

For collective identities that do not share norms, values, and beliefs that are congruent with the legal requirements of formal institutions, alert members may become more attuned to and able to recognize opportunities in the informal economy.

Proposition 3: A group's collective identity, as framed by at least some characteristics outside formal institutions, strengthens the relationship between entrepreneurial alertness and opportunity recognition in the informal economy.

Collective Identity and Opportunity Exploitation in the Informal Economy

Formal institutions do not facilitate access to important factors of production (e.g., labor, supplies, and financial capital) for informal economy entrepreneurs. Because of this, these entrepreneurs leverage identity-based groups that, in part, act as a substitute for formal institutions (Wilson & Portes, 1980). A group with a strong identity can enhance cooperation among members and provide access to resources and markets. Informal economy entrepreneurs may gather needed resources from other members of their group through financial bootstrapping—the "highly creative ways of acquiring the use of resources without borrowing or raising equity financing from traditional sources" (Freear, Sohl, & Wetzel, 1995: 102). They may borrow equipment or acquire loans from other group members, maintain flexible credit arrangements, and establish other efficient relational routines (Winborg & Landström, 2000). This is important, because as a venture's risk increases, so does the significance of its financial bootstrapping strategies (Van Auken, 2004).

Growth-oriented entrepreneurs in the informal economy pursue opportunities beyond their local group of family, ethnic enclave, or community. In growing into the broader society, they

recognize similar others by identifiable attributes. Entrepreneurs solidify relationships with these individuals and increase the salience of their collective identity through interaction and discourse. The degree and frequency with which they utilize these forms of identification depend on the entrepreneurs' inherent willingness to accept risks of detection by formal institutions' enforcement agents. Interestingly, attempting to elicit illegal yet legitimate behaviors from others may be unsuccessful when an entrepreneur fails to engage adequately with other group members, since these others may suspect the entrepreneur has ties to enforcement agents (Wiegand, 1994). This reflects the need to foster a shared identity as a precursor to acquiring and leveraging resources.

Much of Napster's early success resulted from the help Fanning received as a member of an identity-based group. The group, known as w00w00 Security Development, emerged from a younger generation of programmers and hackers. Being a somewhat clandestine group, members recruited others after observing in them special skills in programming or hacking, or they were drawn from similar other groups (e.g., Association de Malfaiteurs and e18.org). Fanning bootstrapped valuable programming assistance from numerous individuals in the group at various stages of Napster's development. Much of this assistance was without cost, since these individuals wanted to help more for the enjoyment of programming than for financial gains (Menn, 2003; Merriden, 2001). Thus, Fanning's identity-based relationships were instrumental to the financial bootstrapping of critical resources.

Cooperative groups in the informal economy also form through the collective disidentification of individuals with a common institutionalized entity or practice. Disidentification occurs when an individual perceives the characteristics of his or her identity as divergent from another group's identity (Kreiner & Ashforth, 2004). As a collective disidentification coalesces around a common institutionalized entity, groups may form to circumvent the entity. Flynn (1997) provided a compelling description of entrepreneurial activities in the informal economy of the Shabe along the Benin-Nigeria border. These entrepreneurial activities principally involved the smuggling of various products, from clothing to petroleum, for these

border residents. A strong border identity, solidified in large part by disidentification with institutions erected by the respective Benin and Nigeria states, facilitated these activities. As Flynn describes:

Local antagonisms toward the Nigerian and Beninois states have intensified markedly in the wake of a series of economic developments that have restricted opportunities for trade and wage labor at the border. Because border residents perceive the state as the catalyst and cause of the economic hardships and because the state offers little or no infrastructural or economic development to this marginal rural border area, a heightened sense of border solidarity has emerged. A growing distrust and suspicion of government . . . has contributed to a strengthened border identity . . . that defines, on the one hand, their roles in transborder exchanges and, on the other, their relations with both the state and nonborder residents (Flynn, 1997: 315, 318).

By defining who or what the competition is and the "team" to which one belongs, disidentification may facilitate entrepreneurial activities. Increased levels of disidentification with formal institutions engender support for the entrepreneur, regardless of the business activity. In order to undermine the formal institution with which they disidentify, individuals more strongly support the survival of entrepreneurial activities that ignore specific laws and regulations. Therefore, entrepreneurs in the informal economy rely on existing rhetoric and animosity to transform others' disidentification into a concerted effort against the source of discontent. Regardless of the basis of their groups, entrepreneurs with stronger collective identity may be able to increase the chances of exploiting the opportunity they recognized in the informal economy.

Proposition 4: A group's collective identity, as framed by at least some characteristics outside formal institutions, strengthens the relationship between opportunity recognition and opportunity exploitation in the informal economy.

Growth and Transition of Informal Economy Ventures

The growth of ventures in the informal economy creates a paradox. On the one hand, growth allows successful entrepreneurs to enjoy gains in wealth; on the other, growth increases the

possibility of detection by enforcement agents. The risk of detection motivates a transition to the formal economy. However, differences in the locus of illegality (i.e., means or ends) among informal economy ventures likely affect the feasibility of a transition. In fact, we argue that ventures feeling the greatest pressure for immediate transition are the least likely to be able to transition successfully.

As noted, growth of a venture in the informal economy increases its visibility to enforcement agents. Increased visibility exerts greater pressure that leads informal economy entrepreneurs to consider various growth options. A partial transition, in which entrepreneurs maintain the size of their venture at less visible levels while pursuing formal economy opportunities, is one option. Two other options are (1) resisting any transition to the formal economy and instead expanding within the informal economy by exploiting existing or new opportunities therein and (2) fully transitioning to the formal economy. We expect differences in the locus of illegality (i.e., means or ends) to influence this decision. Specifically, we expect entrepreneurs pursuing illegal yet legitimate ends to feel greater pressure to fully transition to the formal economy than those exploiting illegal yet legitimate means.

Exploiting illegal yet legitimate means (Case B, Figure 1) affords a distinct growth advantage over exploiting illegal yet legitimate ends (Case A, Figure 1). Innovation theory logic suggests that, in general, means are less imitable because they take place behind closed doors; in contrast, end products are distributed within a market where both competitors and enforcement agents can study them. Therefore, innovations in a venture's means—that is, processes—tend to lead to a more sustainable source of competitive advantage than innovations in a venture's ends—that is, products (Kotabe, 1990).

In contrast, it is easier to detect entrepreneurs' efforts to exploit illegal yet legitimate ends. For example, informal economy entrepreneurs sell ends (products) in markets over which they have limited influence. Because they share a common collective identity with the entrepreneurs, customers purchasing illegal products likely perceive these ends as legitimate. However, customers may use products in public, share them with others, and communicate various aspects

of their buying experience with others. Each of these actions increases the likelihood of detection by enforcement agents. Even without customers undermining an informal economy entrepreneur's activities, though, too much growth for ventures exploiting illegal yet legitimate ends increases the potential for detection and subsequent termination. As noted, Napster's substantial growth and visibility contributed to its detection by enforcement agents and its subsequent problems.

Therefore, informal economy entrepreneurs employing illegal yet legitimate means may be more likely to resist transition to the formal economy. Because means are more sustainable in the informal economy, these growth-oriented entrepreneurs do not feel the acute pressure to operate within the formal economy's boundaries. Conversely, entrepreneurs pursuing illegal yet legitimate ends feel greater pressure to transition from the informal economy to the formal economy in that their ends are visible to enforcement agents.

While informal economy entrepreneurs exploiting illegal ends feel greater pressure to pursue transition to the formal economy, the risk and uncertainty in redefining the entrepreneurs' ventures make the probability of successful transition low. Specifically, because selling illegal ends is unacceptable in the formal economy, a transition requires these informal economy entrepreneurs to redefine their market offering. The uncertainty of the market substantially increases downside risk associated with changing ends (Sarasvathy, 2001; Shane & Venkataraman, 2000). In contrast, entrepreneurs using illegal means merely need to replace those means while continuing to exploit their current (legal) ends within existing markets. These entrepreneurs have much more control over the resources and processes used in their venture and do not have to redefine their product offering or establish a new customer base. Therefore, the probability of a successful transition to the formal economy is greater for informal economy ventures exploiting illegal yet legitimate means rather than ends, because replacing means involves less uncertainty and risk than developing new ends.

Generally, this logic suggests a paradox. The enforcement pressures are greater for growth-oriented informal economy ventures exploiting illegal yet legitimate ends rather than means.

However, the probability of successful transition is greater for the ventures exploiting illegal yet legitimate means.

Proposition 5: Although informal economy ventures exploiting illegal yet legitimate ends feel more pressure to transition to the formal economy, the probability of successful transition for informal economy ventures exploiting illegal yet legitimate means is greater.

DISCUSSION AND CONCLUSIONS

Despite its widespread use, the entrepreneurial process in the informal economy has received little theoretical attention. We have integrated entrepreneurship theory with arguments from institutional and collective identity theories to explain the origin and use of the entrepreneurial process in the informal economy. The multilevel analysis we have used may have the potential to inform future theoretical work examining these phenomena. Additionally, the results of future research could shape the development of public policy.

A focus on the influence of institutional incongruence and weak enforcement of formal institutions provides the macrolevel effects in our theoretical framework. First, we suggested that the incongruence between formal and informal institutions creates the potential for an informal economy. In contrast to the formal economy, means and/or ends are illegal yet legitimate in the informal economy. Consistent with prior literature, our arguments differentiate the informal economy from the renegade economy (e.g., Portes & Haller, 2005); in the latter, means and ends are illegal and illegitimate. We excluded the renegade economy from our analysis. Given our context, we developed a series of propositions focusing on macrolevel and mesolevel effects on the entrepreneurial process in the informal economy.

We proposed that incongruence between formal and informal institutions strengthens the relationship between entrepreneurial alertness and opportunity recognition in the informal economy. Additionally, weak enforcement of formal laws and regulations enhances the relationship between opportunity recognition and exploitation in the informal economy. Next, we

considered the potential of collective identity, which provides the mesolevel effects in our model, to facilitate the entrepreneurial process in the informal economy. We argued that collective identity positively moderates the relationships between (1) entrepreneurial alertness and opportunity recognition and (2) opportunity recognition and opportunity exploitation. Our final proposition explored the transition of entrepreneurial ventures from the informal to the formal economy. Here we argued that informal economy ventures producing illegal ends are subject to greater pressure to transition to the formal economy compared to ventures using illegal means to produce legal products. In contrast, we suggested that the probability of successful transition from the informal economy to the formal economy is lower for ventures making illegal ends than for ventures using illegal means.

We believe our theoretical analysis can inform future informal economy research. First, understanding entrepreneurial activities in the informal economy may facilitate further analysis of this underexamined topic. For example, studies of competitive dynamics among firms often exclude competitive threats by ventures in the informal economy. In addition to their negative effects, though, some previous work notes the positive contributions to society that flow from the efforts of informal economy entrepreneurs. For instance, although software piracy captures legal sales from software providers in the formal economy, such activities frequently help solidify the critical threshold of a customer base for the software developers (Givon et al., 1995). In turn, this baseline set of users promotes legal adoption of the software and establishes entry barriers to competing software products. Previous research also suggests that entrepreneurial activities in the informal economy drive social cohesion in communities and offer employment alternatives for many individuals who have few options or who face discrimination (Gaughan & Ferman, 1987; Priest, 1994; Villar, 1994).

Moreover, many parties may benefit when aspects of a complex value chain include informal economy participants. For example, residential home building has long been a critical part of the U.S. economy. The supply chain in residential home building is elaborate. While a consumer interfaces with a general contractor, that

contractor often employs numerous subcontractors. As market pressures mount on the general contractor to produce an attractively priced quality home, the general contractor, in turn, pressures the subcontractors to reduce costs. Labor is a variable cost subcontractors can reduce. Under pressure, subcontractors may turn to undocumented workers. Using undocumented workers may increase societal costs (e.g., emergency room visits); the realized benefits to the contractors, consumer, and undocumented worker, however, are more immediate. Thus, the interface between formal economy firms (i.e., the general contractor) and informal economy firms (i.e., subcontractors using undocumented workers) creates costs and benefits. Future research may seek to determine the net outcome of informal economy activity and, as we discuss, how policy can positively affect the ratio of benefits to costs.

Furthermore, the theoretical framework developed here highlights the relevance of various disciplines (such as sociology and anthropology) for studying questions related to entrepreneurial activities. Beyond the talent and other personal traits of the entrepreneur, the social context of the entrepreneur's activities (such as the boundary between the formal and informal economy), the enforcement of regulations, and the collective identity supporting legitimate activities are all important issues for scholarly attention.

Our exploration of entrepreneurial activities in the informal economy also contributes to institutional theory. Although a substantial amount of scholarly work has examined the role of institutional constraints, little research has focused on organizations operating outside of laws and regulations in different societies or on how institutions can encourage ventures to transition from the informal to the formal economy. Furthermore, institutional theory research tends to pay limited attention to the behavior of individual actors under given institutional constraints. We suggest that there is variation across entrepreneurs in their desire to seek legality within a given regulatory system. Furthermore, some entrepreneurs can operate their businesses effectively outside the formal economy's institutional framework.

Another potentially interesting agenda for institutional theory is the study of the informal

economy in different countries.⁴ Although informal economy activities tend to be more prevalent in developing economies, their scope may vary based on the legal, cultural, or other historic traditions of a country, regardless of its economic development. For example, differences across legal traditions may change the meaning of law enforcement and modify the pressures for transition to the formal economy. Specifically, countries with English common law traditions tend to have less corruption and more transparency than countries with legal traditions rooted in French civil law (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Future comparative studies of entrepreneurial activities occurring in the informal economy worldwide could provide interesting tests of the boundaries of our proposed framework.

Examining entrepreneurial activities in the informal economy has the potential to contribute to collective identity theory as well. We suggest that entrepreneurs may replace the rules of market transactions by associating with other actors in the informal economy. Networks with investors, suppliers, and customers are important in many settings. However, the formation of a collective identity by informal economy entre-

preneurs is especially critical in facilitating the procurement of inputs for their ventures' growth. Thus, research exploring how collective identity influences the different stages of the entrepreneurial process in the informal economy may offer valuable insights (Schoonhoven & Romanelli, 2001).

In addition to implications for theory, examining entrepreneurial activities in the informal economy has several implications for public policy decisions. Developing effective laws to regulate the formal economy, as well as specific policies aimed at entrepreneurs in the informal economy, may reduce the scope of illegal activity and motivate entrepreneurs to transition to the formal economy. Incongruence between institutional boundaries suggests a need for different types of policy reform. Policy makers may need to redress existing formal institutions by removing economic barriers and rectifying discriminatory laws. In doing so, formal institutions may expand the scope of available opportunities in the formal economy and open legal avenues to those entrepreneurs for whom such avenues do not presently exist.

From a policy standpoint, another potentially effective approach to limit the scope of the informal economy is to pressure large formal economy firms to sever ties with suppliers using illegal means. For example, Nike is proactively policing its outsourcing firms. The company recently announced a shortage of soccer balls because it cut ties with a major supplier that was violating labor laws (Kang, 2006).

A longer-term approach to managing the informal economy is to modify informal institutions. To be effective, such actions would ideally target specific beliefs that support entrepreneurial activities in the informal economy, rather than the values and norms defining collective identities. Policies formed and implemented for these purposes should seek additional congruence between formal and informal institutions.

In developing better policies, regulatory and developmental agencies should address differences among the three cases of informal economy entrepreneurs. As suggested earlier, different informal economy entrepreneurs vary in the pressure they feel to transition to the formal economy, as well as in the uncertainty they perceive in such a transition. These differences imply the need for policies uniquely facilitating

⁴ Because informal institutions vary widely across cultures, what is illegitimate in one culture may be widely seen as legitimate in others, as in the following example:

Akin, who lives in Lagos, is one of a new generation of entrepreneurs that has emerged in this city, Nigeria's largest. . . . Call him a "Yahoo! Millionaire." Akin buys things online—laptops, Blackberries, cameras, flat-screen TVs—using stolen credit cards and aliases. He has the loot shipped via FedEx or DHL to safe houses in Europe, where it is received by friends, then shipped on to Lagos to be sold on the black market. . . . Akin's main office is an Internet café in the Ikeja section of Lagos. He spends up to ten hours a day there, seven days a week, huddled over one of 50 computers, working his scams. And he's not alone: The café is crowded most of the time with other teenagers, like Akin, working for a "chairman" . . . who gets a 60 percent cut and reserves another 20 percent to pay off law enforcement officials who come around. . . . A sign at the door of the café reads, WE DO NOT TOLERATE SCAMS IN THIS PLACE. DO NOT USE E-MAIL EXTRACTORS OR SEND MULTIPLE MAILS OR HACK CREDIT CARDS. YOU WILL BE HANDED OVER TO THE POLICE. The sign is a joke. . . . Attempts to speak to government officials about Internet crime were futile. They all claimed ignorance of such scams; some laughed it off as Western propaganda (Lawal, 2006).

each case's successful transition to the formal economy. From a policy standpoint, however, society may also benefit from the revision of some formal institutions to usurp marginal informal economy activity. Both formal and informal institutions have dynamic boundaries that shift over time based on broader sociocultural, technological, and political/legal trends in society. Some entrepreneurs may attempt to anticipate these shifts by exploiting opportunities in the informal economy. These anticipatory actions allow a first mover advantage when the formal institutional boundary eventually shifts outward to encompass these opportunities.

Last, formal institutions at the local and national levels are not always congruent (Karrush, 2007), creating difficulties in coordinating informal economy policy. Although the informal economy is often framed at the national level, local government agencies normally have a better understanding of informal economy ventures. Because of this, using local agencies' knowledge of informal economy ventures may help enforcement efforts at national levels.

In conclusion, we have used the informal economy to highlight the importance of the social context of entrepreneurship theory. Because the informal economy exists in many nations throughout the world, understanding the entrepreneurial process in the informal economy provides theoretical and practical relevance. Our framework integrates entrepreneurship theory (microlevel) with arguments from institutional theory (macrolevel) and collective identity theory (mesolevel). The roles of incongruence between formal and informal institutions, enforcement, and collective identity form the core of our theoretical arguments. We have also explained influences in the transition from the informal to the formal economy. We hope this work motivates additional research on the informal economy.

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