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# Informal Business Practices exception or the Norm?

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# I. Introduction

The inspiration for this paper comes from years of observation and interaction with business owners and managers in emerging markets. Many people working in these markets are often surprised by the difference between theory and practice, what we believe ought to happen (formalization and organization, legal compliance, best practices etc.) and what is actually happening on the ground. In our experience, most businesses, small and large, are not (fully) compliant with many rules and regulations, be it their country's formal laws, contractual obligations or internal codes of conduct, guidelines or manuals. However, not all these business practices are necessarily illegal or inappropriate. They are also a way of getting things done in what is often a difficult business environment. This is why we prefer to refer to them as "informal business practices" (IBP).

There is very little academic literature about the concept of IBP as such, although elements of it can be found in micro-economics, behavioral economics, psychology and sociology. One reason is no doubt the difficulty in obtaining reliable data on such a sensitive topic. Nevertheless, it is still surprising, as IBP seem to be much more frequent and significant than is recognized in management literature. If we wish to understand how business really works, especially in emerging economies, we must delve deeper into the phenomenon of IBP. There are many definitions of a business, but for the purpose of this paper, we define a business as "any organized, commercial activity that seeks profit by providing goods and services to others in exchange for money". This definition excludes commercial activities that are undertaken by unorganized individuals such as street vendors, day laborers or subsistence farmers (Dau and Cuervo-Azurra 2014).

The first research question is: are the observations and experiences referred to above a correct interpretation? We need to determine what informal business practices vis-a-vis formal business practices are, and what they are not. In line with micro- and behavioral economics, we are taking the business entity as the basic unit of analysis and particularly the owners/managers. Is it possible to come to a definition?
The second question is: how large and significant is this phenomenon i.e. how widespread are IBP? We take a look at the big picture and also highlight some of the IBP practices at the business enterprise level.
The third question is: after we have described the phenomenon and established its significance, can we perhaps come to a theory that explains the occurrence of IBP?

## II. The meaning of Informal Business Practices

The first thing we need to state for the purpose of this paper is that a theory of IBP doesn't need to distinguish between the informal sector and the formal sector, since these are related to **enterprise characteristics** such as size, registration, annual sales, access to credit, fixed location and tax status (Benjamin et al 2012). In our study, we would like to focus on **enterprise behavior**. The OECD distinguishes the informal economy between hidden (evasion of taxes and other legal obligations), informal (not registered, not in line with professional standards), illegal (smuggling, fraud, drug trafficking, counterfeiting) or household economic activities (personal use of paid domestic services) (OECD 1997).

In view of tax evasion scandals as demonstrated by the Panama papers and recently Pandora papers, fraud scandals around large accounting firms and the occurrence of illegal activities by large, multinational enterprises, especially in the extractive industries, we contend that these economic activities or business practices can be found in both the formal and informal sector and in small as well as large businesses worldwide.

In line with Benjamin et al (2012), we believe it is more productive to see IBP as a continuum. Other authors have also recognized that informality is a matter of degree, best captured by a range of indicators (Steel and Snodgrass 2008; La Porta and Schleifer 2011; Guha-Khasnobis and Kanbur 2006), but these authors did not propose operational definitions. Indeed, informality is a complex issue. Some firms are registered and pay taxes but at the same time underreport sales and profits and use informal subcontractors for a large part of their business activities.

Hence, a definition of informal business practices, challenging as it is, should both be clear and concrete as well as encompassing multiple criteria which capture its significance and meaning, both within the business and in its dealings with the external environment. In this effort, we would also like to be more comprehensive than the distinction by the OECD, as described above, and propose to include those business practices that are not **only hidden, informal or illegal but also unethical,** i.e., those business practices that are considered morally "wrong" and inappropriate at the local as well as international levels (such as discrimination, bribery, insider trading, favoritism, pollution etc.) (Crane and Matter 2007). This approach brings us to the following criteria and indicators for informal business practices.

| Part of the Business | Formal | Informal |
|---|---|---|
| **Governance/leadership** | Board of Directors, professional management, formal mandates, accountability and transparency, full disclosure | Behind the scenes decision making, shadow directors, financiers/investors power, 'old boy network', political influences, patronage, conflicts of interest |
| **Legal and tax compliance** | Meet legal and contractual obligations and tax compliance | Freely Interpret, not strictly adhering to or ignoring contractual obligations, plagiarism, violation of legal obligations incl. environmental regulations, tax avoidance, tax evasion, insider trading |
| **Financial management** | Bank finance, professional administration in place, formal procedures and systems, insurance | Informal finance, informal money transfers, shadow bookkeeping, skimming, fraud, no insurance |
| **Production/working conditions/ safety/quality control** | Work floor organization, standard procedures and safety measures in place, quality assurance, competence, oversight | Violation of labor laws and workers safety and health regulations, adulterated or substandard products |
| **Procurement** | Formal procurement procedures in place, strict policy of gifts and payments by third parties | Non-transparent process, single sourcing, price inflation, acceptance of bribes and gifts |
| **HR management and administration** | Official recruitment processes, performance management systems, reward/promotion on merit | Nepotism, favoritism, no social security coverage, no contract, discrimination, unpaid or delayed salaries, undeclared work[3] |

[3] Undeclared work refers to paid work, which is legal in all respects other than it is not declared to the authorities for tax, social security or labour law purposes.

| | | |
|---|---|---|
| **Sales and Marketing** | Marketing strategies, media campaigns, advertisements | Word of mouth, personal network, unfair and restrictive trade practices[4] |
| **Transport/Logistics** | Regulatory compliance, appropriate storage and cooling solutions to minimize losses/damages, well managed and maintained transport fleet | Long working hours for drivers, Overloading, lack of maintenance of transport fleet, personal use, inadequate storage and handling leading to losses/damages |

*Table 1. Indicators of IBP compared with formal aspects of a business (Dellevoet 2021)*

The difference between formal and informal as described in table 1 is less clear cut than it seems, and it would be mistaken to equate informal with illegal. Sometimes, the law does not exist or is limited in its effect. For example, Chatterjee and Kanbur studied the impact of India's Factories Act of 2011, which requires manufacturing firms of a certain size to register and comply with regulations. They found that the category of firms that are not affected by the Act, given their small size, was 97% of all manufacturing firms (Chen and Carré 2020 p. 15).

The situation gets even more complicated when there is collusion of state representatives and private businesses in identifying or creating loopholes in, or simply bypassing, existing rules and regulations to serve their mutual interests. In a recent publication, Barbara Harris-White and Lucia Michelutti examined eleven case studies in South-Asia, focusing on business enterprises in coal, oil, real estate, and industrial labor and how state regulatory law is ignored or selectively manipulated, revealing the workings of regulated criminal economic systems in which politicians, police, judges, and bureaucrats are closely involved (Harris-White and Michelutti 2020). So how can these business activities be illegal if the (local) government is involved?

Clearly, IBP manifests itself in many forms, making it difficult to come to a clear cut definition. It must be comprehensive and yet particular. In view of the criteria in Table 1 to describe IBP, we propose to use the following definition of IBP:

**"All those practices, in contravention of formal rules, laws and regulations and generally accepted principles of business ethics, that give the business owners/managers maximum leeway to achieve a competitive advantage, lower costs and increased profitability, as they see fit."**

[4] These are business activities that have the effect of preventing, distorting or restricting competition which includes such practices as exclusive dealings, tie-up sales, full line forcing, concert or collusion cartels, price discrimination, re-sale price maintenance, area restriction, bid-rigging and output limitations. Sometimes, they are prohibited under prevailing anti-trust legislation, but often they are not.

The focus is on business entities or enterprises and particularly the owners or managers, which helps to distinguish between IBP and any transaction between a buyer and a seller. The reference to competitive advantage, costs and profits can be seen as an economic principle, while the last sentence "...as they see fit" points towards another characteristic of IBP, namely the attitude, the norms, and the values of business owners/managers, which is the domain of behavioral theories. More about this in the sections below.

If we consider informal business practices as a continuum, then we can in principle position every business on a bar between the extremes of fully informal and fully formal. Suffice to say that very few businesses will in reality meet all criteria at the extremes, so it may be expected that most businesses will find themselves somewhere in the second and third quarter of the scale as depicted in figure 1 below.

Hence, the first assumption is that probably all businesses in the world are involved in both formal as well as informal business practices. However, as we shall explain below, where the business finds itself on the scale depends very much on both internal factors (i.e. corporate governance, ownership, transparency and accountability, labor relations) as well as external factors (government relations, law enforcement, relationship with stakeholders and clients).


*Figure 1. the continuum of informal business practices*

A good example of how a business may be positioned on this scale is given by Benjamin et al (2012), who describe large informal businesses in three West-African countries. They appear to meet most of the criteria defining formality; they are registered, they pay taxes under the regular business tax regime, handled by the Division of Large Companies within the Revenue Authority, they have a high level of sales, access to bank credit and are known to and collaborate with the authorities. Yet, their practices are informal, their administrative structures and managerial styles resemble those of small, informal firms. Formal firms of the same size have distinct departments (HR, sales, finance, marketing etc.) and a coherent organizational structure, while these informal firms do not. Apart from the owner/director and a few permanent staff (rarely more than five), the rest of the personnel are temporary. Functions and responsibilities overlap and are often done by the same person. Accounting is often done in-house and is typically highly inaccurate, massively underreporting sales and profits, while formal firms often outsource the accounting function (Benjamin et al 2012, p. 76).

Based upon this description and many others like it (Chen and Carré 2020), one can actually develop a force field analysis for such businesses that operate somewhere between the formal and informal, as illustrated in figure 2. This approach allows an IBP analysis of each company.

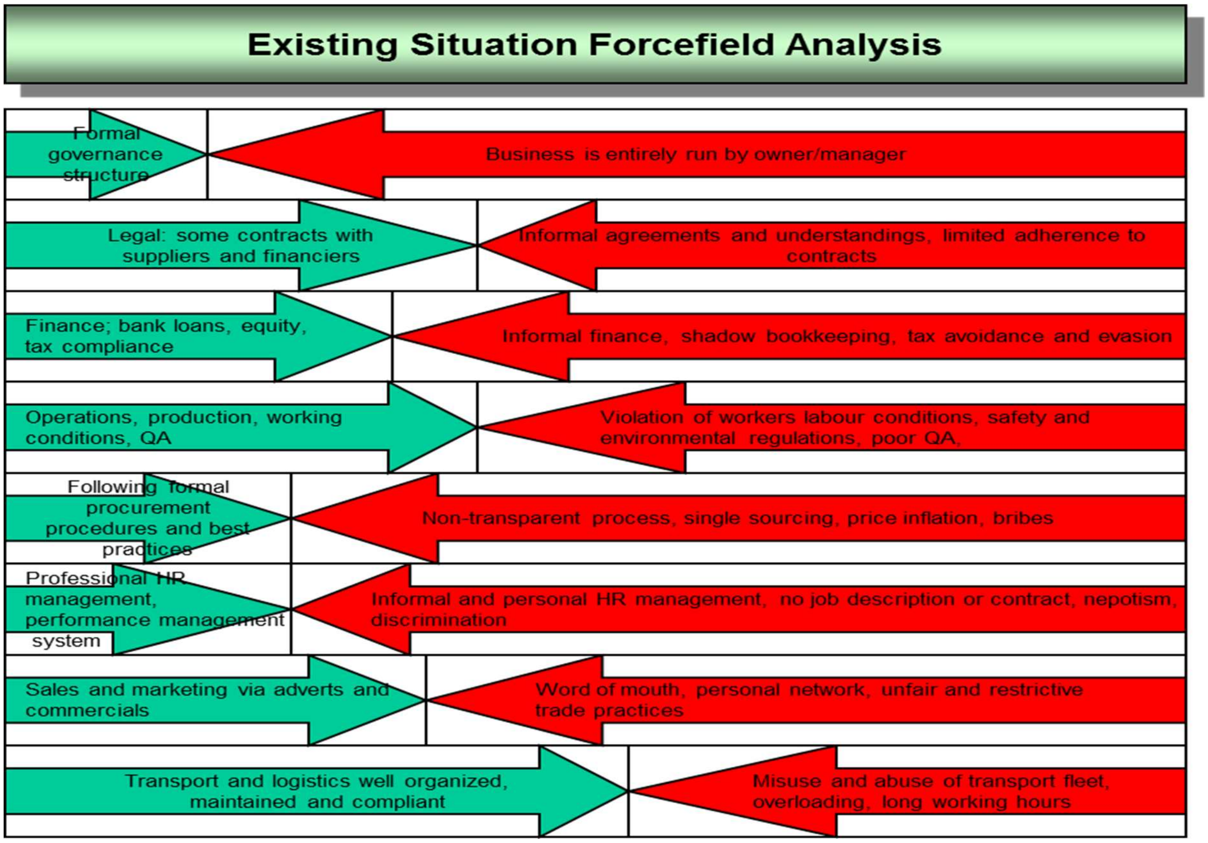



*Figure 2. typical IBP analysis of an individual small business* (*adapted from S. Jones and M. Tynan (2021), 7 Entrepreneurial Leadership Workouts.* London: Anthem Press.*)*

## III. The significance of Informal Business Practices

The next question which we need to answer is to what extent these informal business practices are occurring, in order to understand their significance and magnitude. This can be determined through a number of indicators. Of course, it can be assumed that informal business practices are even more prevalent in the informal sector, as these businesses by definition operate below the radar of government, not being registered and paying no (direct) taxes. In the absence of government oversight and control, these informal businesses typically operate outside of the legal and regulatory framework. For example, labor compensation is much lower in the informal sector, due to evasion of labor market regulations (Benjamin et al. 2012 p.66). Hence, the size of the informal sector does indicate the prevalence of informal business practices.

A few specific indicators, explained below, show how sizeable the informal sector is and by extension, the likelihood of IBP:

- In the advanced economies, between 10% and 20% of income comes from the shadow or "black" economy[5]. In some emerging countries, it can represent more than 30 percent as demonstrated in Chart 1 below (Schneider and Ernste 2002, Schneider et al 2010)
- According to the International Labour Organization, about two billion workers, or 60 percent of the world's employed population aged 15 and older, spend at least part of their time in the informal sector (Delechat & Medina, 2020). Other authors estimate that around 80-90 percent of the labour force is informal (Benjamin et al 2012, p.48, Breman in Chen and Carré 2020)
- In a typical developing country, the informal sector produces about 35 percent of GDP [6] and mostly consists of micro, small and medium sized businesses (MSME's) who make up more than 95% of all businesses.

Examples of black-market activity are quite common worldwide, whether it is the issue of a warehouse worker driving an unlicensed taxi between shifts or an electrician accepting cash payments without declaring his earnings. However, the level of black market or shadow economy activity depends highly on the country of residence. Benjamin et al (2012) mention that there are few completely formal firms in West African economies. The only firms that meet all the criteria such as taxes, registration and legal compliance, are branches of MNC's, banks and financial institutions, SOE's, certain professions (law firms, notaries, accountant firms) and a few large, local enterprises. Others are involved in at least some of the IBP activities such as undeclared sales or services, value added tax collected and not remitted, and undeclared imports through smuggling. This applies to some of the largest and fastest-growing sectors of West African economies; wholesale and retail trade, transportation, restaurants, counterfeit and pirated consumer goods varying from electronics to medicines, carpentry, construction (incl. subcontracting by formal firms under government contracts), manufacturing (use of informal distribution channels) real estate and (artisanal) mining.

## Macro examples of IBP

*The shadow economy*

It seems that the occurrence of IBP is strongly related to the capacity and legitimacy of state institutions. According to Medina and Schneider, heavily regulated economies with weaker

[5] Generally defined as businesses and individuals engaging in inappropriate practices without complying with certain legal obligations such as paying tax or maintaining official standards of employment (Delechat et al 2020).

[6] Steel and Snodgras (2008) estimate that the informal economy in Africa even accounts for 50-80% of GDP and as much as 90% of employment.

administration tend to have well-established shadow economies (Medina and Schneider 2018). These practices can be much less common in nations with strong, well-regulated and efficient government institutions, as can be seen in chart 1 below. Delechat et al (2020) estimate that the shadow economy costs governments around the world trillions of dollars every year.

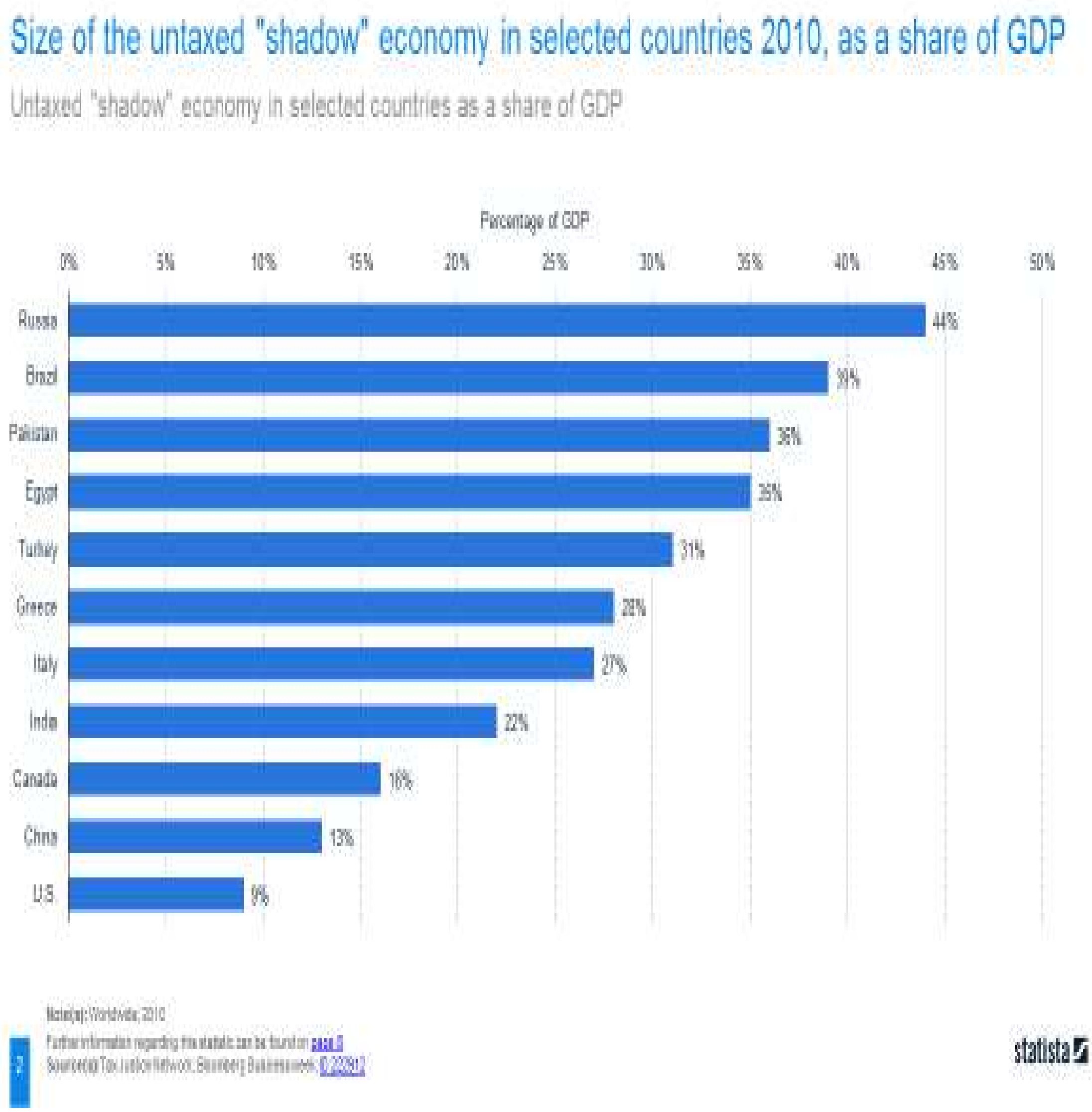



*Chart 1. The size of the shadow economy in selected countries (source: Statista)*

*Corruption*

One related area that is well documented is the extent of corruption. Every year, Transparency International publishes the Corruption Perception Index [CPI], covering all countries in the world. Data on the CPI score of countries in the European Union, as of

2020, show that Denmark is the EU country with the highest CPI score, implying that it is the least corrupt country in the European Union. The other Nordic countries in the EU, Finland and Sweden, also have high scores and are second and third in this statistic respectively. Bulgaria and Hungary have the lowest index score of all EU countries with a score of 44 each (Transparency International 2020). The index itself is a composite indicator that includes data on the perception of corruption in areas such as bribery of public officials, kickbacks in public procurement, embezzlement of state funds, and effectiveness of governments' anti-corruption efforts. The highest possible score in perception of corruption is 0, whereas a score of 100 indicates that no corruption is perceived in the respective country. The index provides a good indicator of corruption in the EU, both by the state and the private sector when dealing with the state.

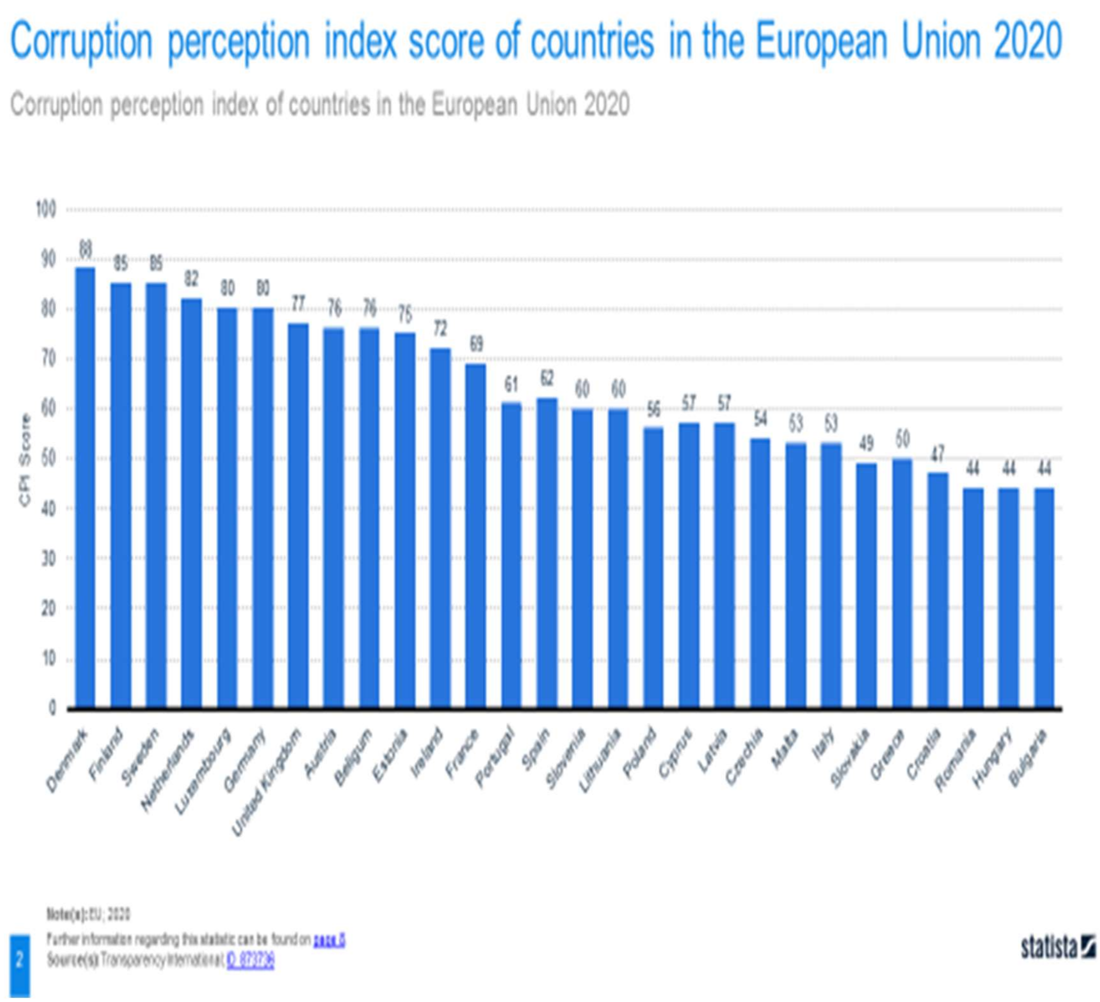



*Chart 2. Corruption perception in selected EU countries 2020 (Source; Statista)*

*Cross Border trade*

Informal cross border trade is another area where IBP is rife, often with the explicit or tacit approval of the authorities. In West Africa, for instance, informal trade activities involve three types of flows: 1) smuggling of imports from other continents, usually entering through the port without being recorded, 2) exports and imports of locally produced products within the region and 3) unofficial re-exports of legally imported goods. The re-export trade involves importing goods and subsequently shipping them to other countries with no additional processing or packaging, except for transport services. This kind of informal trade can be a highly complex and well-organized system which involves large, formal enterprises that import goods through official channels and paying duties; but operating through a sophisticated distribution chain that engages in transshipment through informal mechanisms, avoiding the necessary licenses and tax obligations. This informal trade is a major source of revenue for some West-African countries such as Benin and the Gambia, accounting for about half of these countries' tax revenues (Benjamin et al 2012, p.198).

Examples of IBP in cross border trade can be found everywhere, where state control is limited or absent. Looking at cross border trade in the Myanmar-Thailand border and the tribal areas in Pakistan bordering Afghanistan, Lertchavalitsakul and Salman Khan respectively, describe how the limited presence of state authorities or application of state law, leads to the creation of " common spaces" such as border posts or bazaars, where trade is illegal but licit or a form of legalized informality ( Horodnic et al 2018 pp. 173 and further). Local (municipal) taxes or "gifts" to state officials may be paid and businesses may have some form of license or permit, but their goods are traded informally.

## Micro examples of IBP

*Governance*

At the micro-level of the business itself, IBP can also be detected throughout an organization. For example, the reality of Board governance may be quite different from what many people imagine it to be. Tricker (2012) puts it succinctly: "Director's behavior is influenced by interpersonal relationships, by perceptions of position and prestige, and by the processes of power. In fact, corporate governance is more about human behavior than about structures and strictures, rules and regulations. Corporate governance involves the use of power. It is a political process" (Tricker 2012, p. 327).

Outsiders often look at the formal side of the business i.e., the articles of association, the existence and composition of the board, by-laws, the presence of Board committees, shareholder meetings and so forth. However, anyone who has Board experience knows that behind the façade, all kinds of informal governance practices may or may not happen. These practices include, amongst others:

- Pressure on the board by a dominant shareholder or group of shareholders;
- Strong influence on decision-making by an overly-dominant Board chair;
- Director's 'games' and behaviors such as; alliances against certain decisions, coalitions pushing for certain decisions, cronyism (personal relationships between Directors), deal making outside the Boardroom, dereliction of duty, divide and rule, empire building (privileged access to information, people, resources to acquire power), hidden/personal agendas, lobbying, log rolling, scaremongering, sub-optimization (focusing only on one part of the organization), window dressing, meeting manipulation.

If these governance practices lead to official, properly constituted decision-making, there is little that can be done about it. However, many stakeholders (inside and outside the firm) would still consider these practices as inappropriate and illegitimate (Counts 2020).

Tricker (2012) points out that the "secretive, authoritarian and family-centric governance" of family and listed companies is still very common in Asian countries and the MENA region, leading to issues such as abnormal dealing prior to mergers of acquisitions (insider trading) and the existence of "Insider Boards" and cross ownership with subsidiary companies (Tricker 2012, p. 457, Gul and Tsui 2004). In some MENA countries with official common law or civil law governance, significant legal influence on contracts, property rights and external finance is exercised by the overarching Islamic Shariah law.

*HR management*

As we saw in table 1, IBP manifests itself in many ways inside the business organization including when it comes to Human Resource Management [HRM]. HRM practices may be highly unprofessional or informal. Job descriptions, if in writing, may be very vague and not accurately reflect the job environment, tasks and performance criteria. Job selection may be based upon exam scores, formal CV's and letters of recommendation, without any form of interview or tests, as frequently happens in Japan, Korea and many other Asian countries (Robbins 2001). In African small businesses, jobs are often given to candidates that are related to the business owners and managers, without any formal recruitment process, which may lead to less workplace diversity as biases based upon gender, religion and ethnicity may prevail (Benjamin et al 2012). Most businesses, however, do use interviews as the main selection tool but interviews may be unstructured, short in duration, casual and made up of random questions, which lead to bias and a weak relationship with future job performance (Robbins, 2001 p. 476).

In certain sectors, such as the construction industry, agriculture, leisure and hospitality and domestic staff, low-skilled workers often have no contract, and their terms of employment do not include anything about leave days, pensions, social security or even working hours. In family businesses such as retail shops, cottage industries and farms, it is quite common to 'employ' unpaid contributing family workers, even children[7]. Some of the IBP seem to undermine the very basics of an employment relationship i.e. those pertaining to "decent" or living wages for work, which seems to be a major issue in the apparel, textiles and leather industries[8]. In other countries, employers attempt to reduce their labour costs by offering different kinds of salaries. In a study about envelope wages, Horodnic and Williams, mention that in the Baltic region, envelope wages[9] represent a high share of the shadow economy, being at 52,3% of the shadow economy in Estonia, 42,9% in Lithuania and 39,2% in Latvia (Horodnic et al 2018, p. 41).

In fact, the standard employment relationship - full-time, year-round, employment with a single employer - seems to be the exception rather than the rule, as most workers in developing countries are self-employed (Chen et al 2020). Looking at small, informal firms in the three West-African cities of Dakar, Ouagadougou and Cotonou, World Bank researchers found that only about 20% comply with social security obligations, while this number is about 80% for formal enterprises (Benjamin et al. 2012, p. 118).

Most businesses assume that workers are qualified at selection and pay little attention to further training. Despite the fact that most employees of small firms have low education levels, very few resources are invested in employee training. Nielson, Rosholm and Dabalen (2007), found that only 4.6 % of businesses with fewer than ten employees in Kenya, Zimbabwe and Zambia offer training programs for their staff. This often leads to low quality and low productivity of work, which in turn limits the growth prospects of the businesses as clients do not return and do not recommend the business to others (while most MSME's depend heavily on word-of-mouth as their key marketing channel).

In small businesses, decision-making about de- or promotion are often the prerogative of the business owner/manager with very little involvement of anyone else. Performance management systems are not in place. The decision is mostly based upon the observations and perceptions of the owner/manager which is a response to the "Impression management" of the employee i.e. the effort to control or influence other people's perceptions[10]. Robbins (2001)

[7] ILO and UNICEF: Child Labour: Global estimates 2020, trends and the road forward (New York, 2021).
[8] See for example the work of the Global Living Wage Coalition: https://www.globallivingwage.org/.

[9] This is a form of undeclared labor in order to reduce tax and social security payments to the government. In Horodnic and Williams' study about student employment in Romania and Moldova, it was shown that 70% of businesses offer student employees an official, declared salary, which is mentioned in a formal, written contract, and an additional undeclared "envelope wage" (cash) via a verbal unwritten agreement. This practice seems to be widespread in Eastern Europe (Horodnic et al 2018, Ledeneva 2018).

[10] *Rosenfeld, Paul; Giacalone, Robert A.; Riordan, Catherine A. (1994-03-01). "Impression Management Theory and Diversity Lessons for Organizational Behavior". American Behavioral Scientist. **37** (5): 601–604*

noted that performance evaluations are less important in many cultures compared to the US or Canada. Individualistic cultures such as the US emphasize formal performance evaluation systems, for example by having yearly written evaluations, to a greater degree than informal systems in Asia and Latin-America. These informal systems downplay feedback, take a longer term view by having less frequent performance reviews and disconnect rewards from performance ratings. US and Canadian organizations hold people responsible for their actions, because people in these countries believe they can dominate their environment. In Middle Eastern countries, on the other hand, performance evaluations are not likely to be widely used, since managers in these countries tend to see people as subjugated to their environment and follow orders (Robbins 2001, p. 496).

*Accounting*

One could argue that nowhere are IBP more common than in financial accounting. There are formal and legal practices where business accounts are presented in annual financial statements and reports and tax returns. Then there is the grey area where accounts are incomplete and poorly administered or the practice of "creative" bookkeeping, where financial data are presented in a beneficial manner towards the tax authorities, banks and investors. Finally, there are the illegal practices of misrepresentation of the financial status of a business and outright fraud. As Benjamin et al noted when they looked at informal businesses in West Africa, it is common to underreport sales and profits and inflate cost prices (Benjamin et al 2012). Apparently, the risk of these illegal practices as well as the rather complicated technical character of accounting, has led to a whole services industry of accounting firms worldwide, amongst them well-known names such as KPMG, PWC, Ernst &Young, Deloitte & Touch and BDO.

The extent of these practices is difficult to measure, but sometimes the veil is lifted. An internal audit at a Ugandan agribusiness development organization called the Agricultural Business Initiative (ABI), looking at over 200 small to medium sized Ugandan firms, NGO's and farmer organizations over the period 2013-2016, came to the conclusion that about 6% of the expenditure under ABI grants, were questioned (including fraudulent transactions with no supporting documents), about 15% did not follow procurement guidelines, 41% failed to comply with statutory laws (taxes, social security), 31% did not review their bank statements every month, 24% failed to report to ABI and 36% could not provide evidence of their own financial contribution to the project, as per the project agreement (ABI 2016).

Benjamin et al. (2012) noted that these IBP are more common among small firms than larger firms. Only 30% of small firms maintain proper accounts and 60% of firms with turnover below CFAF 300 million (at todays' exchange rate about US$ 538,000) do not maintain up-to-date and complete books. A similar trend is evident in business registration decisions. Only 62% of firms with turnover below CFA 5 million (US$ 8900) are registered, as opposed to 100% of firms with a turnover at or above CFA 100 million (±US$ 179,300) (Benjamin et al 2012, p. 97)

The general examples of corruption, shadow economy and cross border trade as well as the micro-economic examples of corporate governance, HR management and accounting lead us to the second assumption, namely that IBP occur everywhere and are in fact a very significant, even common, part of business affairs and the economy.

# IV. A Theory of Informal Business Practices

Now that we have developed a definition, based upon a comprehensive list of criteria, and established that IBP are a significant phenomenon in developing as well as developed countries, we can try to develop a Theory of Informal Business Practices.

A key element in the development of the theory is to explain why IBP occurs in so many countries. To answer this question, we need to look at the multiple dimensions of a business, both in its internal mode of operations and in its external environment, and differentiate between economic factors and other influences, such as behavioral factors.

## Economic Factors

A business often starts at the initiative of an individual or a few partners, who identified a business opportunity and decided to invest their resources in exploiting that opportunity. Hence, the occurrence of IBP can best be explained by understanding the motivation of the founder/owner or management of the business to behave in a certain way. There is a strong body of evidence around entrepreneurship development, micro-economics and behavioral economics that suggests that an entrepreneur or manager of the business is driven by various motives, where the rational profit maximization motive (“making money”) is pivotal but also includes other motives such as self-fulfillment, being in charge and having autonomy, reducing risks and guaranteeing business continuity (Cyert 1992, Gavetti 2012, Petty et al 2012).

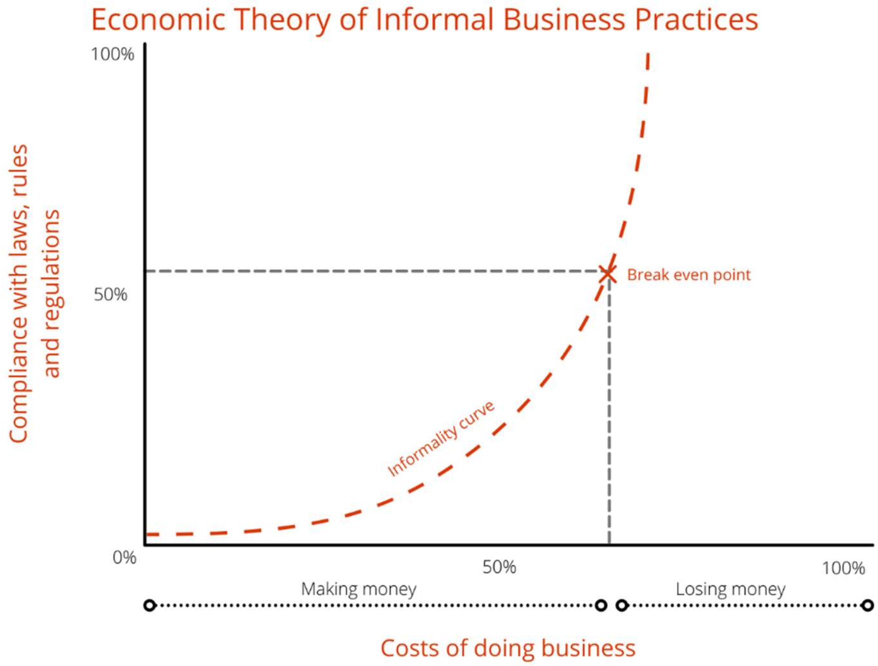
Of course, the cost of doing business is at the heart of economics and there is a large body of literature that delves into cost structures and how it influences business behavior. However, these costs are often related to the production of goods and services. In the last few decades, influenced by such studies as the World Economic Forum’s World Competitiveness Index and the World Bank’s annual “Doing Business” indicators, more attention has been given to other factors that lead to higher business costs, such as “hidden” costs of getting permits, paying fees for services, investing in infrastructure (for example by generating your own electricity), red tape and costs of compliance with regulations. These costs may even be so high that a business actually loses money, especially at the start.

Many studies in developing countries agree that excessive taxes and regulations are an important determining factor for informality (Benjamin et al 2012). Using data from 69 countries, Friedman et al. (2000) found that the high costs of corruption and bureaucracy pushes firms to the informal sector. La Porta and Schleifer (2008) distinguish between: 1) the

cost of becoming formal determined by the number of procedures required to start an enterprise legally, 2) the cost of remaining formal determined by the cost of paying taxes, abiding by work regulations and the costs associated with bureaucratic red tape and 3) and the benefit of becoming formal, determined by access to public services and legal rights in a court of law. The authors find that these three categories of variables strongly correlate with the size of the informal sector.
Trying to keep costs of doing business at the minimum is in line with rational choice theories in classical economics that posit IBP, including tax evasion, as the result of rational and self-interested decision making. This notion is also reflected in the rational behavior model of crime, which argues that would-be criminals make a rational assessment of the possible consequences of their actions and take the opportunity to commit a crime, only if the economic advantages would outweigh the disadvantages (Jones 2006).

Indeed, there seems to be some evidence for the rational choice theories. Horodnic et al note that the (financial) performance of informal businesses that start-up unregistered and spend some years operating informally, is stronger than businesses allocating all their resources to be fully compliant (Horodnic et al 2018, p. 232). Informal firms have a cost advantage compared to larger, formal businesses, as they don't pay taxes and minimize their labour costs and are therefore more able to offer less expensive products and services (Williams and Martinez-Perez 2013). This is in line with Marxist theories that point out the exploitative aspects of business practices, especially when it comes to labor.

This leads us to the first, **economic theory** of IBP. As illustrated in Graph 1 below, the economic theory of IBP states that the higher the costs of compliance with laws, rules and regulations, the stronger a business will resort to informal business practices.




*Graph 1. The economic theory of IBP (Dellevoet 2021)*

The economic theory of IBP, with its emphasis on financial issues, seems to apply to most of the following indicators taken from Table 1, as highlighted in Table 2 below, where the indicators that are less related to financial or economic issues are rendered more vague.

| Part of the Business | IBP |
|---|---|
| **Governance/leadership** | Behind the scenes decision making, shadow directors, financiers/investors power, 'old boy network', political influences, patronage, conflicts of interest |
| **Legal and tax compliance** | Freely Interpret, not strictly adhering to or ignoring contractual obligations, plagiarism, violation of legal obligations incl. environmental regulations, tax avoidance, tax evasion, insider trading |
| **Financial management** | Informal finance, informal money transfers, shadow bookkeeping, skimming, fraud, no insurance |
| **Production/working conditions/ safety/quality control** | Violation of labor laws and workers safety and health regulations, adulterated or substandard products |
| **Procurement** | Non-transparent process, single sourcing, price inflation, acceptance of bribes and gifts |
| **HR management and administration** | Nepotism, favoritism, no social security coverage, no contract, discrimination, unpaid or delayed salaries, undeclared work[11] |

[11] Undeclared work refers to paid work, which is legal in all respects other than it is not declared to the authorities for tax, social security or labour law purposes.

| | |
|---|---|
| **Sales and Marketing** | Word of mouth, personal network, unfair and restrictive trade practices[12] |
| **Transport/Logistics** | Long working hours for drivers, Overloading, lack of maintenance of transport fleet, personal use, inadequate storage and handling leading to losses/damages |

*Table 2. Indicators of the Economic Theory of IBP*

## Behavioral factors

However, the rational, economic motive for IBP is only one factor that explains these practices, albeit an important one. Ledeneva (2018) defines informality as “the world’s open secrets, unwritten rules and hidden practices, as ‘ways of getting things done’”. Described this way, it seems that the phenomenon is more embedded in social and cultural behavior, rather than economic behavior, even though it may strongly influence business functioning and performance. This is in line with other authors who have taken a closer look at the prevailing “business culture” in societies. One of the features of that business culture is the general lack of respect for and distrust of the authorities and negligence towards public goods such as the environment and a general leniency to abiding to laws and regulations (Kanbur 2009).

Indeed, Social norms play a critical role in explaining entrepreneurs’ behavior. Their influence can be exerted both internally- in terms of values related to honesty, fairness, empathy and truth-and externally, reflecting the prevailing views on social conformity; if “everyone” makes their own rules and evades taxes, then why should I stick out for being compliant? Ianole-Călin explains non-compliance in Romania as follows: “Romania has a strong cultural tradition in which rejection of authority, lack of social trust, simulated compliance and a drive towards social conformity are interwoven in a very intricate pattern of social norms (Horodnic et al 2018, p.28). IBP can also be seen as a business response to popular demand. Williams and Martinex-Perez found that in 27 EU member states, only 44% of purchases in the informal economy was motivated by lower price only and a further 28% of purchases were done for several reasons including price. Consumers also use the informal economy to circumvent the shortcomings of the formal economy in terms of the availability, speed and quality of goods and services provision, as well as for social and redistributive reasons (Williams and Martinez-Perez 2013).

Apart from the demand side, much attention also goes to the relationship between the business owner/manager and the external, institutional environment. Schneider (2012) and Benjamin et al (2012) have called attention to the crucial role of the state and argue that the quality of the state in the sense of governance, legitimacy (being accountable, transparent), capacity (enforcement) and justice (equality before the law), is a key determinant in the size of the informal sector and the occurrence of informal business practices.

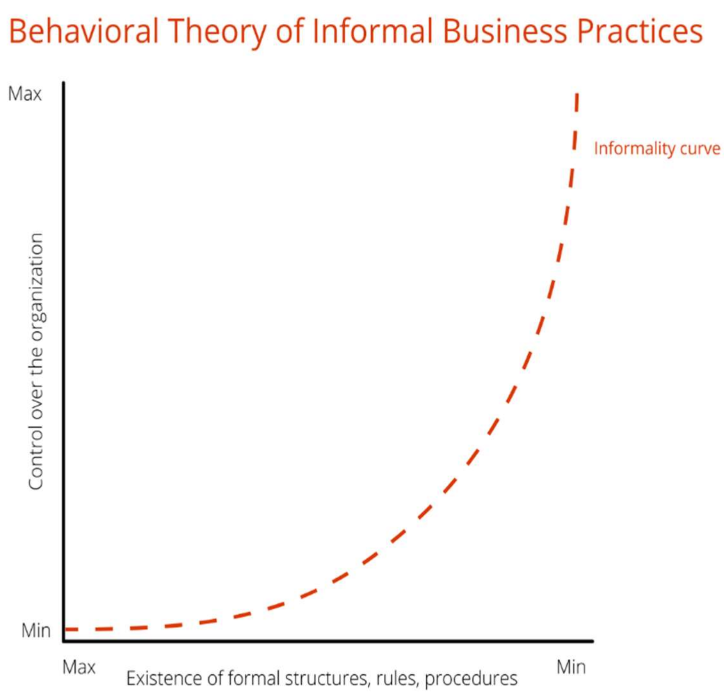
[12] These are business activities that have the effect of preventing, distorting or restricting competition which includes such practices as exclusive dealings, tie-up sales, full line forcing, concert or collusion cartels, price discrimination, re-sale price maintenance, area restriction, bid-rigging and output limitations. Sometimes, they are prohibited under prevailing anti-trust legislation, but often they are not.

For example, tax revenues are relatively low across the African continent. In 2018, 30 African countries had an average ratio of taxes to gross domestic product of 16.5% – less than half the ratio in far wealthier member countries of the Organization for Economic Co-operation and Development (34.3%). In addition to capacity limitations of government tax agencies, low tax revenues can be related to macroeconomic factors such as large agricultural and informal sectors, which are typically hard to tax. But low tax revenues can also reflect micro-level factors such as citizens' willingness to pay taxes ("tax morale"), their knowledge about what they owe and what their taxes are used for, and their perceptions of corruption in the tax administration. If citizens regard paying taxes as a fiscal exchange or contractual relationship, such perceptions can affect the legitimacy of taxation as a whole.

Thus, engaging in IBP by a business owner/ manager may be (strongly) influenced by how they perceive and experience their environment, particularly in relation to other businesses and government. If no one sticks to the rules and the government is nowhere to be seen, why would they? This is in line with Schneider (2012), who established that the most influential factors on the shadow economy and/or shadow labor force are tax policies and state regulation, which, if they rise, increase both. What is interesting about this phenomenon for our purpose is the fact that the determining factor for paying taxes is not the lack of awareness or any legal obligations, but rather the judgment by the business owner/manager himself about the need to be compliant; the tax morale. It is also clear from the literature, that if tax morale is low, the only thing that will ensure some compliance is law enforcement and controls (Kanbur 2009, Gelb et al. 2009). As law enforcement is weak in many countries, people start to make their own rules, thereby creating this grey, informal and insecure space where things get done but often in direct conflict with the law. Chabal and Daloz argue that such "disorder" may actually be preferred by certain political and economic elites as it allows them to enrich themselves and hold on to power (Chabal/Daloz 1999).

This brings us to the third, more idiosyncratic factor that may explain business owners'/managers' behavior, the other two being the demand side and the relationship with the state. As far back as 1985, Kets de Vries pointed to the "Dark Side of Entrepreneurship" i.e., personality disorders such as the strong need to be in control, authoritarianism, micro-management, sense of distrust and need for applause (Kets de Vries, 1985). Petty et al mention that 40% of entrepreneurs state that the main reason for leaving their jobs at other companies is that they wanted to be their own boss (Petty et al 2012). Personal freedom and independence are strong motivators for entrepreneurial activity. This explains why many entrepreneurs have little interest in following best practices or complying with rules and regulations. Studies on entrepreneurship have demonstrated that very few of them will start their business idea with wondering what government policy or the law might say, and instead show that economic freedom is a key determining factor in entrepreneurship self-efficacy and alertness (Hall et al. 2012, Nyström 2008, Boudreaux 2019). Indeed, there is a vast legal and philosophical discourse on the tension between individual freedom and the legal, moral and religious order in a particular business environment. The law as a norm is an ideal and not a natural reality and the behavior of individuals may or may not be in conformity with the legal order in place (Forji 2010).

The business culture as expressed through social norms and market demand, the relationship with government as well as idiosyncratic aspects of business owners/managers behavior, lead us to a second theory of IBP. The behavioral theory of IBP says that the less structures, rules and procedures are applied to and in a business, the higher the control of the owner/manager over the business will be and the higher the prevalence of IBP will be. In other words; the lesser (external and internal) control, the more owners/managers (and most employees) can do what they believe is right.




*Graph 2. The behavioral theory of IBP (Dellevoet 2021)*
Looking at the indicators of Table 1 at the beginning of this paper, it seems that the following indicators are more related to the behavioral theory of IBP, as highlighted in Table 3 below.

| Part of the Business | IBP |
|---|---|
| **Governance/leadership** | Behind the scenes decision making, shadow directors, financiers/investors power, 'old boy network', political influences, patronage, conflicts of interest |
| **Legal and tax compliance** | Freely Interpret, not strictly adhering to or ignoring contractual obligations, plagiarism, violation of legal obligations incl. environmental regulations, tax avoidance, tax evasion, insider trading |
| **Financial management** | Informal finance, informal money transfers, shadow bookkeeping, skimming, fraud, no insurance |

| | |
|---|---|
| **Production/working conditions/ safety/quality control** | Violation of labor laws and workers safety and health regulations, adulterated or substandard products |
| **Procurement** | Non-transparent process, single sourcing, price inflation, acceptance of bribes and gifts |
| **HR management and administration** | Nepotism, favoritism, no social security coverage, no contract, discrimination, unpaid or delayed salaries, undeclared work[13] |
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*Table 3. Indicators of the Behavioral Theory of IBP*

# V. Conclusion

The observations made in the introduction above should not come as a surprise, given the evidence quoted. Historically, all business activities were informal until policies and laws were introduced which then created a divide between formal and informal, i.e., those businesses that are registered with the authorities, tax-paying and compliant with the law, and those that are not. Thus, it is ahistorical to be surprised about the prevalence of IBP and more accurate to say that the process of formalization is still ongoing, which seems to coincide with state formation processes worldwide. However, in recent times this process seems to have stalled somewhat, due to recent developments around self-employment, informal wage employment and contracted employment. The general examples of corruption, size of the black economy and cross border trade quoted above, demonstrate the significance of IBP worldwide; a closer look at corporate governance, HRM and accounting practices showed in some detail what these practices entail. Indeed, one can argue that this is in fact widely recognized, which is why we have commercial laws, corporate governance and accounting standards. The conclusion that IBP exist and are a substantial part of business activity worldwide is therefore valid. It may even be underestimated if we see, for example, the extent of financial scandals in the past two decades. Enron, the subprime financial crisis, the Volkswagen emissions scandal, the Wirecard fintech scandal, the Panama papers and recently the Pandora Papers all come to mind.

However, this doesn't explain the phenomenon. If IBP are so common and persistent, then there must be a deep, underlying reason why business owners and managers behave in this way. To answer that question, evidence was found in the literature around the costs of doing business, leading to an economic theory of IBP, as well as the personal motivations and

[13] Undeclared work refers to paid work, which is legal in all respects other than it is not declared to the authorities for tax, social security or labour law purposes.

[14] These are business activities that have the effect of preventing, distorting or restricting competition which includes such practices as exclusive dealings, tie-up sales, full line forcing, concert or collusion cartels, price discrimination, re-sale price maintenance, area restriction, bid-rigging and output limitations. Sometimes, they are prohibited under prevailing anti-trust legislation, but often they are not.

attitudes of owners/managers of a business which formed the basis for a behavioral theory of IBP. The two theories should be seen as complementary i.e. even if cost reductions are not the primary motive, the perceptions and attitudes of owners/managers may still lead to more IBP.

The consequences of these findings for the management literature are quite profound. Business failure or success may be much more dependent upon favoritism, patronage and the old boys network, than upon competitiveness, innovation and quality of the products or services. Businesses facing harsh times and potential bankruptcy may defy all economic logic if they are able to dodge taxes, delay salary payments, appease creditors and use all their personal savings to stay afloat. Efforts at formalization, regulation and compliance may be ineffective as it seems to be dependent on the relationship with government and may be at odds with the very nature of entrepreneurship, namely to run the business as you want and to make money.

If formalization and regulation aren't the answer, then what may we do to help in the process of countering the detrimental and negative aspects of IBP, such as worker exploitation, pollution and tax evasion? Perhaps, the bar was just set too high by adopting formal standards that are more common among Western, developed countries as described in table 1 above. These may be problematic in non-Western, developing countries, where the Rule of Law and enforcement capacity may be weaker. More effective responses to IBP may be found in practical, informal and diverse approaches which might work well in a specific socio-cultural and political context. More research will be needed to uncover these practices and bring them to the fore, so as to enrich our understanding of IBP and what to do about them.

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