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The double-edged sword of legitimacy in base-of-the-pyramid markets☆

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ABSTRACT

As compared to developed countries, a much higher proportion of entrepreneurs within base-of-the-pyramid (BOP) markets operate unregistered businesses. Prior research has suggested that the primary cause of such informal activity in these settings is the general failure of 'weak' institutions to provide sufficient resources to warrant formalization. We attempt to extend such thinking by deconstructing the discrete and inter-related effects of formal business registration on the level of resources obtained by entrepreneurs from financial, labor, and legal institutions within BOP markets. Using a multi-method approach involving 299 entrepreneurs within Guatemala City, our results suggest that being seen as a 'legitimate', registered business can actually lead to both increased resource provision and resource appropriation. More specifically, adhering to the norms and rules prescribed by regulatory institutions within weak legal environments can convey positive signals of stability and profitability that both attract the desired attention from formal institutional actors, as well as unwanted attention from criminals.

1. Introduction

Base-of-the-pyramid (BOP) markets refer to impoverished regions of the world where the average individual survives on less than $3000 per year in terms of purchasing power parity (Kistruck et al., 2013a; London et al., 2010). While traditionally ignored by management scholars, BOP markets represent a significant $5 trillion block of economic activity (Fitch and Sorensen, 2007) that is in large part spurned by a sizable entrepreneurial sector (Bosma and Levie, 2009). It is estimated that on average 30-40% (based on GDP) of

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such entrepreneurial activity within BOP markets is undertaken by unregistered businesses (Nichter and Goldmark, 2009; Schneider, 2002), a proportion that is significantly higher than the 5-15% estimated for developed contexts.

Prior research has suggested such a large percentage of entrepreneurs elect not to formally register their ventures in BOP markets because the institutional environment in such settings is 'weak' (De Soto, 2000; North, 1990). An institutional environment is considered weak when it lacks the capability "to ensure effective markets or even undermines markets" (Meyer et al., 2009: 63). Thus, institutions within BOP markets, *as a whole*, have been considered incapable of providing significant resources and protection to entrepreneurs who elect to formally register and follow their prescriptions (Clemens and Cook, 1999; North, 1990; Webb et al., 2009). The general lack of institutional benefits, combined with the purportedly high costs of business registration, is thought to sufficiently deter entrepreneurs within BOP markets from formalizing their ventures (Cross, 2000; Webb et al., 2013).

However, recent research has cautioned against painting the institutional environment of BOP markets as universally weak (Mair et al., 2012). For example, although Nigeria ranks within the lowest level on the human development index and nearly 60% of its GDP occurs within the informal economy, its financial institutions rank 13th out of 189 countries in the world for providing small businesses with access to credit. Similarly, while over 50% of the population in Bolivia lives below the poverty line, and nearly 70% of its GDP is derived from unregistered activities, its education institutions rank among the top third worldwide.[4]

Such variance in the strength of individual institutions within BOP markets suggests a much more complex picture than previously theorized, where institutional environments are composed of some relatively weaker institutions alongside other relatively stronger institutions. Does adhering to regulatory prescriptions yield any benefits from relatively 'stronger' institutions within BOP markets as institutional theory would suggest? And how, if at all, are the costs and benefits of formalization intertwined within institutional environments where both 'strong' and 'weak' institutions co-exist?

We attempted to inform such research questions by undertaking a mixed-method study of entrepreneurs in Guatemala. Our initial research efforts involved exploratory interviews with 52 entrepreneurs. The purpose of the interviews was to use an institutional theory lens to better deconstruct the discrete and inter-related institutional effects associated with formal business registration within BOP markets. Thus, in addition to examining the direct linkages between formalization and the distinct level of resources obtained by entrepreneurs from financial, labor, and legal institutions, we also explored how the level of resources obtained from one particular institution may be positively or negatively intertwined with those obtained from other institutions. Based upon these initial insights, we subsequently developed a set of formal hypotheses, which were then tested using a survey of 247 formal and informal entrepreneurs similarly located within Guatemala.

Our results collectively suggest that while being deemed 'legitimate' by regulatory institutions through formal registration can in fact provide an increase in the provision of resources from relatively strong institutions within BOP markets, it can also result in increased resource *appropriation* from drug dealers, gangs, and other criminals when legal institutions are weak. More specifically, by adopting the procedures and symbols necessary to display adherence to the rules and norms associated with operating a registered business (i.e., displaying licenses and issuing receipts), entrepreneurs at the same time inadvertently signal to criminals that they possess sufficient resources to warrant extortion and theft. Thus, in BOP markets where legal institutions often lack the resources to provide adequate protection, the financial and human capital benefits provided by legitimization are largely offset by the increased costs and risks associated with crime.

Our study seeks to contribute to existing theory by suggesting that legitimacy can act as a double-edged sword within certain institutional environments. While prior research has viewed legitimacy as having a largely positive effect for both small and large organizations (Certo, 2003; Navis and Glynn, 2011; Suchman, 1995), our findings suggest this prediction is at least somewhat context dependent. Our findings also highlight the importance of taking a deconstructed view of institutional environments within BOP markets. Whereas developed markets are largely considered to have consistently strong formal institutions (Bruton et al., 2010), institutions within BOP markets are often at various stages of development (Kistruck et al., 2011; London et al., 2014). Understanding the breadth of benefits and costs associated with legitimation in such settings seemingly requires a finer-grained perspective of the institutional environment.

In terms of practical implications, our deconstruction of the effects of legitimization within BOP markets suggests that there may in fact be sufficient resources provided to entrepreneurs by certain formal institutions to warrant investment in business registration. Therefore, it may not necessarily be that entrepreneurs fail to legitimate because they perceive the direct costs of registration and taxation as exceeding the benefits provided by financial and labor institutions; rather, the practices required to access and maintain resources from such institutions inadvertently serve as signals of profitability and stability to criminals. Thus, policy makers would do well to reconsider their prescribed practices as it relates to publicizing regulatory adherence in the absence of effective legal enforcement.

2. Theoretical framework – institutions and legitimacy

Institutions refer to the relatively stable systems of prescriptions that define what is acceptable within society and provide the incentives and constraints to encourage compliance (Clemens and Cook, 1999; North, 1990; Suchman, 1995). Herein, we focus on formal institutions. Formal institutions are expected to serve two primary roles: (1) to provide structure to economic activity by defining and enforcing economic, political, and legal prescriptions (North, 1990; Suchman, 1995), and (2) to provide general public

[4] The preceding statistics were compiled from several World Bank studies including the 2013 "Doing Business" survey, the 2013 "Human Development Index", and the 2010 "Size of the Informal Economy" report.