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Transitioning entrepreneurs from informal to formal markets

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A B S T R A C T

Informal markets encompass economic activity that occurs outside of formal regulations and is rather guided by informal norms, values, and understandings. A growing stream of research explores the transition of entrepreneurs from informal to formal markets. Past research appears to portray the transition to formality as a strategic choice made by entrepreneurs and to center on regulatory concerns, such as acquiring licenses, registering the business, and paying taxes. Such an approach to studying formalization, however, may not adequately account for the influence of informal institutions on such a transition, and ignores the facilitating role often played by institutional intermediaries, a type of institutional entrepreneur. Thus, the purpose of this study is to explore a more comprehensive view of formalization in which an institutional intermediary seeks to help small producers transition from selling their goods in informal markets (where formal regulations and infrastructures do not exist or are severely underdeveloped) to formal markets (where developed formal regulations and infrastructures have engendered stronger competition and heightened quality and efficiency standards). More specifically, we examined the process by which an NGO attempted to transition approximately 1,800 dairy farmers in rural Nicaragua from informal to formal markets. Our results suggest that the success of formalization efforts by institutional intermediaries hinges on a series of inter-related tactics aimed at providing "institutional scaffolding" to encourage and facilitate informal entrepreneurs' participation in formal markets.

Executive summary

There has been growing interest in the motivations and societal impact of entrepreneurs' transition from informal to formal markets (De Castro et al., 2014). An implicit assumption underlying much of this work is that formalization occurs based on a rational consideration of the benefits relative to the costs (Siqueira et al., 2014; Webb et al., 2014). While providing valuable insights, the focus on how formal regulations and infrastructures create economic (dis)incentives that encourage or discourage a legal transition to formal markets has led to an incomplete understanding of how formalization unfolds. In reality, formalization occurs as entrepreneurs transition from one institutional framework based on minimal standards (i.e., standards underpinning the

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informal market) to another institutional framework with specified and enforced standards of quality, efficiency, and volume (i.e., standards underpinning the formal market). Such transitions are often facilitated by institutional intermediaries, a type of institutional entrepreneur that seeks to bridge entrepreneurs from one institutional arrangement to another (c.f. Dutt et al., 2016; Mair et al., 2012).

To better understand how institutional intermediaries transition entrepreneurs from informal to formal markets, we conducted an in-depth case study of a non-governmental organization (NGO), acting as an institutional intermediary. The NGO worked with Nicaraguan dairy farmers (small entrepreneurs) to help them transition to formal markets. We found that this transition process was best understood by considering both institutional economics and organizational institutionalism, as the NGO worked not only to construct appropriate incentives and infrastructures but also to bridge the differences in norms, values, and understandings that underpinned formal market practices. Consistent with organizational institutionalism, we also found that the NGO's efforts were affected by the discordant institutional prescriptions characterizing formal and informal markets. In order to facilitate formalization, we found that the NGO engaged in a series of tactics at multiple levels to help bridge the gap between informal and formal markets. The NGO used tactics at the individual and network levels, introducing new norms, values, and understandings to shape farmers' individual and relational practices with the objective of meeting formal market standards. Consistent with institutional economics, the NGO also established new rules and infrastructure at the system level to facilitate appropriate incentives for the farmers. Collectively, these changes constituted "institutional scaffolding," or the nascent institutional arrangement that supported a transition to formal markets by helping farmers understand formalization benefits, accept new individual- and network-level practices, and govern their activities and outputs in order to meet formal market standards. Importantly, we observed that the construction of this scaffolding was fragile, with the NGO's efforts across the individual, network, and system levels being highly interdependent and temporally sensitive. Despite the NGO's significant institutional intermediation efforts and success in facilitating the formalization of a majority of farmers participating in the program, we found that farmers reverted back to the informal markets for different reasons at various stages of the formalization process.

We seek to contribute to the literature in two ways. Our study's central theoretical contribution to institutional entrepreneurship research is the introduction of the concept of institutional scaffolding. As a specific form of institutional entrepreneurship, institutional intermediation involves bridging actors between existing institutional fields, and we find that intermediaries use a holistic process that bridges institutional arrangements at multiple levels. Furthermore, we find that the construction of this scaffolding is both temporally sensitive and interdependent. When the scaffolding is not put into place in a timely and mutually reinforcing way, it quickly falls apart and entrepreneurs revert back to informal markets. Second, prior work on informality and entrepreneurship has predominantly adopted an institutional economics lens, portraying formalization as a conscious and calculated choice based largely upon cost considerations and perceived benefits (Dau and Cuervo-Cazurra, 2014; Kistruck et al., 2015). Incorporating an organizational institutionalism lens, however, our study suggests that while rational considerations by entrepreneurs can encourage their formalization, existing informal norms, values, and understandings influence their adoption of formal business practices. As such, the transition from informal to formal markets may involve a more complex process guided by an institutional intermediary that involves overcoming existing institutional prescriptions and adopting new perspectives and practices.

1. Introduction

Informal markets are places of economic exchange where behavior is governed primarily by the prescriptions of informal institutions (i.e. norms, values, and understandings), rather than formal institutions (i.e. government regulations, written contracts, etc.) (Hart, 1973; Webb et al., 2009). Informal markets comprise a large proportion of the total economic activity that takes place around the world, with estimates showing that informal economic activity accounts for approximately half of developing economies' annual gross domestic product (Schneider and Enste, 2013). While informal markets provide a substantial degree of adaptability and flexibility (Godfrey, 2011), they are also limited in their ability to support anonymous transactions, generate taxes, and provide the legal framework necessary for large-scale investment (North, 1990). As such, they are generally viewed as a hindrance to economic development (Rakowski, 1994). Not surprisingly then, there has been growing scholarship which has yielded important insights regarding the motivations and impacts of the transition from informal to formal markets (De Castro et al., 2014). In this body of research, scholars have focused more on the legal transition of entrepreneurs from informal to formal markets, in particular examining why entrepreneurs decide to register their businesses, pay taxes, and comply with regulations. An implicit assumption has been that formalization occurs based on a straightforward rational consideration of the benefits relative to the costs (Siqueira et al., 2014; Webb et al., 2014).

While providing valuable insights, the focus on how formal regulations and infrastructures create economic (dis)incentives that encourage or discourage a legal transition to formal markets has led to an incomplete understanding of how formalization unfolds. Transitioning from informal to formal markets involves fundamentally changing the way the business operates. Whereas transactions in informal markets are based largely on trust and word-of-mouth, formal market participation is based on detailed contracts that comply with existing law. Whereas product quality in informal markets is ascertained by visual inspection and touch, government regulations in formal markets require specific testing and labeling to ensure consumer safety. Such changes involve adopting a whole new mindset and knowledge base that is not simply triggered by the payment of a registration fee. Instead, the transition from informal to formal markets often implies transforming the business to conform to a new institutional context. With a primary focus on the economic calculus related to legal compliance, extant research on the transition to formal markets has largely overlooked the influence of informal institutions.

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