

Informal Business Practices: Some Early Evidence

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The paper introduces a new management theory, “Informal Business Practices” (IBP), focusing on micro-level business practices that are informal, illegal, unregulated, or unethical. Evidence for IBP is found in general literature on taxes, shadow economies, corporate governance, accounting, and human resource management. It also references the World Bank’s ‘doing business’ indicators and enterprise surveys, further confirmed by a small survey among retired managers in emerging markets. This led to formulating an economic theory of IBP focused on minimizing business costs and a behavioral theory linking IBP to business attitudes and behaviors.

In 2022, a field study in Uganda used over 80 Likert variables for a survey among 18 SMEs to determine the economic drivers of formality and establish the “formality gap” with full regulatory and legal compliance. Insights were verified through semi-structured interviews with business managers/owners, providing further evidence for the economic and behavioral theories of IBP. The paper concludes that this preliminary result justifies more extensive research into the concept of IBP.

Keywords: informality, business practices, shadow economy, regulatory compliance, costs of doing business, behavioral theory

INTRODUCTION

Throughout my international development career, spanning over three decades and three continents, I have always wondered why so much attention and effort goes to setting up institutions, building their capacity, drafting policies and regulations, concluding formal agreements, and focusing on good governance, transparency, and accountability. Yet, at the same time, as you familiarize yourself with the local environment, you can’t help to notice that many players don’t respect these institutions, rules or agreements and find other ways to get things done. In the private sector, we often refer to the “Shadow” or “Black” economy and the informal sector and in the public sector to a “Captured” or “Parallel” state (David-Barret 2023, Chabal and Daloz 1999).

This gap between the formal and informal, theory and practice, seems to be widespread as news headlines reach the public every week on corruption and tax evasion scandals (e.g. Panama Papers, Pandora Papers), fraud (e.g. Volkswagen emissions scandal, food fraud, Wirecard scandal, fake or illicit components and products), violation of environmental laws and regulations, disrespect of international conventions and agreements and illegal business activities (extractive industries, arms industry, financial world) (ICIJ 2023). From these examples, it also becomes clear that this gap is a global phenomenon, in both formal and informal institutions, small and large businesses, in rich and poor countries. This led me to the question;

are these practices not the norm, rather than the exception? Indeed, informality is so diverse and widespread that Ledeneva couldn't formulate a definition when she published her *Encyclopedia of Informality* (Ledeneva 2018).

Our research at MSM focused on what this tells us about business behaviour (Dellevoet/Jones 2021). If these practices are so common, there must be good reasons for it. Could these practices be part and parcel of any business model, which includes both a formal, legal and accepted way of doing business, as well as an informal, possibly illegal, unregulated or unsupervised way? If so, we need to find a better balance in the management literature about our understanding of business performance. It may be less dependent upon innovation or the price and quality of goods and services and more on cost savings related to partial- or non-compliance with prevailing laws, rules and regulations or business-government relations.

In this paper, I would like to share our work on what we have termed "Informal Business Practices" (IBP). We wanted to take the work of Ledeneva further and try to describe these practices and develop a definition. We researched the literature, looked at the World Bank Enterprise Surveys, and did a small survey amongst practitioners to find out if the concept of IBP is indeed part of business reality. The insights from the research led to a Theory of IBP, which is split into two theories: an economic theory of IBP and a behavioral theory of IBP. Last year, we sought to further validate the Theory of IBP by doing a small field study in Uganda, which produced enough results to encourage us to prepare for a much larger research in 2023-2025.

A DEFINITION OF IBP

There are many definitions of a business, but we have chosen to 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 undertaken by unorganized individuals such as street vendors, day laborers or subsistence farmers (Dau and Cuervo-Azurra 2014). It also excludes non-profit NGO's but includes social enterprises.

We particularly wanted to focus on the informal aspects of a business, not just in the sense of unregistered or unregulated, but also in terms of what are these hidden practices, these "ways of getting things done", as Ledeneva puts it (Ledeneva 2018). 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).

Informality is not a question of black and white. In line with Benjamin et al. (2012), we see IBP as a continuum encompassing all businesses. Other authors have also recognized that informality is a matter of degree, best captured by various indicators (Steel and Snodgrass 2008; La Porta and Schleifer 2011; Guha-Khasnobis and Kanbur 2009).

Hence, a definition of informal business practices, challenging as it is, should both be clear and concrete and encompass 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 Matten 2007). This approach brought us to the following criteria and indicators for informal business practices (see Table 1).

TABLE 1
INDICATORS OF IBP COMPARED WITH FORMAL ASPECTS OF A BUSINESS

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 boys 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, fraud, no insurance, transfer pricing
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 ¹
Sales and Marketing	Marketing strategies, media campaigns, advertisements	Word of mouth, personal network, unfair and restrictive trade practices ²
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

(Dellevoet/Jones 2021)

These various indicators have in common that they are very much based upon economic considerations, i.e., saving money, as well as behavioral characteristics such as carelessness and a dislike of transparency and accountability. Given the criteria in Table 1 to describe IBP, we have come to 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.” (Dellevoet/Jones 2021)

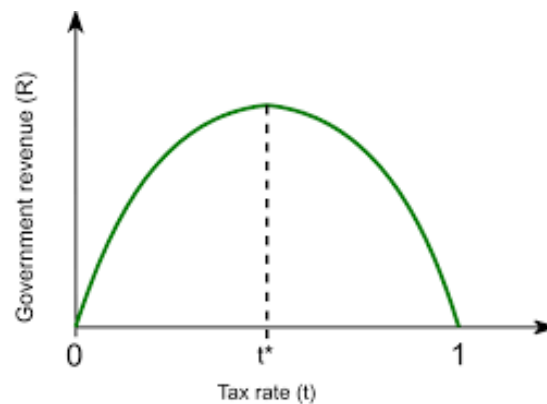
EARLY EVIDENCE OF IBP

Literature Studies

First, we did a literature study to understand the significance and magnitude of IBP. There is quite a substantial body of theoretical literature in both classical and behavioral economics that underpin the concept of IBP. In classical economic theories, going as far back as Adam Smith, man is considered as a rational, informed being who will weigh (financial) costs and benefits before making a decision (Levin and Milgrom 2004). In behavioral economics, such decision-making is much more seen as a product of cognitive, psychological, and sociological processes, including risk appetite and tax morale (Cyert 1992, Gavetti et al. 2012)

A well-known example where classical and behavioral economic theories coincide is the “Laffer curve”, named after American supply-side economist Arthur Laffer, who argued that high tax rates generally might lead to fewer government revenues, investments, and work (Trabandt and Uhlig 2012).

FIGURE 1



There are two extremes in this figure being a 0% and a 100% tax rate. At 0%, the government receives nothing. This is also the case at 100% because no one would have the intention to work anymore (unless off the books). Somewhere between 0% and 100% there is a rate (percentage) at which the revenue is maximum for the government (t). Before this percentage is reached, an increase in the rate will also increase revenues. After this maximum percentage has been reached, the tax revenue will decrease as more people evade taxes, close their businesses, remain unemployed, emigrate or move their capital elsewhere. If an economy's tax rate is assumed to be above that maximum, a decrease in the tax rate will increase tax revenue again.

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 found that the high costs of corruption and bureaucracy push firms to the informal sector (Friedman et al. 2000). 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

rationally assess the possible consequences of their actions and take the opportunity to commit a crime, only if the economic advantages outweigh the disadvantages (Jones 2006).

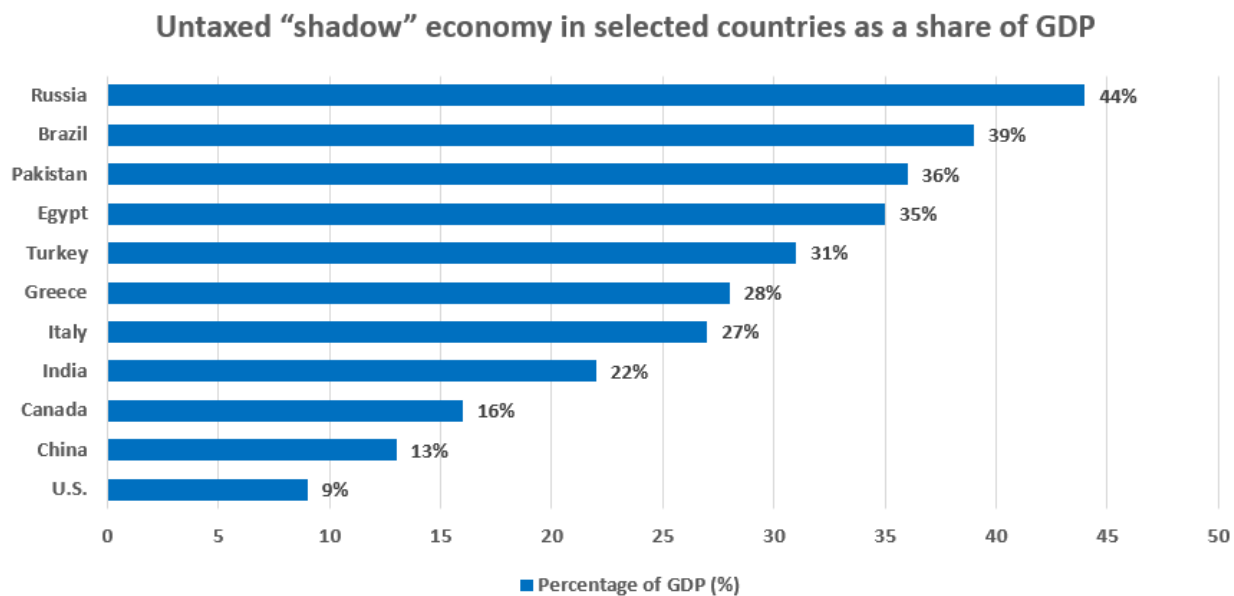
Indeed, there seems to be some evidence for the rational choice theories. Horodnic notes that the (financial) performance of informal businesses that start up unregistered and spend some years operating informally is stronger than businesses allocating all their resources to be fully compliant (Horodnic 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 labor 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 regarding labor (Piketty 2014, Guha-Khasnobis and Kanbur 2006).

As mentioned above, Ledeneva's Encyclopedia of Informality is an excellent source of reference for a comprehensive overview of open secrets, unwritten rules and know-how of how to get things done, affecting business behaviour (Ledeneva 2018). They include emotion-driven exchanges of gifts or favours and tributes for services, interest-driven know-how (from informal welfare to informal employment and entrepreneurship), identity-driven practices of solidarity, and power-driven forms of co-optation and control.

Apart from the rich diversity of informal practices as described by Ledeneva, more evidence can be found in the literature about the shadow economy and the informal sector. Of course, it can be assumed that informal business practices are even more prevalent in the informal sector, as these businesses operate below the government's radar, not being registered and paying no (direct) taxes. Without 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 informal sector's size indicates the prevalence of informal business practices. They are significant;

- In the advanced economies, between 10% and 20% of income comes from the shadow or "black" economy. In some emerging countries, it can represent more than 30 percent as demonstrated in Figure 2 below (Schneider and Enste 2002, Schneider et al. 2010).

FIGURE 2
THE SIZE OF THE SHADOW ECONOMY IN SELECTED COUNTRIES



(source: Statista 2021)

- 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 labor 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 and mostly consists of micro, small and medium sized businesses (MSME's) who make up more than 95% of all businesses (Dellevoet/Jones 2021).

Other studies also demonstrate the extent of IBP, particularly in relation to government. For example, Transparency International publishes the Corruption Perception Index [CPI] every year. The index 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 government's anti-corruption efforts (Transparency International 2020).

Another good example is cross-border trade, especially in border areas that provide ample opportunities for smuggling 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. (Benjamin et al 2012, p.198). All across Asia, border posts are "common spaces" where trade is illegal but licit or a form of legalized informality. 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 (Horodnic et al 2018 pp. 173 and further).

The literature also provides many examples of IBP at the micro- or intra-firm level. Regarding corporate governance, Tricker (2012) points out that it is a political process. In fact, corporate governance is more about human behavior than about structures and strictures, rules and regulations. Corporate governance involves the use of power (Tricker 2012).

Another example is the frequent shortcomings of HR management, where staff are not professionally recruited or selected, leaving room for favoritism and nepotism, or not having an employment contract or even a job description upon which job performance evaluations could be based. Salaries may be extremely low, irregular, and statutory, social benefits denied (Horodnic et al 2018, Benjamin et al. 2012, Robbins 2001).

A final example that we looked into was 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 beneficial to the tax authorities, banks and investors. Finally, there are the illegal practices of misrepresentation of the financial status of a business and outright fraud (Benjamin et al. 2012).

WB Enterprise Surveys

The annual World Bank "Doing Business" reports, between 2004 and 2020 when it was discontinued, measured business regulations for local companies in 190 countries. The idea behind that research was that too much regulation and government interference would increase business costs, act as a disincentive for investments, and reduce growth. The "Doing Business" indicators are one of the sources that led to the economic theory of IBP. However, whereas the World Bank would use the Doing Business reports to improve the enabling environment, our research is more interested in how businesses respond to the regulatory environment³.

This can be found with another World Bank tool, the World Bank Enterprise Surveys (WBES). These are firm-level surveys covering a representative sample of an economy's private sector. They collect data on firm characteristics and performance, and a broad range of business environment topics, including access to finance, corruption, infrastructure, crime, regulations, and competition⁴.

The surveys give insight into business conditions and behaviour that align with the economic and behavioural theories. For example, the informal sector in an economy may be a source of unfair competition to registered, formal firms. In a survey of more than 160.000 enterprises, almost 50% replied that they were

competing against unregistered or informal firms. Almost 30% identified practices of competitors in the informal sector as a major constraint. In other studies, it is noted that this means that informal firms gain an unfair competitive advantage since they don't pay taxes or very little, don't comply with legal and regulatory provisions and are thus able to undercut market prices.

The informal sector enterprise surveys conducted over 26,000 interviews covering 35 cities in 11 countries since 2015. Looking at recently completed surveys in Iraq (1,996 interviews across 4 cities) and India (10,672 interviews across 9 cities), some patterns emerged regarding the informal sector. In Baghdad, the main business city of Iraq, the most frequently cited reasons for not registering are not wanting to pay taxes (73%) and entrepreneurs see no benefit to registering (71%). The surveys also provided evidence for the behavioural theory of IBP, especially about the Government. 47% of respondents preferred to remain informal to avoid the paperwork, time and fees, 61% to avoid meetings and inspections and 65% to avoid bribes⁵.

Small Survey Among Retired Managers

The Dutch Program for Retired Managers (PUM), supports MSMEs in the Global South with practical business advice. They can draw on a pool of senior experts who volunteer to assist the MSME's after their retirement. At the moment, a total of 145 PUM representatives work across 37 countries worldwide⁶. One of the advantages of this program is that the senior experts build up a personal and quite confidential relationship with MSME management in the countries where they work.

The MSM research team used this knowledge during a workshop in 2022 by doing a small online survey, which formed the basis for in-depth discussions. We had two groups of participants, male and female, from all regions of the Netherlands, with and without experience working in the Global South. After explaining the meaning of IBP, we only asked two key questions; one on corporate governance and one on legal and tax compliance. The response was as follows:

FIGURE 3



The results were similar. Almost 2/3 of the experts had experience with or believed that businesses were not compliant with legal and tax obligations and governance of the company was not in the hands of the

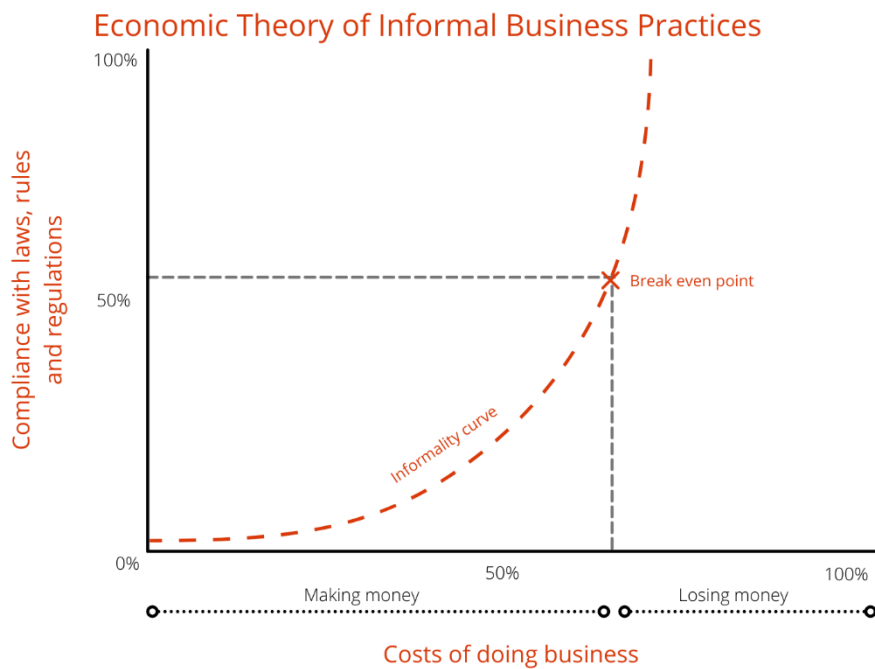
Board of Directors (BoD), who are officially responsible for the companies' affairs, but rather with management. These are clear indicators for the behavioral theory of IBP.

THE THEORY OF IBP

The literature and the small surveys provided quite a few insights into business behavior, which led to the development of a general theory of IBP, which encompasses both an economic and a behavioral side.

As illustrated in Figure 4 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.

FIGURE 4
THE ECONOMIC THEORY OF IBP



(Dellevoet and Jones 2021)

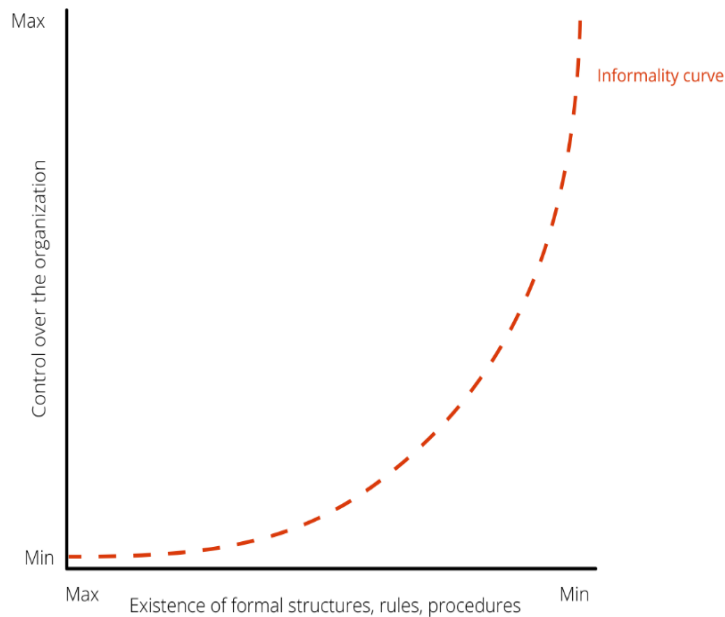
The economic theory of IBP, emphasizing financial issues, seems to apply to most of the indicators taken from Table 1, including tax avoidance, shadow bookkeeping and fraud.

However, as we have seen, the rational, economic motive for IBP is only one factor that explains these practices. The phenomenon seems to be embedded in social and cultural behavior, rather than economic behavior, even though it may strongly influence business functioning and performance. This aligns 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 by laws and regulations (Kanbur 2009). Indeed, social norms play a critical role in explaining entrepreneurs’ behavior. Their influence can be exerted 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 (in Horodnic et al. 2018) 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).

The behavioral theory of IBP says that the fewer structures, rules, and procedures are applied to. In a business, the higher the control of the owner/manager over the business will be and the higher the prevalence of IBP. In other words, the lesser (external and internal) control, the more owners/managers (and most employees) can do what they believe is right.

FIGURE 5
THE BEHAVIORAL THEORY OF IBP

Behavioral Theory of Informal Business Practices



(Dellevoet and Jones 2021)

Looking again at the indicators of Table 1 at the beginning of this paper, it seems that indicators like patronage, behind-the-scenes decision-making, disrespect for agreements, tax evasion, bribes, nepotism, and favoritism can all be attributed to the behavioral theory of IBP.

FURTHER RESEARCH

Once the theory of IBP was developed, the research team at MSM felt that we needed to move away from qualitative research, as can be found in the literature and surveys, and try to substantiate the economic theory of IBP, which, although challenging, lends itself well to quantitative research.

In the first half of 2022, we sent a BA student to Uganda to conduct field research amongst a pre-selected and representative group of small agri-businesses. We chose the same kind of firms as the World Bank in their enterprise surveys, i.e. SMEs that are quite formal, since they need to know what their costs and revenues are for tax purposes and in their relationship with clients and suppliers.

To measure IBP at the firm level in quantitative terms, we focused on business costs. In particular, we wanted to estimate the potential costs of **full compliance** (i.e., all business operations are 100% formal) and compare these to the actual costs in the books/records/reports/ memory of firms/employees. Full compliance costs entail not only the final costs of, for instance, corporate tax and social security contributions but also the costs associated with the creation of that formal arrangement (such as legal and admin costs), the waged hours worked to meet all legal obligations, the cost of complying with work-safety or environmental standards and the understanding thereof (we call these costs “**opportunity costs of**

formality”). These costs could then be compared against the costs that a business saves if it is not or partially compliant.

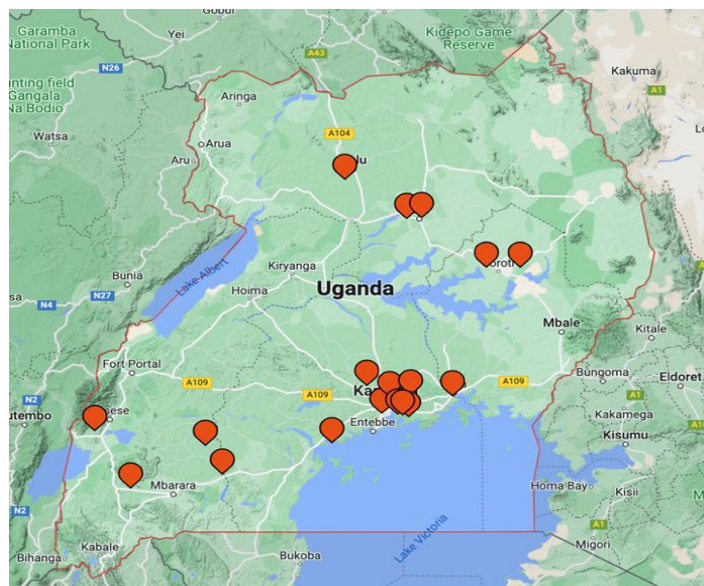
This method allowed us to record the difference between the (hypothetical) ‘full compliance costs’ (FCC) and the current/real ‘no or partial compliance costs’ (PCC), which we called the “**formality gap**” of a given firm. The formality gap is a strong indicator of the occurrence of IBP.

Then, assuming that total costs are a suitable representation of business operations, dividing the differential by FCC will give a percentage of firm operations that represents the formality gap.

$$\boxed{\text{Formality gap}} = \frac{\text{FCC} - \text{PCC}}{\text{FCC}}$$

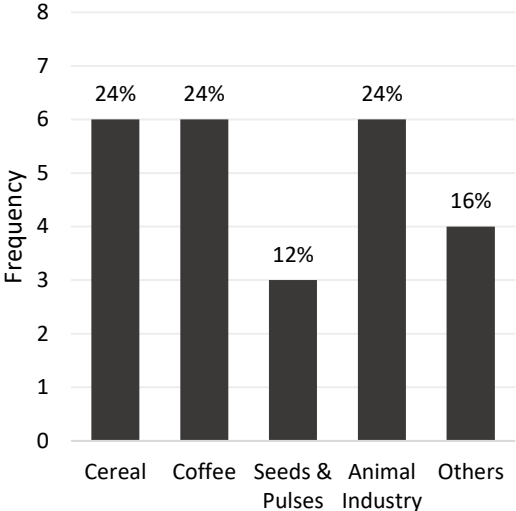
Next, we wanted to determine the formality gap in financial terms and compare it with the total turnover of the business. This required some research into the company’s accounts to see how many of these compliance costs are covered. This was quite confidential information, so we asked a Ugandan grant-making institution, which had supported these businesses, to act as our intermediary and reference. This enabled the team to get collaboration of 18 companies who gave insight into the annual accounts, reports or tax returns. We could then compare FCC with PCC and see if significant (10-20% of annual revenues) or excessive costs (>20% of annual revenues) were made. Finally, we did semi-structured interviews with the business management to determine if the formality gap was based upon economical or behavioural, firm-specific or external motivations. The sample of 18 agri-businesses was quite varied and had the following characteristics.

**FIGURE 6
GEOGRAPHIC DISTRIBUTION OF THE SAMPLE**

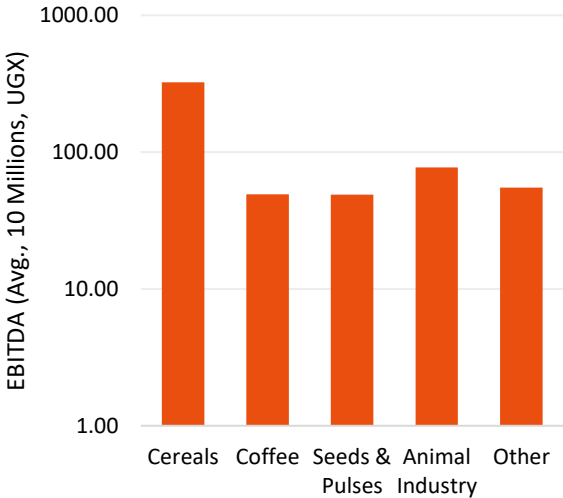


SAMPLE DESCRIPTIVE STATISTICS

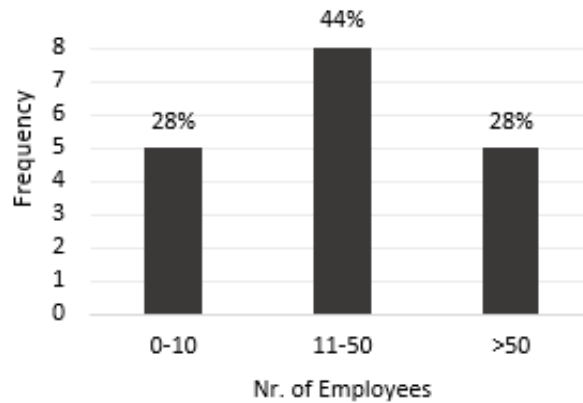
**FIGURE 7
DISTRIBUTION BY INDUSTRY**



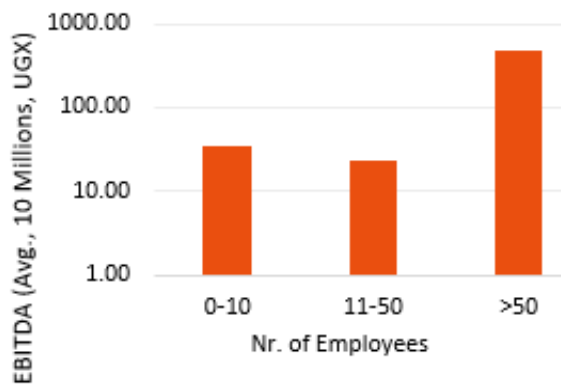
**FIGURE 8
EBITDA BY INDUSTRY (AVG)**



**FIGURE 9
DISTRIBUTION BY FIRM SIZE**



**FIGURE 10
EBITDA BY COMPANY SIZE (AVG)**



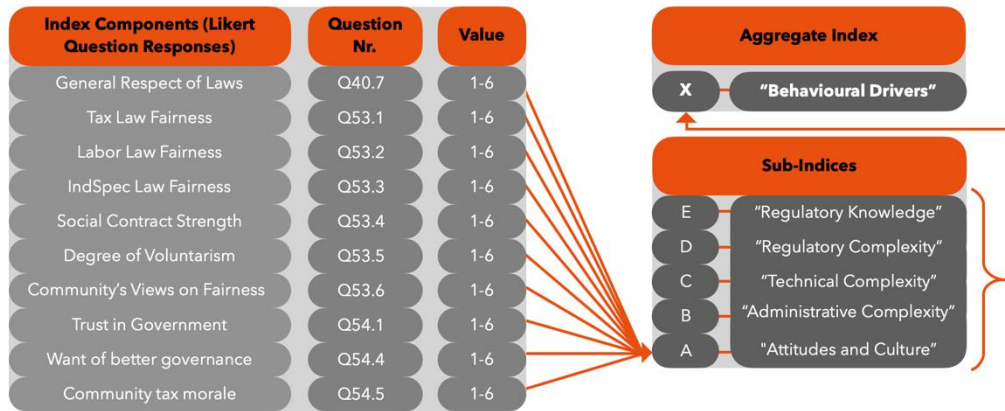
Survey Methodology and Measurement

To identify the various drivers of informality and their relative significance, a detailed survey comprising 99 questions was administered to the participating firms. The survey was organized into three thematic sections, with the first section focusing on self-evaluation of compliance levels regarding three sub-categories: taxation, labor, and industry-specific regulations. The second section examined the perceived impact of economic factors on compliance, including questions on non-compliance fines, the degree of law enforcement, competitive market pressures, exposure to corruption, and access to financial resources. The third section assessed exposure to behavioral and social forces, and their relation to compliance.

The survey employed 82 Likert variables, which were then aggregated into a variety of indices. Figure 11 describes the method of indexing. For example, individual responses to questions (Likert ratings ranging from 1 = very weak, to 6 = very strong) were aggregated by an unweighted average into an index “A” representing an overall attitude favoring compliance and government. This process was repeated for sub-categories “B-E”. All indices “A to E” were then aggregated into an index “X” representing the sum of all Behavioral Drivers. In this manner, two core indices on “Behavioral Drivers” of informality, “Economic Drivers” of informality, and ten sub-indices of their components were constructed. Similarly, three Likert-based indices named “Tax Compliance,” “Labor Compliance,” and “Industry Specific Compliance” were

created to quantify formality levels. Figure 12 shows the final collection of indices and their respective definitions.

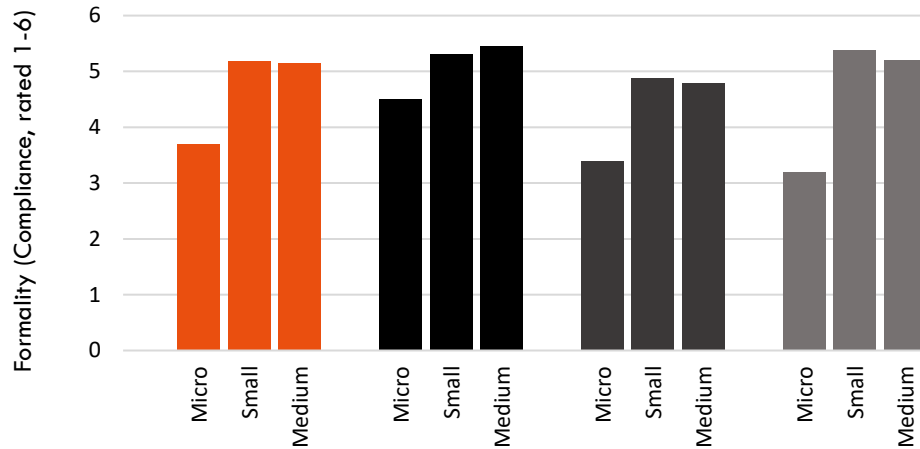
**FIGURE 11
METHOD OF INDEXING**



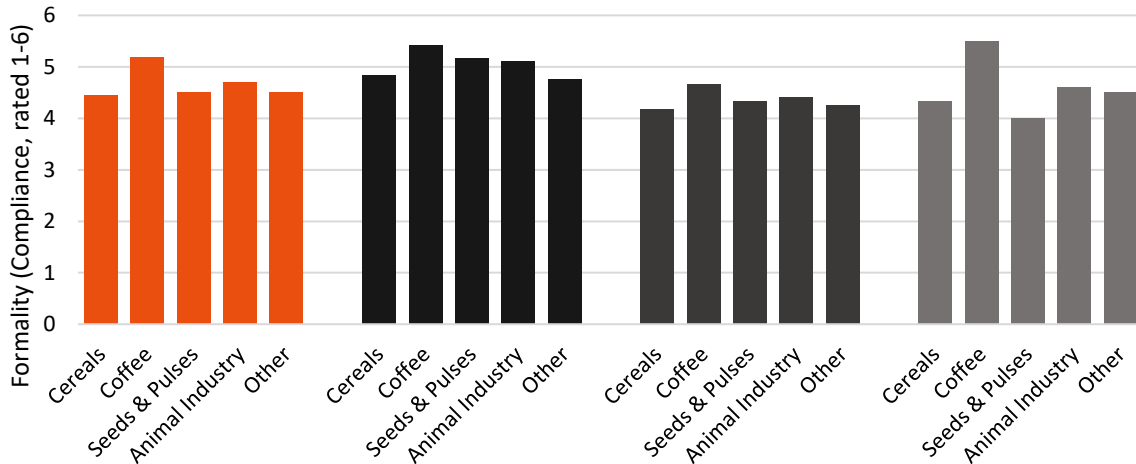
**FIGURE 12
INDICES ON FORMALITY, ECONOMIC DRIVERS, AND BEHAVIORAL DRIVERS**

"Formality"		"Economic Drivers"	
Index / Sub-Index	Definition	Index / Sub-Index	Defintion
"Tax Formality"	Degree of compliance with tax laws	"Enforcement"	Perceived level of government enforcement of compliance
"Labor Formality"	Degree of compliance with labor / safety laws	"Market Pressures"	Degree of competitive pressures to comply less (e.g. price)
"Industry Specific Formality"	Degree of compliance with quality standards, export regulation and environmental laws	"Targeted Corruption"	Perceived level of corruption in compliance processes
"Total Formality"	Degree of compliance with laws and regulation (sum of tax, labor and industry specific formality)	"Access to Finance"	Perceived importance of compliance for finance
		"Total Economic Drivers"	Perceived level of economic factors in the compliance decision-making process (sum of enforcement, market pressures, targeting, corruption and access to finance)
		"Behavioural Drivers"	
Index / Sub-Index	Definition	Index / Sub-Index	Defintion
"Regulatory Knowledge"	Perceived level of firm knowledge of laws and regulation	"Regulatory Knowledge"	Perceived level of firm knowledge of laws and regulation
"Regulatory Complexity"	Perceived level of complexity of laws and regulation	"Regulatory Complexity"	Perceived level of complexity of laws and regulation
"Technical Complexity"	Degree of technical difficulty complying (e.g. calculating tax)	"Technical Complexity"	Degree of technical difficulty complying (e.g. calculating tax)
"Administrative Complexity"	Level of difficulty in administering compliance (e.g. filing tax)	"Administrative Complexity"	Level of difficulty in administering compliance (e.g. filing tax)
"Attitudes"	Degree of positive attitudes on government and taxation	"Attitudes"	Degree of positive attitudes on government and taxation
"Total Behavioural Drivers"	Perceived level of behavioural factors in the compliance decision-making process (sum of knowledge, complexity technical aspects, administration and attitudes)	"Total Behavioural Drivers"	Perceived level of behavioural factors in the compliance decision-making process (sum of knowledge, complexity technical aspects, administration and attitudes)

**FIGURE 13
COMPLIANCE SCORES BY FIRM SIZE (AVG.)**



**FIGURE 14
COMPLIANCE SCORES BY INDUSTRY (AVG.)**



Preliminary Results: The Drivers of Informality

Having established the existence of substantial differences in formality across firms in terms of taxes, labor, and industry-specific regulations, this section examines the extent to which potential drivers of informality contribute to these disparities. In essence, we aimed to evaluate the impact of the opportunity costs of compliance (be they behavioral or economic) on firm decision-making.

It is important to acknowledge that these costs are indeed substantial. Our data indicates that the sampled firms' average annual expenditure on taxes was 34.9 million UGX, with an additional cost of 3.6 million UGX for tax advisory services. Furthermore, tax advisory and financial management costs (keeping accounts) accounted for a substantial proportion of operating costs, with an average of 6.5% dedicated to these activities. The average annual expenditure on social security contributions was also determined to be 49.4 million UGX. 63% of the firms reported that the total costs of tax, labor, and quality compliance were

unbearable, occasionally threatening profitability. The complexity of compliance was also visible, as 74% of the sampled businesses required tax advisory services, 26% required assistance with labor compliance, and 37% required quality testing services. When these costs are offset against profits, it becomes clear how difficult it is to maintain full compliance. One commonly used measure of profitability in agribusiness is the farm’s operating profit margin (OPM), the ratio of operating profit to gross farm income. Suppose operating profits comprise less than 10 percent of the gross cash farm income (GCFI) from the sale of commodities and other farm-related goods and services. In that case, the farm is considered to be in financial trouble (Hoppe 2014). In another study by Purdue University, it was recommended to keep the OPM to at least 20% (Langemeijer and Jaeger 2020).

Moving beyond the descriptive data, the research aimed to better understand economic and behavioral drivers. To this end, we related the firm specific indices to compliance scores and analyzed the emerging correlations.

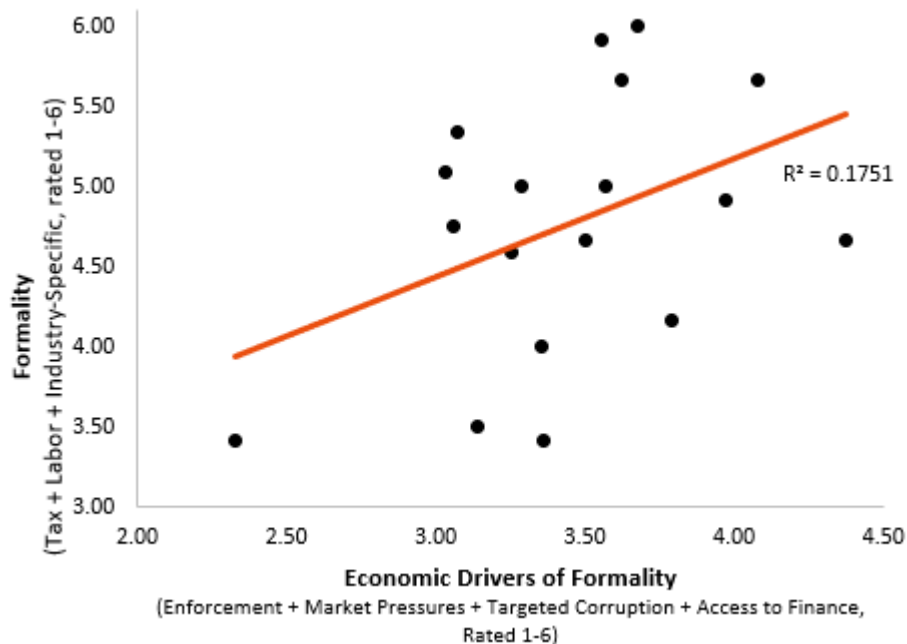
The Economic Drivers

Mapping the sample of 18 firms by their aggregate index of all Economic Drivers versus their aggregate score of Formality (combined tax, labor, and industry-specific compliance) reveals a weak positive relationship (Figure 15). This means that, on average, the more Ugandan agribusinesses feel economically incentivized to comply, the more they will behave formally.

However, dissecting the index of total economic drivers into its subcomponents shows a more nuanced picture. Figures 16 to 18 demonstrate that among our sample of 18 firms, those who perceive to be more exposed to tax enforcement are, on average, more tax compliant. Similarly, industry-specific formality is also positively related with industry-specific enforcement. In contrast, labor compliance is seemingly unrelated with labor enforcement.

Seeking competitiveness on price does not seem related with formality levels (figure 19). Involvement with corruption exhibits an unexpected inverse U relationship with formality (figure 17). Firms that claim to be least and most involved with corruption are very informal, and those that act moderately corrupt are most formal. The desire to access finance is strongly related to formality (figure 18)

**FIGURE 15
TOTAL FORMALITY VS. TOTAL ECONOMIC DRIVERS**



DISSECTING FORMALITY AND ENFORCEMENT

FIGURE 16
TAX FORMALITY VS. TAX ENFORCEMENT

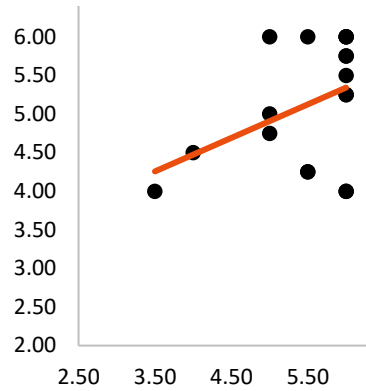


FIGURE 17
LABOR FORMALITY VS. LABOR ENFORCEMENT

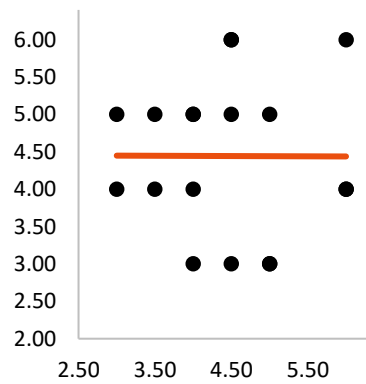
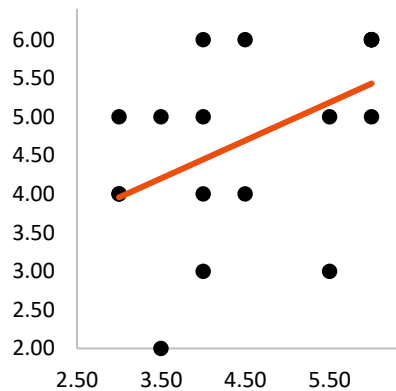
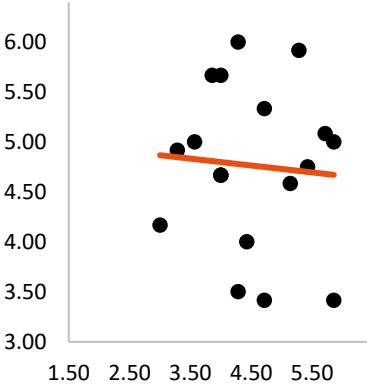


FIGURE 18
IND.-SPEC. FORMALITY VS. IND.-SPEC. ENFORCEMENT

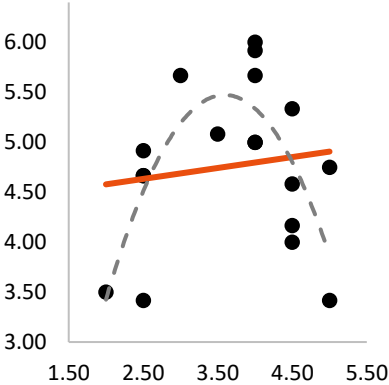


DISSECTING MARKET, CORRUPTION AND FINANCIAL PRESSURES

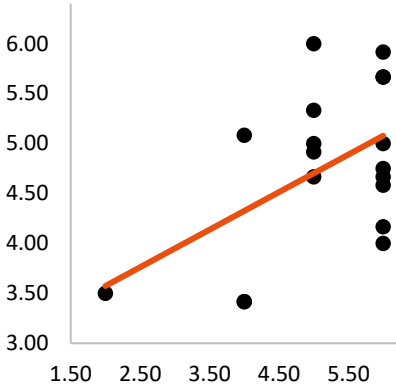
**FIGURE 19
TOTAL FORMALITY VS. MARKET PRESSURES**



**FIGURE 20
TOTAL FORMALITY VS. TARGETED CORRUPTION**



**FIGURE 21
TOTAL FORMALITY VS. ACCESS TO FINANCE**



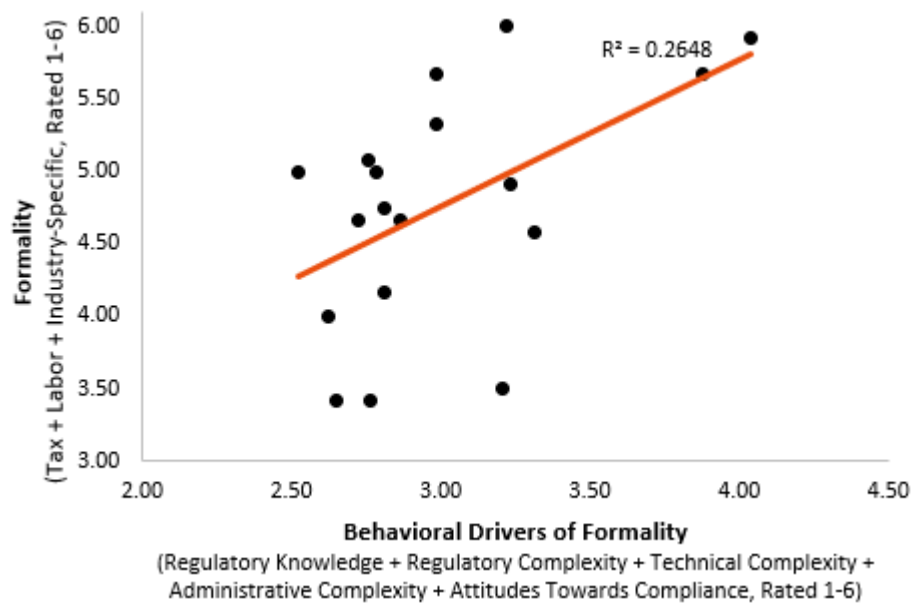
These results offer an indication that financial access, exposure to corruption and enforcement of laws (apart from labor laws) play a role in firm compliance decision-making in the context of Ugandan agriculture.

The Behavioral Drivers

Mapping our sample by their aggregate index of all Behavioral Drivers versus their aggregate formality score (combined tax, labor, and industry-specific compliance) reveals a strong positive relationship (figure 22). Furthermore, we find that all subcomponents of the index exhibit a positive relationship with formality levels.

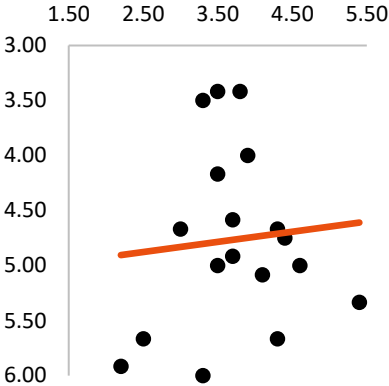
The data indicates that firms with differing perceived complexity of complying with tax labor and industry specific laws vary in their formality. Figures 24 and 25 specify that compliance processes' technical and administrative complexities are strongly related to formality. In contrast, no clear relationship is found between the inherent complexity of legal texts and formality (figure 23). The degree of knowledge on rules and regulations is positively related to formality (Figure 26). Most discernible of all behavioral relationships is that of attitudinal drivers. Firms' trust in government, public figures, and the social contract is strongly related with formality levels.

FIGURE 22
TOTAL FORMALITY VS. TOTAL BEHAVIOR DRIVERS

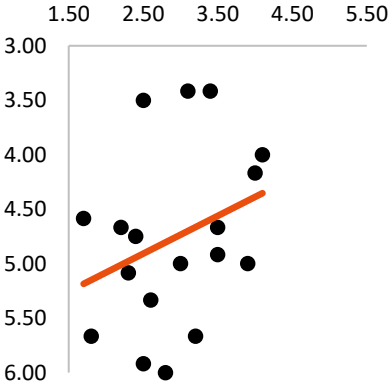


DISSECTING COMPLIANCE AND COMPLEXITY

**FIGURE 23
TOTAL FORMALITY VS. REGULATORY COMPLEXITY**



**FIGURE 24
TOTAL FORMALITY VS. TECHNICAL COMPLEXITY**



**FIGURE 25
TOTAL FORMALITY VS. ADMINISTRATIVE COMPLEXITY**

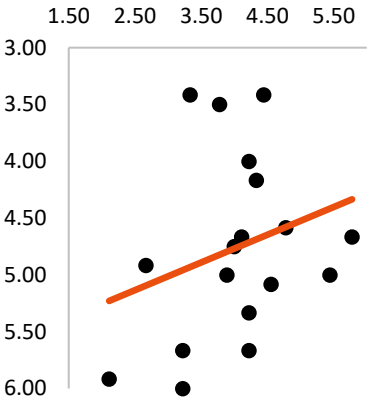


FIGURE 26
TOTAL FORMALITY VS. REGULATORY KNOWLEDGE

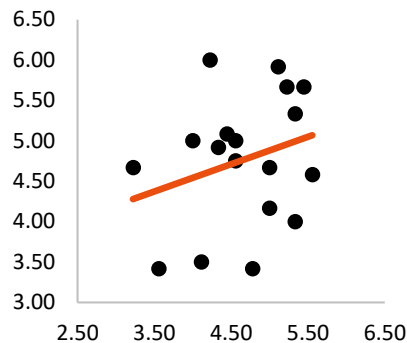
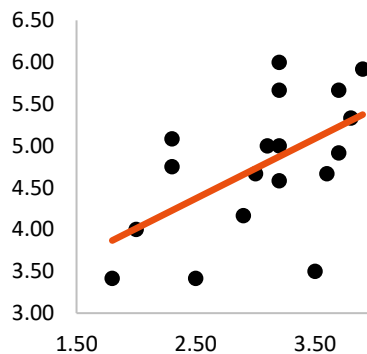


FIGURE 27
TOTAL FORMALITY VS. ATTITUDES



These results prove that the behavioral dimensions of complexity, knowledge and attitudes about compliance are important factors in Ugandan agricultural firms' decision-making to be more (in)formal.

FURTHER RESEARCH

The research so far has led to the conclusion that there is enough evidence to warrant a further development of the concept of IBP.

The field study in Uganda had several significant limitations. Firstly, this study's small sample size and non-random sampling method raised concerns about potential bias and non-representativeness. Secondly, due to the sensitive nature of the subject matter, there was a risk of social desirability bias despite the implementation of multiple measures to ensure confidentiality. Thirdly, the potential for contagion bias existed as some firms may have communicated with one another and were prepared to respond to specific questions. Fourthly, using Likert scales to quantify formality levels, limited the analysis to relative differences between firms and makes it difficult to make absolute comparisons. Fifthly, the construction of aggregate indices as unweighted averages may have obscured or amplified certain subcomponents in the aggregate analysis. Sixthly, the relationships that we found offered no definite conclusion on the direction of causality. Finally, perhaps most importantly, the field study was not multivariate. It assumed no omitted variable bias and non-interaction in behavioral, economic and formality indices.

The field study did confirm to the research team at MSM that quantitative research, based on the economic theory of IBP, is possible but that the methodology needs to be improved. What is now needed is

to further refine the theory of IBP by differentiation per group of countries and sectors and by better understanding specific elements of IBP, such as:

- 1) cause and effect of the occurrence of IBP in the relationship between a business and the government and between competitors;
- 2) Prevalence of the economic or behavioral theory of IBP in specific contexts;
- 3) Quantitative evidence of the significance of IBP for the (financial) performance of a business.

To obtain a sufficient response, we are thinking of a much larger survey among at least 1000 SMEs worldwide. The findings will be validated by interviews with many players around the firm, such as government oversight bodies such as the Food and Drugs authorities, Customs and Tax authorities, legal and accounting firms, trade unions, and others.

It is hoped that we can collaborate with a large accounting firm to get access to anonymized financial data and that the participating SMEs permit us to access their financial and corporate data. Suppose the worldwide survey doesn't produce enough response. In that case, we will focus on a limited number of case studies in a few countries in the Global South, where MSM has partnerships with local academic institutions and use their contacts with businesses.

This should lead to a comprehensive publication regarding IBP in 2025.

ENDNOTES

1. 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.
2. 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.
3. <https://archive.doingbusiness.org/en/doingbusiness>
4. <https://www.enterprisesurveys.org/en/enterprisesurveys>
5. <https://www.enterprisesurveys.org/en/informal-businesses>
6. <https://www.pum.nl/en>

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