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UNDERSTANDING THE FIRM IN THE INFORMAL ECONOMY: A RESEARCH AGENDA

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Abstract: Informal firms prevail and preoccupy a dominant share of the economic activity in many developing countries. Yet, few attempts have been made to systematically integrate dominant theories of the firm with the empirical importance of informal enterprises. The purpose of this paper is to review established theories of the informal economy and the firm, and to explore potential for cross-fertilization to better understand the nature of the firm in the informal economy. We seek to convey two basic points: First, as informal economy firms vary in form, structure, and strategies, a systematic inquiry of their heterogeneous and idiosyncratic nature is warranted. Second, significant opportunities for future development research reside at the interface between existing theoretical explanations of the informal economy (dualistic, structuralist legal, and voluntarist theories) and dominant theories of the firm (contractual and competence theories). We discuss in detail three main themes for future development research seeking to understand informal economy firms: (i) Contract mechanisms and enforcement; (ii) Learning strategies; and (iii) Resource and capability development.

Keywords: Informal economy, theories of the firm, theories of informality, research agenda.

INTRODUCTION

A car hire firm in Lagos, Nigeria, owns six cars registered on the Uber network. It employs six drivers who are verified by Uber and meet the basic requirements (i.e., have valid driver's license and personal tax identification number and bank account). The firm is not registered in the national business registry and has no license, which implies that the firm has no legal redress in the formal system. The six drivers do not receive social security contributions or health insurance, but the firm does provide a car to each driver with an agreement to return a weekly profit of about 80 USD. The agreement with the drivers is verbal and purely trust-based. Each driver manages his own rides, costs, customers, and his weekly salary is the excess above the agreed 80 USD.

A hardware firm is registered at the Nakuru county municipal council, Kenya, and has a trading license that is paid bi-annually. The owner hires his three younger brothers as employees in the shop. All employees live in the room behind the shop. The brothers do not demand for employment contracts but are strict on late salary payments. Due to late payments, some of the firm's suppliers have stopped supplying. In the past, determining the profit was problematic since the firm did not keep updated financial records. Today, one brother tracks transactions in an app and hopes to resolve the financial conflict going forward.

A restaurant in Kampala, Uganda, famous for its extensive local cuisine, received its license from the state authorities to operate. The authorities estimated that the restaurant has an annual turnover above 40,000 USD and registered the restaurant to remit value added tax to the national tax authorities. Despite the high number of customers passing through every day, there is no written menu or prices. Waitresses know the menu by heart and the firm does not record any financial information. Only on a need basis does the firm issue receipts to customers. Given the variety in food prepared, the restaurant procures from several suppliers, including several family and friends who supply food from their gardens. Payments to suppliers are often made in kind.

A youthful hairdresser in Kampala started a mobile hair salon because she lacked the start-up capital to pay for rent and a license. The salon uses social media platforms to advertise the latest braided hairstyles to its customers. When the customers book appointments, the firm's proprietor distributes tasks to its four employees. She matches the employee and client based on skill for style, language/culture of the client, and proximity to the client. Braiding takes place at the client's premises and clients pay by cash or through mobile money. If a client refuses to pay or mistreats the employee, it is common practice to register a loss with no hope for a legal redress. The firm only pays taxes on income from mobile transactions. The salon has monthly sales between 1,000 - 1,500 USD.

As the opening vignettes[1] suggest, the societal presence and impact of the informal economy in developing countries are inescapable. A recent report from the International Labor Organization

[1] All vignettes are based on existing informal firms in Nigeria, Kenya, and Uganda, and were encountered by one of the authors on field research over the years.

finds that 67% of the total work force in North Africa are employed in the informal economy, 89% in Sub-Saharan Africa, 53% in Latin America and the Caribbean, and 68% in Asia and the Pacific (ILO, 2018). Similarly, a study from the International Monetary Fund (IMF) finds that the informal economy account for 15% of GDP in advanced economies and as much as 39% in low-income countries (Medina & Schneider, 2018). In particular, informal economic activity is more prevalent in areas of widespread poverty (Banerjee & Duflo, 2007), and in states with dysfunctional institutions and infringed social systems (de Laiglesia & Jütting, 2009; Meagher, 2018).

While the concept of the informal economy has been questioned due to its analytical vagueness and normative predisposition (Portes & Haller, 2005), there seems to be an agreement that informal economic activities encompass "*those actions of economic agents that fail to adhere to the established institutional rules or are denied their protection*" (Feige, 1990: 990). In this paper, we focus specifically on the concept of the firm in the informal economy.[2] We define informal economy firms as organizational entities that transform bundles of commodities into marketable output (Milgrom & Roberts, 1988) but operate outside the reach of different levels and mechanisms of official governance (Guha-Khasnobis et al., 2006). Importantly, while much research has been devoted to explain the existence and prevalence of informal economic activity in developing countries (Amin & Islam, 2015; Chen, 2012; Godfrey, 2011; Williams et al., 2016), our knowledge of the nature of informal economy firms and its inner workings is still limited. According to Godfrey (2011: 270), "*Informal economic arrangements represent a dominant form of exchange for many of the world's peoples and, depending on how one defines informality, may be the dominant model of economic organization*." However, extant research on the informal

[2] In this respect, we explicitly eliminate two types of informal economic activity from our discussions: domestic work and criminal economic activity. Thus, the main focus of this paper is firm activities that are considered legitimate from an informal institutional perspective, but illegal from a formal institutional perspective (Webb et al., 2009).

economy tends to treat the firm as a rather vague and homogenous entity without a clearly defined form or function. Despite significant variation in aspects such as firm size, approaches to licensing and registration, and the handling of transactions, contract enforcement, and conflict resolution (as indicated in the vignettes above), there is a tendency to ignore the heterogeneity amongst firms operating in the informal economy.

The purpose of this paper is to explore potential for cross-fertilization of established theories of the informal economy and dominant theories of the firm. In doing so, we adopt an integrative literature review approach (Snyder, 2019). Integrative literature reviews are recommended when the purpose of the research is to assess and synthesize literatures on mature topics (i.e., the firm and the informal economy) (Torraco, 2005). Our review attempts to bring apparently disparate concerns of the topic of informality under the conceptual framing of management research to raise questions about points of convergence and departure (Gross, 1998).

We suggest that future development research seeking to understand the dynamics of the informal economy may benefit from placing analytical focus on the firm as a central unit of analysis. Seeing that informal economy firms provide a substantial safety net for up to half of the labor force in the poorest economies (Banerjee & Duflo, 2007), research that increases our knowledge on the nature and processes of these firms will carry important implications for efficient private sector development initiatives. Accordingly, we build on previous research that emphasizes the unexploited potential for extending management research into the realm of the informal economy (Bruton et al., 2012; Darbi et al., 2016; Galdino et al., 2018; Godfrey, 2011; Kiggundu & Pal, 2018; McGahan, 2012), and contribute by connecting established theories of the informal economy to dominant theories of the firm.

We proceed as follows: We start by briefly outlining established theories of the informal economy and theories of the firm. Next, we discuss three main themes that reside at the interface between theories of informality and the firm. Finally, we conclude by outlining a new research agenda on the firm in the informal economy.

THEORETICAL BACKGROUND

The informal economy has been subject to research in a wide range of fields, including anthropology (Hart, 1973), economics (e.g., La Porta & Shleifer, 2008), entrepreneurship (Williams and Nadin, 2010), and sociology (Castells & Portes, 1989). While theories on the existence and prevalence of informal economic activity have been reviewed extensively elsewhere (Chen, 2012; Darbi et al., 2018; Distinguin et al., 2016; Amin and Okou, 2020), we will in the following briefly outline four key perspectives that are partcularly pertinent to understand the firm in the informal economy.

First, an often-used explanation for the existence and prevalence of informal economic activity is embedded in the modernization thesis and most notably Nobel Laureate Lewis' (1954) work on the dual economy. In the 'dualist perspective', firms operating in the formal and informal economy are seen as serving different markets and customers. Besides providing an 'infinite' amount of labor to the modern economy, this view holds that there are very few commonalities between the two sectors, which results in dual or parallel economies. Accordingly, informal agents are generally considered inefficient due to workers and entrepreneurs with lower human capital and limited access to risk capital who are therefore not able to compete with formal firms on price or quality (La Porta & Shleifer, 2008).

Another important theory of informality is the 'structuralist perspective', which emphasizes how the informal economy became poor, underdeveloped, and structurally disadvantaged compared to the rich and developed formal economy (Castells & Portes, 1989; Fortuna & Prates, 1989). This perspective views the informal firms as locked in the persistence of an inequitable world system exploited by the formal economy. Since informal firms are left with no other option than to remain small, they suffer from low productivity (Pratap & Quintin, 2006), and thus create market distortions which hampers general economic growth and development.

A third theory of informality, referred to as the 'property rights perspective', highlights the role of the state in creating the legal context that defines membership and migration within the informal economy (Becker, 2004; DeSoto, 2000), claiming that *"cleavages are not structural, but legal, bureaucratic, of state making"* (Annis & Franks, 1989: 10). Proponents of this perspective argue that firms in the informal economy have the potential to grow big and be productive but are restrained by government regulations and, for instance, poorly protected property rights regimes. The costs of bureaucracy and registration prevent informal firms from unleashing their potential and are therefore refrained from reaping the same resources (such as capital and protection) as their formal counterparts.

A final and more recent theory of informality is the 'voluntary perspective' which views informality as a deliberate agent-based strategy (Maloney, 1999; 2004). In this view, the informal economy is comprised of voluntary entrepreneurial actors with relatively high marginal returns to capital. Hence, informal (self-) employment may actually offer more control and autonomy than a formal job. Related research has viewed informality as a lifestyle choice by social actors aiming for greater freedom, flexibility, and control over their lives (Williams & Youssef, 2015; Williams and Gurtoo, 2012).

The other broad set of theories underlying our review relate to understanding why firms exist, how they are organized, and why some firms are more competitive than others (for extensive literature reviews, see e.g., Zenger, Felin and Bigelow, 2011; Gibbons, 2005; Lockett, Thompson & Morgenstern, 2009). For the purpose of this paper, we focus on two strands of theoretical perspectives that, in different ways, touch upon these questions: the ‘contractual perspective’ and the ‘competence perspective’ (see also Maskell, 2001).

The ‘contractual perspective’ seeks to explain the nature of the firm as embedded in a contractual understanding of economic exchange. Based on the seminal work of Nobel Laureate Ronald Coase (1937), this view suggests that firms exist because it is more effective to internalize costs such as search, information, bargaining, decisions, policing, and enforcement instead of using high market rates. For example, the firm is regarded as an elaborate mechanism for aligning incentives and deploying resources in a cost-efficient way by writing of contracts with employees and other asset owners (Jensen and Meckling, 1976). Related research incorporates the notion that decision makers suffer from ‘bounded rationality’ (Simon, 1956) which gives rise to incomplete contracts and the risk of opportunistic behavior that requires safeguarding in the form of special contract arrangements. Accordingly, ‘the boundaries of the firm’ are determined by decisions on how to effectively organize economic activity, which, in turn, is based on the productive capabilities of economic agents and the costs of maintaining, coordinating and managing conflicts between these agents. Prominent theories of economic organization, including transaction cost economics (Williamson, 1975, 1985), property rights (Grossman & Hart, 1986), and the problem-solving perspective (Nickerson & Zenger, 2004), address how certain governance decisions mitigate coordination and exchange hazards.

The other strand of theoretical perspectives, the ‘competence perspective’, ascribes firm existence to the competences and knowledge owned and controlled by the firm. Specifically, it is argued that with the right mixture of heterogeneous access and control of central assets of competences and knowledge, firms can gain competitiveness in the market, which allows them to carry out their activities in ways that the competitors cannot do as well, as rapidly, or as cheaply (Barney, 1991; Nelson & Winter, 1977). The 'competence perspective' thus sees the firm as an assembly of heterogeneous assets under a common direction leading to a stream of valuable products or services (Wernerfelt, 1984).

Competence theories such as the resource-based view (Argyres, 1996; Barney, 1991), the knowledge-based view (Grant, 1996), and learning perspectives (Mayer & Argyres, 2004) explore how firms can acquire, accumulate, control, and nurture resources and competences to contribute to a firm's success on the market. For instance, the resource-based view of the firm assumes that there are initial differences in the distribution of productive capabilities across firms due to factors such as luck (Barney, 1986), non-tradable resources (Peteraf, 1993), or unique founding conditions (Cockburn, Henderson, & Stern, 2000). Learning perspectives highlight that firms are more competitive when they learn to operate in volatile environments (Mayer & Argyres, 2004), but that the learning process within and between organizations tends to be slow and gradual (Levitt & March, 1988). Since fast learning of new routines tends to improve the organization's efficiency (Herriott et al., 1985), slow learning firms in the market will typically underperform.

A RESEARCH AGENDA ON THE INFORMAL ECONOMY FIRM

The theories of informality and the theories of the firm have largely been developed in parallel. We argue that significant opportunities for future research lie at the interface of these theories. In our literature review, we identified three main themes that are particularly relevant for future development research seeking to understand the informal economy firm: (i) Contract mechanisms and enforcement; (ii) Learning strategies; and (iii) Resource and capability development. While these themes do not comprise an exhaustive list of potential areas of research to explore (see Table

1 for a more complete overview of potential research questions), we argue that they carry important implications for the current use and understanding of theories of the firm while at the same time enhancing our knowledge of the nature of the informal firm.

---*Insert Table 1 about here*---

Contract mechanisms and enforcement in informal firms

The vignette about the hardware firm (where the owner employs his brothers and provides them with free accommodation but fails to pay their salary on time) illustrates reciprocity in transaction costs in an informal context. The restaurant owner paying suppliers (family and friends) in kind with no contract shows how a high level of trust may replace formalized governance mechanisms. And the salon owner and the drivers working for the car hire firm will expect (and enforce) payments from clients based on moral or community norms instead of on formal contractual terms and conditions.

While contractual theories generally assume the legal protection of contracts as essential to the existence of the firm, we propose that a focus on the boundaries of the firm raises several important research questions to understand the nature of the informal economy firm. For example, although firms in the informal economy may not write formal contracts to deal with relationships with suppliers and partners and rather rely on social contracts (London & Hart, 2004), they do face the problems of guarding against shirking, opportunistic behavior, and managing agency problems such as aligning incentives in similar ways to formal firms (Alchian & Demsetz, 1972; Foss & Weber, 2016). Therefore, an obvious but important question relates to understanding how (social) contracts (or informal agreements) are enforced in contexts where formal, regulatory institutions are ambiguous or non-existing. In particular, while it may be inaccurate to consider the informal economy firm a nexus of legally valid contracts (Jensen & Meckling, 1976), a simple dichotomous view of the informal economy stripped from any legal protection is also misleading. For example, a firm may be seen as a nexus of informal agreements and expectations between the stakeholders (internal and external) of the firm.

In this respect, it is important to acknowledge that informal economy firms operating in weak formal institutional contexts often replace the law with these informal substitutes (McMillan & Woodruff, 2002; Murphy, 2002). As these are conventionally more embedded in local communities than in formal institutions (Darbi & Knott, 2016; Rothenberg et al., 2016; Tröger et al., 2018), they tend to rely substantially more on social trust (Murphy, 2002) and informal reputational mechanisms (MacLeod, 2007) to increase collaborative efficiency (Mcdade & Malecki, 1997). Informal communities possess an inherent belief that all members behave honestly and reliably (Tröger et al., 2018). Therefore, informal firms are to a larger extent protected against risks of detection by legal enforcement authorities and malfeasance by buyers and suppliers through social trust, solidarity, and reputation afforded by the community (Ojo, Nwankwo, & Gbadamosi, 2013). Operating within this enclave of protection facilitates the flexibility of transactions and fosters firm development (Portes & Haller, 2005). Moreover, to survive or grow, informal firms may need to harness social trust since it lubricates economic exchange, like obtaining finance (Khavul, 2010) and enforcing financing agreements (Bruton et al., 2012).

However, although social trust enhances economic efficiency (Fafchamps, 2006) and breeds a strong support base for informal firms (Murphy, 2002), it is insufficient in itself to boost productivity (Farrell, 2004). Informal firms that want to increase economic gain will therefore typically exit these social enclaves, and expand outside their local community (Meagher, 2005). Yet, as firms operate outside their community, they risk increasing the cost of establishing and maintaining interpersonal links (Fafchamps & Gubert, 2007) and face difficulties building new trust relationships (Hodosi, 2015). Moreover, increased interaction with a diverse set of actors may force firms to adjust customary relational mechanisms (Levenson & Maloney, 1998).

To understand the strategies and boundaries of informal firms, it is therefore important to recognize that transactions are often governed by a combination of formal and informal (relational governance) contracts (Mike & Kiss, 2019; Poppo & Zenger, 2002). While formal contracts are documented and enforced by formal institutions, informal contracts are based on implicit understandings that are inaccessible through written documents or sanctioned in the formal hierarchy (Zaheer and Venkatraman, 1995). Relational governance, often complementing formal contracts (Poppo & Zenger, 2002; Macleod, 2007), facilitates exchange and cooperation based on norms and reciprocal obligations that supersede initial contract clauses and reduce the costs of going through the legal system (if present) (Arranz & de Arroyabe, 2012; Zenger, Lazzarini, & Poppo, 2002). As customized contracts increase in complexity, managers increase their use of relational governance and vice versa (Williamson, 1979), thereby increasing efficiency and reducing enforcement costs by relying on bilateral or community enforcement instead of having to go through formal courts of law (MacLeod, 2007).

Importantly, relational governance mechanisms are vital for efficient contracting and enforcement in both formal and informal firms (Liu et al., 2017; MacLeod 2007; Murphy, 2002; Poppo & Zenger, 2002). Existing theories of the firm explain that relational governance mechanisms operate as complements and substitutes in transactions (Liu, Luo, & Liu, 2009; Poppo & Zenger, 2002) and have direct effects on performance (Liu et al., 2009). Although implicit, an underlying assumption is that governance mechanisms are predominantly between economic agents and/or with institutions (Arranz & de Arroyabe, 2012). For the informal firm, relational governance mechanisms tend to dominate (not substitute or complement formal governance mechanisms) and involve more non-economic actors and institutions such as ethnic minority groups or religious groups (Hodosi, 2015; Ojo et al., 2013) whose economic and political influence does not necessarily have any direct association with firm performance (Arranz & de Arroyabe, 2012; Poppo & Zenger, 2002). However, since transactional mechanisms (relying on contracts) are conventionally assumed more effective at mitigating opportunism and malfeasance than relational mechanisms (relying on social trust), important questions relate to understanding how informal economy firms' strong reliance on non-economic actors impact their performance (Liu et al., 2009).

Accordingly, we suggest that there are several important questions at the interface of theories of the firm and theories of informality relating to understanding how (social) contracts (or informal agreements) are enforced in contexts where formal, regulatory institutions are ambiguous or non-existing. Research studying relational governance mechanisms in informal economy firms can advance existing theories of the firm by exploring under what circumstances relationships with non-economic actors become essential for economic performance, and when these relationships become detrimental. Future research seeking to understand the governance of informal economy firms will therefore benefit from a deeper inquiry into how informal relational contract mechanisms are harnessed.

If we consider the key theoretical perspectives on the informal economy, a number of concrete research opportunities emerge. From a dualist perspective on firm informality, important questions relate to the organizational arrangements of informal economy firms. For example, to what extent and in what ways do informal organizational arrangements resemble formal ones? And, to what extent does vertical integration take place among informal firms? A structuralist perspective of contracting and enforcement raises questions relating to, for instance, the protection of asset specific investments and the protection against agency problems, including what mechanisms informal firms employ to deal with opportunistic behavior within firms and/or value chains. For example: How can informal economy firms survive opportunistic behavior within value chains? A legalist perspective brings up interesting questions about informal governance exchange relationships and conflict resolution, such as community enforcement, social penalties (Portes & Haller, 2005) and reputational mechanism (MacLeod, 2007). For example: What kinds of conflicts are resolved within informal economy firms? How is contract enforcement organized as an alternative to or in the absence of (access to) formal arrangements? Finally, a voluntary perspective of contracting and enforcement raises interesting questions about firm level trade-offs to operate formally or informally bringing to light themes such as, the perceived costs of governing exchanges outside of the formal setting. This leads to questions like: Under what circumstances are informal contracts favored over formal contracts, and vice versa? And how do informal firms optimize this mix?

Learning strategies of informal firms

The opening vignettes also illustrate that informal economy firms employ different learning strategies to gain competitiveness. For instance, the hardware firm employee learned how to use apps to keep track of the firm's transactions. The car hire firm drivers adopted personalized techniques of finding and caring for customers to afford the weekly charges of their boss. And the salon owner used Facebook and WhatsApp to reach out to her clients, avoiding institutional costs, such as rent, licenses, and advertising.

As is established in the competence perspective, organizations must continually learn to gain a sustainable competitive advantage (Grant, 1996). Learning occurs through direct experience, through the experience of others, and the interpretation of compounded experiences in the environment. In many ways, organizational learning is viewed as *"routine-based, history-dependent, and target-oriented"* (Levitt & March, 1988 p. 319).

Prior research has shown that large and formal firms handle learning differently to small and informal firms (McCaig & Pavcnik, 2021; McKenzie & Woodruff, 2017; Spicer & Sadler-Smith, 2006). Differences in learning strategies between formal and informal firms become especially apparent when considering how informal firms have to learn to strategically manage the often challenging, uncertain, and constantly evolving institutional landscapes (Grimm et al., 2012; Meagher, 2018; Vaillant et al., 2014). Moreover, as informal economy firms face extreme resource constraints (Webb et al., 2013), it would be unrealistic to assume that informal firms exhibit the same learning strategies as formal firms.

Research shows how learning levels in informal firms are sometimes serendipitous (Mair, Marti, & Ventresca, 2012; Meagher, 2018) since the informal firm's interaction with multiple actors complicates learning processes (Ault & Spicer, 2020; Guha-Khasnobis, Kanbur, & Ostrom, 2006). Informal economy firms interact with both formal and informal institutions, but interactions with the former are more erratic and distressed than those with the latter, which are more conducive (Guha-Khasnobis et al., 2006; Harriss-White, 2010; Lyons, Brown, & Msoka, 2014). Although relationships with informal institutions may be smooth by offering regular, inexpensive, and swift interactions, these relationships do not translate into a competitive advantage, since competitors can easily learn and understand them (Mair et al., 2012; Webb, Khoury, & Hitt, 2020). Moreover, even though there is collective learning (Kingsley & Malecki, 2004; Murphy, 2002) and efficiency (Schmitz, 1995) in maintaining relationships with informal institutions, Kingsley and Malecki (2002) posit that *"firms will learn little, change little, and innovate in an incremental fashion"*

(Kingsley & Malecki, 2002: 74). Hence, smooth and efficient relationships with informal institutions does not necessarily offer a competitive edge over other firms (formal or informal).

To become competitive, informal economy firms thus need to learn what others cannot easily imitate, implying that informal firms must build novel, unique, and unprecedented routines (Krasniqi & Williams, 2020). Especially considering the volatility of informal environments, research suggests that informal firms must adopt agile learning strategies (Monteith, 2016). The volatility, irregularity, and temporality facing informal economy firms often translates into chaotic, unstructured, and unpredictable firm responses. Iriyama et al. (2016) argue that informal economy firms may have a competitive advantage vis-à-vis formal firms precisely because of their ability to operate more quickly and at a lower cost when faced with uncertainty and ambiguity. Informal firms are well versed in navigating volatile environments as well as defying (formal) institutions such as fees and regulations (Uzo and Mair 2014).

Research also suggest that learning in informal economy firms happens through cultural, social, and familial relationships (Khavul & Bruton, 2009) such as traditional apprenticeship programs (Basole, 2016; Igwe et al, 2018; ILO 2020) and socialization processes (Singh, 2000). Moreover, informal firm learning often takes place through imitation (Bu & Cuervo-Cazurra, 2020), trial and error (Darbi & Knott, 2016), and through indigenous or local knowledge management systems (Uzo & Mair, 2014). It is thus argued that in order to build routines and strategies that facilitate their competitiveness (Krasniqi & Williams, 2020), informal economy firms need to internalize learning from the socio-economic fabric they inhabit (Schmitz, 1995; Uzo & Mair, 2014).

Hence, an inquiry into informal firms' learning techniques would provide important insights to better understand strategic and operational dynamics within informal firms, raising questions related to, for instance, whether these firms systematize (e.g., document) learning strategies and the more general consequences of these strategies (e.g., updated routines, new products/markets, performance consequences, etc.). When we consider the key theoretical perspectives on the informal economy a number of opportunities for future research on learning become visible. From a dualist perspective, important questions relate to understanding whether and how much learning takes place through interactions with formal and/or informal firms. Taking a structuralist perspective on firm informality, important questions include: How does learning take place in situations where informal firms are part of a value chain? What strategies are adopted to take advantage of learning opportunities that lie within the chain? A legalist perspective raises interesting questions regarding how learning takes place when navigating challenging institutional environments, such as: How does operating in volatile and/or ambiguous institutional environments result in firm-level opportunities for learning? Finally, a voluntary perspective of learning strategies raises questions that explore the strategic competitive advantages derived from deliberately operating informally, leading to questions such as: What (implicit, explicit) learning strategies do informal economy firms adopt to take advantage of challenging institutional environments?

Resource and capability development in informal firms

Finally, the vignettes illustrate the importance of informal economy firms' resources bundles and capability development. For instance, the hardware firm employee shows personal initiative when utilising a transaction tracking app to resolve the bookkeeping challenge. The restaurant owner's unique capability is a local cuisine and she uses her family resources to ensure efficiency in supply. And the salon owner assigns her staff to clients based on skill and language capabilities to ensure that work processes are more efficient.

The relevance of resource and capabilities development for studying informal economy firms becomes particularly apparent when considering the unique resources that informal firms possess, acquire, develop, and leverage to exploit opportunities in resource-constrained environments (Webb et al., 2013). As Uzo & Mair (2014: 70) note, managing institutional ambiguity becomes "*a vital strategic capability for organizations operating at the intersection between the formal and informal economy*". These authors demonstrate that informal economy firms develop strategic capabilities as a coping mechanism to operate in contexts with limited access to formal institutions. Considering that firm capabilities are context specific and not all capabilities contribute to firm performance in the same magnitude (Ethiraj et al., 2005), it is important to understand how firms manage heterogeneous bundles of resources to satisfy the firms' desire to ensure continued growth and sustained competitiveness (Jacobides & Hitt, 2005). Therefore, a number of relevant areas of research open up when applied to informal economy firms as they need to configure resources and capabilities in response to their changing environment (Teece, 2018; Teece et al., 1997).

To build capabilities, informal economy firms are more inclined to invest in informal institutions, such as social relationships, and less in market research as their formal counterparts tend to do (Bruton et al., 2015; Darbi & Knott, 2016; Rothenberg et al., 2016). Instead, informal firms scan the market by relying on social relations, family networks, and their community embeddedness (Bruton, Nuhu, & Qian, 2021; Bruton, Sutter, & Lenz, 2021). Therefore, social identity and belonging to the community are key resources for informal economy firms (Dungy & Ndofor, 2019). Besides, informal institutions, such as religion, ethnic, and cultural norms, have a significant influence on decision-making. Informal economy firms tend to rely on local knowledge rather than rational logic to resolve issues and challenges (Godfrey, 2011; Ketchen et al., 2014;

Namatovu et al., 2018; Uzo & Mair, 2014). While these informal institutions reduce the costs of building capabilities in the short term, their underlying demands may impede performance in the long run (Khayesi, George, & Antonakis, 2014; Webb, Khoury, & Hitt, 2020).

Relatedly, seizing capabilities requires firms to make decisions about product portfolios, technology, and human resources. However, due to their transient nature, informal economy firms may be less inclined to invest in these capabilities (Verbrugge, 2015). Although informal firms are often seasonal or temporary ventures or a stepping-stone for more established enterprises (Bennett, 2010), long-standing informal economy firms will need to develop capabilities to orchestrate the right resources for optimal business models. Their performance depends on their capability to assimilate and maintain asymmetric resources over time (Lee & Hung, 2014; Ren et al., 2016). Moreover, informal economy firms need capabilities to face challenging regulatory frameworks and stressful periods of regulatory enforcement to maintain their market position (Lee & Hung, 2014). More research exploring the nature of resources and capabilities that matter for the performance and competitiveness of informal economy firms and the investment required to maintain these resources and capabilities is therefore important.

Accordingly, a number of research questions emerge when assuming that competitive advantage among informal economy firms is achieved through relation-specific assets, knowledge-sharing routines, complementary resources, and effective governance (Dyer & Singh, 1998; Dyer, Singh, & Hesterly, 2018). In particular, from a dualistic perspective, interesting questions relate to make-or-buy decisions when exchange relationships are limited to firms operating in the informal economy, such as: How do informal firms, limited to the bounds of the informal economy, choose between developing capabilities in-house or contracting it externally? From a structuralist perspective, important questions relate to understanding competitive advantage when linked up with formal firms (e.g., in value chain relationships). For instance: How do informal firms derive competitive advantage from sharing their unique assets (e.g. informal institutional knowledge, networks) with formal (lead) firms? A legalist perspective brings up questions about resource and capability development (e.g., traditional credit and trust systems) in contexts of institutional deficit, such as: How do informal firms gain resource-based competitive advantage when formal institutional support is lacking? How do firms remain competitive when sensing the markets using informal institutions? And finally, resource and capability development from a voluntarist perspective raises questions about the trade-offs of which activities to organize formally and which informally, such as: How do informal economy firms optimize informal and formal knowledge? What knowledge management mechanisms are used? And to what extent do trade-off efforts lead to competitive advantage?

DISCUSSION AND CONCLUSION

Because of the sheer size and significance of the informal economy, especially in contexts where poverty prevails, there is a need to better understand the challenges and opportunities that firms in the informal economy encounter. Moreover, there are vast differences in the degree and nature of informality of firms operating in the informal economy. Due to this heterogeneity it would be impossible to outline a single policy intervention that can target all informally operating firms, let alone the informal economy at large (Blunch, Canagarajah, & Raju, 2001). Understanding the heterogeneity of informal firms is crucial in current times where policy on informal economy firms is shifting. While policy approaches to informality were formerly geared towards deterrence, control, and eradication (Lyon, Sepulveda, & Syrett, 2007) the global financial crisis inspired a new wave of policy options that integrate the social, fiscal, and political economy (Meagher & Lindell, 2013). Yet, lessons from policy processes indicate that no single institutional set-up works in diverse policy areas and neither does copying policies from one context to another. (Meagher, 2018). To contribute to sound policymaking on informal economic activity, this paper calls for research that sheds light on the heterogeneity of informal economy firms.

We argue that analyzing the nature and dynamics of informal economy firms is imperative to understanding the causes and consequences of informality. In this paper, we have discussed three specific themes that we argue are particularly important to understanding informal firm activity in developing economies. Obviously, we acknowledge that theories of the firm and theories of informality bear a certain degree of incommensurability. For example, within the dual economy perspective (Boeke, 1953; Lewis, 1954), it is argued that informal economy firms are generally more inefficient than their formal counterparts due to a comparably lower degree of human capital and access to risk capital. According to this perspective, informal and formal firms may thus be seen as "*very different animals*" (La Porta & Shleifer, 2008: 344). Moreover, the structural perspective (Castells & Portes, 1989) suggests that firms are kept small by the exploitative nature of formal firms and global capitalism more broadly. Due to power asymmetry and unequal bargaining power, informal economy firms have fewer opportunities to develop their market shares in a globalized economy (Meagher, 2007). Arguably, both informal economy perspectives are also in stark contrast with, for instance, the competence perspective, which assumes that it is within the nature of firms to build, acquire, and combine competencies and hence obtain and sustain competitiveness in spite of structural challenges (Barney, 1991).

Moreover, theories within the contractual perspective largely hinge on assumptions of formal institutions supporting firm growth (such as property right protection) (Williamson, 1985) and their explanatory power in environments where formal institutions are absent or severely constrained might be limited. For example, the voluntarist perspective of the informal economy stipulates that firms often make trade-offs regarding which activities to organize formally and which informally, either as a rational economic decision (Maloney, 1999) or as a lifestyle decision aiming for greater freedom and flexibility (Williams & Gurtoo, 2012).

Notwithstanding, we have presented an avenue to better understand the relationship between informal firm dynamics and situated competence-based theory. For instance, we might expect learning strategies, resources, and capabilities conventionally studied in the management field to differ from those that can be observed in informal settings. Depending on sectoral focus within the informal economy, knowledge management and dynamic capabilities are likely to inform new learning patterns, resources, and capabilities. Relatedly, the significance of the plurality in learning, shaping informal firm dynamics might influence the broader firm boundaries of knowledge and resource management.

We believe that a closer scrutiny of the nature and dynamics of informal economy firms will advance our understanding of their heterogeneity, and thereby offer important input to policy discussion on how to create more conducive business environments and private sector development. It has been argued that *"despite their prevalence, we still know very little about informal organizations, such as how being informal affects firm performance."* (Assenova & Sorenson, 2017: 804). With this paper, we hope to inspire research that seeks to understand the nature of this dominant model of economic organization. Although the research avenues discussed above are not exhaustive, they do show that important progress can be made to arrive at an enhanced theoretical understanding of the informal economy firm.

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Table 1: Summary of research questions

Theories of the informal economy		Theories of the firm: *Contractual perspective*	Theories of the firm: *Competence perspective*
	Dualist perspective	The organizational arrangements of informal economy firms - between hierarchical firm structure and pure market exchange – e.g., hybrid organizational arrangements? • *To what extent does vertical integration take place among informal firms?* • *To what extent and in what ways do informal organizational arrangements resemble formal ones?* • *To what extent do hybrid arrangements act as temporary 'transitional phenomena'?*	Inter-organizational competitive advantage among informal firms – e.g., relation-specific assets, knowledge-sharing routines, complementary resources, effective governance. • *How is value jointly generated in informal-informal firm relationships?* • *How does learning take place through interactions with formal and/or informal firms?* • *How are rents preserved for informal economy firms' relationships to remain competitive? And under what circumstances does the value of rents wear off in informal economy firms' relationships?* • *How do informal firms, limited to the bounds of the informal economy, choose between developing capabilities in-house or contracting it externally?*
	Structuralist perspective	The governance of formal-informal firm relationships without the possibility of writing formal contracts - e.g., in global value chains. • *What do formal interactions imply for the protection of relationship-specific investments?* • *What mechanisms do informal firms employ to deal with opportunistic behavior in within-firm or within-value chain exchanges?* • *How can informal economy firms' survive opportunistic behavior within value chains?*	Competitive advantage from linking up to informal firms – e.g., tapping into their entrepreneurial energy, unique assets, networks, local embeddedness, indigenous/market knowledge. • *Which informal resources and competences are sought after by formal (lead) firms? Under what circumstances are these attractive (e.g., long term/short term investment, tacit knowledge)?* • *How does learning take place among informal economy firms that are linked up to value chains? To what extent do informal economy firms become competitive when they share their entrepreneurial energy, unique assets, and networks with formal firms?*
	Legal perspective	Informal governance of exchange relationships and property rights - e.g., community enforcement, third party enforcement, social penalties. • *What do informal economy firms resort to for conflict resolution?* • *How is contract enforcement organized in the informal economy as an alternative to and in the absence of (access to) formal arrangements?* • *What kinds of conflict are resolved within the informal economy firms?*	Resource and capability development in the context of institutional lack/deficit - e.g., traditional credit and trust systems. • *How do informal firms gain resource-based competitive advantage when formal resources and formal institutional support is lacking?* • *How does dealing with volatile and/or ambiguous institutional environments result in firm-level opportunities for learning? And what role does learning play in overcoming severe resource constraints? Can the unique social capital and market knowledge of informal economy firms protect these firms from ex-ante and ex-post opportunistic behavior (extortion) from formal firms?*
	Voluntarist perspective	Firm level trade-offs to operate informally - e.g., the perceived costs of governing exchanges outside the formal setting. • *Why do informal firms choose informal contracting when they have the option of drawing on formal contracts?* • *Under what circumstances do these firms choose for formal contract and when for informal contracts?* • *How do informal economy firms optimize the mix?*	Informality as a strategic competitive advantage - e.g., unique capability to maneuver strategically in ambiguous environments. • *Under what conditions does operating informally become a source of competitive advantage?* • *What (implicit, explicit) learning strategies do informal economy firms adopt to navigate challenging (volatile, ambiguous) institutional environments?* • *How does avoiding the costs of operating formally, or more broadly, institutional defiance, become a competitive advantage for informal firms? How does informality relate to valuable, rare, inimitable, and non-substitutable resources?* • *How do informal economy firms optimize informal and formal knowledge? What knowledge management mechanisms are used? And to what extent do trade-off efforts lead to competitive advantage?*