Informal Economy: Why First-Generation Entrepreneurs Prefer it over Formal Economy?

Devendra Jarwal  
Associate Professor, Motilal Nehru College  
University of Delhi, New Delhi, India  
https://orcid.org/0000-0001-8601-4187

Anju Kahal  
Associate Professor, Department of Commerce  
Motilal Nehru College, University of Delhi, New Delhi, India

Abstract  
Generally, there is a dominance of informal economy across all over the world economies and particularly in respect of first-generation entrepreneurs. We know that a formal economy is essential for comprehensive and inclusive economic development yet third world countries are mostly dominated by the prevalence of informal economy rendering slower economic growth. The present study determines the factors attracting or supporting first-generation entrepreneurs to operate under the informal economy and therefore, the objective of this study is to identify and examine such factors. The data was collected through the survey and to test the significance of variables of the hypothesis we have employed the chi-square test $\chi^2$. The study will help the policymakers to enhance the quantum of the formal economy and make suitable policies to discourage the informal economy. The findings of the study conclude that first-generation entrepreneurs do prefer the informal economy over the formal economy due to the various reasons predominantly cost efficiency in the informal sector, urbanisation based retail trade, easy entry and exit, low capital requirement, non-compliance of procedural laws, exclusive control in case of locally operated businesses, etc.

Keywords: Entrepreneurship, Formal Economy, Informal Economy, Chi-square test, Forms of Business Organisation

Introduction  
Employment opportunities are shrinking in India and consequently, unemployed youths are embracing small businesses for survival (Srivastava). The adoption of capitalistic policies leads to business opportunities but reduces jobs, as for the sake of cost-cutting, businesses opt for outsourcing instead of hiring employees (Spargo). This phenomenon is also known as vertical disintegration of the production chain (Holmes). The government is also incentivizing self-employment over jobs to achieve economic prosperity and regional development (Thakur and Ray). Therefore, unemployed youths have to start a business and for starting a business they must choose a proper form of business organisation. There are four types of popular forms of business organisation viz. sole-proprietorship, traditional partnership firms, limited liability partnership firms, and companies (Devi and Devaki). Each of these forms of business organisation has its merits and demerits. The first two i.e., sole-proprietorship and traditional partnership belong to the informal economy as largely these are unregistered bodies while the limited liability partnerships and companies belong to the formal economy as these bodies have legally registered existence of their own distinct from their owners.
Risk-taking is a basic trait of entrepreneurship and limited liability partnerships and companies offer cover for risk in the form of limited liability concept where personal assets of entrepreneurs would not be liable to pay the business debts (Jarwal). Despite this risk cover, the first-generation entrepreneurs prefer the informal economy route to start their entrepreneurial journey.

Stakeholders have different assumptions about the informal economy. For social scientists, it is the only means of survival for unemployed persons (Warren). For politicians, it is a cover-up for their failed policies as they cite it provides livelihood opportunities in lieu of structural employment (Coser). For consumers, it is an avenue for easy availability of cheap products (Kirchgässner). If we talk about the overall benefits as enjoyed by the matured economies, the formal economy is more beneficial for economic development as compared to the informal economy (Sobel and Postel). For entrepreneurs, the informal economy provides the easiest and simplest platform to start a business. For employees, the informal economy provides a wide range of employment opportunities even for those who could not compete or lacks skills to get a job in the formal economy.

A formal economy offers numerous benefits to entrepreneurs as well as to the nation. It provides expansion opportunities and robust legal protection to entrepreneurs. It offers a better consumer redressal mechanism to consumers as compared to the informal economy. It also offers stability and social protection to the employees. It generates data for the policymakers for planning and policy implementation. Players in the formal economy enjoy easy access to institutional financing. The facilitation of ease of doing business also indicates the ease of operation in the formal economy yet the preference of first-generation entrepreneurs towards the informal economy puzzles the administrators and policymakers to offer competitive substitutes of the formal economy to the entrepreneurs and thereby minimize the menaces of an informal economy.

**Literature review**

The informal economy is also known as ‘the irregular economy’, ‘the subterranean economy’, ‘the underground economy’, ‘the black economy’, and ‘the shadow economy’. The informal economy reflects an unrecorded sector not forming part of the official national accounting system. Firstly, the term ‘informal sector’ was used by the International Labour Organisation in its study on the urban labour market in Ghana (Hart). The term informal economy was later used to describe the dualistic economic structure prevailing in developing countries. Dualistic economic structure means the existence of mainstream formal economy and unofficial economy (Ercolani and Wei). Later researchers examined the status of dual structure in developed economies and its role in economic development.

Economic development links with the existence of a level of the formal and informal economy. Formalisation of the economy reflects in the development of the society and informal economy is correlated to the existence of poverty in the society (Casson et al.). Producers are focusing on the bottom of the pyramid, and in the process of cost-cutting to provide cheaper goods to the lower-income people they are restructuring the production process through outsourcing and subcontracting strategies. Therefore, due to the emergence of flexible outsourcing and subcontracting, new entrepreneurs are more likely to operate in the informal sector (Godfrey).

High compliance cost is restraining entrepreneurs from adopting formal economy. Each and every action of the formal sector units requires paper formalities and complex administrative procedures. The bureaucratic atmosphere has worsened the situation for new entrants to deal with the system. These cumbersome formalities coupled with lethargic
public service delivery outweigh the benefits of the formal economy and many end up working under the informal sector (Boza et al.). Though the desire to improve rankings in the ease of doing business index has led many countries to simplify the compliance procedures yet improvement in the ease of doing business rankings is certainly not reducing the size of the informal economy.

High taxation on formal sector units is also contributing to the exponential growth of the informal sector units. Due to recorded and traceable transactions, the incidence of taxation is higher in the formal sector as compared to the informal sector. Unrecorded activities in the informal economy facilitate the avoidance of taxation (Maiti and Bhattacharyya). Some studies suggest that there is no impact of taxation on the existence of formal or informal economy rather other factors outweigh the role of taxation (Stenkula). Institutional factors do influence the choice of the formal or informal economy rather than the incidence of high taxation (Williams). However, weak enforcement of the taxation on the informal economy does support it to flourish. Effective implementation of taxation and labour laws will make the informal economy less attractive (Webb et al.)

Some studies describe the disadvantages of the informal economy (Godfrey). Labour efficiency is much lower in the informal economy as compared to the formal economy. The prime reason for this inefficiency is the hiring of unskilled labour. But, still, it is good for unskilled people to get jobs who are otherwise not getting any opportunity in the formal sector. Of course, labour in the informal economy is being exploited with low wages and no social security (Leonard). These literature reviews largely described the existence of the informal economy and its pros and cons. The research question that seeks to explore various reasons responsible for the preference of first-generation entrepreneurs’ preference for informal over the formal economy has remained unanswered.

The preference of entrepreneurs towards informal economy is based on three theories, namely, institutional theory, motivation-related theories, and resource allocation theories (Webb et al.). Institutional context refers to the social, political, and legal framework facilitating entrepreneurship (North). The institutional theory establishes that the external factors influence the choices of entrepreneurs to operate within or outside the formal economy. Stringent compliances in the formal economy incentivise entrepreneurs to explore opportunities in the informal economy. Legal compliance becomes more difficult with the rapid changes in the policy framework consequently entrepreneurs tend to operate informally by circumventing legal compliance-related obligations and bureaucracy has also worsened the compliance framework. Other institutional factors facilitating informality are business-process outsourcing by the large scale industries, migration of rural population towards urban centres for seeking employment opportunities, adoption of free trade policies leading to uninterrupted import of cheap goods posing cost-cutting competition before the local goods (Portes and Sensenbrenner).

The motivational theory proposes that due to certain motivational factors, entrepreneurs tend to deviate from following societal norms and regulatory framework which eventually leads them to the informal economy (Robinson and Bennett). The forms of business organisation in the formal economy attract a higher rate of taxes as compared to unregistered forms of business organisation in the informal economy, thus entrepreneurs operate informally in order to avoid higher taxation (Alm et al.). If revenues and other benefits available in the formal economy are more than compliance cost and taxation then entrepreneurs will stay in the formal economy in the expectation of growth. But on the contrary, often entrepreneurs perceive the cost of operating in the informal economy as less than the cost incurred in the formal economy.

The resource allocation theory suggests that entrepreneurs have limited resources and for maximization of profits they would not be able to allocate resources for the costs associated with the formal economy therefore due to optimum rationalisation of their resources they prefer the informal economy (Gibbs et al.). According to resource allocation theory, entrepreneurs leverage family resources including borrowing money from relatives and employment of family members thus they prefer to operate informally.
All the above studies are based on extensive literature review and establishing propositions for future research. However, the present study is empirical research to determine the factors that are encouraging first-generation entrepreneurs to prefer informal economy over the formal economy.

**Hypothesis and Research Methodology**

Ho: $\rho = 0$ the first-generation entrepreneurs equally choose both sectors i.e. formal and informal economy to carry out their businesses

Ho: $\rho \neq 0$ the first-generation entrepreneurs prefer informal economy over the formal economy to carry out their businesses

To test the significance of variables of the hypothesis we have employed the chi-square test $\chi^2$. The probability of preferring a formal and informal economy is not based on the normal frequency distribution as the informal economy is dominant across all over the world economies. To illustrate statistically the non-parametric nature of frequency distribution of data of our study we have first assumed that there are equal numbers of entrepreneurs under the formal and informal economy and accordingly every second entrepreneur chosen through random sampling method should be from the formal economy. In successive samples under the normal distribution, the number of respondents chosen before the respondent appears from the formal economy takes the values 0, 1, 2, 3, 4, 5, ..., $n$ ..., with the respective probabilities i.e. $1/2, 1/4, 1/8$ ........ $1/n$ but our data’s frequency for getting any firm to be under the formal economy is not equal to $1/2$ thus assumption of having a normal distribution does not fit in our data. Thus, the $\chi^2$ test is the best suitable test for the present study. The $\chi^2$ test is also suitable as we have:

- A random sample consisting of independent members/ respondents, and
- A sample size larger than 50 i.e. $n < 50$.

**Data Collection**

This study is based on our Research Project on Dalit Entrepreneurship. The said research project was focused on Dalits but during the course of our survey, we had collected data from entrepreneurs from all sections of the society during our follow-up study. The present study is extracted from our research project accordingly this is survey-based research and therefore the choice of entrepreneurs for forms of business organisation was explored through gathering primary data. A questionnaire was designed and 1280 respondents participated in the interview based on the questionnaire. We have considered a unit as a formal unit only if it has an incorporation registration or a tax registration or any kind of registration under labour laws. The entities having only one-time shop registration from municipal corporation/ municipal bodies have been classified under the informal economy as getting shop registration is an annual exercise and such entities did not get their shop registration renewed, thus classified accordingly under the informal economy. In the case of companies, if all the subscribers to the memorandum were first-generation entrepreneurs then only such companies were classified as a company founded by first-generation entrepreneurs and chosen for our study. Similarly, in the case of partnership firms, only those partnership firms have been chosen for the study where all the founder partners are first-generation entrepreneurs. The proprietorship includes family-owned businesses except for family-owned partnership firms and Hindu Undivided family businesses. The survey was conducted in the city of Jaipur, Udaipur, New Delhi, Bhopal, Indore, Hyderabad, and Mumbai. The respondents were selected through a random sampling method. To figure out first-generation entrepreneurs, we eliminated entrepreneurs who are carrying their inherited family business, thus the random sampling method has been further modified to a purposive random sampling method. The respondents represent farming and agricultural activities/ service (including animal husbandry, dairy, and poultry), mining & quarrying, manufacturing, gas & water, construction, service & maintenance, wholesale trade, retail trade, restaurants & hotels, transport & storage, posts & communication, real estate, and educational services.

**Findings and Discussions**

We found that in almost all cases the journey of a business entity starts as a proprietorship and gradually some of them chose to turn into partnership and later on to other corporate forms. During the
expansion of business, pooling of capital and collective management of the affairs of the business mostly occurs through partnership and then under the formalisation process, the entity gets converted into the corporate forms. Our survey results show the following outcome:

**Table 1 Various forms of business organisations under the formal and informal economy**

<table>
<thead>
<tr>
<th>Forms of Business Organisations</th>
<th>Number of Organisations</th>
<th>Formal Economy</th>
<th>Informal Economy</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td>76</td>
<td>76</td>
<td>00</td>
<td>5.94</td>
</tr>
<tr>
<td>Partnership</td>
<td>186</td>
<td>157</td>
<td>29</td>
<td>12.26</td>
</tr>
<tr>
<td>Proprietorship</td>
<td>1018</td>
<td>79</td>
<td>939</td>
<td>6.18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1280</strong></td>
<td><strong>274</strong></td>
<td><strong>1006</strong></td>
<td><strong>24.38</strong></td>
</tr>
</tbody>
</table>

According to the above table no. 1, around 79.54 percent of first-generation entrepreneurs are carrying their business in the type of proprietorship firm. 828 entrepreneurs working as proprietors revealed that they started their business activities because they could not find any kind of employment hence their enterprises represent survival activities. Being sole proprietors they lack the ability to raise adequate capital to incorporate a company or a limited liability partnership.

Given that all the surveyed entrepreneurs are first-generation entrepreneurs hence the concentration of business units in the form of proprietorship is natural but despite some extent of expansion (growth) they chose to remain in proprietorship that too in the informal economy. As we found that 1103 enterprises have secured growth in their business activities but still they have bypassed the formalisation step. Most of them reported that they want complete autonomy to run their business and thus proprietorship is best suitable for them. Their hired number of employees is also not exceeding the threshold limits that require mandatory compliance of labour laws and their financial figures are also exempted from mandatory tax registrations, therefore they remained in the informal sector.

**Table 2 Expansion status of establishments**

<table>
<thead>
<tr>
<th>Forms of Business Organisations</th>
<th>Number of Organisations</th>
<th>Expansion</th>
<th>Not Expanded</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Formal</td>
<td>Informal</td>
<td>Formal</td>
</tr>
<tr>
<td>Company</td>
<td>76</td>
<td>65</td>
<td>00</td>
<td>11</td>
</tr>
<tr>
<td>Partnership</td>
<td>186</td>
<td>138</td>
<td>23</td>
<td>19</td>
</tr>
<tr>
<td>Proprietorship</td>
<td>1018</td>
<td>51</td>
<td>826</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1280</strong></td>
<td><strong>254</strong></td>
<td><strong>849</strong></td>
<td><strong>48</strong></td>
</tr>
</tbody>
</table>

In the present study, expansion has been defined as adding up of new place of business or new workers after the setting up of the establishment. According to the above table, 949 entrepreneurs (74.14 percent) did not opt to formalise their enterprises into the formal unit. All entrepreneurs told that even some of them did achieve some growth but still they are at a nascent stage and the cost of incorporating a company or a limited liability partnership is relatively high and incorporation expenses often considered as non-productive while the paper formalities are also cumbersome. All such circumstances have compelled the nascent first-generation entrepreneurs to carry their business in the sole proprietorship instead of a limited liability entity.
Table 3 Geographical growth of business organisations

<table>
<thead>
<tr>
<th>Forms of Business Organisations</th>
<th>International / National</th>
<th>Intra-state</th>
<th>Local</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Formal</td>
<td>Informal</td>
<td>Formal</td>
</tr>
<tr>
<td>Company</td>
<td>12</td>
<td>00</td>
<td>58</td>
</tr>
<tr>
<td>Partnership</td>
<td>19</td>
<td>00</td>
<td>116</td>
</tr>
<tr>
<td>Proprietorship</td>
<td>33</td>
<td>00</td>
<td>18</td>
</tr>
<tr>
<td>Total</td>
<td>64</td>
<td>00</td>
<td>202</td>
</tr>
</tbody>
</table>

The area of operation has been taken on the basis of place of business. The first-generation entrepreneurs have mostly started as survival activity; therefore they are operating largely in the local areas and within State. Of course, the above data is not static and it is bound to be affected by growth of business, nature of business, further investment, diversification and age of the enterprise as well as age of the entrepreneurs. Twelve companies are running by first-generation entrepreneurs having international/ national level operations, while 58 companies are doing business intra-state and six companies are having local area based operations. Nineteen partnership firms are having international or national geographical reach, while 137 partnership firms are doing business intra-state or intercity within the State. 116 partnership firms having intercity operations are formalised ones and 21 are under informal economy. There are 33 proprietorship firms that are having a national expansion, 111 proprietorship firms are doing intra-state operations and 874 enterprises have operations at the local level.

Almost all the entrepreneurs carrying proprietorship businesses revealed that the utmost incentive to operate under proprietorship business is the ease of setting up the proprietorship business. Similar answers were recorded from the unregistered partnership owners. All of them did admit that the registration of a business requires initial capital cost and subsequent compliance cost. At the time of setting up their business in the informal economy, they were not in the position to bear such incorporation cost as they started their business just to survive in absence of any fruitful organised employment opportunity. Although the incorporation expenses or compliance costs will be bear by the customers yet it will increase product cost and due to cut-throat price competition, the customers will prefer goods and services from the informal economy to get competitive prices.

Apart from ease of setting up business in the informal economy, the exit is also very easy. As under the formal economy, the business entities come into existence in the eyes of law thus their exit is also through due legal process which is very exhausting and extremely lengthy. Therefore the first-generation employers prefer the informal economy over the formal economy because there are high chances of business failure due to their inexperience and accordingly they want an easy exit from the business. The liquidation process of companies and limited liability partnership firms is very lengthy and cumbersome. Moreover, the overall legal redressal process is very complex, time-consuming, and lethargic. Exit from a business is a critical feature of ease of doing business environment and exit from the informal economy is very easy. To deal with bankruptcy and insolvency in the formal economy is coupled with tedious compliance processes and often liquidated assets go frittered away in absence of a hassle-free liquidation process.

We found that mid-career managerial level executives are most likely to leave their jobs and want to start their own ventures. Such mid-career managerial level executives are classified as intrapreneurs. Being working in the business atmosphere they acquire managerial experience and also have some money to invest in their ventures. The intrapreneurs enter the formal economy as they had already worked in the formal forms of business organisations. The red-tapism also hinders the entrepreneurs to operate formally. Red-tapism is a framework of excessive regulatory control or rigid compliance to paper formalities that have become redundant leading to a bureaucratic environment and hindering ease of doing business or decision-making. Ironically, many rules do not have any practical purpose but such rules are still in force. Such rules give an opportunity to bureaucrats to
harass the entrepreneurs and compel them to pay bribes. Such practices include useless paperwork, obtaining licenses for generalised activities that are freely operating in the informal economy under the patronage of local leaders or bureaucrats, multiple agencies or committees to get approval for a business venture, and other various colonial-era rules that leave carrying one’s affairs slower, more complex. We found that those entrepreneurs having well educational background easily deal with such a bureaucratic environment due to their knowledge and awareness.

Most of the entrepreneurship in the present era is the outcome of urbanisation economies. Urbanisation economy means generation of demand due to concentration of population in a specific area, and thus there are various retail opportunities due to spur in demand of basic amenities and fast-moving consumer goods. The urbanisation economy has a disadvantage that due to urban location it becomes very costly to establish a business venture at a demarcated commercial place. Therefore, first-generation entrepreneurs choose to operate from non-commercial places and fall under the informal economy due to lack of adequate permissions and licences having essential requirement of commercial place to operate.

**Test of Hypothesis**

We have the hypothesis that the first-generation entrepreneurs equally choose both sectors i.e. formal and informal economy to carry out their business.

Statistically:

\[ \rho = 0 \]

By applying the \( \chi^2 \) test we assume that the expected frequency distribution of enterprises under the formal and informal economy, in case of no preference or biasness, shall be equally distributed between both the sectors. Hence the expected and actual frequencies are as follows:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Actual Frequency (O)</th>
<th>Expected Frequency (E)</th>
<th>(O-E)</th>
<th>(O-E)^2</th>
<th>(O-E)^2/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formal</td>
<td>274</td>
<td>640</td>
<td>-366</td>
<td>133956</td>
<td>209.30625</td>
</tr>
<tr>
<td>Informal</td>
<td>1006</td>
<td>640</td>
<td>366</td>
<td>133956</td>
<td>209.30625</td>
</tr>
</tbody>
</table>

\[ \chi^2 = \frac{\sum (O-E)^2}{E} = 418.6125 \] and \( \nu = (2-1) = 1 \)

For \( \nu = 1, \chi^2_{0.05} = 3.84 \)

The calculated value of \( \chi^2 \) is more than the table value i.e. 418.6125 > 3.84 and hence the hypothesis that the first-generation entrepreneurs equally choose both sectors i.e. formal and informal economy to carry out their business gets rejected and the alternate hypothesis stands valid. This means that entrepreneurs’ frequency is not equally distributed and one of the sectors gets preference over the other. If we look at the share of informal economy in our sample data it is 75.62 percent. Therefore, we conclude that first-generation entrepreneurs prefer informal economy over the formal economy due to the various reasons predominantly cost efficiency in the informal sector, urbanisation based retail trade, easy entry and exit, low capital requirement, non-compliance of procedural laws, exclusive control in case of locally operated businesses, etc. We have observed that geographical expansion of business leads to the formalisation of entities as according to our sample those having national or international expansion are working in the formal sector. Intrapreneurs turned entrepreneurs enter the formal economy rapidly as having executive experience helps them to operate formally. Intrapreneurs have business experience as executives and they do have some amount of capital to invest.

Complex paper formalities and procedural compliance are the biggest barriers for entrepreneurs in the formal sector. The educated people are at ease to handle such compliances as compared to a less
educated person. Most of the entrepreneurs do not want to bear the extra cost to hire any professional to carry out compliance work for them. The educated people do not want to pay bribes to bureaucrats for ignoring non-compliance thus they operate formally. They easily deal with the bureaucracy because of their awareness. The educated person should be motivated to opt for entrepreneurship. Therefore, identify such students from the undergraduate programme and train them to become entrepreneurs as they are in a better position to comply with the formalities of the formal entities. Though the progress in the ease of doing business rankings have improved the bureaucratic environment through various online-based single-window mechanisms yet the lethargic legal redressal system needs to be looked upon.

References


**Author Details**

**Devendra Jarwal**, Associate Professor, Motilal Nehru College, University of Delhi, New Delhi, India, *Email ID*: devendra.jarwal@mln.du.ac.in

**Anju Kahal**, Ph.D., Associate Professor, Department of Commerce, Motilal Nehru College, University of Delhi, New Delhi, India, *Email ID*: anjukahal74@gmail.com