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EVALUATING INSTITUTIONAL THEORIES OF INFORMAL SECTOR ENTREPRENEURSHIP: SOME LESSONS FROM ALBANIA

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This paper evaluates three waves of institutional theory that have variously explained participation in informal sector entrepreneurship. Informal entrepreneurship has been explained in a first wave of institutional theory as resulting from formal institutional failures, in a second wave of theory as resulting from an asymmetry between the laws and regulations of formal institutions and the unwritten socially shared rules of informal institutions and in a third wave of theory as resulting from a lack of both vertical and horizontal trust. To evaluate these waves of institutional theory, evidence is reported from a 2015 survey of businesses in Albania. This finds that 30% of turnover of Albanian businesses is under-reported, and that this is higher in smaller firms. In terms of the institutional failures that explain participation in informal entrepreneurship, the regression analysis reveals a strong association between annual under-reporting turnover and the red tape involved in dealing with the tax administration and the frequent visits of tax inspectors. Moreover, both vertical and horizontal trust are shown to be strongly associated with participation in informal entrepreneurship. The paper concludes by discussing the theoretical and policy implications.

Keywords: informal economy; entrepreneurship; development economics; institutional theory; Albania.

1. Introduction

Over the past decade or so, there has been widespread recognition that if entrepreneurship is to be more fully understood in developing economies, there is a need to extend analysis beyond entrepreneurship in the formal economy (Adom and Williams, 2012; Bureau and Fendt, 2011; Chepurensko, 2018; Coletto and Bisschop, 2017; Karki and Xheneti, 2018; Khan and Wuaddus, 2015; Mannila and Eremicheva, 2018; Lin, 2018; Linares, 2018; Ram et al., 2017). This is because two-thirds of all enterprises across the world start-up

unregistered (Autio and Fu, 2015) and at least a half of all enterprises globally are unregistered (Acs et al., 2013). If the uncalculated number of formal enterprises under-reporting turnover is also included, an even higher proportion participate in the informal economy (Ketchen et al., 2014; Siqueira et al., 2016; Williams et al., 2017, 2018).

To advance the small but rapidly growing literature on informal entrepreneurship, the aim of this paper is to evaluate the contemporary scholarship that predominantly explains such entrepreneurship using institutional theory (North, 1990). A first wave of institutionalist theory explaining informal entrepreneurship deemed it to result from the existence of formal institutional failures (Puffer et al., 2010; Sutter et al., 2013), while a second wave explained such entrepreneurship to be a result of the asymmetry between the laws and regulations of formal institutions and the unwritten socially shared rules of informal institutions (Godfrey, 2015; Webb et al., 2009, 2013). This paper evaluates the validity of these two waves of institutionalist theory and a new third wave of institutionalist theory explaining such entrepreneurship as resulting from both a lack of vertical trust (i.e., an asymmetry between formal and informal institutions) as well as a lack of horizontal trust between entrepreneurs.

To do this, section 2 provides a brief review of the literature that explains informal sector entrepreneurship using institutional theory and formulates hypotheses to test various waves of institutionalist explanation. Section 3 then explains the methodology and data used for testing the hypothesis, namely a survey with 400 businesses conducted in Albania in 2015. Section 4 then presents the results while the last section discusses the theoretical and policy implications.

2. Literature Review and Hypotheses Development

Entrepreneurship scholarship has increasingly recognized the importance of studying informal sector entrepreneurship (Aidis et al., 2006; Kus, 2014; Morris and Polese, 2014; Mróz, 2012; Webb et al., 2009, 2013; Welter et al., 2014; Williams, 2006, 2013, 2015, 2018; Williams and Kadir, 2016, 2017; Williams and Youssef, 2013). Such scholarship has highlighted not only that the majority of entrepreneurs start-up in the informal sector (Autio and Fu, 2015) and that many formal enterprises under-report their turnover (Williams, 2018), but also why participation in the informal economy is more common in some countries than others (Dau and Cuervo-Cazurra, 2014; Siqueira et al., 2014; Thai and Turkina, 2014), who participates (Williams and Horodnic, 2015) and the motives of informal entrepreneurs, such as whether they operate in the informal sector out of choice or necessity (Maloney, 2004; Perry and Maloney, 2007; Williams and Round, 2009; Williams et al., 2012).

Increasingly, and reflecting entrepreneurship scholarship more generally, those seeking to explain informal entrepreneurship have done so using institutional theory (Baumol and Blinder, 2008; Denzau and North, 1994; North, 1990). From an institutional theory perspective, institutions refer to the rules of the game that govern behavior. Every society is asserted to possess not only formal institutions (i.e., laws and regulations) that are the legal rules of the game, but also informal institutions that are the unwritten socially shared

rules of the game (Helmke and Levitsky, 2004; Krasniqi and Desai, 2016), and reflect the norms, values and beliefs of citizens and entrepreneurs about what is acceptable and what is unacceptable (Denzau and North, 1994). Therefore, from an institutionalist theory perspective, formal sector entrepreneurship is entrepreneurial activity that abides by the formal rules of the game. Meanwhile, informal sector entrepreneurship is entrepreneurial activity that takes place outside of formal rules of the game but abides by the informal rules of the game about what is acceptable (Godfrey, 2011; Kistruck et al., 2015; Siqueira et al., 2016; Webb et al., 2009; Welter et al., 2015; Williams and Gurtoo, 2017), while criminal entrepreneurship is entrepreneurial endeavor that takes place outside of both the formal and informal rules of the game of what is acceptable.

A review of institutional explanations of informal entrepreneurship, three waves of institutionalist thought can be identified that have explained informal entrepreneurship in different ways (Williams and Krasniqi, 2018). Here, each of these waves are reviewed in turn and hypotheses developed to test each wave of institutionalist theory.

2.1. First-wave institutionalist theory: failures of formal institutions

In the first wave of institutional theory, informal entrepreneurship was viewed as resulting from the failings of formal institutions. These formal institutional failings included: resource misallocations and inefficiencies; formal institutional voids and weaknesses, and formal institutional powerlessness (Webb and Ireland, 2015; Williams, 2018). Here, each is considered in turn.

A first group of formal institutional failings are associated with resource misallocations and/or inefficiencies by formal institutions (Qian and Strahan, 2007). These are often the product of the “misuse of public office for private gain” (Svensson, 2005; Tonoyan et al., 2010; Williams, 2018). For example, public sector officials may demand or receive bribes, gifts and other payments (e.g., a percentage of a contract) from entrepreneurs and enterprises for a service provided (e.g., providing a construction permit). This form of corruption represents an additional tax for entrepreneurs, which pushes entrepreneurs into the informal economy to evade these types of extortion (Williams et al., 2016b). Resource misallocations and inefficiencies also arise when formal institutions act in ways that protect or maximize the economic rents of elites (Acemoglu and Robinson, 2012). Referred to as state capture, this occurs when enterprises or groups of enterprises shape legislation and government policies to their advantage in a non-transparent manner (Fries et al., 2003). The result is their preferential treatment and the diversion of state resources to the provision of support for them. For consequence of elites capturing state resource is that others suffer more burdensome taxes, regulations and costs, and fewer public goods and services for their taxes and social contributions (De Soto, 1989; Siqueira et al., 2016; Williams et al., 2016a). When the perceived value of the goods and services received does not equate with the taxes paid, the result can be that entrepreneurs will operate informally. Therefore, to evaluate whether informal sector entrepreneurship results from resource misallocations and inefficiencies, a proxy indicator is whether entrepreneurs perceive the level of taxes not to

equate to the value of the public goods and services received. As such, the following hypothesis can be tested:

H1: Entrepreneurs perceiving taxes to be a barrier to the operation of their business will have a higher under-reporting of turnover

A second group of formal institutional failings are associated with formal institutional voids and weaknesses. There are competing perspectives on which institutional voids and weaknesses produce higher levels of informal entrepreneurship. Neo-liberal scholars explain informal sector entrepreneurship to be a result of too much state interference (Becker, 2004; De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Saavy 1984). From this perspective, participation in the informal sector is a rational economic decision taken to evade over-interference by the state (De Soto, 1989, 2001; Schneider and Williams, 2013). Informal entrepreneurs therefore choose to operate in the informal sector to evade the costs, time and effort of operating formally (De Soto, 1989, 2001; Perry and Maloney, 2007; Small Business Council, 2004). Therefore, for neo-liberals, the formal institutional weakness is over-intrusive state interference (De Soto, 1989, 2001; Perry and Maloney, 2007; Small Business Council, 2004). To evaluate this, the following hypothesis can be tested:

H2: Entrepreneurs perceiving the red tape of the tax administration as a burden to the operation of their business will have a higher under-reporting turnover

In contrast, a political economy perspective argues that informal entrepreneurship arises due to too little state intervention. Therefore, state intervention is required. Informal entrepreneurship, in consequence, is viewed as resulting from too little state intervention (Aliyev, 2015; Davis, 2006; Gallin, 2001; Portes, 1994; Sassen, 1996; Slavnic, 2010). The consequent solution is to pursue state intervention in the economy and welfare provision to mitigate the requirement for citizens to enter informal entrepreneurship as a survival strategy (Small Business Council, 2004). However, this will only be effective if the social contract is maintained between the state and the population (Williams, 2018). For this to be achieved, there is a need to make entrepreneurs aware of the public goods and services that they received in return for the taxes paid (Williams, 2018). To evaluate this, the following hypothesis can be tested:

H3: Entrepreneurs perceiving their tax payments as used to fund important services will have less under-reporting turnover.

A third group of formal institutional failings relate to formal institutional powerlessness. Powerlessness here refers to the lack of ability of the authorities to enforce the formal rules (Webb et al., 2009). This lack of power of enforcement authorities leads to informal entrepreneurship having low costs, due to the lack of likelihood of detection,

and high benefits of informal entrepreneurship, coupled with high costs and low benefits of formalization, not least due to the inability of authorities to make formality an attractive option (e.g., in terms of social insurance benefits). The outcome is that when entrepreneurs weigh up the costs and benefits, they will make the decision to operate informally because the benefits of formality are insufficient to outweigh the benefits of informality.

To resolve this, enforcement authorities need to develop their ability to alter the cost/benefit ratio. Two basic methods exist for doing so at present, both of which focus upon increasing the costs of informality. Firstly, they can increase the costs of informality by increasing the administrative sanctions and penalties. Secondly, they can improve the perceived or actual likelihood of detection (Williams and Puts, 2017). In many countries, the level at which sanctions can be set are hindered by what is perceived as “just”. The consequence is that much of the emphasis is put on increasing the perceived or actual probability of detection. This is mainly achieved by increasing the number of inspections. Nevertheless, the evidence-base is inconclusive on whether this is an effective strategy. Some scholarship suggests that raising the likelihood of detection decreases informality, at least for some income groups (e.g., Alm et al., 1995), but other scholarship suggests that increasing the likelihood of detection does not reduce informal entrepreneurship (e.g., Webley and Halstead, 1986). Instead, it results in greater non-compliance because of the breakdown of trust between the state and enterprises (Murphy and Harris, 2007; Tyler et al., 2007). To evaluate this and the wider issue of the power of authorities, the following hypothesis can be tested:

H4: Entrepreneurs perceiving the number of tax inspections to be a burden to the operation of their business will have a higher under-reporting turnover.

2.2. Second-wave institutional theory: institutional asymmetry

The focus in first-wave institutional theory was only on formal institutional failures. In a second wave of institutional theory, it was recognized that this ignored the role of cognitive and normative institutions, which can be joined together in the category of informal institutions (Godfrey, 2015; North, 1990; Scott, 2008). Formal institutional failings do not always result in informality. They only do so when the socially shared values, beliefs and norms of entrepreneurs and enterprises do not align with the formal rules (Dau and Cuervo-Cazurra, 2014; Godfrey, 2015; Webb et al., 2009; Williams and Shahid, 2016; Williams et al., 2017).

In consequence, in second-wave institutional theory, formal institutional failings per se are not the determinant of informal entrepreneurship. When formal and informal institutions are “complementary” and align, informal entrepreneurship will not result from formal institutional failings. Instead, formal institutional failings only result in informality when the formal and informal institutions do not align, and therefore the rules of informal institutions act as a “substitute” for the formal rules (Godfrey, 2011; 2015; Williams et al., 2015, 2016a). As Webb et al. (2009) assert, “the informal economy exists because of the incongruence between what is defined as legitimate by formal and informal institutions.”

If formal and informal institutions are not aligned, the outcome is informality which, although it is illegal in terms of the formal rules, is viewed as socially legitimate (De Castro et al., 2014; Kistruck et al., 2015; Siqueira et al., 2016; Webb et al., 2013, 2014). Indeed, the greater the degree of non-alignment of the formal and informal rules, the higher is the prevalence of informality (Williams and Shahid, 2016).

Therefore, second-wave institutional theory has employed proxy measures of the degree of asymmetry between the formal and informal institutions. One such proxy measure is the perceived level of public sector corruption. When public sector corruption is perceived to be higher, the greater is the degree of institutional symmetry (Daude et al., 2013; Torgler, 2012). To evaluate the level of institutional asymmetry, the following hypothesis can be tested:

H5: Entrepreneurs perceiving corruption among governmental officials as a barrier to the operation of their business will have a higher under-reporting turnover.

2.3. Third-wave institutional theory: vertical and horizontal trust

Second-wave institutional theory has near enough entirely focused upon the degree of “vertical trust” (i.e., the non-alignment of the formal and informal institutions) and its relationship with informality. Less attention has been paid to the relationship between informality and the degree of “horizontal trust” (between entrepreneurs). However, it can be asserted that entrepreneurs and enterprises are more likely to under-report turnover if they perceive under-reporting of turnover as widespread. This is because they might consider that many others under-report turnover and therefore see no reason why they should do so.

Indeed, a small but growing evidence-base exists on horizontal trust but until now, only in relation to voluntary tax compliance, rather than specifically in relation to engagement in informality. Studies have revealed compliance is significantly associated with the actual and/or perceived behavior of other enterprises and citizens (Ajzen, 1991; Chang and Lai, 2004; Mendoza Rodriguez and Wielhouwer, 2015; Narsa et al., 2016). For example, an experiment in three European countries (Belgium, France and the Netherlands) reveals that compliance significantly increased among those receiving information that there was only a very low level of non-compliance (Lefebvre et al., 2015).

Therefore, to further build upon second-wave institutional theory that a lack of vertical trust is significantly associated with informality, third-wave institutional theory views informality to result from not only formal institutional failings that produce a non-alignment between formal and informal institutions (i.e., a lack of vertical trust) but also from a lack of horizontal trust. To test this, the following hypothesis can be evaluated:

H6: Entrepreneurs perceiving unfair competition as a barrier to the operation of their business will have a higher under-reporting turnover.

3. Data and Variables

3.1. Data and sample

To evaluate these different waves of institutional theory that variously explain informal entrepreneurship, a survey was conducted with 400 Albanian enterprises, comprising micro, small, medium and large firms and covering the main economic sectors (manufacturing, service, trade). The survey was developed by the Albanian Center for Economic Research (ACER) - an Albanian research institute - in 2015 and one of the authors of this paper played a lead role in the research project (Albanian Center for Economic Research, 2015). The face-to-face method was utilized to complete the questionnaires. Interviews were conducted by a trained team of Masters' students from the Faculty of Economics at the University of Tirana and the ACER research team supervised their work. The interviews were conducted with individuals holding a limited number of positions within the company. Namely, they were either the owner, executive director, or finance director.

The enterprises were selected randomly from the General Tax Directorate (GTD) data base of enterprises. The sample was stratified based on two variables, namely: size (1-4; 5-9; 10-49; 50 or more employees) and sector (manufacturing, services, trade). In terms of respondents' distribution by economic sector, the service sector dominates with 46.3% of respondents in this sector, followed by manufacturing with 29% and trade with 24.7%. Overall, all business sizes were equally represented. Some 26.2% of respondents were from micro-enterprises, 24.4% small companies, 26.4% medium-sized companies and 22.9% large companies.

The questionnaire collected data on their perceptions of the business climate in Albania and its effect on the operation of their business as well as firm-level data such as the size and age of the enterprise. On the issue of institutional variables, the survey included questions to test the hypotheses formulated, including their perception on tax rates, tax administration bureaucracy, inspections from the tax authorities, corruption among governmental officials, governmental use of tax payments and unfair competition. In addition, the questionnaire required businesses to provide an approximate percentage of annual declared turnover of a typical firm in their sector so to calculate the under-declared turnover. All details regarding the firm and institutional variables are reported in Table A1 in the Appendix.

3.2. Variables

Drawing on the variables previous analyses reveal are significantly associated with participation in the informal economy (Ferrer-i-Carbonell and Gerxhani, 2011, 2016; Gerxhani, 2007; Williams et al, 2017), this study collected data on the following firm-level control variables and institutional variables.

The dependent variable, considering the sensitivity of the information required, indirectly asked businesses about the proportion of turnover that is not declared. This is a

continuous variable based on responses to the following question: “Recognizing the difficulties that many firms face in fully complying with taxes and regulations, overall in your view approximately what part of the annual turnover of a typical firm in your sector or area of activity is officially reported?” To calculate the proportion of turnover that is not declared, all responses were deducted from 100.

The independent and control variables are as follows:

Firm age: Number of years the firm has been operating in Albania.

Firm size: A categorical variable for the number of employees with value 1 for micro firms (1-4 employees), 2 for small firms (5-9), 3 for medium firms (10-49) and 4 for large firms (50 or more employees).

Taxes are too high: Firms were asked to provide their perceptions if high taxes represent a barrier to their business using a Likert Scale of 5= extremely serious 1=not at all serious. Responses with 5 “extremely serious” were recoded to 1 and 0 otherwise to produce a dummy variable.

Red tape of tax administration: Firms were asked on their perception on how burden of some aspects of working with tax authorities, namely administration of tax forms and the time it takes in a Likert scale where 5= Severe burden and 1= Not at all a burden. Responses with 5 “severe burden” were recoded to 1 and 0 otherwise to produce dummy variable.

Government use of tax payments: Firms were asked to evaluate how they would consider the following incentive as a way to encourage the formalization of the economy: Knowing that tax payments are used to fund important services, in a Likert Scale of 5=extremely important and 1=not at all important. Responses with 5 “extremely important” were recoded to 1 and 0 otherwise to produce a dummy variable.

Number of visits by the tax inspectors: Firms were asked to evaluate whether number of visits by tax inspectors represent a burden to the operation of their business, using a likert scale of 5= severe burden 1=not at all a burden. Responses with 5 “severe burden” were recoded to 1 and 0 otherwise to produce dummy variable.

Corruption among government officials: Firms were asked to provide their perception on corruption among government officials being an obstacle for operation of their business in a likert scale of 5= a very severe obstacle and 1=no obstacle. Responses with 5 “severe obstacle” were recoded to 1 and 0 otherwise to produce a dummy variable.

Unregistered competitors represent a severe burden (unfair competition): Firms provided their perception whether other unregistered competitors represent an obstacle to the current operations or economic success of their business, in a likert scale of 5= a very severe obstacle and 1=no obstacle. Responses with 5 “a very severe obstacle” were recoded to 1 and 0 otherwise to produce a dummy variable.

3.3. Empirical model

Considering the nature of under-reporting turnover as a continuous variable, a linear regression model is employed to determine the factors that are associated with the under-reporting of turnover in Albania. Model 1 estimates firm level variables while Model 2 estimates both firm level and institutional variables. The following econometric model

represents the final pattern where β_0 represents the intercept, X_i represents the vector of independent variables and ϵ_i represents the error term, while X_i is composed of firm level and institutional variables.

$$\text{Unreported turnover} = \beta_0 + \beta_1 X_i + \dots + \beta_n + \epsilon_i$$

4. Results

The overall finding is that Albanian business under-report 30.09 percent of their annual turnover. Hence, this intimates that the informal economy is relatively large in Albania compared with other European countries (Williams, 2018). Therefore, this raises the following questions: which enterprises are more likely to under-report turnover? And which institutionalist explanations are valid as explanations for participation in informal entrepreneurship?

Before answering these questions by testing the above hypotheses, the diagnostic testing needs to be reported to evaluate whether heteroscedasticity and non-normality is present. In addition, multicollinearity was tested for using the Variable Inflated Factor (VIF). The finding was this was not found to be a problem in the estimations (see Table A2 in the Appendix). The VIF Mean = 1.16 which is acceptable as far it is less than ten. Furthermore, based on the R-squared in Table 1 which varies from 2.9 percent (basic model) to 10.5 percent (full model), it means that the two linear regression model explains more than ten percent of variation in the dependent variable.

To test the hypotheses, Table 1 reports the results of two linear regression models. Model 1 analysis the correlation the level of unreported turnover and firm size and firm age (firm-level variables). The finding is that there is no statistically significant association between firm age and the level of unreported turnover. However, when it comes to firm size, the results substantiate size to be a strong predictor. The larger the enterprise, the lower is the likelihood to under-declare turnover. Namely, if the enterprise size increases by one percent, the under-reported turnover among Albanian firms decreases by 2.7 percentage points.

Model 2 adds the institutional level variables to the firm-level variables to explore the association between various institutional conditions and the level of under-reported turnover. In model 2, the results in relation to firm size and firm age are the same as in Model 1. In terms of the institutional variables and their impact on under-reported turnover, the results uncover no correlation between the Albanian firms' perception that high taxes represent a burden on the operation of their business and the level of under-reporting of turnover (refuting H1). However, enterprises that consider the bureaucracy of tax administration as an obstacle to the operation of their business do have significantly higher levels of turnover under-reporting (confirming H2). There is no statistically significant relationship between the under-reporting turnover and the firms' perception their tax payments are used to fund important services (refuting H3). Nevertheless, firms that consider the number of tax inspections as an obstacle to the operation of their business do

have a higher under-reporting turnover (confirming H4). Similarly, corruption and unfair competition are good predictors of the level of turnover under-reporting. Albanian firms that consider corruption as an obstacle to doing business are more likely to report higher levels of turnover under-reporting (confirming H5). Those considering that corruption has a profound effect on the operation of their businesses have on average 4.3 percentage points higher underreporting turnover compared with the other group who do not think corruption has such an impact. Likewise, enterprises that consider unfair competition (other businesses operating in the informal economy) as a challenge to the operation of their business do report higher level of turnover under-reporting (confirming H6). Enterprises that consider other businesses operating in the informal economy as an obstacle have on average 4.1 percentage points higher under-reporting of turnover than those who believe the opposite.

Table 1: Linear regression model of turnover under-reporting in Albania.

Variables	Model 1		Model 2	
	Basic Model (Firm Level Variables)		(Firm and Institutional Variables)	
Firm level	B	Std. Error	B	Std. Error
Firm age	.100	.142	.072	.142
Firm size	-2.799***	.857	-2.297**	.895
Institutional-level				
Taxes are too high			.365	2.092
Red tax of tax administration			5.153*	3.133
Knowing that tax payments are used to fund important services			1.594	1.869
Number of visits by tax inspectors			4.608*	2.463
Corruption among government officials			4.340**	2.044
Unregistered competitors represent a severe burden			4.163**	1.972
Constant	35.934***	2.320	29.324***	2.831
Observations	363		340	
R-squared	0.029		0.105	

Significance: ***p < 0.01, **p < 0.05, *p < 0.1.

5. Discussion and Conclusions

Reporting a 2015 survey of 400 enterprises in Albania, this paper has revealed that enterprises on average under-report 30.09 percent of their annual turnover. Evaluating the various waves of institutional theory so as to explain the high level of under-reporting of turnover, the finding is that the second- and third-wave institutionalist explanations are supported which identify the level of vertical and horizontal trust as significantly associated with informal entrepreneurship, whilst the formal institutional failings of first-wave institutionalist explanations significantly associated with informal entrepreneurship are the bureaucracy of tax administration and the number of tax inspections. Here, the theoretical and policy implications of these findings are discussed.

The key theoretical implication of this paper is that it makes three distinct advances in relation to institutionalist explanations of informal sector entrepreneurship. Firstly, it reveals that not all formal institutional failings discussed in first-wave institutional thought are significantly associated with informal entrepreneurship. Only the bureaucracy of the tax administration and the number of tax inspections are significantly associated. Secondly, it has shown that second-wave institutional theory appears valid in that informal entrepreneurship is found to be significantly associated with the non-alignment of the formal and informal institutions. A lack of vertical trust in the formal institutions by entrepreneurs seems to be a key explanation for the level of turnover under-reporting in Albania. Third and finally, third-wave institutionalist theory is validated. A lack of both vertical as well as horizontal trust is found to be significantly associated with the prevalence of the informal entrepreneurship. Therefore, the key finding of this study of informal entrepreneurship in Albania is that future scholarship on informal entrepreneurship should perhaps move away from first-wave institutional theory that focused upon formal institutional failures as determinants of informal sector entrepreneurship. Rather, and as discussed by second- and third-wave institutional theory, a greater focus is required on explaining informal entrepreneurship in terms of the lack of vertical trust (i.e., the non-alignment of the formal and informal institutions) as well as the issue of the lack of horizontal trust, which until now has received little attention.

These findings also have important policy implications. So far, and reflecting first-wave institutional theory, policy-making has focused upon improving the formal institutions, largely by increasing the power of authorities. This has been achieved either by using disincentives (“sticks”) to deter informal sector entrepreneurship or incentives (“carrots”) to facilitate formal sector entrepreneurship (Matthias et al., 2014). Most state authorities have tended to rely on disincentives to make the cost of engaging in informality higher than the pay-off from participation (Allingham and Sandmo 1972). Incentives to encourage entrepreneurs to operate in the formal economy have only recently started to be used (Williams and Puts, 2017).

Nevertheless, even if one changes the cost/benefit ratio confronting entrepreneurs, this does not alter the lack of vertical and horizontal trust which this paper reveals are strongly associated with informal entrepreneurship. Therefore, rather than alter the cost/benefit ratio confronting entrepreneurs to bring about enforced compliance, there is perhaps a need for greater emphasis on pursuing voluntary compliance. This requires changes in entrepreneurs’ beliefs regarding the acceptability of under-reporting turnover. To do so, three policy measures can be pursued. Firstly, there is a need to educate entrepreneurs about the wider value of formality to change their behavior (Saeed and Shah, 2011). Secondly, marketing campaigns to raise awareness about the benefits of formalization can be pursued which either inform entrepreneurs of the costs of turnover under-reporting or the benefits of fully reporting turnover. Finally, normative appeals can be used, which in Estonia resulted in 46% of entrepreneurs paying more taxes (Lill and Nurmela, 2009).

However, to achieve greater vertical trust (i.e., alignment of the formal and informal institutions), formal institutions also need to change. Entrepreneurs will not reduce the

under-reporting of turnover if they continue to lack trust in government and there is extensive public sector corruption and state capture. Therefore, a modernization of formal institutions is required. There is a need to improve not only procedural fairness, which is the extent to which entrepreneurs believe they are paying their fair share compared with others (Molero and Pujol, 2012) but also procedural justice, namely a belief by entrepreneurs that the tax authority is treating them in a respectful, impartial and responsible manner (Murphy, 2005) as well as redistributive justice, namely that entrepreneurs believe they receive sufficient public goods and services in return for the taxes paid (Kirchgässner, 2010).

Nevertheless, this paper has revealed that it is not only vertical trust that must be improved. So too is there a need to improve horizontal trust. When state authorities publicize figures on the size of the informal economy, few have so far reflected on whether this increases its size by further decreasing horizontal trust. However, great caution is needed when publicizing high estimates of its size. Such figures allow entrepreneurs to neutralize any guilt about their own non-compliance. To prevent such denial of responsibility, when publicizing estimates of the size of informal entrepreneurship, it would therefore be useful to make public the average level of evasion so that informal entrepreneurs do not see themselves as engaged in minor discrepancies compared with others.

Despite these theoretical and policy implications, some caution is required. The limitation of this study is that it evaluates the different waves of institutional theory in the context of only one country, namely Albania. Future studies therefore need to replicate this survey in other national contexts and global regions. Furthermore, there is a need to experiment with using direct questions on entrepreneurs' participation in the informal economy. Surveys of citizens reveal that due to informal economic activity being socially legitimate, even if illegal from the viewpoint of formal rules, participants are willing to discuss their participation in such activity (see Williams, 2015). It now needs to be tested whether this also applies when undertaking surveys of entrepreneurs by asking them directly whether they under-report turnover.

In conclusion, if this paper encourages scholars of entrepreneurship to undertake studies of institutionalist explanations of informal sector entrepreneurship in other contexts, it will have achieved one of its intentions. If this then results in state authorities considering how to improve vertical and horizontal trust, and recognition by governments that this is a key requirement for tackling informal entrepreneurship, rather than simply using "sticks" to deter informality, then this paper will have achieved its broader intention.

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Table A1. Descriptive statistics of surveyed enterprises

	N	Minimum	Maximum	Mean	Std. Deviation
Unreported turnover	365	0	90	30.09	17.233
Firm age	400	0	25	10.52	6.706
Firm size	397	1	4	2.46	1.111
Taxes are too high	393	0	1	.37	.483
Red tape of tax administration	396	0	1	.11	.315
Number of visits by the tax inspector	393	0	1	.20	.397
Corruption among government officials	394	0	1	.36	.481
Knowing that tax payments are used to fund important services	394	0	1	.45	.498
Unregistered competitors represent a severe burden (unfair competition)	388	0	1	.40	.491

Table A2 Test for multicollinearity using the Variable Inflation Factor (VIF)

Variable	Tolerance	VIF
Taxes are too high	.793	1.261
Tax administration burden	.873	1.146
Number of visits by the tax inspector	.835	1.197
Other unregistered businesses remain a problem	.863	1.159
Corruption among government officials	.853	1.173
Knowing that tax payments are used to fund important services	.929	1.077
Firm age	0.877	1.140
Firm size	.839	1.192