

**Emergence of Alternative modes of Economic Governance: How informal entrepreneurs enter and exploit opportunities in a polycentric system**

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## **INTRODUCTION**

This study is a grounded theory of informal entrepreneurs entering a polycentric system characterized by weak macro institutions. They interact with lower-level institutions and exploit the opportunities that arise.

The structure of the paper is organized with a theoretical section where we review the key theoretical blocks or institutional polycentrism, and formal and informal institutions and the emergence of informal adjustments, later we introduce the methods and analysis, finally we briefly show evidence of our findings and conclusions.

## **THEORETICAL CONTEXT**

### **Institutional Polycentrism Theory**

The early use of the term *polycentricity* was initially due to Polanyi (1951). He would refer to the concept as a type of order for organizing social tasks and he would refer to it as spontaneous or polycentric order. In his conceptual development, a polycentric or spontaneous order is characterized by “many elements are capable of making mutual adjustments for ordering their relationships with one another within a general system of rules where each element acts with independence of other elements” (Ostrom, 1999, in McGinnis, 1999, p.57). Thus, within a given structure of rules, individual actors will be able to make decisions within the boundaries constraints and possible enforcement of the decision rules. Within this view individual actors are assumed being able to assess benefits and costs in their decisions within a certain degree of risk and uncertainty (Ostrom, 1999, in McGinnis, 1999). Actors will then pursue strategies to improve their welfare. This polycentric approach can also be applied to firms and organizations of different type and nature, within a market competition, as they similarly face analogous type of strategic dilemmas and opportunities when integrating a polycentric system.

Aligica and Tarko (2011, p.237) effectively suggest that concept of polycentricity was defined by Polanyi (1951) as “social system of many decision centers having limited and autonomous prerogatives and operating under an overarching set of rules”. More recently and thanks to Elinor Ostrom and the School of Bloomington of Institutional Analysis to concept has been applied to governance studies. The approach developed by Ostrom was initially focused on the analysis of American metropolitan areas and metropolitan governance. Further developments focused on a variety of case studies to be understood through the lens of polycentrism. According to Aligica and Tarko (2011, p.239) “the Ostroms explained that the variety of relationships between government units, public agencies, and private business coexisting and functioning in a public economy can be coordinated through patterns of interorganizational arrangements”. Here in this study we refer to polycentricity as the “spontaneous order in which multiple and independent decision-making centers

and actors make mutual adjustments for ordering their relationships within a general framework of rules and norms” (Ostrom, 1999a; Ostrom, 1999b; in Batjargal et al, 2013).

### **Formal and Informal Institutions: Alternative Forms of Economic Governance and Informal Adjustments**

The term institutions refer to formal and informal rules and norms which structure how individuals and organizations act (North, 1990; Scott, 1995). In other fields of social sciences informal institutions have been studied for relatively long time. In the field of political science for example, the seminal work of Helmke and Levitsky (2004) has been looking at clientelism and patrimonialism or bureaucratic and legislative norms as informal rules shaping the political field. The authors suggest that by not looking at informal institutions we may lack a perspective to understand incentives and constraints. Institutions have been defined as rules of the game (North, 1990), as “a system of social factors such as rules, beliefs, norms and organizations” (Greif, 2000) or as “regularity in social behaviour that is agreed to by all members of society” Schotter (1981). Through comparative institutional analysis applied to Latin America, Africa, Asia scholars have come up with the understanding that the authentic “rules of the game” (North, 1990) are in fact informal ones, and those unwritten codes are the ones that outline the micro-dynamics of actions and behaviours actors (Helmke and Levitsky, 2004). The authors define informal institutions as “socially shared rules, usually unwritten, that are created, communicated and enforced outside of officially sanctioned channels” (Helme and Levitsky, 2004, p.727). The authors explicitly suggest that formal institutional weakness, does not always enable the activation of informal institutions, and that informal institutions respond to established rules and their violation it causes some form of external sanction. The authors emphasize how informal rules explains often institutional outcomes but also how they affect formal institutions. For this reason, they suggest that institutional analysis is needed to understand informal institutions and to comprehending (grasping) the motivations for actors’ actions. For example, Helmke and Levitsky (2004, p.726, quoting Della Porta and Vannucci, 1999, p.15) provide with an example of how “in post-war Italy, norms of corruption were “more powerful than the laws of the state”: the latter could be violated with impunity, while anyone who challenged the conventions of the illicit market would meet certain punishment”. The core of their institutional analysis about informal rules has produced a categorization (typology) of four types of informal institutions. Complementary informal institutions, which coexist with effective formal rules and having convergent outcomes, accommodating informal institutions, that is altering the outcomes of formal rules but with no direct violation, substitutive informal institutions, that is having ineffective formal institutions and still compatible outcomes and competing informal institutions (Helmke and Levitsky, 2004).

By looking at more micro-dimensions of formal institutions scholars have looked at the role of formal rules like well-defined property rights and voluntary contracts (Coase,1988). Institutions have been

considered the basic infrastructure for markets to function based on property rights, governance regimes and rules of exchange (Fligsten, 2001). Nevertheless, often scholars have been considering the law for granted and consequently assuming certain mechanisms behind formal institutions. But we know that frequently in emerging economies, markets and institutional environments are characterized by the constant presence of informal rules (Vassolo et al, 2010; Hoskisson et al. 2005) and by different types of strategies firms develop to shape such complex and uncertain institutional environment (Marquis, Raynard, 2015). Examples of this are provided in the literature such as Dixit (2004, p.3) arguing that “economic activity does not grind to a halt because government cannot or does not provide an adequate underpinning of the law...therefore groups and societies have much to gain if they create alternative institutions to provide the necessary economic governance”. The author mentions how within the literature we can identify different examples of alternative forms of economic governance such as hiring professional-crime related individuals for property rights protection (Hirschleifer, 2001; Gambetta, 1993) or the use of social norms for enforcing agreements and contracts (Greif, 1993; Milgrom, North and Weingast, 1990). Dixit (2004) emphasizes that individuals and societies at large will try to develop private/alternative institutions, even if they are not perfect to sustain their economic activities when the formal law is either missing or not functioning well. In the same direction, Dixit (2004) suggest that Rodrik (2003, p.10-16) argues that “state institutions are not the only ones that matter...social arrangements can have equally important and lasting consequences”. Thus, the key insight here is that markets, particularly in emerging economies, will function well only by acknowledging the proper form of economic governance that can concretely support them. Dixit (2004) points out also the importance of private ordering in dispute resolution. In the shadow of the law, it is costless to recur to these private mechanisms of resolution rather than state ones. Dixit (2004, p.11) states that “long-term relationships and arbitration and the most common models of private ordering”. Long term relationships make people thinking about the long term, avoiding short term maximization, while private arbitration, is by far much more cost effective and also quicker, particularly in emerging economies. Another context Dixit (2004) points out is the one where there is a lack of long term relationships but stable membership within certain of large groups, then reputational mechanisms will appear to limit in the future a possible opportunistic behaviour. When the author defines alternative modes of economic governance then, he refers to contexts where government cannot fully guarantee formal institutions and protection of property rights and enforcements of contracts. That is the case of plenty of activities embedded in the informal economy.

### *Institutional Voids*

Institutional voids are a substantive feature of emerging economies institutional environments and they are presented in the literature as potentially being obstacles or opportunities for business. They have been defined as “specialized market intermediaries that are either absent or poorly functioning,

or in other words the ease with which buyers and sellers can come together to do business” (Khanna and Palepu, 2005; 2010, p.). This type of definition has been applied in other studies (Luo and Ching, 2013) and it has a more defined economist-view, by focusing more on the efficiency of the transactions. Other scholars refer to institutional voids as a condition where “the institutional arrangement that support markets are absent, weak, or fail to accomplish the role expected of them” (Mair, Marti, 2009, p. 422); specifically, the authors suggest an approach to institutional voids as limiting or impeding marketing participation, particularly for entrepreneurs in fragile institutional settings. This is particularly relevant for our context of La Salada where protagonist actors have been marginalized by the formal market, and in particular, labor institutions. Institutional infrastructure elements such as defined property rights (Boudreaux and Aligica, 2007), governance structures and boundary rules (Ostrom, 2005) are considered the components to facilitate market exchanges and transactions (Marquis and Raynard, 2015).

#### *Operationalizing (a Theory of) Informal Adjustments*

Studies have shown that for example in the case of informality in Latin America, it can be considered as “a reflection of dysfunctional interaction between individuals and the State and of the latter’s inability to perform adequately in regard to redistribution and the provision of public goods and services” (Saavedra, Tommasi, 2007, p. 279).

Several studies instead have focused on the importance of securing property rights for the effective governance (De Soto, 1989; 2000; Rodrik, 2003) while other studies negative aspects of informal institutions such as low economic performance, corruption and extractive types of institutions (La Porta and Shleifer, 2008; 2014; Acemoglu, Johnson and Robinson, 2001; Acemoglu et al. 2002). In particular, the work of La Porta and Shleifer (2014) has suggested that informal firms tend to have very low productivity, they are small, stagnant and inefficient and that informal economy is largely disconnected from the formal economy. The essentially back a dual model of labour informality.

Within the field of management and organization theory, the relatively little amount of research that has looked in depth at informal institutions and organizations has not been capable of explain these differences in their cases of analysis. Research so far would suggest that informal institutions or rules emergence is explained by formal institutions being incomplete or imperfect (Webb and Ireland, 2015; Bruton et al. 2012; McGahan, 2012; Khavul et al. 2009). In other cases, because formal institutions are considered ambiguous (Uzo and Mair, 2015), or existing but quite ineffective in practice (De Castro, et al. 2013) or by the quality of formal institutions (Autio, 2015). All these approaches are valid and useful to advance our knowledge and understanding of the organizing of economic activity within the informal economy. We would rather argue that these approaches have been somewhat static, because they would focus on the phenomena to study as mere reactions/responses to some type of deficit of formal institutions. Different scholars would explicitly

or implicitly push towards the idea developed by Webb et al. (2009) of institutional incongruence, that is the different signalling towards large group of people of formal and informal institutions. In this study, we aim to move forward the research agenda of the field, by asking a research question that can contribute to understand more dynamically governance mechanisms of informal institutions or organizations when embedded in more complex systems, particular, in polycentric systems. Specifically, we aim to understand what happens when national-level, formal institutions are weak and inefficient, and informal organizations start to interact with lower-level formal institutions (i.e. municipal); we have in this case a system where both, lower-level formal institutions and informal organizations (firms) act in a context of weak macro institutions within what is called a polycentric system (Ostrom, 2005; Batjargal et. al., 2013). Thus, we aim to explaining the mechanisms of self-enforcing exchange and in particular we want to explain the mechanisms used by informal entrepreneurs to enter a polycentric system and how, in a second stage, they exploit opportunities in a polycentric system by producing a form of institutional innovation.

Scholars have been paying attention to how different actors and organizational forms, such as social-movement organizations or hybrid form of organizations, in fragile institutional settings are able to develop alternative institutional arrangements to overcome emerging economies liabilities (McDermott, 2007; Mair, Marti, 2009). In this study, we focus on how informal entrepreneurs enter a polycentric system interacting with lower-level formal institutions (Municipal) and exploit opportunities in a context of limited rule of law. We found that in a configuration of weak and inefficient macro (national) institutions, there is the emergence of governance activities organized in multiple layers of nested enterprises (Ostrom, 2005).

## **METHODS**

This study is part of an effort to understand how informal entrepreneurs enter a polycentric system where they interact with lower-level institutions and exploit opportunities in a context with little rule of law. We follow an inductive, qualitative, and grounded approach (Glaser and Strauss, 1967), to discover the unexpected. Accordingly, this study was intended to generate a new theory, and aims at presenting a new model.

### **Data Collection**

This research is based on a four-month organizational ethnography of La Salada. Ethnographic techniques contribute to capture the interplay of activities and meanings (Van Maanen, 1979). Moreover, we conducted 75 in-depth interviews and collected archival data. Data gathering was organized through a combination of semi-structured interviews, non-participant observation, and the consultation of archival documents.

## **Ethnographic observation**

The first author traveled at the research setting three times a week, twice during the opening time of 2 am until 8 am (Tuesdays and Thursdays) and Sunday mornings from 6 am until 1 pm. On Tuesdays and Thursdays, La Salada operates as a wholesale market, with small and medium formal and informal entrepreneurs coming there from all the countries of the Southern Cone (i.e., Brazil, Paraguay, Uruguay, Bolivia, Chile, and Argentina itself). On Sundays, La Salada serves retail shoppers, most of whom come from the Province of Buenos Aires, as well as other provinces within the country.

According to standard ethnographic guidelines (Hammersley and Atkinson, 1989), the first author observed the weekly practices of the stall owners, attended meetings with CEOs and other managers and took part in social activities after office hours.

We collected more than 550 hours of participant observation, both of the micro-enterprises selling their products and of the work of the CEOs of the three main organizations of La Salada (Punta Mogote, Urkupina, Ocean), including the participation at meetings with clients, politicians, and employees. Such access gave the researcher conducting the field work the opportunity to observe directly the relationships between the informal entrepreneurs and a variety of formal institutions.

## **Interviews**

We conducted interviews with 59 informants working within La Salada, from people belonging to the top-management, to micro-entrepreneurs, stall-owners, workers from sweatshops, but also those working in area such as safety. We also interviewed 16 external stakeholders, such as Argentinian MPs, officials from the Ministry of Labor and other ministries that have a particular interest in employment in the informal sector, senior members of the leading textile industry association in Argentina directly involved in the sector where La Salada operates, staff of an NGO fighting against the informal economy in Argentina (*Fundacion la Alameda*), journalists who had conducted in-depth investigations of La Salada, and political consultants and lawyers working for La Salada.

The interviews of those working in La Salada were conducted on-site. All the other interviews were conducted in the city of Buenos Aires and in the Province of Buenos Aires.

Data were collected between December 2014 and September 2015, through face-to-face in-depth interviews using semi-structured questions. The interviews lasted, on average, 60 minutes, ranging from 35 to 180 minutes. The interviews (all of them conducted in Spanish) were subsequently transcribed by Argentinians. The transcriptions were then reviewed by the author who had conducted the interviews, and the data was coded and analyzed.

**Documents.** We collected archival data to trace event chronologies and discourses over time (Langley et al., 2013). The ethnographer's privileged access included views of internal documents, legal

authorization granted by the local council, and La Salada documents. The proprietary documents were used to validate observations and interview impressions but they are not formally included in the text. We also had access to public policy papers provided by the Ministry of Labor in Argentina, and research books published on La Salada and reports elaborated by international bodies on informality (the International Labor Office and *Women in Informal Employment: Globalizing and Organizing*).

### Data Analysis

We analyzed our data following the prescriptions for naturalistic inquiry (Lincoln and Guba, 1985) and taking a constant process of comparison (Glaser and Strauss, 1967; Strauss and Corbin, 1990). We initially draw on the multiple stories from the interviews, our archival data and several documents gathered to construct narratives of the different organizations (*ferias*) to obtain the first insights on how these informal entrepreneurs entered the polycentric system of local formal institutions. This procedure was an iterative for examination and comparison of key events (Isabella, 1990), in which our understanding of the historical events as they emerged from the first stages of analysis was checked with key informants within La Salada, and with key stakeholders.

Following Charmaz (2006), we collected and analyzed the data simultaneously, and integrated the data analysis by making systematic comparisons throughout inquiry. In line with grounded theory guidelines, the emerging theoretical ideas were constantly compared with the accumulating data, while the researchers remained open to different theoretical understandings, looking for processes in what people said about their experiences and perceptions (Glaser and Strauss, 1967; Charmaz, 2006). In initial coding, each interview was coded separately for processes, with an emphasis on actions, and comparing data with data (Charmaz, 2006). Words, phrases, and key terms mentioned by the informants were coded “in vivo”, and first-order codes derived as a result (Van Maanen, 1979). We then moved to first-order categories, focusing on the actions, aiming for specificity, looking for tacit assumptions, and trying to crystalize the significance of the key codes, now in a more selective or focused way. Once the first-order categories emerged, we look for relations between them, which allow us to move to a higher level of theoretical abstraction and thus obtain second-order themes. These themes constitute induced concepts with a theoretical basis. Finally, following grounded theory guidelines, the second-order themes are aggregated into overarching theoretical dimensions. This process involves both inductive and abductive reasoning, in which plausible theoretical explanations for the emerging data are considered by checking them against the data until the most plausible description is reached (Charmaz, 2006)

## FINDINGS

In this section, we briefly highlight some of the evidence coming from our data set. The Table 1 (below), shows some of the categories emerging from the data analysis. We identified two key phases. In the first one, which we named entering a polycentric system, the workers, entrepreneurs and owners of La Salada were able to take advantage of the ambiguity of the law and the conflicts across institutional centers about the informality and how to deal with it. The findings suggest that different institutional centers in Argentina treated La Salada, differently, and that these entrepreneurs put in place institutional work to taking advantage of this.

Within this phase one, a second process was the leveraging the institutional centres that legitimized the work of these informal entrepreneurs. Here, they would leverage the relationship with the Secretary of Commerce to expand their legitimacy.

**Table 1**

<b>Sample Qualitative Evidence</b>	
Phase 1: Entering a Polycentric System	
Actors: Workers, Entrepreneurs and Owners of La Salada	
Micro Level: <i>Taking advantage of the ambiguity of law, lack of coordination, and conflict across institutional centres regarding informality</i>	Macro Level: <i>Leveraging the institutional centres that legitimize the work of informal entrepreneurs through symbolic actions</i>
1.1 "We are paying all our taxes here, if you look at our books, you see how much money I am paying to the state, then if the state is not capable of raising taxes to the thousands of people working independently here, that is not my duty, it is the state's one"	1.3 "We have been invited by the Government Secretary of Commerce Guillermo Moreno, and we believed it was a good opportunity. Despite the fact that some people discriminate us, today we are fully capable of exporting everything we manufacture in Argentina, to almost everywhere in the world, we recently provided the full list of entrepreneurs of La Salada that will be part of this journey"
1.2 "We are showing the paradox of how formal businesses and shops are buying from La Salada and also from sweatshops producing for La Salada...in fact we are helping to shed light on how formal and mainstream business often, very often do have the same practices as we do, with the only difference we are often stigmatized by the media"	1.4 "We have daily revenues of almost 400\$ million and more than 30,000 people are working in La Salada. We have the conditions required to compete with China and to sell at low prices. I see myself very close and similar to Guillermo Moreno, he is the first top-government official who understand the real value of what we are doing here"
Phase 2: Exploiting opportunities in a polycentric system	
Actors: Workers and Founders of La Salada	
Micro Level: <i>Interacting with lower-level formal institutions (municipal)</i>	Macro Level: <i>Creating new opportunities by taking advantage of the lack of enforcement</i>
2.1 "It is not that they want us to have formal documents (papers). The problem is that	2.3 "And...I know, but I do not think we have much of choice, Quique. We will have to accept. Here, we can be in good terms with

they just want to take our money, and they want more and more money”	the municipality...it may be our opportunity to stop moving from side to side”
2.2 “We made the negotiations, we talked with the municipality, with the security forces...going to negotiate was something new (to us), we learned it at the time...we had to find agreements with them in order not to be hurt, to save the people’s merchandise they seized it”	2.4” The three acres of land, but also the rest of the lots that they (the feria) would be buying over the years, were registered in the “Registro de la Propiedad Inmueble” in the name of Urkupina S.A.”

Within the phase two, that we named exploiting opportunities in a polycentric system, we highlight two processes: interacting with lower-level formal institutions and creating new opportunities by taking advantage of the lack of enforcement. In the first process, the evidence shows the content of the interaction between the informal entrepreneurs and the municipal level institutions. It suggests that this relationship was characterized by formal institutions trying to get as much money as possible from these entrepreneurs. The informal entrepreneurs were capable then to negotiate with lower-level institutions and finding agreements. In the second process, the informal entrepreneurs move one step forward. They are not simply negotiating or just responding to the demands of lower-level institutions, but they begin to take advantage of operating in the shadow of the law. Particularly, they start to acquire land which allows them to expand their business and growth. This process indicates that while in the first phase they would have to adjust to the demands of lower-level institutions, in the second process they are capable of exploiting opportunities by using the same tools required to deal with the municipality.

## CONCLUSIONS

This study suggests that the lack of macro institutions (national level) has been the initial conditions for the informal entrepreneurs of La Salada to start to deal with the lower-level (local) institutions. This emergence of informal institutions which deal with municipal institutions is what we define a polycentric system. Within this system, informal entrepreneurs are skilled enough to take advantage of the ambiguity of the law and the lack of coordination between different institutional centers. Furthermore, they are also capable of, once established in the polycentric system, to negotiate with lower-level institutions and to exploit opportunities where such conditions arise. These findings would suggest that, contrary to the view of scholars who believe that informal firms are capable of building solid institutional arrangements (La Porta, Shleifer, 2014), informal firms are capable to operate in dynamic polycentric systems and taking advantages of such conditions.

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