

Competing with Informality: Strategic Responses of Formal Firms in Dual Economic Systems

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ABSTRACT

This is a conceptual paper that synthesizes established literature in institutional theory, strategic management, and development economics to address a gap that most mainstream strategy frameworks have not adequately confronted: how do formal firms compete when a large portion of their competitive landscape consists of informal businesses operating entirely outside the regulatory system? The paper is written from the perspective of corporate managers, business leaders, and organizational decision makers who need both a clear understanding of the problem and a set of workable responses to it. Drawing on documented theoretical frameworks and real-market observations from developing and emerging economies, the paper traces why dual economic systems develop, what makes informal competitors genuinely difficult to displace, and what specific strategies formal firms can deploy to protect and grow their market position. The paper concludes with six practical advisories for managers, each accompanied by concrete implementation steps. Limitations of the conceptual approach are acknowledged, and directions for future empirical research are identified.

Keywords: Informal economy, dual economic systems, formal firm strategy, emerging markets, institutional voids, competitive strategy

INTRODUCTION

Walk into any busy market street in Lagos, Jakarta, Nairobi, or the outskirts of Lima, and you will see something that formal sector managers rarely account for in their strategy documents: a thriving, chaotic, and surprisingly resilient informal economy running parallel to everything that appears on government registers and corporate balance sheets. Street vendors, unlicensed manufacturers, unregistered service providers, and cash-only traders are not a fringe phenomenon. In many countries, they are the majority of the economy.

Schneider and Enste (2000) estimated that the informal economy accounts for anywhere between 25% and 60% of GDP in many developing nations. The International Labour Organization (2018) reported that more than 60% of the world's employed population earns its livelihood in the informal economy. Those numbers are not small enough to ignore in any serious competitive analysis.

Yet if you search a standard strategic management textbook for a chapter on competing with informal rivals, you will likely find nothing. The field has spent decades refining frameworks for competitive analysis, market positioning, and resource-based advantage, but almost all of that thinking was built on assumptions that simply do not hold in dual economic environments: that competitors follow the same regulatory rules, that prices reflect comparable cost structures, and that market entry is governed by similar institutional constraints for everyone.

This paper addresses that gap directly. It is written for corporate managers, business leaders, and decision makers who operate or plan to operate in markets where informal competitors are a real and persistent

force. The goal is not only to describe the problem but to work through what managers can actually do about it, and how they can move from strategic intent to practical action.

UNDERSTANDING THE DUAL ECONOMY

The concept of a dual economy has a long history in development economics. Lewis (1954) described developing economies as split between a traditional subsistence sector and a modern capitalist sector, with surplus labor flowing from one to the other as the modern sector expanded. That early model captured something real, but it did not quite anticipate what would happen when the surplus labor flowing into cities did not get absorbed into the formal modern sector at all.

Keith Hart (1973) captured that reality in his fieldwork in Ghana, where he observed that millions of urban workers were neither employed in the formal sector nor simply unemployed. They were working, earning, and transacting outside the formal system. Hart coined the term "informal sector" to describe this, and the term has held its explanatory power ever since.

What makes dual economic systems strategically significant for business is that the two sectors do not operate in isolation from each other. They compete for the same customers. A formal firm selling packaged drinking water competes with an informal vendor selling the same product at half the price from an unlabeled container. A registered tailoring shop competes with home-based seamstresses who charge a fraction of the price and deliver to the customer's doorstep. The overlap is constant, and it puts formal firms in a genuinely difficult position.

North (1990) offered a useful lens for understanding why informal sectors survive and grow rather than simply disappearing as economies develop. He argued that formal institutions, meaning the laws, regulations, property rights, and enforcement mechanisms that govern economic life, are costly to build and even costlier to enforce. Where those institutions are weak or incomplete, informal rules and social arrangements fill the gap. People do business based on trust, reputation, and community ties rather than contracts and courts. Informal firms thrive precisely because they operate within this alternative institutional framework, one that formal firms often cannot access or replicate.

This is what Khanna and Palepu (2010) called "institutional voids," the absence of market-supporting institutions that formal firms in advanced economies take for granted. In markets shaped by institutional voids, the competitive environment looks nothing like what conventional strategy frameworks assume. De Soto (2000) made a related point in arguing that the inability of the poor to formalize their assets and activities is itself a product of institutional failure, not personal failing or cultural preference. The implications for formal firms are significant: the informal sector persists not because informal operators are irrational, but because the formal system has not made itself accessible or beneficial enough for them to join it.

THE INFORMAL COMPETITOR: MORE THAN A PRICING PROBLEM

The first instinct among formal sector managers when they encounter informal competition is to frame it as a pricing problem. Informal firms sell cheaper, so the solution must involve cutting costs or finding a way to match informal prices. That framing is understandable but dangerously incomplete.

Informal firms enjoy structural cost advantages that formal firms cannot simply replicate without abandoning their formal status. They pay no corporate taxes. They carry no compliance costs. They do not maintain formal employment contracts, which means no provident fund contributions, no paid leave, and no formal wage obligations. La Porta and Shleifer (2014) found that the productivity gap between formal and informal firms is considerable, but informal firms compensate for that gap through dramatically lower

regulatory and labor costs. That structural cost advantage is not something a formal firm can erase through operational efficiency alone.

But informal competitors offer more than cheap prices. Many of them offer convenience, proximity, personal relationships, and flexible credit that formal firms cannot or do not provide. A customer who buys groceries from a neighborhood informal trader may be doing so not because the price is lower but because the trader knows their name, extends them informal credit at month-end, and delivers to their home. Webb et al. (2009) noted that informal firms often succeed by exploiting what they called "institutional incongruence," the gap between formal rules and what local communities actually recognize as legitimate and fair. Informal firms that serve communities well earn a form of social legitimacy that can be just as durable as legal legitimacy, and in some communities more trusted.

This means that competing with informality is not purely a cost exercise. It is also a legitimacy exercise, a relationship exercise, and in some cases, a political one. Managers who treat it as only a cost problem will keep designing solutions that miss the point.

STRATEGIC RESPONSES: WHAT FORMAL FIRMS CAN DO

Differentiation Through Quality and Credibility

The most direct strategy available to formal firms is to compete on dimensions where informal firms genuinely cannot follow. Quality certification, warranty obligations, after-sales service, standardized products, and verifiable safety standards are all areas where formal firms hold structural advantages that informal competitors cannot easily replicate without becoming formal themselves.

For managers, this means investing deliberately in quality signaling rather than assuming that quality alone will communicate itself. In markets where customers have encountered poor products from both formal and informal sources, the formal label alone does not carry automatic credibility. Certifications need to be visible. Inspection records need to be accessible. Supply chain transparency, store presentation, and even staff appearance all function as credibility signals in markets where customers are appropriately skeptical of unverified claims.

Cost Structure Reconfiguration

Managers cannot match informal prices without compromising the attributes that make their firms formal and valuable to customers who specifically want a formal product. But they can work on narrowing the cost gap in ways that do not require abandoning compliance. Lean operations, supplier rationalization, technology adoption, and process automation can reduce operating costs meaningfully without touching regulatory standing.

Khanna and Palepu (2010) observed that successful firms in emerging markets often reconfigured their business models specifically for local cost realities rather than simply transferring their home-market model wholesale. That reconfiguration often involves rethinking what a product or service actually needs to contain to meet customer needs, stripping out premium features that local customers do not value and are not willing to pay for, and rebuilding the offering around what actually matters in that specific context.

Serving Informal Customers Through Formal Channels

One of the more counterintuitive strategies that some formal firms have pursued is to deliberately serve informal economy customers rather than treating them as outside the target market. This means designing products and payment systems that work for customers with irregular incomes, limited documentation, and no formal credit history. Mobile money platforms in sub-Saharan Africa, for example, have allowed

formally licensed financial institutions to reach customers who previously had no access to formal banking at all. The platform is formal and regulated; the customer base is largely informal.

This approach requires managers to set aside assumptions about what a formal-sector product looks like. Smaller packaging sizes, pay-as-you-go pricing models, mobile-based distribution, and community sales agents are all tools that formal firms have used to reach informal economy customers without sacrificing regulatory compliance or brand credibility.

Institutional Engagement and Regulatory Advocacy

Formal firms sit at an interesting position relative to policymakers: they are the ones paying taxes and complying with regulations, which gives them a legitimate voice in conversations about how those regulations are designed and enforced. Peng et al. (2009) argued that in emerging economies, the institutional environment is itself a competitive arena. Firms that understand this and engage with it actively can influence the rules of competition in ways that gradually favor formality.

This does not necessarily mean lobbying for regulations that crush informal competitors outright, an approach that tends to generate public backlash and rarely works sustainably. It means advocating for a regulatory environment that makes formalization more attractive for small businesses, reduces the compliance burden across the board, and ensures that enforcement is consistent rather than selective. When formalization becomes easier and more beneficial, the informal sector naturally contracts over time.

Coexistence and Complementarity

In some markets, the most realistic strategy is not to defeat informal competitors but to work alongside them in ways that benefit both sides. Formal firms in retail and manufacturing have built distribution networks that rely on informal traders as the last-mile link to consumers. The formal firm supplies the product and maintains quality control; the informal trader handles local distribution using social capital and community relationships that the formal firm cannot replicate on its own.

Portes and Haller (2005) noted that the boundary between formal and informal economic activity is rarely sharp in practice. Formal and informal actors frequently depend on each other in ways that a purely adversarial framing misses entirely. Managers who recognize this can build distribution and partnership models that extend their reach far beyond what a fully formal supply chain would permit.

PRACTICAL ADVISORIES FOR MANAGERS: WHAT TO DO AND HOW TO DO IT

The strategies outlined above describe what formal firms can do in principle. This section translates those principles into six specific advisories for managers, with concrete implementation steps for each one. The advisories are structured to move from diagnosis to action, because the most common failure in strategy implementation is the gap between deciding what to do and actually doing it.

Advisory 1: Map Your Informal Competition Systematically

Most formal firms maintain a reasonably detailed picture of their formal competitors. They track market share, pricing moves, new product launches, and distribution changes. Very few maintain an equally rigorous picture of their informal competitive landscape. That is a basic intelligence gap, and it needs to be closed before anything else can work.

Mapping informal competition means going beyond desk research and internal assumptions. It requires field-level market intelligence: who is selling what, at what price, through what channels, and to whom. It means talking directly to customers about where else they buy and why. It means understanding the informal supply chain that feeds informal competitors and how that supply chain is structured. This is

not glamorous analytical work, but it is foundational. You cannot respond to competition you have not properly understood.

To implement this, assign clear ownership of the competitive intelligence function, including its informal dimension. This work typically falls between departments in most organizations, with marketing finding it too operational and sales finding it too strategic. A designated owner with a budget and a mandate to produce usable outputs should produce a quarterly competitive briefing that covers informal sector dynamics as a standard input to strategy and planning reviews. Field visits, customer surveys that explicitly ask about informal alternatives, and partnerships with local research firms that have ground-level access are all practical tools for building this picture.

Advisory 2: Reframe Your Value Proposition Around Formal Advantages

Managers often default to defending their position against informal competition by talking about quality. That is not wrong, but it is incomplete as a value proposition. The full range of advantages that formal firms offer includes contractual guarantees, consistent product specifications, after-sales service, data security, regulatory compliance credentials that matter for business-to-business customers, and the reputational insurance that comes from dealing with a registered and accountable entity.

The key is to be specific and segment-specific about which of these advantages resonate most with which customer groups. Business customers often care considerably about supplier compliance credentials because they face their own regulatory scrutiny and cannot afford to be associated with unregistered supply chains. Consumer customers in safety-sensitive categories like food, pharmaceuticals, and financial services respond to credibility signals that informal firms genuinely cannot offer. The value proposition needs to be built around what actually matters to the specific customer, not around what the firm finds easiest to talk about internally.

To implement this, start with customer research before rewriting any value propositions. Focus groups, intercept interviews at points of purchase, and digital sentiment analysis can generate the raw material for a sharper and more credible positioning. Once revised, the value proposition needs to be embedded in sales training, marketing communications, and all customer-facing documentation, so that every touchpoint with the customer is reinforcing the same message.

Advisory 3: Compete on Access, Not Just on Price or Quality

Informal firms frequently win on access rather than on product superiority. They are physically closer to the customer. They operate during hours that formal firms do not. They offer informal credit that formal firms rarely extend. Managers who focus only on price and quality miss the access dimension entirely, and it is often the access dimension that is actually driving the customer's choice.

Competing on access might mean extending operating hours, opening smaller-format outlets in underserved areas, building mobile or digital channels that reduce the friction of accessing formal services, or creating installment payment options that make formal products accessible to lower-income customers. None of these require abandoning regulatory standing. They require a willingness to redesign the service delivery model around the customer's actual circumstances rather than around the firm's internal convenience.

A pilot-first approach to implementation generally works better than a system-wide rollout when redesigning access models. Identify two or three geographic markets where informal competition is most intense and customer access to formal alternatives is weakest. Design an access-oriented service model for those markets specifically, measure results rigorously over a defined period, and use the evidence gathered

to build the internal case for broader rollout. Internal resistance to service model changes is almost inevitable; evidence from a working pilot is the most effective way to overcome it.

Advisory 4: Build Institutional Capital Alongside Market Share

Managers in emerging markets tend to focus almost exclusively on market share metrics. That focus misses something important. In markets where the institutional environment is itself unstable or evolving, a firm's relationships with government bodies, regulatory agencies, industry associations, and community organizations are assets that protect market position in ways that market share alone cannot guarantee.

Institutional capital means being known, trusted, and respected by the people and organizations that shape the rules of competition. It means having senior leaders who actively participate in industry bodies and policy consultations, not as a formality but as a genuine investment of time and credibility. It means maintaining relationships with regulators that are built on transparency and consistent engagement rather than crisis management. It means being visible and constructive in conversations about how the regulatory environment for both formal and informal firms develops over time.

To implement this, start with an honest audit of the firm's current institutional relationships. Who do the senior leaders actually know in relevant regulatory bodies? What associations is the firm a member of, and how actively does it participate? What policy consultations has it contributed to recently? That audit typically reveals significant gaps. Closing those gaps requires a sustained investment of senior leadership time, not simply a dedicated public affairs hire who operates at the margins of the real business. Institutional capital is built by principals, not only by designated representatives.

Advisory 5: Reduce Informality Dependency in Your Own Supply Chain

Many formal firms inadvertently sustain the informal sector by sourcing from unregistered suppliers or relying on informal service providers to keep their own costs down. That creates a strategic contradiction: competing against informality in the market while depending on it in the supply chain. It also creates regulatory and reputational risks that tend to be underappreciated until something goes wrong publicly.

The advisory is to audit the supply chain and partnership network for informality exposure, and to build a structured plan for transitioning critical relationships toward more formalized arrangements over a realistic timeframe. This does not mean cutting off small suppliers overnight or imposing compliance burdens that make it impossible for them to continue the relationship. It means providing support, information, and sometimes direct assistance to help key partners formalize: connecting them to finance they could not access alone, helping them understand registration processes, or offering longer-term contracts that make the investment in formalization worthwhile for them. That kind of supportive approach creates a more stable, less risky supply base for the formal firm over time, and it builds goodwill that has its own strategic value.

Advisory 6: Be Disciplined About Where You Choose to Compete

This is probably the most uncomfortable advisory, but it is also one of the most important for long-term firm health. There are segments of the market in dual economies where informal firms hold such a structural cost advantage that formal firms simply cannot compete profitably at current cost structures. The combination of extreme price sensitivity, thin margins, and the informal sector's compliance-cost savings makes those segments genuinely unviable for formal players without a fundamentally different operating model.

Managers need the discipline to identify those segments clearly and make a deliberate strategic choice about whether to pursue them, and if so, how. Sometimes the right answer is a separate low-cost subsidiary or a partnership model that achieves market coverage without the full cost structure of the formal parent.

Sometimes the right answer is to concede those segments and concentrate resources on segments where formal advantages can be maintained and defended. The worst outcome is to pursue loss-making segments halfheartedly with a cost structure that cannot support them, draining resources and management attention while delivering poor returns and no strategic learning.

A clear-headed segmentation analysis is the starting point for implementation here. Each major market segment needs a realistic profitability assessment that accounts for informal competition as a structural factor, not a temporary anomaly. That analysis needs to be presented to senior leadership with honest recommendations, including, where the numbers warrant it, the recommendation to exit or restructure certain segments rather than continuing to compete in them by default.

LIMITATIONS

As a conceptual paper, this work draws on published theoretical frameworks and general market observations rather than original empirical data. The advisories put forward here are grounded in established literature and documented market experience, but they have not been tested through a systematic empirical study across industries or geographies. Readers should treat them as analytically informed starting points rather than empirically validated prescriptions.

The paper also deals with a broad phenomenon, informality, that varies considerably across countries, industries, and cultural contexts. A strategy that works well for a consumer goods firm in West Africa may be poorly suited to a financial services firm in Southeast Asia or a manufacturing company in South Asia. The general principles hold across these contexts, but the specific application requires local judgment and market-specific knowledge that no conceptual paper can fully substitute for.

Future research that tests these strategic responses through comparative case studies, longitudinal firm-level data, or structured field experiments would considerably strengthen the evidence base for the advisories outlined here. Industry-specific studies would also be valuable, since the intensity and character of informal competition differs significantly between sectors such as retail, manufacturing, financial services, and healthcare.

CONCLUSION

The informal economy is not going away on its own. In many developing countries, it has grown in absolute terms even as formal institutions have strengthened over time. For corporate managers and business leaders working in these environments, treating informality as a temporary nuisance or as a regulatory enforcement problem to be solved by government is a strategic mistake. Informality is a structural feature of the competitive landscape, and it needs to be treated as such.

Formal firms are not without genuine advantages. They can access formal finance, credibly signal quality and reliability, build institutional relationships, and scale in ways that most informal competitors cannot. The challenge is to build a strategy that actively deploys those advantages rather than assuming they will naturally translate into competitive success against rivals who operate under a fundamentally different set of cost and compliance realities.

The six advisories laid out in this paper are not exhaustive, and they are not a universal formula. Every market and every industry generates specific dynamics that require specific adaptations. But the underlying logic holds across contexts: understand the informal competitor honestly and in detail, compete on dimensions where formal advantages are real and defensible, build institutional relationships that protect market position over the long term, reduce your own dependency on informality, and make clear-eyed choices about where to compete and where to concede. That combination of intellectual honesty and

strategic discipline is what separates formal firms that build sustainable positions in dual economic systems from those that keep wondering why their standard playbooks are not working.

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