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PARITY, PATERNALISM AND PEONAGE IN THE INFORMAL ECONOMY: AN EMPIRICAL STUDY OF OFF-THE-BOOKS LOANS

RICHARD A. HUNT
Leeds School of Business
University of Colorado – Boulder
Boulder, CO 80305

KIP KIEFER
University of Colorado – Boulder

INTRODUCTION

This study provides a rare portal to informal economic behavior through the use of transaction-level data involving 459 off-the-books (OTB) loans issued to employees at 83 small and medium-sized businesses. Our findings suggest that actors who perceive formal market alternatives to be inefficient or unfair will seek complementary exchanges in the informal economy. Through this, relational surplus is created; however, business owners deftly appropriate the surplus by binding employees through paternalism and peonage, simultaneously creating both opportunities and serious complications for disadvantaged participants.

Financially and operationally, there seems to be no incentive to lend money to employees. If interest is charged, it almost certainly falls below the owner's cost of capital. If default occurs, there is no constructive means to extract payment from the employee without the risk of business disruption. And yet, not only do business owners frequently lend money to employees; they often do so "off-the-books," meaning that the loan is made as an informal economic transaction with no loan agreement, no interest, and no repayment schedule (Glasscock, 2011; Osteryoung, 2011; WSJ, 2010). OTB loans flout applicable tax laws because neither party to the transaction recognizes it as a taxable event (26 U.S.C. 102(c)). The existence of OTB loans is a curious phenomenon. Why would a business owner ever assume the risk of making a loan through informal economic mechanisms, with no documentation, legal recourse or apparent financial benefit? And more generally, why would an individual forego the protections of formal markets and institutions by engaging in informal market mechanisms even when formal alternatives are available?   While commonsense would seem to dictate that an owner should either refuse to lend altogether or should at least insist upon a comprehensive loan agreement that addresses creditor rights, this study suggests that informal market activity through OTB lending constitutes a rational alternative to formal market inefficiencies (Henry, 1987; Castells & Portes, 19889; De Soto 2000; Portes & Haller, 2005; Venkatesh, 2006; Chen, 2007), labor uncertainties and unavailability of reasonable credit.

THEORETICAL FRAMEWORK AND HYPOTHESES

The Informal Economy

Social conditions are undeniably connected to the persistence of the informal economy, but an exclusive focus on social conditions can result in the myopic categorization of the informal economy as a patently third world phenomenon (Portes et al., 2005). Conversely, a

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focus on decision-making logics may result in a more fruitful distillation of the reasons individuals engage in unofficial activities. For instance, Webb et al., assert that the informal economy engages "activities through which actors recognize and exploit opportunities" (2009: 492). Extending this line of analysis, we predict that the common thread running through informal activity involves actors choosing between formal and informal mechanisms based on two factors: (a) a personal preference test, driven by necessity, opportunity cost and perceived fairness; and (b) the ability to identify and informally contract with a party experiencing a complementary need that cannot be serviced through formal market mechanisms. We agree with Godfrey that "one avenue for fruitful inquiry would consider not *if* informal and formal arrangements are substitutes or complements but *when* the two substitute for each other" (2011: 268). More formally, we predict:

Hypothesis 1: Individuals will choose to engage in informal economic activity even when formal market alternatives are available when the formal market alternatives are perceived to be unattractive

Social Exchange Theory

The informal economy is "governed by custom or personal ties" (Godfrey, 2011:231) in which the "relationships are grounded primarily on social, not legal, contracts" (London & Hart 2004: 352). Given this, social exchange theory (SET) plays a central role describing the interactions that result in informal activities. In the context of OTB loans, the social exchange that takes place between the owner and the employee consists of movement of resources, when imperfect market conditions exist, between dyads via a social process (Emerson, 1976). We predict that business owners will issue OTB loans in order to transform the loan from a financial transaction into a social exchange. However, this preference will only occur in dealing with the most highly prized employees. In essence, the owner uses the informal economy to operationalize benefits that can only be accrued by transforming the loan into a social exchange.

Hypothesis 2a: Business owners will prefer to use informal economy mechanisms with their most-valued employees by issuing OTB loans.

Hypothesis 2b: Business owners will prefer to use formal economy mechanisms with their less-valued employees by issuing written, tax-compliant loan agreements.

Relational Surplus

Relational exchanges have the potential to create value for complementary exchange participants (Dyer & Singh, 1998, Poppo & Zenger, 2002). In the context of the informal economy, relational mechanisms and relational surpluses provide a potent explanatory framework precisely because action is being taken outside the boundaries of formal markets and formal institutions. Although clearly intended for application to the competitive dynamics associated with interfirm alliances, Dyer and Singh's model has interesting implications when transported as a framework to the realm of complementary dyadic exchanges. Although Dyer and Singh (1998) refer to the supernormal gains as "relational rents," it is more fruitful to consider this quantity as a relational surplus in the OTB context of interpersonal exchanges. From a microeconomic perspective this relational surplus is essentially a consumer surplus (Marshall, 2009), the difference between the market-clearing price and the price consumers

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would have been willing to pay. In the case of an interpersonal relational transaction, idiosyncratic linkages allow for a surplus to be generated through an exchange relationship. Absent the exchange, neither partner could achieve the same results in the formal market. OTB loans function in precisely this fashion. The employee needs access to immediate credit at a reasonable rate and the business owner needs a source of reliable labor. Only through the issuance of an OTB loan to top-quality employees can the relational surplus be maximized.

Hypothesis 3a: Business owners will seek to maximize the relational surplus when lending to their most-valued employees.

Hypothesis 3b: Business owners will seek to minimize the relational surplus when lending to their less-valued employees.

Parity, Paternalism and Peonage

Owners' efforts to bind employees through informal economic mechanisms demonstrate the simultaneity of "creativity and coercion" (Godfrey, 2011:265) that underlies much of the informal economy. Venkatesh's insightful explication of the informal economy's schizophrenic nature reveals a conundrum whereby participants encounter opportunity alongside exploitation and punishment (2006). Portes and Sensenbrenner find that informal mechanisms are often accompanied by a loss of "individual freedom" (1993: 1333). The forces of subjugation appear to be linked to the reality that "informality is a feature of labor-capital relations" (Fortuna and Prates, 1989: 79). Indeed, labor-intensive industries are particularly susceptible to the "dark side" of the informal economy. Even relational exchanges that appear to be complementary must be evaluated in terms of parity, paternalism or peonage. Although the reciprocal exchange between business owners and employees appears to be fair and balanced (Akerlof, 1982), the question is: Once a relational surplus is created, who stands to benefit? At first, it appears that employees realize the benefits of the surplus because they are fully paid in cash for the loan at the time of the transaction. However, the owner can recoup the principal and time-value of the money by binding the employee for a protracted period of time. The owner appeals to social, cultural, ethical and economic factors (Knight, 1986; Cross, 1979) to appropriate the relational surplus. Paradoxically then, by explicitly crafting a non-financial transaction with valued employees, the business owner succeeds in achieving a far more lucrative financial payout than if the transaction had been a formal, financial arrangement.

Hypothesis 4: Business owners will appropriate the relational surplus created by complementary informal economy exchanges with their employees.

By exploiting socio-cultural biases towards the most credit-marginalized employees, we predict that business owners will exhibit paternalism and peonage more frequently in their lending to minority workers than to non-minority workers (Alston et al., 2009; Cross, 1979). These dimensions of paternalism and peonage are tested in the following set of hypotheses:

Hypothesis 5a: Business owners will issue OTB loans to minority workers more frequently than non-minorities.

Hypothesis 5b: Business owners will issue large OTB loans to minority workers more frequently than non-minorities.

Hypothesis 5c: Business owners will issue OTB loans to minority workers more frequently than they will issue formal, tax-compliant loans.

Hypothesis 5d: Business owners will issue OTB loans to non-minority workers less frequently than they will issue formal, tax-compliant loans.

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DATA AND METHODS

Cognizant of prior literature connecting informal activity to "labor-intensive businesses requiring little capital" (Henry, 1989:140; Becker, 2004), we concentrated our initial search for informal economic decision-making and behaviors in labor-intensive industries. In order to assemble a pool of loan transactions for this study, we chose to focus on specialty contractors: painting, asbestos abatement, walls and ceilings, roofing, masonry, glazing and curtain walls. This sector was chosen in order to access businesses facing a common set of macro-level challenges and industry-specific features, including a heavy reliance on labor as the largest factor of production. Using Colorado trade association web sites and directories, we compiled list of 900 specialty contractors for initial screening. From this pool, an addressable survey population of 124 potential participants was identified, comprised of individuals who owned operational businesses with at least three employees and who had previously loaned money to employees. From this group, usable data were obtained for 459 transactions from 83 businesses. 197 loans (43%) involved a formal loan agreement detailing interest, repayment terms and recourse in the event of a default. 262 loans (57%) were issued off-the-books.

Dependent Variables

Three dependent variables were used to test the hypotheses: loan type, large OTB loans and relational surplus. *Loan Type* is a discrete dichotomous variable, involving the issuance of either a formal, legally compliant loan or an off-the-books loan. Applying applicable provisions of the U.S. Internal Revenue Service (26 U.S.C. § 102(c)), the definitions were set so there are no possible categorizations other than "formal" or "OTB." *Large OTB Loans* consisted of OTB loans over $1,000. And, *Relational Surplus*, is essentially "consumer surplus" (Marshall, 2009), the difference between the price an owner actually paid for labor or the interest an employee actually paid for a loan versus the highest price that they would be willing to pay, respectively.

Measures

Loan Type. Coded with a value of 1 if an OTB and 0 if a formal loan.
Loan Amount. A continuous variable of the principal amount loaned.
Large Loans. Coded 1 if the loan principal exceeded $1,000 and indicating 0 otherwise.
Minority Employee. Variable has a value of 1 if employee is Minority and 0 otherwise.
Minority Employer. Variable has a value of 1 if employer is Minority and 0 otherwise.
Employee Gender. A dummy variable that has a value of 1 if the employee is male.
Employee Age. This is a continuous variable for employee age at the time of the survey.
Length of Service – Pre-Loan. Total length of employment prior to receiving the loan.
Length of Service – Post-Loan. Total length of employment after receiving the loan.
Performance Rating. Rating between 1 (low) and 5 (high), assigned by business owners.
Reason for the Loan. This is a categorical variable based on a ladder of ten loan request categories, ranked by severity of financial need.

*Control Variables***.** Control variables are included in the models in order to properly account for potential differences arising as a consequence of observed and unobserved firm-level and macro-level effects.

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Model Specifications

Three statistical methods were used to test the hypotheses. The most basic of these, mean differences, relates to those hypotheses that predicted an occurrence of the focal phenomena at a rate statistically greater than random chance. The second method utilizes logistic regression to assess the probability of an outcome in relation to a set of hypothesized predictors. Key among these is the set of predictors related to the issuance of formal or OTB loans. The final method involves model comparisons using OLS regression to test for the best fitting relationship between relational surplus and transaction-specific and employee-specific predictors.

RESULTS

Analysis of the model results reveals significant support for all of the hypotheses, with noteworthy effect sizes and a probability of error less than 0.001.

In extending propositions by Chen (2007) and Portes and Haller (2005), Hypothesis 1 predicted that informal economic activity occurs even in the presence of formal economic alternatives. Logit results provide strong support for this assertion. Among owners who issue both formal and OTB loans greater than $1,000, OTB loans were issued 72% of the time, confirming our prediction that actors engage in informal economic activity even in the presence of formal market alternatives.

Analysis of Hypotheses 2a and 2b support the prediction that the most-valued employees are channeled towards OTB loans while less-valued employees are channeled towards formal loans. From an owner's perspective, an employee's value is demonstrated by the ability and willingness to deliver "good and faithful labor" (Alston & Ferrie 1993). Among owners issuing both formal and OTB loans there is a pronounced preference to use OTB loans with the most-valued employees and a preference for formal loans with the least-valued employees. For example, 96% of employees who were rated as a "5" (on a scale of 1 to 5) were issued an OTB loan. Furthermore, 90% of employees between the ages of 30 and 35 (prime labor years in these industries) were issued an OTB loan.

Hypothesis 3a predicted that owners attempt to maximize the relational surplus with their most-valued employees, while hypothesis 3b predicted owners attempt to minimize the surplus with their least-valued employees. OLS analysis provides strong support for both hypotheses. The data suggest that business owners will issue OTB loans when doing so will enrich their self-interest. The measure of this enrichment is relational surplus; the value created by transacting a complementary exchange at a cost less than what would have been achievable through formal market mechanisms. The relational surplus across the 459 transactions ranged from a low of $23 to a high of $44,361, with a mean value of $2,917. On average, formal loans created a relational surplus of $227, while OTB loans created a surplus that is 23 times greater, at $4,940.

Regarding Hypothesis 4, we have asserted that business owners are motivated to create relational surplus through employee loans because doing so addresses formal market difficulties in obtaining and retaining reliable labor. In analyzing all 459 transactions, there is evidence that the issuance of an OTB loan results in extended service, enabling an owner to appropriate the relational surplus though the avoidance of numerous costs: recruitment, training, equipment, quality impacts, and productivity impacts. The length-of-service effects are even greater for loans over $1,000. Consistent with our predictions, large OTB loans result in 1.74 more years of service (i.e. 1.78 years for formal vs. 3.52 years for OTBs). In order to determine if the owner

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appropriates the relational surplus, it is necessary to calculate the value of extended service. As part of the detailed survey, we asked owners to estimate the annual retention benefit based on the performance rating scale. Applying the mean values to each of the 262 OTB loans in the study, owners fully appropriate the relational surplus 94% of the time.

Hypotheses 5a, 5b, 5c and 5d involve an intensive analysis of the role played by ethnicity in the issuance of debt. Both the logit analysis of loan type preferences and the OLS analysis for relational surplus provide support for the four hypotheses. Even after controlling for performance rating, age and reason for loan request, being a minority was positively related to the issuance of OTB loans and the creation of relational surplus. Supporting hypotheses 5a and 5c, minority workers are issued substantially more OTB loans, relative to formal loans and to the lending trends involving non-minorities. With respect to large OTB loans, the logit analysis demonstrates that the disproportionate tendency to issue OTB loans to minority employees increases with loans over $1,000. This support for hypotheses 5b and 5d is reinforced by the findings that minority employees received 94% of the large OTB loans, despite representing only 70% of the employee population. The results in support of hypotheses 5a through 5d suggest that minorities are disproportionately targeted for this cycle of surplus creation and appropriation.

DISCUSSION

Relational exchange in the form of OTB loans to employees is a microcosm of the conundrum that engulfs all efforts to comprehend the informal economy. On the one hand, a complementary OTB exchange that allows each party to reciprocally internalize one another's costs appears to be highly entrepreneurial. On the other hand, while OTB loans may appear to be parity-based transactions at the time of the complementary exchange, the targeting of minority employees and the significantly longer post-loan tenures for OTB recipients suggest that parity gives way to the forces of paternalism (Alston & Ferrie, 1993) and peonage (Fishback, 1989) when owners appropriate the relational surplus created by the exchange.

In the end, our study of OTB data generates a number of empirical and theoretical contributions. First, this study is among the first to examine the informal economy at the transaction level of analysis. Second, we offer empirical evidence that informal economic activity occurs even in the presence of formal market alternatives. This constitutes the first study of which we are aware that demonstrates a selection-choice dynamic in which actors actively choose to undertake either formal or informal economic activity. Third, we present an explanatory mechanism for the presence of informal activity in developed countries, namely: actors perceiving formal market alternatives to be inefficient or unfair will seek to consummate complementary exchanges in the informal economy. We invoke the concept of "relational rents" (Dyer & Singh, 1998) and extend its application in novel fashion to dyadic interpersonal exchanges, recasting the relational element in terms of "relational surplus." As complementary exchanges, OTB loans create benefits that neither party could achieve independently using formal mechanisms. Finally, we contribute empirically and theoretically to understanding the informal economy as a collection of "mixed blessings" (Venkatesh, 2006, Portes & Haller, 2005) by extending the conceptualization, developed by LaPorta and Schleiffer (2008) that neither a romantic nor a parasitic model of the informal economy is useful or accurate (LaPorta & Schleiffer, 2008; Portes & Sensenbrenner, 1993; Venkatesh, 2006).

REFERENCES AVAILABLE FROM THE AUTHORS