Exploring the processes underpinning informality

A research project about the grey economy in Kosovo*

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Abstract: The paper at hand constitutes a draft version of a project plan regarding a study of the grey economy in Kosovo. The aim of the paper is to argue the need of a broader institutionalist perspective in order to fully understand the workings of and the persistent nature of informality. Based on a discussion of the points of departure of the project as whole, with its particular focus on Kosovo, the paper at hand turns into a theoretical discussion of dominant perspectives of informality, in which three main schools are being identified. The most recent one, the legalist school, builds upon the theoretical approaches of rational choice institutionalism and the new institutionalism in economics. However, elements within the literature on informality hint at features of the grey sector that are not easily captured by these theoretical approaches. Therefore, the paper argues the need of a broader institutionalist perspective - one that provides greater room for true agency – in order to understand the more abstract question of institutional stability and change with regards to the grey economy.

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Introduction

The whole city seemed to be in a permanent state of change. Construction sites were everywhere; buildings were being torn down, and half-finished steel and concrete structures dotted the landscape. Little shops were squeezed into every available niche: most were simple steel structures with metal walls. The city appeared to be bursting at the seams. Much of it looked unfinished or plainly improvised (Vöckler 2008, 8).

The city found in a permanent state of change is Prishtina. After the Kosovo conflict of 1999, Prishtina came to embody many features of informality – as most noticeable perhaps in the lack of urban planning and the “turbo urbanism” that transformed the townscape. Vöckler claims that “Prishtina is everywhere” – at the same time referring to the growing city as such, but also to the fact that what is seen in Prishtina is to a large extent a global phenomenon (Vöckler 2008). Naturally, the general spread of informal activities, also highly noticeable within the private business sector, was not a development that went unnoticed. In particular, in the many programmes of reconstruction (promoted first by the international protectorate and later in cooperation with the national government of Kosovo) the need of turning grey businesses into formal ones has been strongly underlined in order to facilitate the introduction of a market economy. As argued below, in order to understand the processes and dynamics of the grey economy, it is suitable to look upon the phenomenon as a social dilemma. To some extent, this goes against the dominant view of informality which considers the solution to be much more unidirectional.

In 1984, March and Olsen wrote: “It is interesting to suggest that political institutions and the society are interdependent, but that statement needs to find a richer theoretical expression” (March and Olsen 1984, 742). Against the background of informality, this statement appears still highly relevant; turning the grey economy into an interesting phenomenon to explore in order to gain a more complete picture of institutional change and stability - both from a purely empirical point of view but also from a more theoretical stand.
The point of departure of this thesis lies in the existence of an empirically-theoretically driven puzzle, grounded in the notion of the persistent nature of so-called social dilemmas - a conceptual visualisation of a most real empirical phenomenon (See for example Rothstein 2003 who instead uses the term social trap). After the self-proclaimed declaration of independence in 2007, fears that Kosovo will remain an unfinished state in the midst of Europe have partly been transformed into fears that it will instead become a failed state, marked by weak state capacity and lacking administrative power over its territory. Parallel to a discussion of whether the Weberian state model is really a viable solution to strive for in the Kosovo case (and similar ones) or if there is a need to move beyond territory and hierarchy to a more complex model of governance based on a premise of dispersed and functional structures of control (Stroschein 2008); a large share of the reforms promoted by the national government of Kosovo and the United Nations/European Union aims at the former model, i.e. institutional-strengthening at the national and local levels, in order to achieve a social and economic development.

During the 1990s, the existence of the Kosovar\(^1\) parallel society was characterized by a strong social pressure – both explicit and implicit – to conform to certain principles and ways of acting (Pula 2004). Often, the parallel society is described as a successful example of non-violent resistance, as the Kosovars created and maintained a shadow state (towards Serbia) which consisted of various functions, for example an education system (Maliqi 1998; Pula 2004; Stroschein 2008). According to Stilhoff Sörensen, the Albanian population came together due to a notion of Serbia being the enemy and independence being the common goal. The struggle against the Serbian state functioned as a homogenizing factor for the Albanian population and what it meant to be Albanian was partly defined in opposition to “Serbian-ness” (Stilhoff Sörensen 2006b).

As Kosovo together with the EU now strives to create a functioning state of its own, one could tentatively imagine at least two possible consequences stemming from this particular social

\(^1\) The term “Kosovar” could technically denote any inhabitant of Kosovo no matter ethnic origin. However, the term has largely come to refer to Kosovo Albanians only, which is also the use in this paper and in the project as a whole.
heritage: one being a strong support of the national state institutions (for example manifested in a willingness to pay taxes), another being a continued resilience towards any kind of state authority, Kosovar or Serbian alike. Given the long history of struggle against the Yugoslav/Serbian state – aptly depicted by Judah as “(…) in Kosovo, history is not about the past, but about the future” (Judah 2002, 2) – one would have suspected the strong support for the national government to persist after the declaration of independence (especially perhaps since this was a unilateral one), i.e. the former tentative consequence would appear as most likely. Rather unexpectedly thus, many indicators point at the latter development – unexpected given that the extremely strong unity that existed among the Kosovars only a few years ago does not appear to be channelled towards the own national government.

As an example, in a survey conducted by the UNDP and the USAID in January of 2010, the level of satisfaction with the governing institutions of Kosovo has decreased by some 20 percentage points since September 2009 and shows that around 36 percentages of the respondents are satisfied with the national government (UNDP Kosovo/USAID 2010). Another example comes in the form of the existence of a sizeable grey economy\(^2\) – an empirical phenomenon with grave consequences for any state's attempts of achieving de facto administrative control over its territory and its citizens. The problematic implications stemming from informality have been recognized by both the international community and the Kosovar government; the need of decreasing the size and spread of unofficial economic activities – in particular among micro- and small entrepreneurs - has been underlined since the first programme of reconstruction after the conflict of 1999 and is still considered decisive in order to achieve an economic and social development (Džihić and Kramer 2009; European Commission/World Bank 1999; B&S Europe 2007). At a conference in 2008, Kosovo's Prime Minister Hashim Thaçi presented his view by stating that: “the non-formal economy in Kosovo represents a considerable part of gross local production. It has a negative impact on the country's development, consequently hindering both economic growth and the wellbeing of Kosovo's citizens” (Thaçi 2008). Thus, a formalisation of the grey economy is seen as necessary in order to “fix” Kosovo and avoid the seal of failure.

\(^2\) Hereafter the terms grey economy/sector, unofficial economy/sector and informality will be used interchangeably. Another commonly used term is “informal economy” which is not used in this project in order to avoid conceptual confusion with the concept of informal institutions.
In order to get a more complete understanding of the (somewhat unexpected) Kosovar development – and, on a more abstract level, of problems facing a state under construction that tries to achieve administrative control over divergent sectors of the society - this thesis argues the need for a more thoroughly explanation of the persistent nature of social dilemmas, in this project embodied by a sizeable unofficial economy. In the spirit of Migdal, the existence of a grey economy is considered an empirical manifestation of deficient state capacity in the notion of “the ability of state leaders to use the agencies of the state to get people in the society to do what they want them to do” (Migdal 1988, xiii).

The basic idea being that it is not only the state and the issuing of rules and regulations that exert an impact over the grey economy and the society in general, but that the relationship is rather one of reciprocity, where the capacity of a state stands in relation to structures found in society (Migdal 1988, xiv). However, the theoretical assumptions put forward by the dominant perspective upon informality – which also many of the reforms pursued in Kosovo build upon - argue that the unofficial sector can be diminished through the means of changes in the surrounding formal institutional framework, i.e. promoting a top-down solution to informality. Stilhoff Sörensen argues that in the Kosovo case, the provision of incentives so that the grey economy can merge with the formal one should be interpreted as an attempt of trying to introduce an economy which has never existed in the region through the means of the formal institutional framework (Stilhoff Sörensen 2009).

In viewing the Kosovar grey economy as a social dilemma – opening up for the possibility that there is an incongruence between realities-on-the-ground and state stimuli to fight informality - a more complete picture will be given both of the persistent nature of the grey economy and of the more abstract issue regarding problems facing a state that tries to achieve autonomy and authority over its citizens. Attempts of turning the informal into formal are issues of institutional change – of a change in the rules that define action and interaction within the grey economy so that actors within this sector become inclined to take the step (or at least more steps) into the formal and officially regulated economy. Looking at the phenomenon of informality though, it appears to be a trickier question than expected to achieve such an institutional change;
suggesting that a more complete explanation of the mechanisms that work for the persistence of informality is called upon.

Aim and research questions

The aim of this project is to gain a more complete understanding of the dynamics when a state tries to regulate sectors of the society over which it only holds a weak control. More precisely, the aim is to analyse the Kosovar unofficial economy as a case of a social dilemma (thus a somewhat broader notion than viewing it only as a case of a grey economy); in order to both understand the functioning of this sector and to explain if and then how the “mechanisms of reproduction” of the institutional order (Thelen 1999) play a role during state attempts of formalisation. As touched on above, in the back sweeps of the breakthrough of the legalist perspective on informality (following the groundbreaking work of de Soto in Peru) a great deal of the present developmental work to “deal with” informality has its base in the theoretical perspectives of rational choice institutionalism and new institutionalism in economics (Ishengoma and Kappel 2006). With the legalist school and from a purely economic perspective, the solution to the problem had appeared. However, on a general basis, reforms based on this perspective have been unable to decrease the size of the grey sector in the expected way (Arruñada forthcoming; Calderón Cockburn 2002).

By focusing on the Kosovar grey economy as a case of a social dilemma, the aim of the thesis is clearly marked by an empirical stance. Nonetheless, the issue is a broader one that easily can be raised to a more theoretical level, namely to the much debated question of institutional stability and change; the argument here being that more interest ought to be directed towards the role played by informal institutions in this process. As argued below, the literature on informality points at the importance of informal institutions – values, perceptions, norm systems (and the possible consequential organisational forms) – but fails to develop this notion any further. Thus, by focusing on the institutional underpinnings of the grey economy, present theories on informality will be developed with the help of a broader institutional perspective than hitherto employed. In order to understand possible difficulties facing a state that tries to promote an institutional change, this thesis will turn the matters upside down and analyse the grey economy
from a bottom-up perspective; focus being directed at the interplay between actors, institutions and the workings and progression of the unofficial economy. As argued by Helmke and Levitsky, informal institutions have the power to shape formal institutional outcomes by – through various processes - strengthening or weakening incentives to comply with the official rules and regulations (Helmke and Levitsky 2004).

The over-arching research question guiding this thesis inverts the question of state-driven formalisation, asking: *Do – and in that case how - informal institutions existing in the Kosovar society affect the chances of achieving an institutional change with regards to the grey economy?*

If we take a closer look at this question it becomes clear that it is made up out of two sub-questions. The first is of a more descriptive character and relates to the look and content of the informal institutions that are, presumably, of importance for the grey economy to function: What kind of informal institutions exist in the Kosovar society that might be of importance for the internal dynamics of the Kosovar grey sector? The answering of this question will proceed from an ideal typical categorization of various types of informal institutions coupled with analyses of historical and present-day material regarding the existence of norms and values within the general Kosovar society, both towards fellow citizens and towards state institutions. The second sub-question follows naturally and focuses on the possible causal relation between informal institutions and a persistence of informality: Might informal institutions function as mechanisms making relevant actors capable of resisting state reforms that aim at formalising informal economic activities? In other words, this second question departs from the Kosovo society in general and focuses exclusively on the grey sector; the idea being to investigate whether informal institutions might create, widen or shrink opportunity structures related to acting in the unofficial economy rather than the official one.

*Contributions*

The notion that the economy is embedded in a socio-political context is a central tenet in the field of political economy, rejecting the study of the economy (and the market) as a separate unit of analysis. This point - the essentially simple coupling between the economic, the political and
the social - may seem a cheap one to make. Still the literature on the grey economy is characterized by a strong focus on cost and benefit calculations while considerations that include the intersection of the social and the political are left behind (Gërxhani 2004). This situation has bearings both for the empirical and theoretical contributions of the project.

As stated, the thesis will focus on the empirical analysis of the particular Kosovo case – where the legalist solution to informality is pursued – aiming at giving a more thoroughly understanding of the unofficial economy and its repercussions over the process of state building. As stated, the importance of the Kosovar private sector - in particular micro and small enterprises - for an economic development to occur is strongly emphasised, and the need of making the grey sector of the economy to join the formal one is recognised. Without exaggerating, it is clear that the empirical question explored by this thesis is connected to the larger question of stability for the region as a whole.

Further, there is a general lack of studies exploring the question of informality in the post-Yugoslav countries, why this thesis will help to fill an empirical lacuna (Sources – Gërxhani 2004; Losby et al 2002). Stilhoff Sörensen has conducted one of the very few existing studies of the unofficial economy in Kosovo (and Serbia) and more so - one of the few that analyses this sector from the viewpoint of political economy; arguing that economic relations and institutions are shaped within – and thus an integral part of – the surrounding political, social and cultural context (Stilhoff Sörensen 2006a, 33). In his thesis as well as related works, Stilhoff Sörensen analyses what he calls the emergence of the shadow economy in Serbia and Kosovo and the role played by the grey economy during the Yugoslav conflicts. In particular, Stilhoff Sörensen pays attention to the criminal side of the informal sector – how organised crime faced a new opportunity structure given the context of conflict. Accordingly, by placing the emphasis on the “war economy” (Stilhoff Sörensen 2006b, 323) and by being less interested in theory development and the role of the “non-physical dimension” of informal institutions, the project at hand differs from the work of Stilhoff Sörensen although use is likely to be made out of his research.
Regarding the theoretical contribution, this is twofold as well. First, by embarking from the notion of an embedded economy, the dominant theory regarding the motivations and actions of actors within the grey economy will be developed by analyzing the possible importance of informal institutions. This argumentation will be explored by investigating the underlying theoretical assumptions of this perspective – based on rational choice institutionalism and new institutionalism in economics – and analyse whether the causes of informality might not be the same as the cures (i.e. explaining the persistence). After more than twenty years since Migdal wrote his famous book, state capacity is not as much taken for granted and there is indeed a greater acknowledgement of the not always straightforward relationship between formal rules and regulations and the existence of informal practices (North 1990, 45). Nonetheless, despite being recognised as important, informal institutions – and in particular any systematic analysis of these – remain at the margins of institutionalist thinking, not least in connection to questions of stability and change (Helmke and Levitsky 2004).

On a yet more abstract level, the analysis of the grey economy as a social dilemma will deeper the knowledge concerning institutional change and stability and the role played by informal institutions - central themes within the discipline of political science (Goodin 1998, 17). Thelen (1999) argues that in order to understand institutional change it is essential to understand the “mechanisms of reproduction” that work to sustain a particular institutional order. This is something agreed upon by this project. However, in many institutionalist perspectives the space for endogenous change – as well as what I intend to name “active endogenously created stability” - is highly limited. Therefore, I argue that we should re-direct the focus towards stability (without for that matter equalling institutions with structures); the interesting issue being how the institutional order is upheld, what mechanisms are involved and the role of actors within that process.

**Viewing informality as a social dilemma**

A “social dilemma” is a metaphor for a most real empirical phenomenon, also known as the tragedy of the commons (Hardin 1968), the logic of collective action (see for example Olson
1965; Ostrom 1990) and the often used idea of the prisoners' dilemma. The idea of a dilemma refers to that when a group, an organization or a society finds itself being caught in such a situation it is often difficult to escape it – a solution demands trust to be established for example among individuals or between the members of a society and the state institutions. The central idea here is that the behaviour of an individual is influenced (wholly or partially) by his or her judgment of how other relevant individuals will act. Behaviour is seen as strategic but not necessarily rational in the sense of rational choice theory with its base in pre-set preferences. Rothstein is one to argue that an analysis of the workings of a social dilemma is not necessarily based on the assumptions of either rational choice theory or rational choice institutionalism but might equally well be based on things such as social norms or culturally established worldviews. Rather, what is to be seen as rational is wholly or partially decided upon by the social and institutional context and here the concept of trust plays a central role (Rothstein 2003).

In order to fully grasp the complexities of the issue, this project intends to looks upon the grey economy as a case of a social dilemma, in which informal institutions (norms, values and “unwritten social rules”) and trust are expected to play central roles – both for the functioning of the grey sector and in times when a state tries to diminish this sector with the help of the formal institutional framework. As stipulated by the dominant perspective of informality, changes in the formal institutional framework will provoke a changed behaviour at the micro-level of the grey sector, given that actors' costs of acting informally become higher than the gains. This top-down view has for long been dominant both in institutional theory as well as in literature regarding the grey sector – slightly surprising given recent years' shift in aid policy and thinking towards a focus on civil society (rather than the state) as the promoter of change (Stilhoff Sörensen 2009).

The notion of the unofficial sector as a social dilemma works as an illustration of a broader problematic – concerning a state that tries to regulate the society and its members. Despite recent developments in for example the field of economic sociology, the market – formal and informal alike – might be the arena where actors are still believed to act as most rational and atomized. Thus, the interest of this project lies not really with the grey market as such (which then would perhaps imply a theoretical framework based on for example economics or organizational theory) but rather as a hands-on example of a social dilemma; the main issues being how this
sector functions and persists on the ground – more specifically how the actors behave in relation to formal and informal institutions, with the political level in the background as provider of stimuli of formalisation thus shaping the surrounding institutional environment. As will be specified below, the legalist view of informality assumes that changes in the formal institutional framework will produce a changed behaviour at the societal level, which includes the notion that all actors will react in the same manner. Thus, the Kosovar grey economy is a suitable empirical issue to scrutinise in order to analyze the more abstract theme – the interplay between informal institutions and the formal institutional setting for the question of institutional stability and change.

The embeddedness of informality

The emphasis on informal institutions and the idea of viewing the grey sector as a social dilemma is closely related to the interdependence between the economic, the social and the political. The notion that also the economy is a sphere in society that is affected by social relations and norms is an old line of thinking. In 1985 Granovetter discussed the concept of embeddedness, arguing that social relations are always present in any sphere of life – the opposite would only be possible in a society similar to the Hobbesian state of nature (Granovetter 1985). Thus, the question is more about to what extent actors are affected by these relations. Granovetter depicts two extreme positions: on the one hand the argument promoted by rational choice theory and neoclassical economics that assumes rational and self-interested individuals whose behaviour stays unaffected by anything else than their own preferences. Granovetter frames this as the under-socialized actor; human action is not in any way affected by existing social structures or social relations, and the market is seen as containing perfect information, perfect competition and atomised actors. On the other extreme lies the embeddedness argument which according to Granovetter invokes the idea of the over-socialised actor; “the behaviour and institutions to be analysed are so constrained by ongoing social relations that to construe them as independent is a grievous misunderstanding” (Granovetter 1985, 482).
The embeddedness argument carries some nuance though. According to Granovetter, the fields of history, anthropology, sociology and political science tend to attribute the logic of embeddedness in particular to “pre-modern” societies; the importance of the social dimension and social relations would disappear during the process of modernization – leading up to an economy where transactions no longer are defined by kinship or social obligations but by the rational calculations of economic gain, i.e. similar to much of the under-socialized view as depicted above. The other extreme position, much based on neo-classical economics, does not accept this break in embeddedness connected to modernization – instead they simply argue that the level of embeddedness was equally low in both pre-modern and modern societies. The new institutionalism in economics (hereafter NIE) stems from this latter perspective, arguing (much in line also with the approach of rational choice institutionalism, hereafter RI) that the behaviour of actors and the existing institutions are better understood as resulting from deliberate choices taken by rational (and atomised) individuals (Granovetter 1985).

Against the two extreme positions, Granovetter argues for a position in between, claiming that on the one hand the level of embeddedness in so-called non-market societies was (is) indeed lower than the proponents of embeddedness would argue; on the other that the level of embeddedness in modern societies is greater than most economists and others today claim. In other words, embeddedness is not a feature of pre-modernity and does not disappear with modernisation. However, Granovetter’s critique is based on the notion that the over-socialised view places too much emphasis on the desire of individuals to achieve a desirable self-image by winning the approval of others. The under-socialised perspective on the other hand provides no room for power relations or dishonest behaviour; rather the simplified view of the market works to remove the problem of order providing no room for trust – indeed the social atomisation is necessary for truly perfect markets to exist (Granovetter 1985).

Clearly then, neither the notion of embeddedness nor the critique of the idealized version of the market is something new (even though the latter may still exist in some highly simplified economic models). Even Granovetter recognises this, claiming that more and more economists seem to appreciate the role played by the social surroundings. So far so good – leading up to the question of why my argument about the role of informal institutions within the grey economy is
at all interesting? Granovetter puts it distinctly by stating that when economists have tried to include the social context, they have often fallen in the same over-socialized trap as the proponents of embeddedness. “More recent comments by economists on ‘social influences’ construe these as processes in which actors acquire customs, habits, or norms that are followed mechanically and automatically, irrespective of their bearing on rational choice” (Granovetter 1985, 485). This view however, runs the risk of viewing social relations in precisely as functional terms as institutions are being looked upon by proponents of NIE and RI. Instead (and much in line with recent years’ debate on social capital), Granovetter argues that social relations may be a necessary but often not sufficient condition for trust, as both fraud and trust alike might stem from deep social relations. In other words, the concept of trust comprises many facets (Granovetter 1985).

*Is informality even a problem?*

Today, a grey economy is a sizeable reality in many countries and appears if not a growing (there exists some controversy regarding how to measure informality, why it is difficult to find reliable data on the size and spread in different countries and also difficult to make comparisons both across and within countries) so at least a persistent phenomenon. The point here that the existence of a grey economy should be viewed as a social dilemma might cause some resistance, but of importance is that this project does not carry a normative stance. For certain, there are commentators either arguing the good in informality or at least presenting a less negative view than commonly known among proponents of formalisation reforms. For one, we can mention Muhammad Yunus, the founder of the Grameen Bank and laureate of the Nobel Peace Prize in 2006, who considers the grey sector to be the “people’s economy”, wanting to increase the efficiency of this sector rather than undermining it (Yunus 2007).

Some of the positive effects of a grey economy (at least in a developing country) might be a supply of products and services that are not offered by the formal economy to the low and middle income segments of the population, plus naturally a supply of employment (Ishengoma and Kappel 2006). Chen argues that the whole question of whether or not to formalise is greatly misunderstood. To begin with, it is unclear exactly what is meant by formalisation as it differs
between for example self-employed entrepreneurs and wage workers. Chen presents another view: she means that it is unlikely that most unofficially operating businesses and workers will be formalised, why measures should meanwhile be aimed at reducing the disadvantages connected to informality, i.e. make the grey sector more “decent”. At the same time though, Chen states that efforts of formalisation ought to continue – why in the long-run a decrease of informality ought to be interpreted as a good thing (Chen 2004). In the opposite ringside, arguments often circulate around the negative effects of lowered state revenues, and at the micro level bad working conditions for the informal worker, a lack of security and low income levels. Taken together, this leads to a shared view of (indeed many) practitioners and theorists arguing that the negative long-term effects of the grey economy demand efforts to decrease this sector (Gërxhani 2004; Ishengoma and Kappel 2006).

Thus, in some cases the grey sector might constitute a well-functioning alternative – a kind of safety net – to a state that fails to deliver; why formalisation reforms might be viewed as attempts of destroying this functioning alternative. If having this perspective, the notion of a social dilemma might be interpreted as comprehending a negative conceptualisation of informality as such, yielding a support of formalisation reforms. Still, the question of whether or not the grey economy is indeed a functioning alternative is a highly contextual issue which it is difficult to make any clear-cut statement about.

Rather, the stand taken by this project is not to focus on whether the informal economy is an inherent good or bad thing (presumably it is both), but rather on how informality can be such a persistent phenomenon when attempts of formalisation are made - embarking from a reality where de facto many attempts of formalisation have taken place, are taking place at the moment and are likely to take place in the future. The concept of a social dilemma is thus a suitable way to frame the problem. In other words, the idea is not to explain what might be missing in certain implemented policies, but rather to focus on the grey sector as such and understand the role played by informal institutions when the state tries to regulate something that pretty much lies in the periphery of its outreach.
The grey economy in Kosovo – what do we know so far?

As mentioned above, following the 1999 conflict over Kosovo and the establishment of a UN administration, it was claimed that the future of Kosovo (among other things) lies in the introduction of a market economy and a re-vitalisation of the local economy, by providing enough incentives so that the grey economy can merge with the formal one. This section of the paper is devoted to the question of what is today known about the grey economy in Kosovo. As it turns out, not much. After over two years of self-proclaimed independence, it has become clear that the road to a sustained economic and social development is a long and winding one – recognised to be particularly depending on a strengthening of the micro, small and medium sized businesses of the private sector that totally dominate the Kosovar economy (Džihić and Kramer 2009). At present, the majority of businesses in Kosovo (95-98 per cent of the total private sector) comprehend micro and small ones that employ one to ten employees and are typically to be found in so-called low-barriers-to-entry sectors such as trade or service activities (UNDP 2007).

As large numbers of the Kosovo Albanian population were dismissed during the beginning of the 1990s (Maliqi 1998; Pula 2004), which forms part of the explanation behind the establishment of a parallel society, and together with the outbreak of the Kosovo conflict a few years later, a standstill of the formal economy was produced which in turn lead to a heavy increase in the spread of unofficial economic activities, comprehending both grey activities of a legal nature and more purely black/illegal ones. At this time, the economy consisted of three main components: small private family farms, around 200 publicly-owned enterprises (most in poor condition and not operating) and a large number of privately owned micro and small businesses – recognised as being informal mostly due to lacking state regulations (European Commission/World Bank 1999).

Thus, informality in Kosovo increased both before the conflict of 1999, as Kosovo Albanians moved further away from the Yugoslav/Serbian state, and during the conflict. According to Stilhoff Sörensen, the common view is to see the formal economy as being damaged or

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3 UNMIK – the United Nations Mission in Kosovo
destroyed by conflict whereas Stilhoff Sörensen prefers to talk about a transformation of the economy and the society, rather than a complete destruction. Central to Stilhoff Sörensen's analysis stands the concept of “opportunity structure” and he argues that the Kosovo conflict provided both the grey but also the purely black sectors of the economy with changed possibilities to act (Stilhoff Sörensen 2009). Soon after the end of the 1999 conflict, the Commission of the European Union and the World Bank (in cooperation with UNMIK) presented their view on how to reconstruct and recover Kosovo; one way of achieving an economic and social development was considered the provision of incentives for the grey economy to merge with the formal sector – mainly through the creation of proper institutional framework (European Commission/World Bank 1999). This approach fits with the general view of transitions to a market economy, in which small businesses and the private sector is considered the agents of change and development (Stilhoff Sörensen 2006a).

As part of a larger EU-funded (the European Agency for Reconstruction) project to combat corruption and money laundering, a study was carried out a few years ago to assess the impact of the grey and black economy in Kosovo. By explicitly separating the black from the grey sector and by using both direct and indirect measurements, the study finds the latter type of informal activities to constitute the largest share, in which micro, small and medium sized businesses are the main actors (B&S Europe 2007). Also, the study argues that despite some advancement, the main reason behind the continued large scale of informal economic activities is still the lack of a proper regulative framework. However, there is a lack of clear and reliable data when it comes to the size and content of the grey economy in Kosovo. According to Ahmeti, official numbers often circulate around 30-40 per cent of GDP whilst at the same time the share of businesses not reporting their complete income to the government may amount to much more, even as high as 80 per cent (Interview Ahmeti, Prishtina August 2009).

Summing up, the origin of the grey economy in Kosovo remains somewhat unclear, although we can note an increase taking place during the 1990s. As the formal market is a more recent phenomenon than its informal counterpart though, informality is certainly dating back much longer.
The informal side of institutions

What constitutes an institution? Despite a general agreement on the importance of institutions, what is perhaps the most striking difference between the divergent approaches of new institutionalism is this very basic question. Controversy arises for example over whether institutions are considered exogenously or endogenously given, thus rendering differing views on how they are created, maintained and changed. Let us look at two rather different examples. First, in a recent work in defence of the so-called Varieties of Capitalism-approach, Hall and Thelen conceptualise institutions as: “sets of regularized practices with a rule-like quality in the sense that the actors expect the practices to be observed; and which, in some but not all, cases are supported by formal sanctions. They can range from regulations backed by the force of law or organizational procedure (…) to more informal practices that have a conventional character (…)” (Hall and Thelen 2009, 9). In a study of political participation, the meaning of an institution is much more diffuse as institutions are considered to stem from the supply side (supply side equals institutions) whereas the demand side is seen as something else (Andersen and Roßteutscher 2007). In other words, institutions refer here to formal institutions (rules) issued by the political level – giving rise to a notion much spread within the current institutionalist literature: actors' incentives and preferences are shaped primarily (or exclusively) by formal institutional arrangements (Helmke and Levitsky 2004).

However, of importance as of now is not to achieve an all-encompassing definition of the concept of institutions. Rather, the point here is to argue against the notion of institutions as being of interest only as formal rules; this project sides with North in underlining the importance of informal institutions. According to North, institutions comprehend both formal (laws, regulations, constitutions etcetera) and informal ones (norms, codes of conduct, conventions etcetera). Together, institutions provide certain structure to human action and interaction by providing a framework within which action takes place (North 1990). Often, and rather naturally one might add, it is much easier to depict the formal institutions that are present in a certain context than to sort out the informal ones – importantly though, this cannot reduce the importance of the latter ones, especially when attempts of achieving an institutional change are made. In the words of North: “Equally important is the fact that the informal constraints that are
In order to distinguish partly between formal and informal institutions and partly between the latter ones and other phenomena, such as weak institutions or culture in general, Helmke and Levitsky propose a rather straightforward definition of informal institutions when saying that formal ones are created, communicated and enforced through official channels whilst informal institutions are “socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels” (Helmke and Levitsky 2004, 726). This definition brings three main advantages.

First, it clarifies that not all informal institutions are simply derived from the culture at large and also that elements within the culture might well be informal but also non-institutional. For example North argues that informal institutions are derived from what is commonly known as culture, either in the form of extensions or modifications of existing formal rules or as socially sanctioned norms or codes of conduct (North 1990). This might be the case for the existence of some informal institutions – not denied by the definition above – but the cultural stance also carries a notion of non-changeable informal practices; a deterministic view which fails to capture any internal process of change within the informal institution as such. Also, an equal sign between informal institutions and culture makes it difficult to differentiate between behavioural regularities and institutions. Helmke and Levitsky argue that the latter must respond to an established rule or guideline, subject to some form of sanction if being violated. Admittedly, the distinction is not always easily done: “Culture may help to shape informal institutions, and the frontier between the two is a critical area for research” (Helmke and Levitsky 2004, 728). In order to at least partly overcome the problem, informal institutions are characterised by “shared expectations” rather than “shared values” – where the latter may well give rise to the former (Helmke and Levitsky 2004).

Second, a common distinction between formal and informal institutions is that the latter concept consists of norms and unwritten rules that are self-enforcing in themselves (again, more equal to the broad notion of culture) whilst formal institutions are enforced by a third party, often the
state. Again, the definition posed above does not rule out this possibility, but also serves to open up for situations when informal institutions are externally enforced by various kinds of organisations, examples often mentioned involve clans or mafias (Helmke and Levitsky 2004).

This brings us to the third advantage, that informal institutions should be distinguished from informal organisations. However, informal institutions may be embedded in the structure of organisations or the other way around that institutions may give rise to certain organisational structures (North 1990; Helmke and Levitsky 2004). A last clarification is needed. Informal institutions are not equal to weak institutions even so-called strong states may incorporate informal institutions, for example in the shape of bureaucratic norms. However, the existence and persistence of informal institutions may indeed be facilitated by a weak formal institutional framework.

*Informal institutions within the grey economy*

Taken together, informal institutions provide a more complex picture of human action and interaction than does a mere focus on their formal counterparts. As argued by this thesis, actors within the grey economy do not operate in a vacuum where only the relationship with the formal regulatory framework is of importance. Still, in a literature overview Gërxhani concludes that at first sight it seems as if every possible explanation has been given concerning motives for participation in the grey sector. At the same time however (and somewhat surprising given the last years' huge interest in the legalist perspective) she claims that only little attention has been given individual actors within the informal sphere, and their behaviour and motivations (Gërxhani 2004). In other words, despite the knowledge of the strong influence exerted by institutions on not least the economy (North 1990), the institutional micro-level of informality remains an understudied object. Indeed, the literature in the field does hint at elements within the grey sector that are likely to play a role for the question its persistence, denying however these elements any closer scrutiny.

Let us take an example. Schneider acknowledges that much empirical evidence regarding the existence of informality indeed point at the importance of government rules and regulations,
precisely as stipulated by the legalist proponents. Importantly though, Schneider claims that the causes of informality are not easily transformed into cures. When studying tax reforms made in a number of developed countries, Schneider finds that this kind of cost-reducing reform has not produced any substantial decrease of the grey economy but merely served to stabilise the size of the sector and eventually preventing further growth. One reason would be that “social networks and personal relationships, the high profit from irregular activities and associated investments in real and human capital are strong ties which prevent people from transferring to the official economy” (Schneider 2004, 6). Ishengoma and Kappel touch upon the issue as well, arguing that – for a relatively small firm – access to informal social institutions such as social networks/relationships; informal capital markets; family; networks for implicit contract enforcement etcetera can well exert an influence over the decision on whether to act formally or informally (Ishengoma and Kappel 2006).

Further, by looking at the political, the economic and the social institutional criteria that the literature argues characterise the grey economy, Gërxbani (2004) has conducted an exploration of the “institutional patterns by which society shapes the informal sector”. The basic criterion has been the economic one (including tax evasion or an activity’s unregistered status), followed by the inclusion of the political aspect (including governmental regulations). The social institutional patterns are the least developed and least studied. In a similar way as Schneider, Gërxbani claims that studies on the grey economy indicate that words such as “a friend of a friend” are of key importance within this sector but that this remains an understudied issue. Other social institutional patterns involve the perception of a greater autonomy and flexibility of the unofficial sector as compared to the formal one, as well as the issue of survival (mostly emphasised in a context of less developed countries).

Further, it is rather uncontroversial that within the grey sector (and within its formal counterpart for that matter), economic activities impose diverse transaction costs which in turn create asymmetries and open up for one actor to exploit another. However, in the formal sector exchanges are mediated through the use of legally binding contracts and the possibility of official exogenous enforcement; in the unregistered market such formal and official institutional safeguards are missing. The common view is that both formal and informal institutions reduce
transaction costs and uncertainty about the behaviour of others, which facilitates action and interaction - but in the context of a grey economy the informal ones play a greater role. Within a package of informal constraints in general, trust is presumed to be of great importance as a basic enabler of cooperation by functioning as a mechanism of enforcement (Oskarsson, Öberg and Svensson 2009).

Taken together, the studies mentioned above together with for example Losby et al (2002) and Jenkins (2001) all touch upon the issue of certain “social elements” that matter within the realm of the grey economy but not much has been done to explore this issue any deeper and – importantly – to investigate if these constraints of a more informal character exert an influence also on the persistent nature of the grey sector. Last but not least, more mental informal constraints like the notion of the state and the level of trust – especially in times of uncertainty - are expected to serve as important ingredients within an unofficial sector (Gërxhani 2004). In this project, trust refers partly to horizontal trust, i.e. the extent to which actors within the grey sector trust each other to stick to the accepted norms, and partly to vertical trust, i.e. the extent to which the actors display a trust towards the institutions of the state. The opposite of trust - various forms of coercion, supposedly on the meso institutional level – must also be taken into consideration.

**Perspectives on informality**

This sector will present previous research done on informality – a wide field which encompasses a number of academic disciplines and sub-fields. However, the focus is for now placed upon two aspects, beginning with a short note on the evolution of the concept which brings us to a larger discussion of the three major perspectives often evoked to explain informality.

**Roots of the concept**

What is to be named informal or not is both a disputed issue and one of shifting character. From being a phenomenon mostly of interest to anthropologists and sociologists, economic activities
that took place outside of the legal framework started in the mid of the 20th century to interest also economists and other scientific domains (Gërxhani 2004). At this time, it was a widespread assumption that economic growth would bring an increased demand for labour - why the marginal grey sector, or “traditional” as the terminology went at the time, would be merged into the formal and “modern” economy. By the 1970s though, this view was overrun by less optimistic perceptions about the possibilities of economic growth in developing countries.

In 1972, the International Labour Organization (ILO) conducted a number of studies in developing countries in order to get an understanding of the small-scale and unregistered economic activities that to a large extent characterised the economy of these countries. In a report on employment in Kenya, the ILO used for the first time the term “informal” sector instead of “traditional” – the term itself was coined by Keith Hart (1973) one year earlier in a study of economic activities in urban Ghana. The debate on whether modernisation and growth would eventually undermine informality continued and developed into three main schools yielding differing perspectives regarding the defining characteristics of the grey economy, what gives rise to informality and in what ways the informal is linked to the formal: the dualist, the structuralist and the legalist school (Chen 2004).

*Three main schools of thought*

The dualist perspective on informality looks upon this sector as consisting of marginal economic activities that constitute a separate economic domain not connected neither to the formal sector of the economy nor to the formal regulative framework of the state. The idea of a dual economy denotes the existence of on the one hand a modern urban market economy and on the other a rural traditional subsistence economy. The dualist school forms part of the earliest research on informality, arguing that economic growth would bring greater demand for labour thus eventually leading to absorption of the grey economy into the formal one. After some years though, this perspective started to get criticised for its descriptive rather than explanatory character and for the assumption of non-dependence between the informal and the formal sectors; instead the dominant discourse on informality became one that emphasised domination and subordination (Chen 2004; Gërxhani 2004).
The structuralist school rejects the notion of economic dualism and marginality, i.e. dismissing the idea of the grey sector as a sector comprised of survival activities in marginalised parts of society. Instead, structuralists argue the strong interdependence between the formal and the grey sector, in particular the dependency of the latter one on its formal counterpart. At the same time though, informality is considered a reality with its own characteristics, conditions and rules. Further, this perspective views the informal economy as comprised of subordinate (micro) firms and labour that reduce different costs and thereby increase the competitiveness of larger, formal firms. According to this school then, the persistence and growth of informality has more to do with the specific nature of the economic development than with a lack of economic growth per se, where the role of the government lies in regulating the unequal relationship between the two types of businesses (Chen 2004; Gërçhani 2004).

The most recent contribution to the knowledge of informality is termed the legalist school, heavily promoted in the 1980s and 1990s but still going strong. This perspective builds on the new institutionalism in economics together with rational choice institutionalism, directing the attention towards the relationship between the “rules of the game” and economic development – departing from the idea that institutions are not neutral beings but rather actively influencing both the formal and the unofficial sector. The legalist view focuses heavily on the concept of transaction costs and subscribes to the idea that the grey economy consists of micro businesses or employees that deliberately choose to operate informally in order to avoid the costs associated with acting in the formal sector. Thus, the existence and growth of informality is due to cumbersome and costly governmental rules and regulations and informality will persist as long as that situation remains unchanged (Chen 2004; Gërçhani 2004).

Today the dualist school is largely outdated. Both the structuralist and the legalist perspectives are however still invoked – with the emphasis on the latter one – to explain the existence and persistence of informality. Importantly though, the two schools focus on rather different features: “In particular, the legalist perspective is used to explain the behaviour of the entrepreneurial class among the informal workforce who seek to avoid the costs associated with formalizing their enterprises; and the structuralist perspective is used to explain the subordinate relationship of labour and small producers to big businesses and, more specifically, of sub-contracted firms
and workers to the lead firms who sub-contract work to them” (Chen 2004, 5). This is only partly true though, as the legalist perspective not only focuses on self-employed entrepreneurs but also on issues connected to informal housing and land issues (de Soto 1989; 2000). Given that the interest of this thesis lies with actors within the grey economy, the idea is to show why the most recent and probably also the most invoked school of the three presented above needs to be complemented with insights from a broader institutional perspective. Accordingly, the purpose is to focus on the level of actors, not to say everything there is to say about the grey economy as such.

So, let us take a closer look at what the legalist school actually says. Proponents of this view claim that operating informally is a rational choice, given the existence of cumbersome governmental rules and regulation that make the costs of acting or becoming formal higher than equivalent costs present in the informal sector. Excessive regulations – in particular present in developing countries – create barriers for self-employed entrepreneurs to act formally (Chen 2004). Accordingly, the legal status with regard to the formal regulatory framework functions as the differentiator between formal and informal economic activities. Working within the rational/legalist approach in the early 1990s, Feige noted the considerable amount of ambiguity related to the theme of informality. As a basic proposition then, Feige argued that an economic agent would be seen as belonging to the formal economy given that his or hers actions were protected or lay within the established institutional “rules of the game”; in other cases that same agent would be part of the informal economy (Feige 1990).

The legalist perspective does acknowledge that institutions consist of both formal (the political and economic “rules of the game”) and informal (here seen as social norms and traditions) ones; recognising that a clash between these two types will yield non-compliant behaviour, in other words producing informality (Gërxbhani 2004; Chen 2004). But still, the assumption is that a proper formal institutional framework will lead to a reduction of informality, often to be achieved through deregulation of the market and strengthening of private property (Gërxbhani 2004). Thus, barriers of entry into the formal economy is seen as forcing businesses to operate semi-legally or illegally and in focus of the analysis lie cost and benefit calculations. According to Ishengoma and Kappel: “When the costs of being formal are higher than the benefits, the firm
is more likely to operate informally and the other way around” (Ishengoma and Kappel 2006, 15). Accordingly, even though there is some mentioning of informal institutions, the legalist perspective argues that informality will persist as long as the formal regulatory framework imposes greater economic costs on the actors than does the unofficial economy – in this way neglecting the possible role played by informal institutions a closer scrutiny.

Then, what type of costs are we talking about? This is naturally a context-dependent question related to the regulatory framework of the particular state, but on a most general level Ishengoma and Kappel argues that in many developing countries it is indeed the case that the transaction costs of acting informally are much lower than the ones present in the formal sector. It might even be the case that otherwise formal firms lack a provision of basic public services, which bring that some transactions even for these firms are coordinated by informal networks. Transaction costs of the formal sector involve entry costs such as for example registration fees; number and costs of various start-up procedures, and operating costs such as for example taxes; time consuming forms; labour regulation; property registration; loan applications; as well as lacking contract enforcement mechanisms on part of the state. The grey sector is not costless though, and costs are here for example connected to state penalties; corruption; limited access to public services; and a limited access to financial services having to depend on more expensive informal sources (Ishengoma and Kappel 2006).

**A broadened institutionalist perspective**

The line of thinking of the legalist school fits into the framework of rational choice institutionalism coupled with the new institutionalism in economics - two strands within the umbrella concept of new institutionalism. As something becomes trendy, many tend to want a share of it. This holds true for the re-awakening of the institutionalist perspective within political science and other academic fields. In 1984 March and Olsen spoke of *the* new institutionalism, Hall and Taylor discuss three variants in a seminal article from 1996 and three years later Peters mentions six institutionalist approaches. Recently, arising out of an acknowledgement of the inherent limitations of the other approaches (in particular regarding the question of institutional
stability and change), voices have been raised that want to add yet another perspective to the three dominant ones as mentioned by Hall and Taylor⁴ - namely the approach either known as constructive, ideational or discursive institutionalism (hereafter named constructivist institutionalism or CI) (Hay 2006; Schmidt 2010).

This section of the paper argues the need of a broader institutionalist understanding of the grey economy in order to provide a thicker understanding of institutional change or stability within this sector. The need of a wider perspective departs from the existing literature on informality which – as mentioned above - hints at elements characterising this phenomenon that are not easily captured by neither the rational choice institutionalism nor the sociological variant (SI), the latter which at first glance might appear an appropriate alternative.

*A historical and constructivist approach – or, why not the rational or the sociological approach is enough*

Besides the controversy regarding what constitutes an institution, another contentious issue (strongly connected to the former one) is how to look upon the interaction between institutions and actors – which in turn is related to the question of institutional stability and change; one question being whether institutional change is seen as part of everyday life or as the exception to a rule (Peters 1999). Following Granovetter (1985) and later Hay (2006), the main shortcoming of both RI and SI is to be found precisely in the question of agency, which in turn brings consequences for their ability to partly understand but also explain institutional stability or change. According to Hall and Taylor, these issues are simply fundamental to any institutional analysis (Hall and Taylor 1996).⁵

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⁴ Rational choice institutionalism (RI), Historical institutionalism (HI) and Sociological institutionalism (SI). Hall and Taylor view the NIE approach as being part of RI and not as a separate approach.

⁵ In order to deal with the question of agency, for example Hall and Taylor (1996) take on a more flexible stance in arguing for the combination of the “calculus” (rationally based) and the “cultural” approach in an attempt to bring more agency into the historical institutionalist (or the sociological) perspective. Such a combined approach has gained more and more strength during the last years, as exemplified by for example the Analytic Narratives approach or even Thelen in recent works. Still, the basic problem of a too static perspective upon institutions and actors remains, see for example Schmidt (2010), why a combination of HI and CI could prove more useful.
In studies conducted on the unregistered sector in so-called transition countries, there is a notion that a general lack of confidence in state institutions together with a certain path dependent development, seen as “the conflict between the established economic and social norms in the past and the reaction to a new reality in the present” work to explain much of the existence of informality (Gërxhani 2004, 283). However, this is not something really accounted for by the RI and NIE based legalist perspective, given that in these perspectives the behaviour of actors is not seen as influenced by any historical or social processes (Peters 1999). The traditional way of looking upon RI and NIE is through the lenses of methodological individualism where accordingly there is a rather great space for individual agency – the problem is thus not the lack of such space but rather that the assumptions underpinning the notion of actors’ behaviour are simplistic.

In the RI perspective, institutions are conceptualised as the rules of the game that work to establish the conditions for a space characterised by bounded rationality, in which the actor is expected to act rationally when trying to maximise utility. As in general rational choice theory, utility maximisation is the primary goal but the freedom of action of the actor, and thus the actor's behaviour, is shaped and constrained by the institutional framework. As acknowledged by Hall and Taylor, rational choice turned to institutions in the late 1970s in order to solve problems connected with collective action (Hall and Taylor 1996) and accordingly, one difference from unconstrained rational choice is how preferences are formed. On the one hand they stem from the general strive from utility maximisation but on the other preferences are also shaped by the surrounding institutional setting (Peters 1999).

Despite the tendency to treat RI as a unified approach (or as being equal to pure rational choice theory as for example in Green and Shapiro's famous critique from 1994), the approach is marked by internal differences, for example due to if one uses a game-theoretical approach or departing from a principal-agent problematic. Still, there are some basic core assumptions within RI that are important for how this perspective looks upon institutional stability and change.

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6 The focus of RI is on the individual actor but much work within this tradition deal also with collectives as actors, see for example Ostrom 1990.
(Peters 1999; Hall and Taylor 1996), which in turn will bring us to the issue of why the RI approach is not enough to understand the grey economy. These core assumptions are:

i. Institutions are formal or informal rules that work to shape the behaviour of actors, who in turn act instrumentally and rational in relation to the institutional constraints and incentives. Thus, institutions structure the choices and information available to the actors, and also the interaction between actors by reducing uncertainty about the behaviour of others.

ii. Actors are rational in their attempt of maximising utility, having fixed preferences that are both exogenously and endogenously (as formed by the institutional context) based.

iii. All actors are expected to respond in the same way to the same institutional framework and actors behave strategically based on (bounded) rational calculation.

iv. Institutions are formed on a tabula rasa – explicitly and consciously designed and the outcome of the institutional formation is determined by the particular preferences that existed in the start of the process.

Thus, institutions are considered from a purely functionalistic point of view as being consciously created and designed, persistent due to the effects that follow from them and open for changes only due to an exogenous shock or when the institutions fail to deliver the effects as stipulated when they are formed. In other words, any institutional equilibrium is easily achieved through the selection of new rules and regulations (Peters 1999). As described earlier in this paper, this is in accordance with much theorising on informality, in which the formal institutional framework is seen as structuring the behaviour of actors, making them choose the grey sector when the costs of acting formal outweigh the benefits. Also, it is assumed that a change in the formal framework, leading to reduced costs of acting formally (or higher ones of acting informally) will produce a diminished size and spread of informal economic activities. However, this notion of an easy solution to the problem of informality does not gain empirical evidence, rather the opposite applies. RI as well has been the subject of heavy criticism for being too simple minded when it comes to human behaviour, motivations and interactions – a critique applicable as well to current research on informality. As stated by Hall and Taylor: “The usefulness of the approach is also limited by the degree to which it specifies the preferences or goals of the actors exogenously to
the analysis, especially in empirical cases where these underlying preferences are multifaceted, ambiguous or difficult to specify ex ante” (Hall and Taylor 1996, 18).

After this short review of well-known critique against the RI perspective, time now to focus on the sociological approach (SI) – which at first glance might appear suitable either to replace or to complement the RI approach. In particular, what is really the main difference between SI and the constructivist newcomer? According to Nee and Brinton, the SI perspective adheres to the notion of a context-bound rationality (leading back to Weber) and places the focus on the social context within which interests and norms develop as well as on the influence exerted by norms and interest on the process of institutional change (and stability) - explicitly drawing on a number of academic fields, not least on economic sociology and especially on Granovetter (Nee and Brinton 1998). Nee claims that the core of SI lies in explaining the sub-institutional social basis of formal institutions: “the social matrix that comprises the basis of informal constraints” (Nee 1998). The role of SI is thus to bridge the micro-reality of individuals and networks and the larger macro-institutional framework.

Institutions within the SI perspective are defined as “webs of interrelated rules and norms that govern social relationship and that comprise the formal and informal social constraints that shape the choice-set of actors” (Nee 1998, 8), working to reduce uncertainty in human interaction. More specifically, Nee depicts informal institutions as being customs, conventions and norms that comprise the explicit or implicit rules of expected behaviour, monitored by friends, family, acquaintances or the close-knit group or community in which they are seen to exist, where social approval or disapproval are seen as the main form of sanctions. Informal institutions are seen as helping to solve the problem of collective action and coordination, making it possible for actors to enjoy the gains of cooperation, thus under certain circumstances giving rise to what is known as social capital. Formal institutions on the other hand are (mostly) monitored by the state and when formal institutions are in conflict with the informal ones, they become costlier (for the state) to monitor (the other way around applies as well). Regarding the issue of context-bound rationality, Nee claims that SI does not abandon the rationality assumption put places it under many more constraints than the NIE or the RI approaches do. Human action is seen to be
purposive in that interests still matter but that preferences and interests ought to be placed within a wider institutional environment and in the broader cultural context (Nee 1998).

So far the similarities with the CI approach seem indeed greater than the differences. Despite a great variance within the SI approach as such (indeed some claim preferences to be nothing more than social constructions, see Nee and Ingram 1998), there is a general tendency to promote an over-socialised view of actors – leading, amongst other things, to a mixing up of informal institutions and the broader notion of culture. This is one of the trickier aspects when dealing with informal institutions; however, in line with Helmke and Levitsky (2004) and the discussion above, I argue the need to separate between culture at large and informal institutions, not least since the latter may involve things that might well be informal but also non-institutional (making it difficult to differentiate between behavioural regularities and informal institutions).

The seminal work by North (1990) faces the same problem, as North argues that informal institutions are derived from what is commonly known as culture, either in the form of extensions or modifications of existing formal rules or as socially sanctioned norms or codes of conduct. This might surely be the case for the existence of some informal institutions but the cultural stance also brings a notion of non-changeable informal practices; a deterministic view which fails to capture any internal process of change within the informal institution as such. This notion is crucial as it refers to the difference between SI and CI, and also strengthens the argument put forward in the discussion above about viewing the grey economy as a case of a social trap, creating a larger space for agency.

Further, in both SI and RI the preferences of an actor are seen as pre-fixed, based on the institutional context in which the actors find themselves. One important consequence of this is the assumption that all actors react in the same way to the institutional context. This is exemplified by Hay when he discusses the basic assumptions underlying the SI and the CI approach respectively. In SI, the assumption is based on a cultural approach – actors follow norms, conventions, cognitive frames due to a logic of appropriateness; the social approval or disapproval being considered the main mechanisms through which conformity to the norms is achieved (Nee and Ingram 1998). The focal point here is that the preferences of actors within the
informal economy should not be taken for granted as stipulated by both SI and RI. In order to understand the mechanisms of reproduction producing institutional stability, adaptation, evolution or disruptive change, a more dynamic approach is needed. Hay claims that:

Actors are strategic, seeking to realize certain complex, contingent, and constantly changing goals. They do so in a context which favours certain strategies over others and must rely upon perceptions of that context which are at best incomplete and which may very often prove to have been inaccurate after the event. Moreover, ideas in the form or perceptions “matter” in a second sense – for actors are oriented normatively towards their environment. Their desires, preferences, and motivations are not a contextually given fact – a reflection of material or even circumstances – but are irredeemably ideational, reflecting a normative (indeed moral, ethical, and political) orientation towards the context in which they will have to be realized (2006, 63-64).

Thus, institutions are not seen as merely a filter laid upon actors that structure their behaviour; rather, the issue of change and stability is based on the interplay between actors and the institutional context - not least the perceptions or “ideas” that actors hold of that context. A process of change might then develop that has both intended and unintended consequences.

Summing up, the main reason for employing constructivist institutionalism together with historical institutionalism is rather straightforward: functionality, rationality and stability – whether based on a logic of calculation (RI) or a logic of appropriateness (much of SI) should

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7 Constructivist institutionalism as an approach is still rather undeveloped. Some, for example Schmidt (2010), would argue that there must be a focus on discourse in order to rightfully understand institutions, thus promoting discourse analysis as the specific method to conduct an institutionalist analysis – which by the way is a rather paradoxical view to adopt given that Schmidt at the same time thinks of DI as an umbrella concept cutting across all ontological and epistemological borders. This is not the stance taken here though; rather, CI is considered a way to gain a broader understanding of actors in the context of institutions. On a tentative basis and given the undeveloped nature of CI, this project might also contribute to a greater knowledge of how to empirically approach institutions, from the combined CI and HI perspective. However, this might be a contribution entering the project through the “back door”, given that the main focus is on informal institutions and their role for institutional stability and change. Also, the CI approach has mainly been concerned with institutional change, whereas this project argues that the same logic ought to apply to instances of stability as well, in the notion of an “endogenously created active stability”.
not be taken for granted but be an open and empirical question. In other words, rationality cannot be totally neglected but it might take a different form. What might from the SI perspective appear to be irrational behaviour may turn out to be most rational when the situational constraints are clarified. The problem is not that rationality only is a too naïve psychological assumption, rather that both the RI and the SI approach carry too deterministic accounts of what is to be seen as rational.

Thus, the stance taken by this project is that an empirical reality do exists – including institutions and material interests – but there is a constant interaction between actors and institutions in order to shape perceptions and interests within the institutional context. As argued by Risse and Wiener (2001), constructivism as an ontological assumption implies that it is not possible to put the rationality assumption as such against constructivism in any meaningful sense; rather it is a questioning of the arguments underlying the assumption of rationality. Risse and Wiener argue that what we can do empirically is to explore the circumstances under which a constructive institutionalism is more apt to explain the possible effects of norms and other informal institutions than do SI or RI. The tipping point here is precisely that interests are subjectively rather than objectively given and that informal institutions such as norms and trust must be explained in terms of the interpretation on behalf of the relevant actors and not only as structures that are being imposed from above. As argued by Schmidt:

“Material interests, economic in particular, which are at the basis of much of the institutional incentives in the rationalist choice institutionalist literature, are not ignored. But in discursive institutionalism, scholars tend to separate material interests analytically into material reality and interests rather than to conflate them, such that material reality constitutes the setting within which or in response to which agents may conceive of their interests (Schmidt 2010, 5).

Written in 1992 but apparently still relevant: questions of institutional change and stability are current frontiers of institutionalist research and more so when combined with a focus on perceptions and ideas (Steinmo and Thelen 1992).
Last but not least, if we connect this discussion to the one above on Granovetter, we can see that the points of critique are very much similar. Both the RI and the SI approach carry an image of an actor without true agency. In the under-socialised (RI) version due to only acting upon rational self-interest and exogenously given preferences; in the over-socialised (SI) version due to actors embedded to such an extent that their behavioural pattern has been completely internalised – leaving no room for agency and change, or in Granovetter’s words: ongoing (or changing, my comment) social relations thus have only peripheral effects on behaviour. In this way, behaviour guided by norms and values provides a highly mechanical understanding of human action and interaction (Granovetter 1985). Somewhat paradoxically then, SI tends to lean towards an institutional (and behavioural) equilibrium – the functionalistic perspective that March and Olsen themselves were highly critical of when laying the foundations for the normative/sociological institutionalism (March and Olsen 1984). As argued by Granovetter, ongoing social structures and relations become irrelevant as certain roles and guiding norms rule over the individuals – role positions and role behaviour which work to make the atomisation still very much present but only lifted up to a higher analytical level than provided for by the under-socialised perspective (Granovetter 1985).

Thus, in many ways the line of argumentation of this thesis is in accordance with Granovetter. However, where Granovetter speaks mainly of social relations, there is arguably a need to extend the argument to comprehend informal institutions. Granovetter does speak about norms and customs, but his main focus is on what I would call the physical forms these informal institutions take, i.e. particular relations between human beings or with another word, networks. Of interest in my project then is both the informal institutions underlying these social structures and the relations or networks as such, if they are to be found. Granovetter fails to fully account for both culture and informal institutions, which brings that he also fails to be clear on the difference between the two – which, as seen, is a recurrent point of critique that both the proponents of the total embeddedness argument and the SI approach have been subjects of.

Thelen (1999) argues that in order to understand institutional change it is essential to understand the “mechanisms of reproduction” that work to sustain a particular institutional order. This is something agreed upon by this project. However, as put forward in the discussion above, in both
SI and RI the space for endogenous change – and what I intend to name “active endogenously created stability” - is highly limited as both perspectives underline the self-enforcing equilibrating effects of institutions (both in the formative phase and during the subsequent development) leaving little room for change other than an exogenously based more or less radical re-organisation of the institutional order (Hay 2006).

Tentatively, it seems as if the heavily debated issue of institutional change has directed the focus away from the issue of stability. As argued by Thelen (1999) and Streeck and Thelen (2005) a consequence of this is that we dismiss the possibility of a gradual institutional transformation or adaptation – something also underlined by Hay (2006). Therefore, I argue instead that we should re-direct the focus towards the question of stability, without for that matter equalling institutions with structures. Instead, the interesting issue is how the institutional order is upheld, what mechanisms are involved and the role of actors within that process. In other words, in order to understand change we must not focus on when change happens but rather on the situation before, on issues of stability. The combination of constructivist and historical institutionalism works to bring about a more nuanced view upon institutional stability and change, opening up for more gradual processes of change.

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