The State, the Market and the Shadows

Examining the institutional underpinnings of the grey sector

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Introductory comments

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 conflict over Kosovo in 1999, Prishtina came to embody many features of informality – as most noticeable perhaps in the “turbo urbanism” and the lack of urban planning that transformed the townscape. The claim that “Prishtina is everywhere” refers partly to the growing city as such, but also to the fact that what is seen in Prishtina is a global phenomenon (Vöckler 2008). In 2002, the International Confederation of Free Trade Unions (ICFTU) estimated that in Central and Eastern Europe approximately 10 million people were acting in the grey economy¹, and that the number is growing (Union of Independent Trade Unions of Kosovo 2005). The spread of informal activities in Kosovo, highly present also within the private business sector and the agricultural sector, is not a development that has gone unnoticed. In particular, in the many programmes of reconstruction (first promoted exclusively by the international protectorate and later in cooperation with the Kosovar² government) the need of turning grey businesses into formal ones has been much underlined in order to facilitate the introduction of a market economy, much in line with other states that have gone through what was at least formerly known as “transition”.

In Kosovo, as in other post-conflict societies or states that are in a process of state-building, the level of legitimacy enjoyed by the state corresponds to the challenge of creating an inclusive political, economic and social order that is based on the rule of law; a situation where the state controls certain functions such as for example the legitimate monopoly on the means of violence; administrative control (partly connected to the extent that the citizens accepts the promulgation and enforcement of

¹ Hereafter the terms grey economy; grey sector; unofficial economy; unofficial sector; and informality will be used interchangeably. A commonly used term is otherwise informal economy - which is not used in this project in order to avoid conceptual confusion with the concept of informal institutions.
² 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.
laws and regulations as serving the interest of the majority); and provision of an environment that gives rise to the formation and expansion of the (legal) market (Ghani, Lockhart and Carnahan 2006). Not surprisingly thus, in Kosovo the change from conflict to stability— and the fulfilment of these functions – is considered to go hand in hand with a transition to a formal market economy. Thus, 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). In other words, the existence of a sizeable grey sector coincides with a loss of state legitimacy (Ghani, Lockhart and Carnahan 2006).

Around the globe, the so-called dealing with informality has become a well-known sight, particularly in developing countries. In the back sweeps of the breakthrough of the at present dominant perspective regarding the grey economy – the legalist one (following the groundbreaking work of de Soto and his team in Peru) – a great deal of present attempts of decreasing informality has its base in the theoretical perspectives of rational choice institutionalism and new institutionalism in economics (Ishengoma and Kappel 2006). In short, the legalist perspective claim that the size and spread of the grey sector can be diminished through the means of changes in the surrounding formal institutional framework, i.e. promoting a unidirectional and top-down solution to informality. With the appearance of the legalist school and from an economic perspective, the solution to the problem of informality had appeared. However, on a general basis, reforms based on this school have been unable to decrease the size of the grey sector in the expected way (Arruñada forthcoming; Calderón Cockburn 2002).

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). Thus, the idea to be developed in the paper at hand is 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 rather that the relationship is one of reciprocity, where the capacity of a state stands in relation to structures found in society (Migdal 1988). Against the background of informality, March and Olsen’s statement is thus of continued relevance – with severe impacts in particular for states that are in a process of state-building and that are trying to achieve administrative control over divergent sectors of the society and over its citizens.
The paper at hand forms the basic theoretical departure points for a doctoral thesis (a project still much in its infancy) and the structure of the paper is as follow: first, an overview of previous research on informality will be provided for. Thereafter follows an argumentation of the need of broadening the institutionalist perspective and examine the informal sector from its embedded position in society. Last but not least, the paper will end with a short discussion of the contemporary situation in Kosovo, serving to exemplify the ideas put forward in the theoretical discussion above. In Kosovo, 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 really existed in the area through the means of the formal institutional framework (Stilhoff Sörensen 2009). Thus, the Kosovar grey economy constitutes an interesting empirical phenomenon to explore in order to problematise the assumptions underlying the legalist perspective, and thus also gain a more complete picture of the processes of institutional stability and change on the micro, meso and macro levels.

**Perspectives on the unofficial**

This sector presents previous research done on the grey economy – a wide field which encompasses a number of academic disciplines and sub-fields. One thing that most observers can agree upon is the little existing consensus on how to conceptualise the phenomenon – apart from it being something more than simply the inverse of the formal economy (Shuaib 2004; Vande Walle 2008; Gërxhani 2004). The use of a variety of labels is a clear sign of this confusion; terms such as underground, unregulated, black, parallel, non-institutional, subterranean, second and Geertz’s notion of the bazaar economy³ have all been evoked denote the grey sector (Shuaib 2004; Gërxhani 2004; Feige 1990; Vande Walle 2008; Ponsaers, Shapland and Williams 2008). One reason behind this conceptual fogginess is the multi-disciplinary interest, where each scientific field (as well as the practitioner community) has brought its own definitions as well as approaches to study it. However, there are arguably a number of core attributes that most would agree form part of a definition, important not least in order to avoid the dangers of conceptual stretching (Sartori 1970).

The core of the concept is that informal activities are “invisible” and thus unregistered by the state. Indeed, the question of non-registration is a central aspect of informality. In the words of Vande Walle: “An informal market differs from a formal market in that it is not officially regulated, in the widest sense of the word `regulation’ (Vande Walle 2008, 651). Accordingly, activities within this

³ See Geertz (1963) *Peddlers and Princes – Social development and economic change in two Indonesian towns*
sector are not recorded, controlled nor enforced by official authorities – in turn implying a lack of formal contracts; worker benefits of various kinds; social protection and commonly also property and tax registers. The grey economy comprehends actors that are either self-employed (often running micro or small businesses) or wage employed inside or outside the ideal type of a purely informal firm. These two crude categories are each equipped with a number of sub-categories. Further, it is important to recognise the non black-and-white character of what is informal; informality ought to be seen as existing along a scale with steps and categories falling in between pure formal activities at one pole and pure informal activities at the other. Also, the two poles are often linked to each other, and workers and businesses may continuously shift in their degree or form of informality (Chen 2004).

Thus, two central aspects are non-registration and/or tax evasion of goods and services that had been taxable if they would have been reported to the state authorities. An example of the sliding scale might be business that indeed is registered but still avoids paying some of the prescribed taxes, thus acting partly informal. Given the heterogeneity of the grey economy as phenomenon, focus is here 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, out of which arguably two are still very much present in the discussion.

From being a phenomenon mostly of interest to anthropologists and sociologists, economic activities that take place outside of the legal framework started in the middle of the 20th century to interest also economists and other scientific domains (Gërxhani 2004). At the 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 merge with 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 diverged into three main strands yielding differing perspectives regarding both the defining characteristics of the grey
economy and what gives rise to this sector: the dualist, the structuralist and the legalist school (Chen 2004).

**Three main schools of thought**

To begin with, the dualist perspective looks upon the grey sector as consisting of marginal economic activities that constitute a separate economic domain, which is 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. As touched on above, 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: the dominant strand became instead one that emphasised domination and subordination, named the structuralist school (Chen 2004; Gërxhani 2004).

The structuralist perspective rejects the notion of economic dualism and marginality. Instead, structuralists argue the strong interdependence between the official and the unofficial sector, in particular emphasising the dependency position of the latter one as this sector is seen as being comprised of subordinate (micro) firms and labour that reduce different costs and thereby increase the competitiveness of larger, formal firms. According to this school, 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; Gërxhani 2004).

The most recent contribution to this body of literature is termed the legalist perspective, heavily promoted in the 1980s and 1990s but still going strong. As stated, this school builds on new institutionalism in economics together with rational choice institutionalism, directing the attention towards the relationship between the “rules of the game” and economic development and arguing that institutions are not neutral beings but instead actively influencing both the official and the unofficial sector. The legalist view focuses 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; Gërxhani 2004; de Soto 1989; de Soto 2000).

Today the dualist school is largely outdated. The other two perspectives however are still invoked to explain the existence and persistence of informality. Importantly though, the two schools focus on rather different features of the grey economy:

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).4

For the sake of clarity: the argumentation regarding the need of re-thinking the grey economy is not meant to cover all aspects of this phenomenon. Rather, in the centre of attention stand the entrepreneurial class and workers within the grey sector, i.e. the interesting issue is actors and their behaviour, interactions and motivations – turning the legalist perspective into the relevant one to focus on. As stated, this is also the dominant perspective when it comes to fight informality in developing countries. Another way to frame it is to say that the legalist perspective (and the paper at hand) is concerned with so-called “informalization from below” – i.e. separating a focus on the micro level (comprehending for example small businesses or workers that develop strategies that go beyond the formal regulatory framework) from the so-called “informalization from above” which include corporate strategies of outsourcing as well as welfare state coping strategies (a notion of informality mostly used in connection to developed Western welfare states) (Slavnic 2010). Often though, these two processes go hand-in-hand.

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4 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, see for example de Soto 1989; 2000.
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 regulations that make the material costs of acting or becoming formal higher than equivalent costs present in the unofficial sector. Excessive regulations – in particular present in developing countries – create barriers for entrepreneurs to act formally (Chen 2004). Working within the 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 unofficial sector (Feige 1990), thus involving non-registration and tax evasion.

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, see section below for a further development of the issue) ones; also recognising that a clash between them yield non-compliant behaviour, i.e. producing informality. 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 (Gërxhani 2004; Chen 2004). 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 already on beforehand neglecting the possibility that informal institutions play a more fundamental role.

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, creating the situation that even for these firms some transactions 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 refer to state penalties; corruption; limited access to public services; and a limited access to financial services thus having to depend on more expensive unofficial sources (Ishengoma and Kappel 2006).

By embarking from the notion of an embedded economy – framing the grey economy as an instance of a social dilemma – the legalist perspective regarding motivations and actions of informal actors ought to be developed by analysing the possible importance of informal institutions, something which the current literature on informality indeed hint at but fail to develop any further. There are some exceptions though. Despite a general lack of knowledge regarding the entrepreneurial process within the grey sector (Webb, Tihanyi, Ireland and Sirmon 2009), a recent strand within the literature on informality does indeed focus in particular on the embeddedness of and motivation for informal work – thus standing in contrast to the more traditional view:

(...) Widespread and taken-for-granted thesis within the research on informal economy holds that the individuals and groups involved in the informal economy are driven primarily by rational self-interest to pursue monetary gain. More recent research, however, shows how people engage in informal economic activities not only for monetary gain, but also for moral reasons of mutual aid, involving ‘active citizenship’ and ‘community building’ dimensions (Slavnic 2010, 4).

Indeed, after more than twenty years since Migdal's famous work, state capacity is not as much taken for granted and there is a greater acknowledgement of the not always straightforward relationship between formal rules and regulations and the existence of informal practices (North 1990). 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).

**Greyness 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 employed idea of the prisoners' dilemma. The notion of a social dilemma refers
to situations when the actions of individuals lead to a sub-optimal outcome for the collective. 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 among individuals or between citizens and the state institutions. Accordingly, the basic idea here is that the behaviour of an individual is influenced (wholly or partially) by his or hers judgment of how other relevant individuals will act. Behaviour is considered strategic but not necessarily rational in the sense of rational choice theory with its base in pre-set preferences. Rather, what is to be seen as rational is wholly or partially decided upon by the social and institutional context and might well be based on social norms or culturally established worldviews; the concept of trust playing a central role (Rothstein 2003).

The use of the concept of a social dilemma is here used in a somewhat unorthodox way, i.e. not as in pure game-theoretical models. Instead of having a goal of constructing theoretical models of behaviour, the use here is to take the basic notion of a dilemma in order to fully grasp the complexities of the grey economy and opening up for informal institutions (understood as norms, values and “unwritten social rules”) and trust to play important 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. For example, and following Elster's understanding of the concept, actors within the grey economy are expected to make choices independently of each other, in the sense that they are commonly not covered by formal enforcement institutions. On the other hand, and for the same reasons, the actors are interdependent and their choice to act formally or informally is expected to depend on a broader institutional framework and on their notion of how others will behave (Elster 1989). Thus, notion of the unofficial sector as a social dilemma works as an illustration of a broader problematic, namely the creation of a “modern” state. Thus, the interest lies not 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 the consequences that stem from a social dilemma; having the political level in the background as provider of stimuli of formalisation and by that shaping the surrounding institutional environment.

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 atomised. Further, the top-down view of informality as discussed above is based on a notion common within much of the neo-institutionalist theory, namely that all actors will react in the same manner to the surrounding formal institutional framework. The argumentation here is meant to question this
idea, and to put forward an alternative way to look upon the issue. First however, some words on the embedded nature of the grey economy.

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 (admittedly in a somewhat caricature-like way): 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-socialised 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 modernisation – creating 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-socialised view as depicted above. The other extreme position, much based on neo-classical economics, does not accept this break in embeddedness connected to modernisation – 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 though, 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 removes the problem of order by not providing any 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 idealised version of the market is something new. Even Granovetter recognises this, claiming that more and more economists seem to appreciate the role played by the social surroundings. Also – and importantly – the notion of the atomised actor only acting out of rational choice is naturally a simplification; Williamson is one who states that the idea of limited cognitive competence, or a bounded rationality, is something that most contemporary proponents of the NIE perspective would adhere to (Williamson 2000). Taken together, the question is 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-socialised 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 is comprised of many facets (Granovetter 1985).
Informal institutions within the grey sector

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 maintained and changed. Despite the controversy, a notion much spread within the current institutionalist literature is that actors’ incentives and preferences are material and primarily or even exclusively shaped by formal institutional arrangements (Helmke and Levitsky 2004), which is why divergent behaviour amongst actors can be explained only by exogenously changed incentives.

However, of importance as of now is not to achieve an all-encompassing definition of the concept. 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 (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 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 when saying that formal institutions 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) (but which for example might be upheld by an “official” actor). 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 the surrounding 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. Often, “culture” has been used as the residual or remaining variable
when a non-rational behaviour has been noticed. Following North, Williamson speaks of the top level (the Level 1 amongst four) of social analysis – where informal institutions such as norms and customs are located. According to Williamson, this level is taken for granted by most working within the NIE; ignoring the interconnections and feedback existing between the four levels. Sticking with the notion that informal institutions change very slowly (which might indeed be the case) given that they are often of spontaneous origin (i.e. not deliberately created), Williamson nonetheless argues in line with the paper at hand when stating that the institutions of the Level 1 constitute a underdeveloped part of the picture and that:

An identification and explication of the *mechanisms* (italics in original) through which informal institutions arise and are maintained would especially help to understand the slow change in Level 1 institutions (Williamson 2000, 597).

Further, 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). However, this would go hand in hand with a rational analysis whereas a focus on values would not – a discussion which requires further elaboration, so far it suffices to say that the ambition to separate between culture and informal institutions is supported by the project at hand.

Second, a common distinction between formal and informal institutions is that the latter ones 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), pointing at the possible importance of the institutional meso level.
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 it might be 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” 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 (and indeed sometimes crowd it out).

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, after 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, she claims that only little attention has been given to individual actors and their behaviour and motivations (Gërxhani 2004); not that surprising given that the rational model typifies behaviour on beforehand, thus being more suitable on the aggregated individual level. In other words, despite the knowledge of the strong influence exerted by institutions on not least the economy (North 1990), the institutional (non-determined) micro-level of informality remains an understudied object. Indeed, the literature in the field does hint at social elements within the grey sector that are likely to play a role for the question of persistence, denying however these elements any closer scrutiny.

Let us take an example. Schneider acknowledges that much empirical evidence regarding informality indeed point at the importance of formal governmentally issued rules and regulations, precisely as stipulated by the legalist perspective. 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 relationships; informal capital markets; family; networks for implicit contract enforcement and so on 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, Gërxhani (2004) has conducted an exploration of the institutional factors by which society shapes the unofficial 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 studied and thus least developed. In a similar way as Schneider, Gërxhani 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).

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 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, but in the context of a grey economy informal ones play a greater role. Among those informal constraints, trust is presumed to be of great importance as an enabler of cooperation given its function 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); trust referring partly to horizontal trust, i.e. the extent to which actors within the grey sector trust each other to stick to accepted norms, and
partly to vertical trust, i.e. the extent to which the actors display a trust towards the institutions of the state.

As mentioned above, there is indeed a recent strand within the literature on informality that more deeply explore the role played by norms, identity and perceptions about what is legitimate in any particular society. One example is a study by Webb, Tihanyi, Ireland and Sirmon (2009) in which the authors employ what they call a “multilevel perspective” to explore the importance of norms, values and beliefs for the existence of a grey sector. Despite some merits, one important point of critique against this work is the too ideal-type-like depiction of the relation between the micro, meso and macro institutional level; where there is not much room for interaction between the different levels, thus for example taking for granted that the purely black sector (dealing with goods and services that are illegal in themselves) is not connected to the grey economy. This works to remove the meso institutional level from a role as provider of security or mechanism of enforcement, thus not engaging in an analysis of informality as a socially embedded phenomenon, but rather sticking with the assumptions proposed by the legalist perspective of the grey economy as a separate sphere.

**A broadened institutionalist perspective**

The line of thinking of the legalist school fits into the framework of two strands within the theoretical bloc 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, in which everything from one to at least six divergent approaches have been referred to (March and Olsen 1984; Hall and Taylor 1996; Peters 1999). Recently, arising out of an acknowledgement of the inherent limitations of the other approaches (in particular regarding the question of institutional stability and change, see for example Weyland 2008 for a recent critique), voices have been raised wanting to add yet another perspective to the three dominant ones as mentioned by Hall and Taylor—namely the approach either known as constructive, ideational or discursive institutionalism (hereafter named constructivist institutionalism, 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 stems from the existing literature on informality which as mentioned above hints at

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5 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.
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 the rational or the sociological approach is not enough**

Besides the controversy regarding what constitutes an institution, another contentious issue (though 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 brings consequences for their ability partly to understand but also to explain institutional stability or change. According to Hall and Taylor, these issues are simply fundamental to any institutional analysis (Hall and Taylor 1996).^6

In studies conducted on the unofficial 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, depicted 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 truly 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.

Within RI, 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

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^6 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).
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\(^7\), 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 a common 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 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 (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 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 formal 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.

\(^7\) The focus of RI is on the aggregated individual actor but much work within this tradition deal also with collectives as actors, see for example Ostrom 1990.
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 were created. In other words, institutional equilibrium is (easily) achieved through the selection of new rules and regulations (Peters 1999). As touched on above, 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 a quick fix to 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 and meso reality of individuals and networks with 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, the former become costlier 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. Still, despite a great variance within the SI approach (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 (in line with the discussion above). 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 dilemma, creating a larger space for agency.

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 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 grey 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 (Hay 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, the meaning they attribute to it. 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 not be taken for granted but be an open and empirical question. In other words, rationality is not to be 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 – including the interaction of 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).

Last but not least, if we connect this discussion to the one above regarding Granovetter, we can see that the points of critique are indeed very 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 socially 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 of this approach (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 paper 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. Instead, of interest ought to be both the “non-physical” informal institutions underlying these “physical” social structures, and the social relations as such, if they are to be found. Further, 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.

*Active endogenous stability in order to understand change*

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 paper. However, as put forward in the discussion above, in both SI and RI the space for endogenous change – and what might be named “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, this paper argues that we should re-direct the focus towards questions 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 not least, the role of actors (as apart merely from the existing structures) within the “stability-creating” process. 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. Last but not least, Weyland recognises – much in the same vein as Migdal above – the need of understanding both the supply and the demand of institutional change. Weyland criticises the three traditional approaches of new institutionalism for having emphasised inertia, for not framing the conditions under which institutions reinforce or undermine themselves as an open question to be studied (Weyland 2008).
Kosovo under (re-)construction

After the self-proclaimed declaration of independence in February of 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 in the sense of the various state functions depicted above. Following the Kosovo conflict in 1999, much energy was spent on the status question, an issue which arguably remains unsolved (although not all involved would agree upon this). At present, 70 states have recognised Kosovo’s independence; a number which generally is expected to increase in the near future given the opinion of the International Court of Justice (ICJ) that the unilateral declaration of independence did not violate international law (EU FM\'s discuss Kosovo in wake of ICJ opinion, Balkan Insight Daily 2010). Parallel to an ongoing discussion of whether the Weberian state model is really a viable solution to strive for in the Kosovo case 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 (see for example Stroschein 2008); a large share of the reforms promoted by the government of Kosovo and the United Nations/European Union has aimed and aims at the former model, i.e. institutional-strengthening at the national and local levels, in order to achieve a social and economic development. A report from the International Labour Organization (ILO) shows that in 2007 the Kosovar economy was still dependent on external funding and remittances (Corbanese and Rosas 2007).

Towards the end of the 1980s and during the 1990s, the existence of the so-called Kosovar parallel society (towards Serbia) 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 maintained a shadow state 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 homogenising factor for the Albanian population and what it meant to be Albanian was partly defined in opposition to “Serbian-ness” (Stilhoff Sörensen 2006b).

So, 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 heritage: one being a strong support of the national state institutions (for example manifested in a willingness
to pay taxes and in a support of attempts of formalising the post-conflict economy), 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, i.e. the former tentative consequence would appear as most likely. Rather unexpectedly then, many indicators point at the latter development – the extremely strong unity that existed among the Kosovars only a few years ago does not appear to be channeled towards the own national government.

For example, in a survey conducted by the UNDP and the USAID in January this year, 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 a sizeable grey economy. As stated above, the problematic implications stemming from informality have been recognised by both the international community and the Kosovar government; the need of decreasing the size and spread of unofficial economic activities 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, from the official point of view a formalisation of the grey economy is seen as necessary in order to “fix” Kosovo and avoid the seal of failure.

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 officially regulated economy. In line with the discussion above and in viewing the Kosovar grey economy as a social dilemma – opening up for the possibility that there is incongruence between realities-on-the-ground and state stimuli to overcome informality – the notion is that in order to understand the Kosovar state-building process,
an understanding of the grey economy and its dynamics on the micro level as well as on the meso and macro ones is called upon.

What then is known today about the grey economy in Kosovo? As it turns out, not much. What has become clear though is that the road to a sustained economic and social development is long and winding; in the official view seen as dependent on a strengthening of the micro, small and medium sized businesses of the private sector that totally dominate the Kosovar economy (Đizić and Kramer 2009). At present, the majority of businesses in Kosovo (around 98 per cent of the total private sector) comprehend micro firms that employ one to nine employees and are typically found in so-called low-barriers-to-entry sectors such as trade or service activities together with family farms; the with small and medium enterprises constituting the rest\(^8\) (UNDP 2007; SMEs Support Agency 2009).

As large numbers of the Kosovars 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 privately owned farms, around 200 publicly-owned enterprises (most in poor condition and not operating) and a large number of privately owned micro and small businesses – at the time considered to be informal mostly due to lacking state regulations (European Commission/World Bank 1999), unsurprising given the conflict-ridden environment.

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 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

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\(^8\) Large enterprises, i.e. with more than 250 employees are almost non-existent, constituting around 0, 06 per cent. In Kosovo, as different from the EU, the only criterion for the classification of the size of an enterprise is the number of employed personnel and not annual turnover etcetera.
after the end of the 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; mainly through the creation of proper institutional framework (European Commission/World Bank 1999). This approach fits with the general view of market transition, in which the private sector is seen as the agents of change under a suitable formal institutional setting (Stilhoff Sörensen 2006a).

As part of a larger EU-funded (the European Agency for Reconstruction) project to combat corruption and money laundering, one of the few existing studies 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 activities is a continued lack of a proper regulative framework. Interestingly, and which would go against the legalist perspective, according to experts within the Kosovo Tax Administration and the Alliance of Kosovar Businesses, the reason behind informality is not the high costs of acting formal; business taxes are for example among the lowest in the region and were actually decreased precisely in order to decrease the level of tax evasion (Interview Imeri, Prishtina September 2010; Interview Shahini, Prishtina September 2010). Rather, one reason might be a heritage from the past – the Kosovars not being used to pay taxes since especially during the 1990s tax evasion was a patriotic act (Interview Imeri, Prishtina September 2010).

However, there is no 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). The somewhat unreliable nature of these numbers is partly due to divergent ways of classifying what is informal or not. If using the criteria of registration for businesses (and the existence of formal employment contracts for employees) a survey done in 2003 showed that around 50 per cent of total employment was to be found in the grey sector (ILO 2007). Nonetheless, a business might indeed be registered but still evading some of the prescribed taxes. According to the Head Chief of the SMEs Support Agency within the Ministry of Trade and Industry, there are two types of informality in Kosovo; one comprehends businesses and family farms that are completely
unregistered, the other comprehends businesses and farms that only partly act informal, i.e. they are for example registered but do not report their whole income (Interview Grajčevci, Prishtina September 2010).

Summing up, the origin of the grey economy in Kosovo remains somewhat unclear, although we can both note an increase taking place during the 1990s and at present differing but still high levels of informality. Given the contemporary low level of taxes, the interesting issue here is thus the role exerted by norms and values inherited from the past on the persistence of the grey sector and on a higher abstract level on the somewhat paradox development from a parallel state to the present situation. Today, the Kosovar parallel structures are physically dismantled, but as revealed in an interview with Venhari, researcher at KIPRED⁹: even though the physical structures have disappeared, the mentality of the parallel society does to some extent still exist but is now instead being directed towards the national government (Interview Venhari, Prishtina August 2009). In a similar vein, Stilhoff Sörensen argues that the traditional structures of social organisation within the Albanian population were decisive during Yugoslav times and that they are of continued great importance as loyalty structures, albeit it remains unclear if and how these structures have been affected by the ongoing process of liberalisation (Stilhoff Sörensen 2006a). Last but not least, given the well-known problem of corruption within the Kosovar government, some experts express doubts of the true will of the government to undertake any serious efforts to decrease informality (Interview Hasani, Prishtina September 2010; Interview Totaj, Prishtina September 2010) – taken together, all this points at the importance of an analysis that opens up for interaction between different institutional levels (building on the critique expressed above against Webb et al).

**Concluding remarks**

The notion that the (grey) economy is embedded in – and affected by – a larger 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. As seen though, the literature on the grey economy is characterised by a strong focus on cost and benefit calculations while considerations that include the intersection of the social and the political are left behind (Gërrixhani 2004). As argued by this paper, a more thoroughly understanding of the Kosovar unofficial economy

⁹ Kosovar Institute for Policy Research and Development
and its repercussions over the process of state building will – apart from filling an empirical lacuna of importance not only for Kosovo but for the whole of the Balkan region including other states that are in the process of state-building – contribute to existing knowledge concerning institutional change and stability and the role played by informal institutions in this process, so far a rather undeveloped theme.

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