

1 DOCUMENT INFORMATION

Project	
Project acronym:	INFORM
Project full title:	CLOSING THE GAP BETWEEN FORMAL AND INFORMAL INSTITUTIONS IN THE BALKANS
Grant agreement no.:	693537
Funding scheme:	H2020-INT-SOCIETY-2015
Project start date:	01/04/2016
Project duration:	36 months
Call topic:	INT-10-2015
Project web-site:	https://formal-informal.eu/en/
Document	
Deliverable number:	D.4.1
Deliverable title:	Policy paper
Due date of deliverable:	31 December 2018
Actual submission date:	
Editors:	Dr Eric Gordy, Dr Adnan Efendic
Authors:	Adnan Efendic, Alena Ledeneva
Reviewers:	Gordy, E., Efendic, A., Klavs, S., INFORM advisory board members
Participating beneficiaries:	CISAR
Work Package no.:	WP4
Work Package title:	Formulating policy measures
Work Package leader:	CISAR
Work Package participants:	UCL,IEF,UM,CISAR,CESK,IDSCS,QKHA,SRK,RSU
Estimated person-months for deliverable:	4 months
Dissemination level:	
Nature:	
Version:	
Draft/Final:	Final
No of pages (including cover):	6
Keywords:	Informal networking, costs, Western Balkans



EUROPEAN POLICY BRIEF



THERE IS NO FREE (INFORMAL) LUNCH:

Cost of informal networking in the Western Balkans

15 March 2018

INTRODUCTION

The interplay between formal and informal institutions gives rise to both formal and informal institutional costs. Both use economic resources and need to be considered. While there is research on the costs of formal institutional environments, the informal dimension of the institutional environment has been rather neglected. Why? The answer to this question is simple. It is much more difficult to measure costs associated with informal institutions due to their elusive nature. Informal costs are linked to activities that may not be visible or counted as costs, yet every social interaction perceived as necessary or beneficial also includes some costs. In our research, we operationalise the costs of informal institutions in the business sector in terms of time and money by asking the following questions:

- **How important/widespread is the informal networking of entrepreneurs in the Western Balkan (WB) region (proxy for benefits)?**
- **What is the approximate cost of informal networking in the business sector of the WB region (proxy for costs)?**

Our findings indicate that entrepreneurs engage in informal networking for various purposes, but most importantly to tackle business issues rising from formal institutional deficiencies and time-wasting procedures. Consequently, each month SME entrepreneurs spend around 160 Euros, on average, which include both the costs

of time and money. The estimated (opportunity) costs of time are greater than the reported monetary costs. If we aggregate these costs annually at the level of SME sector, they range from 0.5% to 2.5% of GDP in the WB countries. Thus, the estimate of the annual costs of informal networking is higher than the annual flow of foreign direct investment into some of these societies. This suggests a need for relevant policies that will reduce the costs of informality by tackling its potential sources identified in these institutional environments.

Although informality is costly, we do not assume that informal networking is a negative phenomenon by definition. Indeed, we identify a beneficial side of informality. For example, informal networking among entrepreneurs does not suffer from ethnic intolerance; informal networking is not driven by ethnicity or religious affiliation. This is a good practice that we recommend to formal institutions, which are not always inclusive in this respect in the WB region.

EVIDENCE AND ANALYSIS OF INFORMAL NETWORKING

We summarize the main findings from our cross-country research as follows:

1. **Entrepreneurs recognize the importance of having informal networks** for establishing, developing and maintaining their businesses in every observed country. Informal networking is motivated by business interests more than by traditional, cultural or other influences. The main differences between WB countries exist in the size and purpose of informal networks.
2. **Informal networks are used for different purposes, including: to exchange ideas, information, and knowledge; to ensure access to the market; to compensate for the lack of rule of law; as a protective shell against political influence; but, most frequently, to avoid formal institutional rigidities and time-wasting procedures, and unnecessary formal institutional costs.** In this diverse spectrum, we identify even examples as providing personal psychological benefits. Nonetheless, a majority of entrepreneurs insist that informal networks are used primarily to substitute for the failures of formal institutional outcomes and to offset political influences on their business. In this case, informal networking arrangements and outcomes are as important and relevant to entrepreneurs as the formal institutional ones. The purpose of networking in the EU countries in our sample (Slovenia and Croatia) is a bit different: here, we identify a dominant complementary role to formal

institutions, with informal networking less used to offset informal institutional failures

3. Thus, we recognize that where **formal institutions relevant for business development are more efficient, informal networking is less present and used for different purposes**. These two processes seem to be simultaneous – more intensive informal networking goes hand in hand with less credible formal institutions. Conversely, the entrepreneurs operating in **more efficient institutional environments use these informal networks to a lesser extent**.
4. **The entrepreneurs report “aversion” towards informality and perceive it as a burdensome but necessary strategy to cope with the poor formal institutional environment**. Although informal networking is frequently used in WB economies and is firmly integrated into the business cultures, it is not generally perceived as something positive, even if used, but rather as a necessary strategy “to get things done”. Once the formal institutional environment for business is improved, for which the best example is Macedonia as a non-EU, post-conflict and transition economy, informality is less used. Furthermore, it is mainly used as a complement to business development, while the aversion towards informality increases further.
5. Most entrepreneurs explicitly point out that **informal networks are blind to ethnicity and religion**, which is a persistent problem for some of these formal institutional environments, especially in BiH and Macedonia. This is a positive feature of informality, sending a message that informal institutions (networks) are better able to accommodate ethnic and religious diversity than are formal institutions. Supporting research from BiH indicates that ethnic diversity is an important resource for entrepreneurial growth aspirations, thus, greater ethnic pluralism may contribute to business development.
6. Once asked about **costs of informal networking**, our interviewees recognize these costs well; they provide quantitative estimates, including costs in terms of both money spent and time invested in establishing, sustaining and expanding informal networks. In addition, we identify a **substituting relation between money and time** – more time is invested into informal networking in the early stage of business development, while more money is invested in the later stages of a company’s development. The entrepreneurs are explicit in trying to prevent any unnecessary time loss, even for informal networking, and apparently substitute their time with more money invested as the business develops and becomes financially stronger.
7. As our key policy relevant finding, we establish that individuals in the WB region who invest into informal networking do so at a high cost, which implies

that the **culturally determined sociability of informal networking has an instrumental purpose.**

8. The **quantitative estimates of monthly costs** spent on informal networking by entrepreneurs in the WB countries **range between 90 and 260 Euros, averaging 160 Euros.** These costs are estimated to be around 100 Euros for general public, while they are grater for males and individuals with higher education.

Table 1: Estimated costs of informal networking by different categories, Euros, PPP adjusted

Business status		Gender		The level of education			
Citizens	Entrepreneurs	Males	Females	Primary	Secondary	University	Postgraduate
100€	160€	120€	80€	50€	100€	150€	210€

Source: INFORM, 2017 survey data and calculations of the authors. The numbers are rounded.

9. To illustrate how significant these costs of informal networks might be at the macroeconomic level, we collected data on the number of SME's in all countries, and calculated **an aggregated estimate of the costs of time and money,** assuming the costs derived from our interviews to be representative. We also assume **that only one entrepreneur from one SME** is doing informal networking. Hence, the numbers we obtained are very likely underestimated. The reported amounts are adjusted to reflect price differences. We obtain the highest costs for Kosovo (3% of GDP) and Albania (2%), while other countries are below 1% of GDP (BiH, Serbia and Macedonia). Our estimate of the total costs of informal networking indicate that these costs should not be ignored, as they absorb significant resources in the SME sector. Moreover, these costs are larger for WB countries than for the two EU countries in the sample (Slovenia and Croatia), including both money and the estimated costs of time. Hence, the competitive advantage of entrepreneurs operating in less developed WB countries is further decreased by higher informal costs.

POLICY IMPLICATIONS AND RECOMMENDATIONS

Based on our empirical evidence from the WB region, we recommend the following:

1. **Policy makers from EU should not look at informal institutions, informal networking and informal practices built in the business sector as a negative phenomenon having cultural, ethnic, religious, and traditional roots, or simply reflecting “the mentality” of the Western Balkans region.** Rather, informal institutions, channelled and supported by informal networks and practices on the ground send a valuable signal, serve as indicators of the

functioning of formal institutions that need attention, and have the potential to be integrated into policy thinking.

2. **A general improvement of formal institutional efficiency works as an efficient strategy of reducing informality – more efficient formal institutions go hand-in-hand with smaller incidence of informal networking.** Policy makers should know that informal institutions in the WB business sector, although built and inherited from the past, do respond to the imposed positive changes of formal institutions. Hence, by introducing relevant policies to increase the efficiency of formal institutions and regulations, informality might be reduced without a need to change cultures, traditions, or the mentality of people.
3. **Policy makers from the EU and the WB region should be aware that informal institutions can deal much better with the ethnic and religious diversities in these societies than do the formal institutions.** While formal institutions are generally prioritized in policy thinking over informal ones, they are only one part of the solution. The other part will remain to depend on the integration of the well-established informal practices of social inclusion of ethnic and religious differences into formal institutional settings. There is strong empirical evidence from BiH that ethnically diverse areas and personal networks provide greater economic benefits to both companies and individuals in comparison to ethnically homogenous areas or networks.
4. **Formal institutions are thought to better regulate the procedures of starting, running and closing businesses.** There is a need to implement at least two related changes. First, **timely and efficient procedures should be reduced to a couple of days, following the EU standards.** After decreasing the time related costs, the entrepreneurs' incentives to invest resources into informal networking will also decrease. Second, **the costs of starting, running and closing a business needs to reflect standards of living and business development in these societies.** Entrepreneurs having less developed businesses offset high financial costs of formal institutions by engaging in more informal networking for instrumental purposes, in which they invest time and effort. These costs and timely demanding procedures are feeding informal networking in the very early stage of business development in countries with expensive procedures, especially in BiH.

To collect data on informal networking costs we relied on qualitative and quantitative data gathered in the WB region. Firstly, we conducted semi-structured interviews implemented in the WB countries – Albania, Bosnia and Herzegovina, Kosovo, Macedonia, and Serbia; including two EU countries – Croatia and Slovenia. Thus, the sample includes EU countries as well as countries in the process of EU integration (candidate and potential candidate countries). The interviews were implemented among the entrepreneurs who run or manage micro, small, and medium businesses. The interviews were conducted in the selected countries over the period from November 2016 to February 2017; the majority of which were recorded with the interviewees' consent, then subsequently coded to ensure the anonymity of respondents, organized in transcripts, and used in later analysis. The effective sample includes 70 interviews: five in Albania; sixteen in BiH; five in Croatia; five in Kosovo; ten in Macedonia; nine in Serbia; and twenty in Slovenia. This sample enables us to make a comparison based on several criteria, including the EU versus the non-EU countries; more developed versus less developed countries; and ethnically and culturally diverse versus more homogeneous areas. Through these interviews, we also collected essential data about the interviewed entrepreneurs and their companies, including the main line of business, performance and costs of informal networking, thereby enabling applied econometric modelling of these data.

The quantitative data are collected through a targeted INFORM survey implemented in six WB countries (Albania, BiH, Kosovo, Macedonia, Montenegro, and Serbia) over the period March – June 2017. To collect this data, a multi-stage random (probability) sampling methodology was used to ensure representative samples. In every household, the 'closest birthday' rule was applied to select respondents, while every subsequent address was determined by the standard "random route" procedure. The dataset comprises 6,040 respondents from these countries, including 302 entrepreneurs, enabling us an investigation that includes the general public as well as a subsample of entrepreneurs. The relevant questions related to informal networking, including the size, structure and associated costs of networks, are included, which are used to construct variables relevant for our investigation.

PROJECT IDENTITY

PROJECT NAME	Closing the Gap Between Formal and Informal Institutions in the Balkans (INFORM)
COORDINATOR	Eric Gordy, School of Slavonic and East-European Studies at University College London, London, United Kingdom, e.gordy@ucl.ac.uk
CONSORTIUM	Centre for Empirical Cultural Studies of South-East Europe – CECS – Nis, Serbia Center for Intradisciplinary Social Applied Research – CISAR – Sarajevo, Bosnia and Herzegovina Institute for Democracy “Societas Civilis” - Skopje – IDSCS – Skopje, Macedonia Institute of Ethnology and Folklore Research – IEF – Zagreb, Croatia Center for Historical and Anthropological Research – QKHA – Tirana, Albania Riga Stradins University – RSU – Riga, Latvia School of Slavonic and East-European Studies – SSEES UCL – London, United Kingdom Social Research Kosova – SRK – Prishtina, Kosovo University of Maribor – UM –Maribor, Slovenia
FUNDING SCHEME	Horizon 2020 Framework Programme for Research and Innovation (2014-2020), “Societal Challenge 6 – Europe in a changing world: inclusive, innovative and reflective societies”, call H2020-INT-SOCIETY-2015, topic “INT-10-2015 - The European Union and integration challenges in the Balkans”.
DURATION	April 2016 – March 2019 (36 months).
BUDGET	EU contribution: 2 486 331,50 €.
WEBSITE	http://www.formal-informal.eu/home.html
FOR MORE INFORMATION	Contact: Eric Gordy, UCL, e.gordy@ucl.ac.uk Klavs Sedlenieks, RSU, ksedleni@gmail.com Adnan Efendic, CISAR, e.adnan@cisar.ba Alena Ledeneva, UCL, a.ledeneva@ucl.ac.uk
FURTHER READING	Efendic, A. and Ledeneva, A. (2018) Modelling the Costs of Informal Networking: Evidence from the Western Balkans Region. <i>UCL Working Paper Series 2018/3</i> . Efendic, A. and Ledeneva, A. (2018) The Costs of Informal Networking in the Western Balkans Region Matter!, <i>Europeanisation of the Western Balkans Region – Between Formal Institutions and Informal Practices</i> (eds. Eric, G. and Adnan, E.), Peter Lang, Bern.