

# **The rules of the game in transition: how informal institutions work in South East Europe**

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## **Abstract**

This chapter reviews the literature on the interaction between formal and informal institutions and undertakes some empirical tests for the validity of frequent claims about the substitutive role of informal institutions. We address two questions: ‘what works when the formal institutions do not?’ and ‘to what extent do formal institutions (operationalised as trust in formal rules and procedures) constitute real constraints in South East European societies with a strong hold of personalised trust and reliance on personal connections.’

To answer these questions we analyse survey data from eight countries of South East Europe on the interaction between formal and informal institutions. When formal rules fail to be effective, social norms of reliance on “trusted people and connections” predominate as a default (substitutive) option. However, there are limits to empirical testing of the existing typologies of the formal-informal interaction, because of the complexity of factors surrounding the workings of informal networks that channel and enable such interactions.

Our findings suggest that both the general public and entrepreneurs rely on personalised trust and invest into informal networking, with entrepreneurs doing so more actively in order to reduce the uncertainty and compensate for the ineffectiveness of formal institutions. The quantitative evidence suggests that maintaining informal networks incur substantial economic costs, which should not be ignored by researchers and policy makers. The qualitative data suggest that without understanding of the strong grip of “trusted people and connections,” it is not possible to model resource allocation, re-distribution and economic behaviour in the SEE region.

## 1. Introduction

Neoinstitutional theory defines institutions as rules of the game, or ‘the humanely devised constraints that structure political, economic and social interaction. They consist of *both* informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)’ (North, 1991: 97). The effectiveness of such institutions is associated with their regulatory and enforcement capacity (Scott, 2004). While the idea of formal and informal institutions is widely used in social sciences, and the effectiveness of formal institutions is monitored consistently, there are few empirical studies on the effects of informal institutions, and little empirical data on the interaction between formal and informal institutions. With the exception of the INFORM project: Closing the gap between formal and informal institutions in the Balkans (2016-2019)<sup>1</sup>, the quantitative data on informal institutions is rare and not integrated with the data on formal institutions.

The idea of closing the gap between formal and informal institutions is especially relevant to societies in transition where legal rules change fast and are imposed top-down, often under the pressure of international organisations and donors. This often results in clashes with existing or local social norms. Such clashes put an enormous burden on people, asked to transform their behaviour, and on governments, required to implement changes in order to score well in international rankings. In SEE countries, the clash of the Europeanisation reforms with people’s resistance to change have become associated with policy failures of ‘over-regulation and under-enforcement,’ otherwise known as the ‘policy implementation gap.’ The respective roles of formal and informal institutions in closing the implementation gap are still to be addressed (Gordy and Efendic, 2019).

It is widely recognized that a ‘good institutional arrangement’ is one where formal and informal institutions are not divergent, or in conflict (De Soto, 2000). In other words, legal norms are in harmony with social norms (Pejovich, 1999), both are embedded in human behaviour, and their outcome is convergent (Helmke and Levitsky, 2004). Views may differ on whether such convergence can be described as complementary or substitutive (North, 1990; Brousseau and Glachant, 2008; Furubotn and Richter, 2005). The existing typologies of informal institutions that use such terminology, presume that informal institutions are secondary to the operations of the formal institutions and residual, i.e. everything that is not formal but passed the test of time is informal (Helmke and Levitsky, 2004; Lauth, 2007). The complexity of empirical data challenges such assumptions. It is convenient to presume that legal rules are enforced formally, by the state, organisations, or formal hierarchies, while social norms are enforced informally, via families, peer circles and networks. Yet, in effect, these are hard to separate, as formal constraints tend to be enforced only if there is informal pressure to enforce them, or can exist only on paper. The reverse is also true: informal pressure may only emerge because there is a formal framework at work.

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<sup>1</sup> <https://www.ucl.ac.uk/ssees/research/funded-research-projects/inform/en/>

The INFORM evidence from transition economies presents additional puzzles. Firstly, in SEE for example, we witness multiple legislative changes that do not get implemented (Gordy and Efendic, 2019). It raises questions on whether codified formal rules can qualify as ‘formal institutions,’ if they are not enforced and do not constitute formal constraints as such (for examples of these see: Sakwa, 2007; Ledeneva 2001; Ginsburg and Simpser, 2013; Newton, 2017).

Secondly, the constraints posed by informal institutions need unpacking, as the enforcement of social norms, sometimes referred to as unwritten or informal rules, vary significantly and is context-bound. “Informal rules, then, are traditions, customs, moral values, religious beliefs and all the other norms of behaviour that have emerged spontaneously, survived the test of time and served to bind the generations” (Pejovich, 2008:11).

Thirdly, in SEE and other transitional contexts, we witness practices and informal exchanges, deemed to be path dependent, traditional or linked to communism, while in fact they are temporal reactions to the post-communist reforms (Ledeneva, 2006, 2008; Henig and Makovicky, 2017). A common assumption about transitional societies has been that ‘economies of favours,’ compensating for the ‘economies of shortage’ and defects in centralised planning and socialist systems of resources allocation and privileges, would become redundant once liberal reforms had opened markets and established democracies. However, the development of informal institutions in transition does not seem to follow this logic.

Fourthly, the role of networks in the enforcement of both formal rules and informal norms is not sufficiently integrated in the conceptualisation of the formal-informal interaction. The informal transaction costs associated with dense networks are often disregarded, and informal networks are not seen as effective for enforcing formal constraints. A more balanced analysis of the transaction costs associated with informal networking is needed (Efendic & Ledeneva, 2020).

These four points need to be addressed to understand the formal-informal interaction in transition societies. Empirically, we need proxies for the degree of institutionalisation of both formal rules and informal norms and the degree for their enforcement; a degree of independence or derivativeness (norms and practices as causal or consequential to the outcome of reforms); and a measure of sociability or instrumentality of networks. Conceptually, we need models accommodating such complexity and change (Andersson, 2008; Brousseau and Glachant, 2008; Ledeneva et al., 2018). The exiting literature on the interaction of formal and informal institutions is not balanced: the scholars either give the primacy to formal institutions and residual status to informal institutions, or informal institutions are studied without much consideration of their formal frameworks. Revisiting the conceptualisation of the formal-informal interaction is thus a necessary starting point.

This chapter starts with a discussion of the existing typologies of interaction between formal and informal institutions; it outlines key features of the institutional framework in SEE region; offers some empirical tests for the validity of claims about a dominant substitutive role of

informal institutions; and presents preliminary findings. We tackle the questions, ‘what works when the formal institutions do not?’ and ‘to what extent changing formal institutions (operationalised as trust into formal rules and procedures) constitute real constraints in the societies with a strong hold of informal norms (operationalised as reliance on personal connections)?’

We rely on evidence from eight countries of South East Europe (SEE) and scrutinise the data quantitatively and qualitatively. The investigation is based on representative survey data collected among the general public (6,000 respondents) and qualitative data collected among entrepreneurs in SEE (70 interviews), specifically in Albania, Bosnia and Herzegovina, Croatia, Kosovo, Montenegro, North Macedonia, Serbia and Slovenia. We conclude that both the general public and entrepreneurs invest much time and resources into informal networking to reduce the uncertainty and compensate for the inefficiency of formal institutions. The quantitative evidence suggests that maintaining informal networks is associated with substantial economic costs. The qualitative evidence emphasizes the predominant role of particular relationships over universal rules, or reliance on “trusted people and connections,” without which it is not possible to model economic behaviour in particularistic contexts.

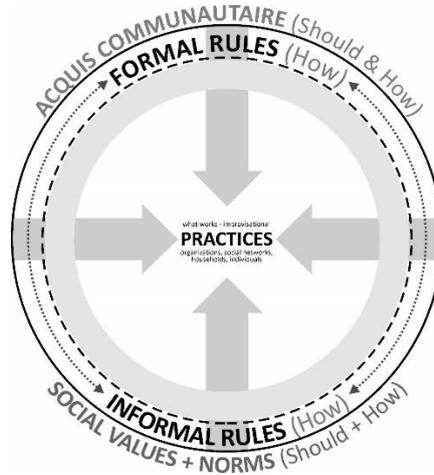
In the next section, we define ‘informal institutions’ and revisit the existing conceptualisations of formal-informal interaction and re-balance them by giving more explanatory power to informal institutions.

## **2. The rules of the game: revisiting formal and informal institutions**

Institutions are “perfectly analogous to the rules of the game in a competitive team sport. That is, they consist of formal written rules as well as typically unwritten codes of conduct that underline and supplement formal rules, such as not deliberately injuring a key player on the opposite team. And as this analogy would imply, the rules and informal codes are sometimes violated and punishment is enacted. Taken together, the formal and informal rules and the type and effectiveness of enforcement shape the whole character of the game” (North, 1990: 4). Compressing this amalgamation of rules, codes, their interaction, and their enforcement allowed North to revolutionise the notion of institution, now associated with neo-institutionalism.

The complexity of such conceptualisation that includes rules, enforcing mechanisms, and players, however, does not lend itself easily to empirical research. Hence, the constituents of institutions – formal and informal constraints have come to be considered apart from each other, and from their interaction and enforcement. Informal institutions are regarded as “conventions, norms of behaviour, and self-imposed codes of conduct” (North, 1995: 23), which produce constraints to reduce uncertainty in human interaction, whereas formal constraints are associated with rules and specifications, statutes and common laws, and constitutions. However, “[the] difference between informal and formal constraints is one of degree. Envision a continuum of taboos, customs and traditions at one end to written constitutions at the other.” Instead of separate entities, North speaks of a continuum of constraints, which can be depicted as in Figure 1 by a dotted line from formal rules to informal norms.

**Figure 1. INFORM model of the interaction of formal and informal institutions – step 1.**



North (1995: 37) acknowledges the role of informal institutions in the functioning of formal institutions and presumes their amalgamation. Because of complexity, “incompleteness of information” and the need to “coordinate human interactions,” informal institutions are necessary and include: “(1) extensions, elaborations and modifications of formal rules, (2) socially sanctioned norms of behaviour, (3) internally enforced standards of conduct” (North, 1990: 40). Some well-known examples would include (1) the use of progress-pushers to enable planned economies to reach their targets (2) widely spread denunciation practices but also social norm of contempt for anonymous letters and whistle-blowers; (3) adhering to the notions of friendships and voluntary acceptance of obligations to help, to “give away the last shirt” to a friend even where it involved formal rule-breaking.

The editors of *The International Handbook of Informal Governance* observe that various authors attach the adjective ‘informal’ to a wide range of conceptions: politics, arrangements, networks, institutions, organisations, norms, rules, activity or influence (Christiansen and Neuhold 2012). They distinguish at least three separate usages of it: first, the designation of the framework within which decisions are taken as being informal (institutions, organisations, networks); second, the identification of the process or procedure through which policies are made as being informal (politics, arrangements, activity); and, third, the classification of the outcome of any such process as being informal (rules, norms, influence). Adding the adjective “informal” to a subject matter reveals some important dimensions of its analysis, but often conceals the intricacies of the formal-informal interaction. Thus, definitions of informal institutions, explicitly or implicitly, presume a certain perspective on the interaction between formal rules and informal norms, often determined by a particular disciplinary method. Four perspectives can be distinguished:

- Normative, top-down perspective: formal (legal, prescriptive) = good, informal (cultural, slow to change) = bad, participants are not given a voice. Prescriptions for formalisation and crusades against informality are taken for granted (see overview in Polese, 2015).

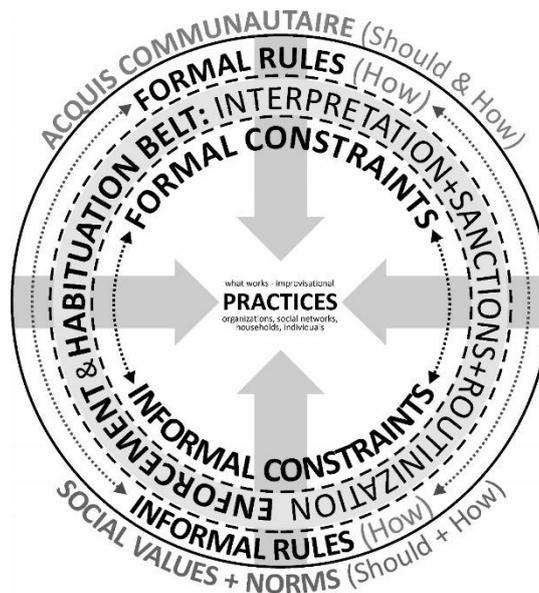
- Residual perspective: formal and informal institutions are co-existent, but priority/legitimacy, primacy is given to the formal. Types of informal institutions, for example, are determined by the (in)effectiveness of formal and convergence/divergence of outcomes of the formal and informal institutions (e.g. Helmke and Levitsky, 2004).
- Symbiotic perspective: formal and informal institutions are co-dependent, presuming a balance between formal and informal institutions, as in the yin/yang approach (e.g. Fang, 2012).
- Inductive, bottom-up perspective: informal institutions are given primacy, and formal institutions are seen as an outcome of a historical process of the institutionalisation of informal norms. “Informal institutions can also serve as templates for formal institutions. Informal rules may generate precedents and prevalent practices that are then formalized for efficiency’s sake, as with the rise of private property and the incorporation of capitalist entrepreneurs into the Communist Party in China” (Tsai, 2006, cited in Grzymala-Busse, 2010; see also de Soto 1989). Participants are given voice and the formal institutions often shift out of the focus of inquiry, as in the majority of ethnographic studies of informal practices.

These perspectives are often implicit in disciplinary method or focus of inquiry. The limitations of each perspective creates a niche for an interdisciplinary approach to grasp the complexity of the formal-informal interaction. However, in order to focus on the interaction of formal and informal institutions in the context of transition economies, we first need to resolve the four puzzles outlined in the introduction.

### **2.1. Differentiating rules and constraints: the ‘enforcement belt’**

North (1990) identifies formal institutions (formal rules) with formal constraints and informal institutions (informal norms) with informal constraints. However, for understanding communist, post-communist, authoritarian and transitional contexts, it is essential to envisage that both formal rules and informal norms do not always constitute real constraints, as many of them are meant to remain the façade of economic and political regimes or traditional practices. In other words: not all formally codified rules constitute formal constraints, and those which do might not necessarily do so with the consistency and predictability we associate with formal institutions. Moreover, relying on the record of codified rules would not produce sufficient data on the workings of an economy. Similarly, there can be informal rules, which never become constraints – this is how Bourdieu got the idea of strategies – he noticed that there are matrimonial rules in Algeria, which everybody knows, but only few follow. Both formal and informal rules can thus be “empty shells” (Dimitrova, 2010). As depicted on Figure 2, the INFORM model differentiates between formal rules and formal constraints in order to point out the issue of the ‘under-enforcement’ of formal institutions in transition contexts, as well as between social norms and informal constraints in order to point out the context-bound nature of the social norms and their partial enforcement. The emphasis here is on the ‘enforcement belt’, that allows us to capture which rules and norms constitute actual constraints.

**Figure 2. INFORM model of the interaction of formal and informal institutions – step 2.**



The main limitation of defining institutions as constraints is that North ignores the *enabling* aspects of institutions. “Institutions do indeed forbid many activities, but they equally make possible an enormous range of activities that would be impossible-inconceivable-in their absence: that is, they are always and everywhere liberating as well as limiting” (Neale 1993: 423). The ambivalent nature of constraints and their enabling power is essential for understanding the dual functionality of informal practices that both support and subvert the formal rules and informal norms that shape them (Ledeneva et al., 2018, Vol. 2: 3-5). Hodgson (2006) states that institutions both enable and constrain behaviour, whereas Searle (2005) suggests that the role of institutions is not to constrain people but to create new kinds of power relationships, which are enabling.

## **2.2. Enforcement of formal rules and informal norms: the effectiveness of constraints**

Formal rules are enforced primarily by hierarchies: state organisations like courts, legislatures, bureaucracies and state enforced rules such as constitutions, laws, and regulations. Informal norms include conventions, codes of behaviour, traditions, cultural norms, religious beliefs, moral norms, habits and are enforced by families, trust circles and networks, or self-enforcement. These are passed from one generation to another through various transmission channels such as imitation, oral tradition and teaching (Tonoyan et al., 2010), and represent an “old ethos, the hand of the past or the carriers of history” (Pejovich, 1999: 166), associated with the phenomenon of path dependency in transitions.

It is often presumed that formal rules are more important because the risks and penalties associated with their violation are more considerable. However, the enforcement of informal norms is sometimes more efficient as it is grounded in daily interactions, self-enforcement, and subtle mechanisms that may not be visible. They are transferred from generations to generations (Pejovich, 2008) and may be just as important determinant of socio-economic environment as

formal institutions (Knowles and Weatherston, 2006; Tabellini, 2010). Hence, the presence of informal institutions is a strong determinant of development (Williamson, 2009). This especially applies to co-coordinating activities where the costs of writing and enforcing contracts are high (Pollitt, 2002), or where “formal institutions exist on paper but are ineffective in practice” (Helmke and Levitsky, 2004: 730). However, informal institutions can be also inefficient; informal institutional voids appear with inability of norms, values and beliefs to facilitate stable, efficient and effective transactions (Webb et al., 2019). Whereas formal institutions might resemble each other in different societies, the informal institutions in which people are socialised and that they learn to respect, are seen as specific, cultural and emerging bottom up.

### **2.3. Differentiating informal institutions from other informal regularities: “trusted people and connection” vs. informal networking in SEE**

Helmke and Levitsky define informal institutions as “... socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels” (2004, p. 727). An example from the Soviet Union, fitting this definition, is an effective and self-enforced set of norms associated with friendship, mutual help and social cooperation (us vs. them). In SEE region, we establish a central role of the so-called “trusted people and connections’ for compensating or substituting the failure of formal institutions to operate effectively. According to a widely cited typology of informal institutions, both complementary and substitutive types are related to the convergent outcomes of formal and informal institutions (see Table 1), whereas the outcomes of formal and informal institutions in SEE are divergent (i.e. there is a gap between formal rules and informal norms). It is thus crucial to emphasize that our hypothesis that the informal norms act as *substitutes* for the failure of formal institutions does not imply the convergent outcomes of formal and informal institutions in SEE.

**Table 1 Types of informal institutions**

<b>Outcomes</b>	<b>Effective formal institutions</b>	<b>Ineffective formal institutions</b>
<b>Convergent</b>	Complementary	Substitutive
<b>Divergent</b>	Accommodating	Competing

In order to qualify the SEE region case, we had to look deeper into the typology of informal institutions, proposed by Helmke and Levitsky (2004). In the matrix above, informal institutions are perceived to be a dependent variable, with an independent variable – formal institutions and their effectiveness – given primacy. The convergent and divergent types of outcomes do not constitute an independent variable as they are intrinsically linked to the first one. Four types of informal institutions are then presented: accommodating, competing, complementary and substitutive relationships. This matrix is consistent with the focus of political science on formal institutions, which somewhat reverses the historical logic of their formation. An example of paving pathways in a park illustrates the point. If the pavements are laid beautifully but in a top-down fashion, without taking into account the bottom-up footpaths that had been in use for generations, the situation of convergence might never occur. Paving the existing footpaths will reduce the transaction costs for their users and the possibility of divergence.

- Complementary informal institutions mean that formal and informal institutions coexist, and informal institutions might serve as a foundation for effective formal institutions. This is clearly not the cases for the SEE.
- Substitutive informal institutions are compatible with formal institutions, but do not engage with them: they operate in environments where formal rules are not routinely enforced, such as local micro-credit schemes or rotational cooperation in rural areas (see Ledeneva et al., 2018). Substitutive institutions aim to achieve what formal institutions failed to achieve, but not by relying on informal contacts for getting things done or circumventing procedures within the remit of formal institutions.

When the outcomes of the informal and formal institutions (effective or ineffective) are divergent, which would primarily be the case of the SEE countries, the types of interaction are:

- Competing informal institutions coexist with ineffective formal institutions. These informal institutions are incompatible with the formal rules and are often found in post-colonial contexts in which formal institutions were imposed on indigenous rules and authority structures. This type would qualify to describe the situation in the SEE region, where external legal norms are imposed on traditional norms and customs.
- Accommodating informal institutions alter the substantive effects of formal rules, but without directly violating them. This, for example, includes *blat* in the Soviet Union, ‘because strict adherence to the formal rules governing Soviet political and economic

life did not allow enterprises to fulfil state targets or permit individuals to meet basic needs, a set of informal norms emerged in which individuals met these goals through personal networks' (from Ledeneva, 1998 cited in Helmke and Levitsky, 2004).

The Helmky-Levitsky typology is widely cited in the literature, and rightly so. Despite the imbalance between formal and informal institutions it embodies, the typology points in the right direction for exploring the formal-informal interaction. In fact, their four types of informal institutions would work much better as four types of interaction, but the matrix should result from cross-tabulating types of formal institutions with types of informal institutions.

In order to focus on the interaction between formal and informal institutions specifically, we have devised an INFORM theoretical model that fits this empirical agenda much better. According to the INFORM model, both formal and informal institutions will only constitute constraints if they are effectively enforced. Needless to say, there will be formal rules that remain on paper and social norms that can be ignored without sanctions. In our study, however, we focus on informal institutions which are effective (i.e. enforced, sanctioned, and constitute informal constraints) and serve to deliver what formal institutions cannot (Webb et al., 2019). We operationalise these as relatively stable circles of "trusted people and connections" that engage in problem solving, perform economic functions, and execute informal pressure on its members (Ledeneva, 2008; Efendic et al., 2011; Efendic & Ledeneva, 2020). These are different from socially shared norms, usually unwritten' by the fact that they are enforced (actually make it through the 'enforcement belt') and thus constitute real informal constraints for economic behaviour (see Figure 2).

#### **2.4. Stability of norms vs. temporality of practices: capturing interactions between formal and informal institutions**

Neither formal nor informal institutions are static, they evolve/change over time (North, 1990; Raiser, 2001; Jutting, 2003; Brousseau and Glachant, 2008; Hinings and Malhotra, 2008; Nelson, 2008; Ebner, 2008; Harriss, 2008; Acemoglu and Robinson, 2010; Efendic and Pugh, 2015). The reasons for institutional changes are multiple: from incremental and hardly noticeable to geopolitical, such as the end of communism in Central and East Europe, collapse of the Soviet Union, and breakdown of former Yugoslavia. For example: existing organisations influence institutional change; political forces are very often invoked in the dynamics of institutional processes; economic reality sometimes provokes changes; outsiders can promote institutional changes; sometimes almost the whole institutional environment is changed as in the case of transition economies during their evolution from centrally-planned systems towards market oriented economies. Finally, revolutions or wars, i.e. "discontinuous institutional change" (North, 1990: 89) may result in changes of institutional frameworks, which happened in some countries of SEE, and to the biggest extent in Bosnia and Herzegovina (Efendic, 2016). However, institutions should have durability as well, in order to be credible and acceptable to agents (Acemoglu, 2009); accordingly, there is continuous tension between the need for persistence and change in institutions (Andersson, 2008; Acemoglu, 2009).

A change in institutions may be caused by variations in formal rules, informal norms, as well as by changes in enforcement (North, 1990), which implies that institutional change may be a very sophisticated process (Brousseau and Glachant, 2008; Opper, 2008). We probably still have rather partial knowledge of how institutions change (Shirley, 2008). However, the literature suggests that informal institutions are more stable than formal (North, 1990; Williamson, 2000; Pejovich, 2008; Ebner, 2008), though this does not mean that some social norms may not change very quickly.<sup>2</sup> Since informal institutions change (generally) slowly they are taken for granted in most institutional research (Williamson, 2000; Andersson, 2008) or focused upon in isolation from formal institutions as is the case with inductive, bottom-up approaches and ethnographic research. Because of difficulties in measurability, informal institutions have been a neglected dimension in empirical research (Raiser, 2001; Harris, 2008) and treated as a “residual category” conceptually (Helmke and Levitsky, 2004: 727; Casson et al., 2010).

If we consider the potential causes and directions of changes, informal institutions tend to change gradually (driven by changes in social norms, customs, traditions, beliefs, habits, and values, i.e. “bottom-up”), while formal institutional change is determined by political forces in “top-down” (Easterly, 2008). The interaction of bottom-up and top-down forces is multidimensional and multilevel, which accounts for the complexity of institutional change. Since empirical studies cannot capture the complexity of institutional change, they have to be simplified and/or modified in various ways (Alston, 1996; Williamson, 2000; Fukuyama et al., 2007). Hence, a number of simplified institutional indicators and proxies are used in quantitative applied research. There are problems of measuring the quality or efficiency of formal institutions, but measuring informal institutions that relate to culture, mentalities, habits, trust, norms, conventions, codes, and informal networks is additionally challenging. Proxies for informal institutions used in empirical research are easy to challenge conceptually: examples include variables capturing culture (Tabellini, 2010; Williamson and Kerekes, 2011); civil society (Moers, 1999); or social capital (Jutting, 2003).

Both formal and informal constraints shape human behaviour – these are neither exogenous nor separate, as they are rooted in formal and informal institutions which are intertwined and in continuous interaction with one another (Redmond, 2005; Andersson, 2008; Webb et al., 2019). The ideal types of such interaction are mostly seen as complementary or substitutive in their influence on socio-economic outputs (North, 1990; Khan, 1995; Eggertsson, 1996; Raiser, 2001; Jutting, 2003; Furubotn and Richter, 2005; Fukuyama et al., 2007; Aidis et al., 2008; Brousseau and Glachant, 2008; Andersson, 2008; Nye, 2008; Efendic et al., 2011; Estrin and Prevezer, 2011; Bo Rothstein et al., 2013; Mungiu-Pippidi, 2015). Some authors provide empirical evidence on the explanatory role of informal institutions in shaping formal institutions (e.g. Casson et al., 2010; Grzymala-Busse, 2010; Williamson and Kerekes, 2011), leading us to conclude that this inter-relationship is very likely endogenous, which should not be ignored in applied research. In our study, we operationalise the interaction of formal and informal institutions by looking into the workings of informal networks, which activate personal

relationships (exercise informal constraints) in order to circumvent formal constraints in the SEE region.

A rare mixed-method investigation of the interaction between formal institutions and informal norms was undertaken within the framework of the INFORM<sup>3</sup> project implemented in SEE. The findings of this project indicate that informal norms in SEE tend to confront the top-down changes in formal institutions. The outcome of this clash results in the intense use of informal networking as an alternative mechanism of problem-solving and the rise of informal practices that point to the defects in workings of formal institutions. The willingness to engage into informal networking (i.e. invest time and money into socialising with subsequent “reliance on trusted people and connections”) was found to be a common mechanism of problem solving. However, informal networking cannot be associated exclusively with ineffective formal rules, or with rational need for problem-solving. Informal institutions – social norms, cultural codes, customs, and traditions – have some explanatory power for the predominance of informal networking (Alesina and Giuliano, 2013, 2015; Cveticanin, 2012; Grødeland, 2013; Aliyev, 2015; Stanojevic and Stokanic, 2014).

### **3. Specifics of the institutional framework in the SEE region: transaction costs of informal networks**

Informal networks are used differently in different cultures and institutional frameworks. In some contexts, informal networks are more oriented towards access to most basic needs and strategies of survival, in others they are associated with ‘gaming the system’ by elites (Ledeneva et al., 2018, Ch. 6). Trust-based networks can emerge in formal environments, and even be generated top-down or initiated bottom-up in organisations (Granovetter, 1985, Williamson, 1993, Möllering, 2014). For the purposes of our investigation, however, we focus on social networks that are biographical by-products of individuals (“trusted people and connections”). We refer to them as ‘in-formal,’ because they are relationship-based, yet aimed at bending the formal rules for competitive advantage.

In a society that operates under *particularism*, the use of informal networks, or reliance on connections and exchange of favours, are the key mode of resource allocation. In general terms, societies of the SEE qualify as ‘particularist,’ where relationships (and the pressure associated with them) mean more than rules, and “where individuals are treated differently according to particular ties or criteria” (Mungiu-Pippidi, 2015: 14). They differ from societies of *ethical universalism* – “where equal treatment applies to everyone regardless of the group to which one belongs”(Ibid.). As Mungiu-Pippidi (2015) argues, a society must transform its dominant social order from *particularism* to *ethical universalism*, in order to overcome the challenges of development and governance. Yet instead of engaging in a collective battle to alter the rules of the game to ethical universalism, a highly particularistic society coerces individuals to seek access to the privileged group and reap the benefits under the current rules of the game. Such individual compliance with *particularism* can be reduced if the equilibrium of *opportunities*

and *constraints* is changed – if one can build a “critical mass” of individuals in favour of changing the rules of the game (Mungiu-Pippidi, 2015: 183).

Effective formal institutions reduce risks and the cost of transactions; both households and entrepreneurs would rationalise their transaction costs and reduce their burden where possible. In the meantime, in the absence of effective formal institutions in SEE, informal networks serve a variety of purposes, from exchange of information, experience and ideas between agents to the provision of goods, services, and favours, not freely accessible on the market. Maintaining such informal networks incurs costs (Efendic & Ledeneva, 2019; 2020).

There seem to be a general consensus over the role of institutions in reducing transaction costs, even if definitions and calculations of transaction costs may vary significantly (Coarse, 2010).<sup>4</sup> Transaction costs are presumed to go down once countries in transition had progressed further towards developed market economies, but for the time being monitoring the costs of informal networks can itself be a way of assessing the so-called ‘implementation gap’ (Blundo et al., 2013; Hudson and Marquette, 2015; Mungiu-Pippidi, 2015; Williams and Vorley, 2015; Baez Camargo & Ledeneva, 2017). While the existing literature investigates predominantly the transaction costs of formal institutions or the benefits of social capital (e.g. Wallis and North, 1986), the question of costs of sustaining informal networks – social networks used for getting things done – remains largely neglected.

Informal constraints and cultural norms are based on particularistic, rather than universalistic assumptions, and remain underrepresented in the analyses of institutional frameworks. To reassess the balance, we associate the informal constraints with the costs they incur by using proxies of time and money (Efendic & Ledeneva, 2020), but with important caveats about informal networks:

- 1) Whereas formal constraints are conceived to be universal and rational, informal networking serves to solve problems in particular contexts and tackle the complexity of social life.
- 2) Unlike social norms, informal networks are fluid and dynamic. Networks can change quickly; and stay dormant until a particular problem arises.
- 3) Similarly, to the formal hierarchies that grant access to resources, informal networks are just as valuable to their members. People care for, pay attention, and invest time and money to establish and maintain them.
- 4) Just as formal organisations are perceived to enforce formal rules, informal networks are perceived to channel informal constraints, peer pressure, and compliance with social norms. The potential of informal networks in channelling compliance with formal rules tends to be overlooked in policy-making.

## 4. Empirical analysis of formal-informal institutional interaction in SEE

Now we move to the analysis of cross-country data and explore heterogeneity of formal and informal institutions in different countries by using representative micro data for individuals in the general public, supplemented with qualitative in-depth investigation of entrepreneurs<sup>5</sup>. Let us start with an outline of the existing assessments of the formal institutional environments in SEE (e.g. World Bank, 2018; Heritage Foundation, 2019). The region is characterised in most cases by institutional complexity, overlapping jurisdictions, government ineffectiveness and time-consuming processes, including some differences between the countries. In other words, there is room for further improvements of the formal institutional efficiency (see Table 2).

**Table 2. Institutional environment in SEE looked through different institutional indices**

Country	WB GE 2018	WB RQ 2018	WB RL 2018	WB CC 2018	IEF PP 2019	IEF JE 2019	IEF GI 2019
Albania	57.7	63.5	39.4	35.1	54.8	30.6	40.4
BiH	28.4	45.2	46.6	31.7	40.2	37.9	30.2
Croatia	69.2	68.3	63.0	60.1	66.0	42.9	38.6
Kosovo	38.0	41.4	40.4	35.6	57.2	53.5	44.7
N. Macedonia	55.8	71.6	43.8	42.3	65.1	60.7	44.7
Montenegro	58.2	65.9	57.7	58.2	55.4	51.8	39.5
Serbia	56.7	56.3	49.0	41.8	50.1	44.8	37.2
Slovenia	83.2	75.0	82.7	80.8	76.4	46.5	53.6

Notes: **WB** refers to the World Bank Governance Indicators, the percentile rank (0 min to 100 max, indicates rank of country among all countries in the world), which includes: **GE** - Government Effectiveness; **RQ** - Regulatory Quality; **RL** - Rule of Law; **CC** - Control of Corruption.  
**IEF** refers to the Heritage Foundation Index of Economic Freedom, (the scale is 0 min to 100 max), **PP** - Property Rights; **JE** - Judicial Effectiveness; **GI** - Government Integrity.  
Sources: World Bank, 2018, <https://info.worldbank.org/governance/wgi/>;  
Heritage Foundation, 2019, <https://www.heritage.org/index/ranking>.

As for the working of informal norms in the SEE region, we operationalise them as reliance on “your trusted people and connections in important places” for problem solving in particular contexts and assess their prevalence and functions (Efendic & Ledeneva, 2020). The functioning of informal norms is not possible without enforcement (peer pressure) and supporting channels to access resources (informal networking), hence, the operationalisation of reliance on “trusted people and connections” (social networks, trust networks or social capital) is done through the use of informal networks. The emphasis is made on use of networks, rather than on the network constitution. The strength of the informal institution of “your trusted people and connections” is tested in the times of need and the data reveal the key importance of the instrumentality of informal networks in the SEE region.

And more generally, one could argue that informal networks are the best proxy for channelling and facilitation of interaction between formal and informal institutions: not only in the bottom-

<sup>5</sup> Appendix 1 reports more details about the sample and how both types of data were collected.

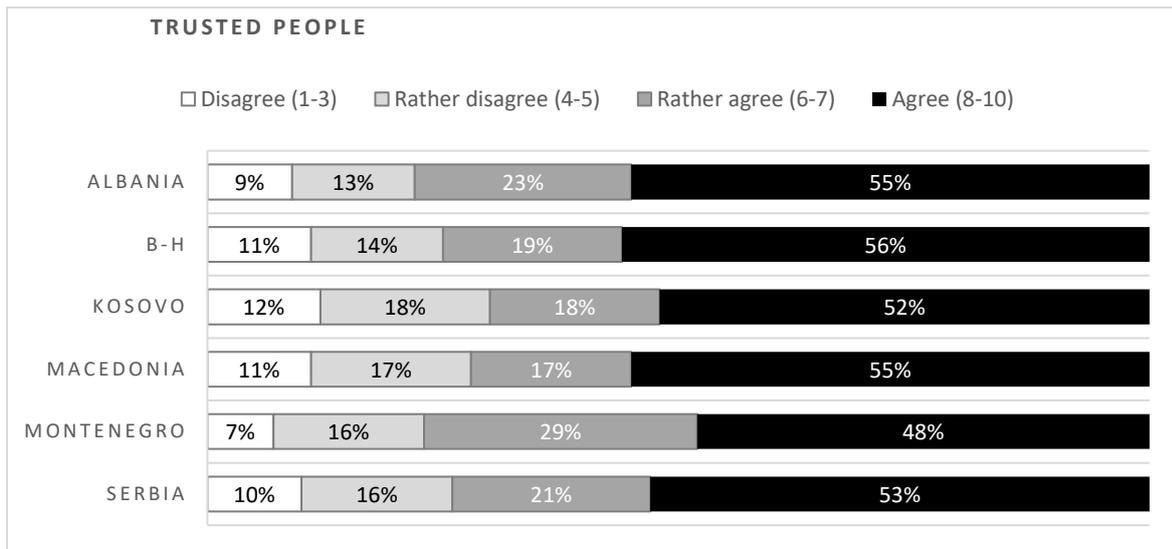
up direction, but also top-down. If one accepts that the formal rules are co-dependent with informal norms, then informal networks within formal organisations are just as essential for promoting top-down agendas: “(...) the discretionary zone in the interpretation and application of formal rules may itself be governed by a set of informal ‘meta-rules’ that tell civil servants when they can relax, suspend or modify rules, in respect of which persons, and in which circumstances” (Ledeneva et al., 2018: 474-475).

In terms of ideal types, in universalist cultures, where formal rules are enforced and followed more or less universally, the informal networks support or re-enhance these formal rules. In other words, informal networks are relationship -based but not aimed at rule-bending, problem-solving, or getting competitive advantage – they are conducive of the predominantly universalist values (in this case informal norms and formal rules play a complementary role to each other). Institutional frameworks within which this is possible are characterised by a stage of development where resources are there to exclude predatory forms of exploitation and fierce competition over resources at the expense of the public good.

### **3a. Informal networking by general public in SEE**

The INFORM survey captures the informal practice of “having its trusted people and connections” by asking the following: Q1. *In our society if you want to get the job done, you always have to have your trusted people in important places and to have connections* – responses are in the range 1 not at all accurate to 10 completely accurate. Over 35% of respondents in SEE takes the maximum value of 10 to indicate that having “trusted people and connections” at different places in these societies is essentially important. Around 50% of respondents chose the value 8-10 (Figure 3). This suggests that this type of informal norm is perceived as widespread and useful, with almost no difference between SEE countries. Similar responses are obtained for the question which asks to what extent is important to have large informal networks in this society (Q2. *On the scale from 1 to 10 please rate how important is to you to have a large number of people that you can rely on* - 1 means not important at all, 10 means very important). Some 36% chose the maximum value of 10, while the mean value is 7.1, with slight variations between the countries.

### **Figure 3. “Trusted people and connections” in SEE countries**



Source: INFORM, 2017

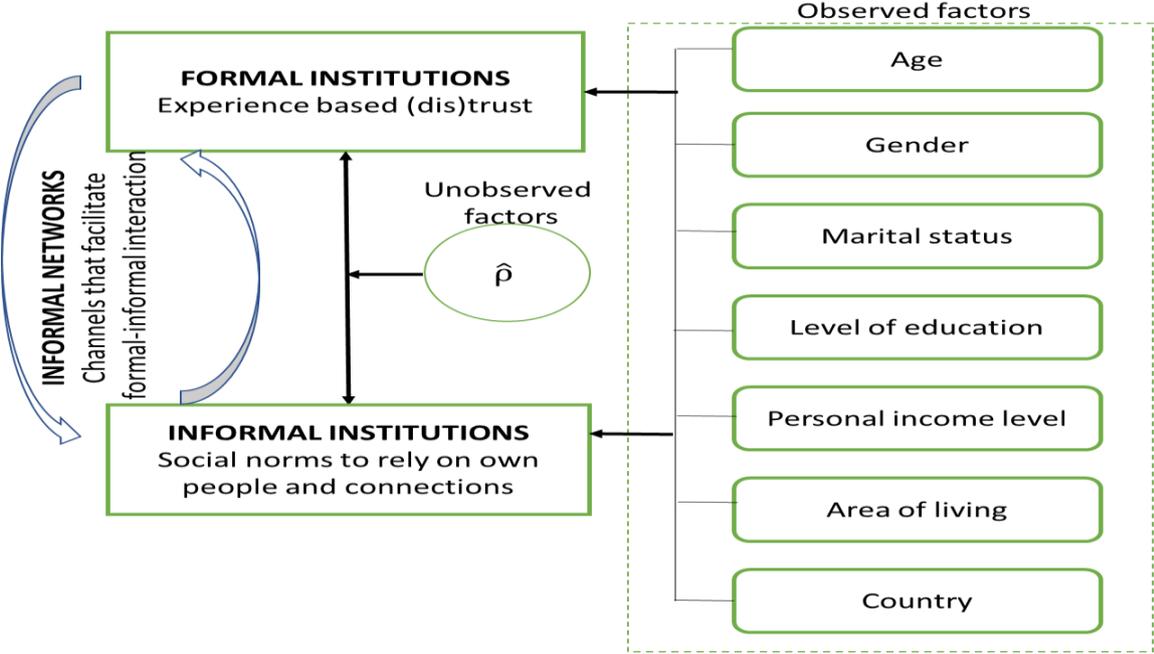
When respondents reflect on their experience of formal institutions and trust in them (Q3. *Based in your own experience, what is your trust in state institutions in our country, like courts, police, governments, ...* – 1 no trust at all to 10 complete trust), their answers are almost the reverse. The most frequently given answer is the lowest level of trust – 1 (22%), and the mean is 4.2. There are a bit more variations between SEE countries on this question, with the lowest trust recorded in Bosnia and Herzegovina (3.5). This suggests quite low level of trust in formal institutions and high incidence of reliance on personal networks and ‘trusted people and connections’ (Figure 3). Thus, it would be important to know if personal trust is used as a solution to the lack of trust in formal institutions (Salinas et al., 2018). Consequently, to know whether the trust in state institutions (which we use as a proxy for efficiency of formal institutions, based on the experience of respondents with these institutions) is associated with the informal norm of relying on “trusted people and connections,” or with the use of “informal networking” through which this informal norm is operationalised, we need a model that can enable us to investigate these complex relationships between formality and informality.

Following similar research by Efendic et al. (2011) on the link between confidence in formal and reliance on informal institutions in BiH, we assume that people’s experience with formal institutions and use of informal norms of reliance on connections and informal networking may differ. The difference can relate to both observable personal characteristics that we can control for - age, gender, marital status, education, economic performance, areal of living, and countries - and unobservable personal characteristics that we cannot control for directly (which might lead to the possibility of the omitted variable bias). In the context of SEE, possible candidates for unobserved factors are likely to be specific cross-cultural issues and influence of cultural diversity. The implication for our modelling strategy is that we need to control both: whether observable or not, both factors affect the informal-formal link that we investigate (inclusive of the immeasurable sociability skills and personal charm).

If there is an unobservable bias that has a systematic influence on the link formal-informal institutions, which is very likely due to the complexity discussed earlier, we hope to eliminate

it by allowing the error term to be correlated between equations: i.e. assuming (and testing) that this correlation will capture unobservable influence. A model possessing such properties is the ‘system of regression equations’ (Greene, 2003), which in our case may be estimated as a seemingly unrelated bi-variate probit model - SUPM. The SUPM is a system of equations in which the error terms are allowed to be correlated between equations (Gould et al., 2006), while common observed determinants are included in both regressions. The SUPM allows for a more complex (seemingly unrelated) pattern of joint determinations than simple simultaneity. The relationship between efficiency of formal institutions and reliance on “trusted people and connections” via informal networking is modelled implicitly through the unobserved correlations in the error terms (Heij et al., 2004). We expect that some culturally rooted factors, for example, “Balkans mentality” that is mentioned by some of our informants (e.g. CRO\_2<sup>6</sup> quote in the next section), might bias all regressions in our study, while this approach should capture it. In addition, we explicitly model the interaction by controlling for common observable variables in the system, and use conservative approach to estimate cluster robust model (with municipalities as clusters). The visual illustration of the model is shown in Figure 4 and quantitative results are reported in Appendix 2, while we discuss the main findings on the type of formal-informal interaction.

**Figure 4. Visual illustration of the formal-informal interaction model**



Of particular interest for our interpretation is the Likelihood-ratio (LR) test, which provides a formal statistical check on the validity of the estimated model (or whether the model should be estimated with two independent binary probit equations). The LR tests the null hypothesis that

<sup>6</sup> Acronyms for countries are introduced in Appendix 1. CRO\_4 means interview number 4 in Croatia. Other countries are, Slovenia - SLO, Croatia - CRO, Bosnia and Herzegovina - BiH, Serbia - SRB, Montenegro – MNG, North Macedonia - MAC, Kosovo - KOS and Albania - ALB

the unobserved influences between the two equations are not associated in the manner suggest by our approach in Figure 4. The outcomes of LR test for the coefficient ' $\hat{\rho}$ ' in Figure 4 yields the p-value of 0.009. Thus, we reject the null hypothesis and conclude that this model is appropriately specified as a system.

The LR test is also informative to check whether formal institutions and informal norms are mutually exogenous (i.e. separate); or, if related endogenous (Fabbri et al., 2004), whether they act as substitute or complement to each other (Efendic et al., 2011). In our case, the test indicates a mutually endogenous relationship between the efficiency of formal institutions and reliance on "trusted people and connections" (Appendix 2, Table A2). According to the negative and significant *rho* coefficient ( $\hat{\rho} = -0.09$ ), the two dependent variables are both determined by (unobserved) influences that are negatively correlated across the equations conditional on observed factors in the model. This means that unobserved (e.g. cultural) influences in the first equation, associated with lower trust in formal institutions, are associated with a greater reliance on 'trusted people and connections', enabled by 'informal networking'. The reverse also works: the higher the trust is into the workings of formal institutions, the lower the reliance on 'trusted people and connections'.

If we look at the influence of observable variables (Appendix 2), the effects of education, economic performance of individuals (measured through their personal income), and the country effects are mainly significant in both models that compose our system. The results indicate that more educated individuals and those with higher incomes report more trust towards formal institutions and less use of informal ones. Or more precisely said, those individuals with education lower than the university degree and with lower level of incomes are less trusting towards formal institutions and rely more heavily on informal once (if measured through the concept of "trusted people and connections"). The country effects are also interesting as they report that respondents from all SEE countries in our sample have higher trust in their formal institutions in comparison to Bosnia and Herzegovina (BiH), which is the base category. This is not surprising, as the institutional setup in BiH is well known for its complexity, on one hand, and inability of political forces to agree on institutional reforms that will lead this country to further institutional prosperity, on the other hand (Williams and Efendic, 2019). However, there are no differences between countries in the use of "trusted people and connections", which suggests that this informal norm is more persistent and less diverse in the region than perceptions regarding the efficiency of formal institutions.

Overall, in our survey, people's trust in formal institutions arise from their experience of constraints of formal institutions (see the related question) and, hence, correspond to the actual enforcement and performance of formal institutions. Given the under-enforcement and overregulation features of formal institutions in SEE region (Gordy and Efendic, 2019), it is logical to presume that the substitutive role of informal institutions is essential, and probably more persistent. It is often suggested in the literature that no society operates without trust. So if trust into formal institutions is low, the personalised trust would compensate for, or substitute for it. On the basis of our data, we can offer further interpretation in that vein:

- First, the reliance on the informal norm of “trusted people and connections” is empowered by the inefficiency of formal rules and procedures.
- Second, the instrumentality of “informal networking” that channels pressure to circumvent formal rules and procedures grows together with the inefficiency of formal institutions.

Although not in themselves surprising, our findings confirm a substituting type of interaction between formal and informal institutions in SEE. Further tests are needed to be able to illustrate empirically that informal norms are more stable and more difficult to change (i.e. circles of trusted people and connections are fairly closed and difficult to acquire).

### **3.b. Informal networking by entrepreneurs in SEE**

Our qualitative in-depth analysis of informal networking among entrepreneurs seem to corroborate the possibility that while the general public is more compliant with the informal norms of reliance on ‘trusted people and connections’, the entrepreneurs are more dynamic in their attitudes: that develop more informal networks, invest in them but also challenge their burden (Efendic & Ledeneva, 2019). Indeed, the entrepreneurship literature reports that entrepreneurs tend to develop compensating mechanisms to operate their business when they need to address the challenges arising from emerging markets and imperfect institutional enforcements (Salinas et al., 2018; Ge et al., 2019). Entrepreneurial activity is thus affected by the formal and informal institutional voids and their interaction (Webb et al., 2019). However, they are also first to recognise the burden of doing so and other limitations associated with informal networking. Although networks might be more open, outreaching and give a better return on investment (supporting weak ties is more cost-effective than strong ties), they are also limited in what they can deliver. Our respondents believe that some problems can only be solved on the basis of strong bonds of reciprocity, so the informal norm of reliance on “trusted people and connections” has been stressed as important also by entrepreneurs from all SEE countries:

*In our society, there is still a system where you cannot make progress without some sort of informal connections, BiH\_1<sup>7</sup>. [Moreover, entrepreneurs believe that if they do not have a proactive position, nothing will change and they will face more challenges]: If you do not have your own informal connections, ... the doors will be closed, SRB\_3, and this is because: There are segments in our society where you just have to have informal connections ... you have to have the ear that listens to you in order to get what you need, BiH\_10.*

What our respondents argue is that connections enable one to “swim in muddy waters”, MAC\_3, and often help to offset political influences in their business. Some entrepreneurs see that ...*corruption is everywhere, SRB\_3* and to get what they even deserve by the law, they ...*would need informal connections, BiH\_4*. This point of relying on informal forms to make the formal rules effective is of key importance to the understanding of the interaction of formal and informal institutions. For outsiders, informal networking may result in loose and open-

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<sup>7</sup> See the previous footnote for explanation and Appendix 1.

ended associations, but these relationships have to become ‘sealed’ into tightly-knit circle of trust, support, and reciprocal obligations in order to be truly effective.

One of entrepreneurs from Croatia, educated abroad, has explained the necessity to develop informal networking in order to get in touch with “trusted people” but also for socialisation.

*I was educated in the USA, so when I came back here and tried to do everything by the book, I did not fully understand informal networking and did not accept this environment, let’s call it “Balkan mentality.” This was the case until several years ago when I realized how our system is functioning, and that it was better for me to start socializing and networking more to find my ‘trusted people’. I could not progress without them (CRO\_2).*

What we find throughout the SEE region is that informal networking among entrepreneurs is commonly used, even if varied in scope and kind. On balance, it is business interests that motivates entrepreneurs to participate in informal networking, and much more so than adherence to an informal norm or cultural conformity (Efendic & Ledeneva, 2020). Although some entrepreneurs acknowledge the necessity to accommodate the mentality of people in this region, their motivation seems proactive and driven by gaining access and creating opportunities, reducing risks and optimising costs. The majority of interviewees argue that informal networks are used primarily to compensate for the failures of formal institutional outcomes - informal networking is used as an efficient mode to cope with burdensome and unnecessary formal institutional challenges; they act as substitutes (BiH\_1, BiH\_3, BiH\_4, BiH\_6, BiH\_7, BiH\_8, KOS\_3, KOS\_5, ALB\_1, ALB\_2, MAC\_1, MAC\_3, MAC\_6, SRB\_1, SRB\_3, SRB\_6, SRB\_8).

This investigation suggests that the functioning of informal norms is impossible without channels associated with informal networking. Although informal networks seem to be a biographical by-product, they are costly to establish, maintain and expand – it takes a lifetime of individual effort, time, and resources. The costs of informal networking depend upon network size, which is limited, given the finite nature of individual time and monetary resources. The available literature reports that density of networks has a significant influence on costs; higher density of informal networks lowers transaction costs (Henning, Henningsen & Henningsen, 2012). Moreover, the structure of networks might influence informal costs differently – network diversity based on race or ethnicity, for example, or networks based on family and friends, or acquaintances (Marmaros & Sacerdote, 2006; Silk, 2003) all might have different effects on costs.

As for the costs of informal networking in SEE, individuals in the region invest considerable time and financial resources into informal networking (Efendic & Ledeneva, 2020). The total informal networking cost, the costs of time and money (standardized by the PPP index to equalize prices between different countries) at the monthly level is estimated to be around 100 euros. This level of costs is not to be ignored considering that the average net monthly salary in Western Balkans region is less than 500 Euro (exceptions are Croatia and Slovenia as EU countries in our sample). Our findings also suggest that the estimated (opportunity) costs of time are greater than the reported monetary costs and higher among entrepreneurs.

The complexity of conversion of informal networks into circles of trusted people and connections require qualitative research, and this will help explain the interaction between the formal institutions and informal institutions further, especially with respect of the pressure and enforcement that people of the circle are capable of imposing on each other. The importance of being networked, which can be estimated in quantitative terms, has to be coupled with the qualitative analysis of the grip that “trusted people and connections” have over each other. Without understanding of this so-called lock-in effect, it is not possible to model economic behaviour in particularistic contexts.

## 5. Conclusion

In this chapter, we have reviewed the existing literature on formal and informal institutions and devised a model for conceptualising the formal-informal interaction, and to empirically test the role of informal institutions in transition. We address the questions, ‘what works when the formal institutions do not?’ and ‘to what extent do formal institutions (operationalised as trust in formal rules and procedures) constitute real constraints in SEE societies with a strong hold of personalised trust and reliance on personal connections.’ We scrutinised the existing typologies of formal and informal institutions and the INFORM model of the interaction between formal and informal institutions. We have established the advantages of the INFORM model for empirical testing as follows. Firstly, it works for transitional contexts where formal rules are often fast-changing and might not necessarily constitute constraints. Secondly, it allows for variation in the pressure of constraints, both formal and informal, which is essential for accounting for the transaction costs. Thirdly, it distinguishes between informal institutions (informal norms) and other informal regularities (informal practices). Finally, it integrates informal networks as channels of interaction between formal and informal institutions. Although such theoretical adjustment in modelling the interaction between formal and informal institutions might be of value in its own right, we have undertook to test it empirically with both quantitative and qualitative data.

To answer the questions on the role of informal institutions in transition we rely on survey evidence from eight countries of South East Europe. When formal rules fail to be efficient, social norms of reliance on “trusted people and connections” seem to predominate as a default (substitutive) option. Reliance on informal norms and investing time and money into facilitating channels, informal networking, to ‘correct’ the failures of the formal institutions in the SEE region is so common that it makes us conclude on the predominantly substitutive role of informal institutions. Our findings hold for the general public, as well as for entrepreneurs, with entrepreneurs playing a more active role in informal networking. While these relationships are perceived to offset defects in the workings of formal institutions, and are thus used for instrumental purposes, they are also an enactment of trust and sociability in daily life, thus holding societies together vis-à-vis challenges of transition, crises or post-war development. The open question for policy-makers is how to re-orient informal networks, make them more open and conducive of norms coherent with the formal rules and the more universal idea of public good. We establish a further need to investigate the ‘capabilities and functionings’ of informal networking and their role in the workings of formal institutions.

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## Appendix

### Appendix 1

#### **Explanation of the SEE sample and the data**

We analyse INFORM data<sup>8</sup> collected in six South East European countries: Albania (ALB), Bosnia and Herzegovina (BiH), Kosovo (KOS), North Macedonia (MAC), Montenegro (MNG), and Serbia (SRB) over the period March – June 2017. A multi-stage random (probability) sampling methodology ensured representative samples in the data collection. In every household, the ‘nearest birthday’ rule was applied to select respondents for interviewing. Every subsequent address was determined by the standard ‘random route’ procedure. The survey was implemented by a professional research agency operating in all WB countries and implementing the survey simultaneously in all countries. The dataset comprises 6,040 respondents from six countries, with over 1,000 observations per country. The survey covers a variety of topics related to formal institutions and informal norms in the WB countries.

Our qualitative investigation included the case of entrepreneurs from small and medium scale businesses in eight SEE countries (including Croatia-CRO, and Slovenia-SLO, in this sample). Our point of entry – the entrepreneurs – enables us to explore the role of informal norms, as informal networking, in more detail, because entrepreneurs are the outsiders of the formal hierarchical structures, such as state or public services, but depend on them, so they have both an expertise and willingness to speak about using their contacts. The interviews were conducted by local INFORM researchers over the period November 2016 - February 2017.<sup>9</sup> Majority of interviews were recorded with consent of the interviewees; anonymised; converted into transcripts; and coded for the purposes of comparative analysis. Our sample includes 70 interviews<sup>10</sup>, which is not representative of SME sector and puts certain limitations on the interpretation of results. However, the illuminating insights and research questions in this article provide valuable hypothesis for assessing the implications of informal networking in future research.

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<sup>8</sup> INFORM is a EU supported project that brought together teams from eight South East European countries to conduct multidisciplinary social science research on formal and informal institutions. The three-year research project, launched in March 2016, was carried out in the framework of the Horizon 2020 programme. 40 researchers from SSE region participated in this project. We thank to all researchers from national teams who helped in gathering the data for particular countries of SEE.

<sup>9</sup> This research relies on the data collected in one point of time (2017); hence, we do not observe longitudinal nor panel data. This approach makes limitation generally acknowledged for the most of cross-sectional research, as we are not able to uncover any dynamics nor to be completely sure about the potential concern on causality.

<sup>10</sup> The questions were tested in five pilot interviews with entrepreneurs in BiH in September 2016 and modified accordingly. They covered five major topics: information about the main line of business; size and structure (density, centrality) of informal networks; costs of informal networks; and general functioning of these networks. Overall, we did not have any major challenges in carrying out these interviews. The majority of respondents were willing to talk about these issues, although some were rather terse in their responses, while some started talking only after the recorder was turned off. INFORM researchers have conducted five interviews in ALB, sixteen in BiH, five in CRO, five in KOS, ten in MAC, nine in SRB and twenty in SLO.

**List of participants/interviewees from the business sector in SEE**

<b>Respondent</b>	<b>Type of business</b>	<b>Company age</b>	<b>Respondent age - category</b>	<b>Number of employees</b>
BiH_1	Civil engineering construction	21-25	51-60	11-50
BiH_2	Automotive	0-5	31-40	0-10
BiH_3	Production of polymers	16-20	51-60	51-250
BiH_4	Land and real estate agency	0-5	21-30	0-10
BiH_5	Accounting agency	0-5	21-30	0-10
BiH_6	Business/start-up hub	0-5	21-30	11-50
BiH_7	Business/start-up hub	0-5	21-30	11-50
BiH_8	Association of entrepreneurs	16-20	51-60	0-10
BiH_9	Association of entrepreneurs	16-20	31-40	0-10
BiH_10	Civil engineering construction	36-40	51-60	0-10
BiH_11	Family winery	36-40	41-50	0-10
BiH_12	Wood instigators production	0-5	31-40	0-10
BiH_13	Catering industry	16-20	41-50	51-250
BiH_14	Catering industry	0-5	21-30	0-10
BiH_15	Private university	0-5	31-40	0-10
BiH_16	Mobile store and Landscaping company	0-5	21-30	0-10
MAC_1	Healthy food stores	0-5	21-30	11-50
MAC_2	Hotel	11-15	31-40	11-50
MAC_3	Marketing agency	16-20	41-50	11-50
MAC_4	Accounting agency	21-25	61-70	0-10
MAC_5	Dairy factory	11-15	51-60	11-50
MAC_6	Catering industry	26-30	41-50	11-50
MAC_7	Online/web shopping company	0-5	31-40	11-50
MAC_8	Private high school	6-10	31-40	11-50
MAC_9	Drugs and medicine distribution	21-25	41-50	0-10
MAC_10	Metallurgy company	21-25	31-40	0-10
SLO_1	Service sector	0-5	31-40	0-10
SLO_2	Service sector - house maintenance	6-10	41-50	0-10
SLO_3	Service sector - mechanic	0-5	41-50	0-10
SLO_4	Restaurant	0-5	41-50	0-10
SLO_5	Service sector - electrician	21-25	51-60	0-10
SLO_6	Research institute	0-5	31-40	0-10
SLO_7	Catering industry	16-20	51-60	11-50
SLO_8	Restaurant	0-5	31-40	0-10
SLO_9	Marketing agency	6-10	31-40	0-10
SLO_10	Marketing agency	0-5	31-40	0-10
SLO_11	Computer shop	0-5	21-30	0-10
SLO_12	Service sector - hairdressing	26-30	41-50	0-10
SLO_13	Wood industry	26-30	51-60	0-10
SLO_14	Cosmetic industry	6-10	21-30	11-50
SLO_15	Service sector - hairdressing	0-5	21-30	0-10
SLO_16	Farming	11-15	11-20	0-10
SLO_17	Power distribution	6-10	41-50	11-50
SLO_18	Plastic industry for construction	16-20	51-60	0-10

SLO_19	Internet shop	16-20	41-50	11-50
SLO_20	Service sector - mechanic	0-5	31-40	0-10
SRB_1	Production of plastic derivate	6-10	31-40	11-50
SRB_2	Health industry - stomatology	6-10	31-40	0-10
SRB_3	Catering industry	6-10	31-40	0-10
SRB_4	Service sector - hairdressing	21-25	51-60	0-10
SRB_5	Private music school	0-5	41-50	0-10
SRB_6	Design agency	6-10	31-40	0-10
SRB_7	Cosmetic industry	11-15	51-60	0-10
SRB_8	Tectonics sector	11-15	51-60	0-10
SRB_9	Purchase and processing of milk	6-10	51-60	51-250
ALB_1	Private high school	0-5	41-50	51-250
ALB_2	Automotive	0-5	41-50	0-10
ALB_3	IT company	0-5	41-50	11-50
ALB_4	Trade, industrial materials	16-20	41-50	11-50
ALB_5	Printing house	11-15	41-50	11-50
CRO_1	Distribution of electric materials	0-5	41-50	0-10
CRO_2	Marketing agency	6-10	31-40	11-50
CRO_3	Hotel	0-5	51-60	11-50
CRO_4	IT company	21-25	41-50	11-50
CRO_5	Production of lighting solutions	6-10	41-50	11-50
KOS_1	Production of polymers	16-20	31-40	11-50
KOS_2	Trade company and production	6-10	41-50	11-50
KOS_3	Catering industry	26-30	51-60	11-50
KOS_4	Wood instigators production	11-15	41-50	0-10
KOS_5	Civil engineering construction	16-20	41-50	11-50

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## Appendix 2

**Table A1. Descriptive statistics of the main variables of interest**

<b>Variables</b>	<b>Description</b>	<b>No. of observations</b>	<b>Mean</b>	<b>Standard deviation</b>
<i>ownlinksd</i>	Trusted people and connections 1-10; 01 to 5; 1-5 to 10	5,943	0.74	0.44
<i>insttrustd</i>	Trust to institutions 1-10; 0-1 to 5; 1-5 to 10	5,876	0.29	0.45
<i>urban</i>	Area of living; 1-urban, 0-other	6,040	0.53	0.50
<i>married</i>	Marital status; 1-married; 0-other	5,975	0.60	0.49
<i>female</i>	Gender; 1-female, 0-male	6,040	0.55	0.50
<i>age</i>	Age in years	6,040	46.53	17.64
<i>hieduc</i>	Education; 1-university or higher; 0-below university	6,029	0.22	0.42
<i>pincome</i>	Personal income; 1-less then 100€; 2-101-200€; .... 9-over 1501€	4,341	2.89	1.63
<i>mac</i>	Country; 1-North Macedonia, 0-other	6,040	0.17	0.37
<i>mng</i>	Country; 1-Montenegro, 0-other	6,040	0.13	0.34
<i>kos</i>	Country; 1-Kosovo, 0-other	6,040	0.15	0.36
<i>alb</i>	Country; 1-Albania, 0-other	6,040	0.15	0.36
<i>srb</i>	Country; 1-Serbia, 0-other	6,040	0.19	0.39
<i>BiH*</i>	Country; 1-Bosnia and Herzegovina, 0-other (*omitted category in the model)	6,040	0.21	0.40

**Table A2. SUPM formal-informal interaction model, cluster-robust estimates**

	<b>SUPM Model</b>			
Variables	Coefficient	P> z	Coefficient	P> z
	<i>DEPENDENT VARIABLE 1 - insttrustd</i>		<i>DEPENDENT VARIABLE 2 - ownlinksd</i>	
<i>urban</i>	-0.02	0.774	0.07	0.290
<i>married</i>	-0.12	0.008	0.02	0.603
<i>female</i>	-0.05	0.302	-0.03	0.572
<i>age</i>	0.00	0.110	0.00	0.075
<i>hieduc</i>	0.17	0.004	-0.09	0.086
<i>pincome</i>	0.03	0.075	-0.03	0.040
<i>mac</i>	-0.14	0.169	0.02	0.819
<i>mng</i>	0.46	0.000	0.06	0.599
<i>kos</i>	0.21	0.052	-0.10	0.413
<i>alb</i>	0.47	0.000	0.08	0.533
<i>srb</i>	0.32	0.001	-0.03	0.766
<i>constant</i>	-0.88	0.000	0.86	0.000
Number of observations		4,200		
Cluster-robust estimate		Yes, clusters are municipalities		
Coefficient of correlation in the residuals		<i>rho</i> = -0.085		
Wald test of rho=0: chi2(1)		Prob > chi2 = 0.0088		
The Wald test for joint significance		Prob > chi2 = 0.0000		