

STATE AGAINST THE INVISIBLE

The Case of Georgian Informal Economy

INTRODUCTION

Informal economic activity is one of the most challenging and controversial aspects of human behavior. On the one hand, it challenges personal morality on the micro level as well as the authority of the state on the macro one. On the other hand, it is controversial as it has negative as well as positive consequences. The latter is extremely important in the context of unprecedented economic decline during the post-Communist transformation. The informal economic activity was almost the only means of survival for the population in the post-Communist countries. Furthermore, the informal sector was the sphere where the economic actors developed economic relations distinct from the centrally planned economy.¹ However, the informal economic activity developed behavioral patterns that created serious problem for the Central and East European emerging markets.²

The phenomenon of informal economy is neither novel, nor exclusive to the post-communist states and has been extensively studied. There is a large volume of literature related to theoretical guidelines, explanations and possible measures to combat the problem.³ However, whether the state should act against the informal economic transactions is a matter of discussion. The followers of the welfare economics, arguing that the main goal of the state is to maximize the social welfare, believe that the state interference in the informal economy violates the Pareto-improvement principle. They claim that the existence of the informal sector is necessary for society as the equilibrium is nearer to the Pereto-optimum than it would be if the formal sector operated only.⁴ This rather interesting point of view is accurately criticized. The critics of this view argue that to fight against the informal economy the government has both economic and ideological incentives such as access to the finances, exercising power and influence.⁵

When dealing with the informal economy it is very important to choose and apply a particular set of notions and definitions, as different authors have developed a variety of

¹ For the positive role of the informal economy both during and after the Soviet system see: Sik, Endre. *From Second Economy to Informal Economy: The Hungarian Case*. Program on Central and Eastern Europe Working Paper Series, No. 23. Minda de Gunzburg Center for European Studies, Harvard University, 1992, pp. 26, 31.

² Stark, David. "Recombinant Property in East European Capitalism." in Grabher, Garnot and Stark, David. (eds.) *Restructuring Networks in Post-Socialism: Legacies, Linkages, and Localities*. Oxford: Oxford University Press, 1997, p. 39.

³ The pathbreaking study of the informal economy is: de Soto, Hernando. *The Other Path. The Invisible Revolution in the Third World*. New York: Harper & Row, 1989. Other important contributions are: Feige, Edgar L. (ed.) *The Underground Economies*. Cambridge: Cambridge University Press, 1989; Alessandrini, Sergio and Dallago, Bruno. (eds.) *The Unofficial Economy. Consequences and Perspectives in Different Economic Systems*. Gower Publishing Company, 1987; Tokman, Viktor E. (ed.) *Beyond Regulations: The Informal Economy in Latin America*, Boulder: L. Reinner, 1992.

⁴ Heertje, Arnold. "Some Observations on the Welfare Economic Aspects of the Unofficial Economy." in Alessandrini, Sergio and Dallago, Bruno. (eds.) *The Unofficial Economy*. Gower Publishing Company, 1987, pp. 305-308.

⁵ Frey, Bruno. "How Large (or Small) should the Underground Economy be?." in Feige, Edgar L. (ed.) *The Underground Economies*. Cambridge: Cambridge University Press, 1989, pp. 124-125.

terms for its description. The terminology differs along the economic systems under study, as well as across national scientific traditions.⁶ In the thesis, however, I will use one of the most general definition proposed by Alejandro Portes, which can be used to describe the informal economic activity in different economic systems: "[informal economy] includes all income-earning activities that are not regulated by the state in social environments where similar activities are regulated."⁷

The purpose of this thesis is to analyze the case of Georgian informal economy. My aim is to investigate the reasons of its persistence during the transformation. Informal economy flourished in Georgia even during the Soviet regime. Contemporary estimations show that in the first half of the 1990s its share in GDP was more than fifty percent. In spite of the political and macro-economic stabilization of the second part of the decade the volume of the informal economy remains large and there is no stable trend towards diminishing its size. I will argue, however, that in the Georgian context the study of informal economic activity can go beyond the analysis of persistent behavioral patterns and can be used for assessment of institutional performance and change. The Georgian government fully acknowledges the need for legalization of informal economic activity. For this purpose a special commission was set up in 1997⁸. A year later within the Ministry of Economy the Shadow Economy Legalization Department was created. However, instead of investing in research the department created a variety of local commissions with ambiguous functions and even more ambiguous capacities.⁹ Thus the complexity of the phenomenon calls for a thorough investigation to understand its origins, implication and relations to broader socioeconomic trends. The present thesis, however, focuses on the theoretical problems, and using available empirical data, seeks to offer a theoretical examination of several hypotheses.

The thesis consists of four parts. In the first part a theoretical framework is developed. I argue that informal economic activity can be better understood in the framework of institutional analysis. There are several approaches within the institutional theory. I discuss the main approaches with the emphasis on modern trends towards their synthesis. I show that particular institutional approaches, as well as the synthetic views, consider institutions in a *static* way. Relying on the static synthesis developed by Richard Scott, I maintain a *diachronic* perspective of institutions. The diachronic understanding of institutions means that in particular historical circumstances particular pillars and careers of institutions dominate.

The second part deals with the case of Georgian informal economy. It starts with the discussion about the main approaches to informal economy and their applicability to the Georgian case. The analysis of the informal economic activity in the post-communist

⁶ Thomas identifies 15 alternative names for the informal economic activity: Thomas, J. J. *Informal Economic Activity*. New York: Harvester Wheatsheaf, 1992, p. 125. In Georgia, however, "shadow economy" is the most often used term. See: The report of the Shadow Economy Legalization Department. Tbilisi, 1999. (In Georgian Language)

⁷ Portes, Alejandro. "The Informal Economy and its Paradoxes." in Neil J. Smelser and Richard Swedberg, (eds.) *The Handbook of Economic Sociology*. Princeton: Princeton University Press, 1994, p. 427.

⁸ The order of the President of Georgia, # 282. 30.04.1998. Tbilisi (In Georgian Language)

⁹ The report of the Shadow Economy Legalization Department. Tbilisi, 1999. (In Georgian Language)

states is dominated by the rational choice institutional approach, which, I believe, is insufficient as it fails to capture the whole dynamics of the matter. The rational choice institutional perspective emphasizes the importance of rational calculus of the economic actors in deciding whether to act formally or informally. Researchers from this perspective use *synchronic* cross-country analysis and conclude that there is a positive association between the size of the informal economy and tax rates, corruption, quality of legal enforcement and rule of law. The negative association is seen between the size of informal economy and the costs of acting informally. I will test these hypotheses on the Georgian case from the *diachronic* perspective. The data show that during the past decade building of market supporting institutions has advanced in Georgia. However, the size of the informal economy has not decreased. The results of these analyses thus call for the alternative explanation. My argument is that persistence of informal economic activity in the Georgian case can be explained by the persistence of cultural values that go beyond the Soviet legacy.

The third part analyzes the Soviet and post-Soviet conditions that created a preferable environment for the persistence of cultural values and thus for the flourishing of the informal economic activity. Firstly, the Soviet legacy has decreased the level of social capital, diminished the trust in public institutions and increased trends towards non-compliance with the regulations. Secondly, cultural heterogeneity contributes to organization of informal economic activity along the ethnic, political and cultural cleavages. Thirdly, institutional incoherence, i.e. inconsistency between heterogeneous society and over-centralized economic and political institutions and changes in political regimes in illegitimate and violent ways has decreased the legitimacy of the state authority.

The thesis ends with the concluding chapter that analyzes the possibilities for the institutional change. I criticize the dominant *institutional bricolage* approach, which argues that during the transformation the institutional change occurs gradually by a *re-combination* of already existing institutional and organizational forms. In contrast, relying on the *punctuated equilibrium* perspective, I argue that when institutions are driven predominantly by the cognitive processes, a window of opportunity for the institutional change opens only through the crisis.

THE INSTITUTIONAL FRAMEWORK

Last two decades have witnessed a closer collaboration of economics and sociology to understand behavioral patterns of the economic action. The outcome of this collaboration is a new trend in economic sociology that argues that economic action is embedded in the networks of social relationships. Furthermore, New Economic Sociologists argue that economic institutions are socially constructed and economic action is guided by the economic as well as non-economic goals (such as sociability, status, power).¹⁰ Following to these ideas, I maintain that informal economic activity can be better understood in the

¹⁰ Velthuis, Olav. "The Changing Relationship Between Economic Sociology and Institutional Economics: From Talcott Parsons to Mark Granovetter." *American Journal of Economics and Sociology* 58, 4, 1999, p. 6.

framework of institutional theory. Under the name of institutional theory, however, there are a variety of approaches. These approaches differ not only in definitions of the key concepts, but also on the level of analysis. Some authors differentiate between historical, rational choice and sociological institutionalisms.¹¹ Others classify it in a different way (normative, rational choice, and historical) and add empirical, international, sociological and mediative approaches.¹² In broader terms, any institutional theory deals with interrelationships between the structure and the agency. In this regard, historical institutionalism tends to be oversocialized, as it sees individual choice structured by institutions. In contrast, rational choice approach emphasizes strategic calculus of the actor and thus tends to be an undersocialized.¹³ Sociological institutionalism that originates from organizational theory stands between these two approaches. It defines institutions broader than other approaches do, incorporating not only formal rules, but also symbol systems, cognitive scripts, moral templates that give meaning to human action. Relationship between structure and agency is twofold: on the one hand institutions influence behavior by providing cognitive scripts, categories and models for interpreting behavior. On the other, action is tightly bound up with interpretation.¹⁴

Without going into the depth of the institutional debate, I will use some concepts that are important for the analysis of the informal economy. From Douglass North I borrow the argument about the need for the enforcement of institutions and regulations by the third party. This third party is the state, which however, is not neutral and has its own autonomous interests.¹⁵ From March and Olsen I will use the idea that institutions do not determine the individual behavior. Rather, institutions constitute the “logic of appropriateness,” which creates the frameworks for the individual interpretation of rules, identities and alternatives.¹⁶ However, the argument that institutions are stable, adaptable to the small-scale changes but changeable during the large-scale upheavals, derives from the historical institutionalism.¹⁷ My further institutional argument deals with the modern trends to combine particular achievements of various branches. Some attempts are cautious,¹⁸ others are more decisive.¹⁹ The details of institutional debate are available elsewhere.²⁰ Here I will rely on the synthetic model of Richard Scott, which identifies regulative, normative and cognitive pillars of institutions. Correspondingly, there are three carriers: cultures, social structures and routines. Scott sees two, not mutually exclusive ways of synthesis. The first is the possibility of combination of regulative, normative and

¹¹ Hall, Peter A. “Political Science and the Three Institutionalisms.” *Political Studies* 44, 1996, p. 936.

¹² Peters, Guy B. *Institutional Theory in Political Science. The ‘New Institutionalism.’* London: Pinter, 1999, pp. 19-20.

¹³ This differentiation of the branches of institutional theory is too schematic. More thoroughly similarities and differences are discussed in Hall, “*Political Science and the Three Institutionalisms*” and Scott, W. Richard. *Institutions and Organizations*. Thousand Oaks, CA: Sage, 1995.

¹⁴ Hall, “*Political Science and the Three Institutionalisms*.” pp. 946-950.

¹⁵ North, Douglass. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press, 1990, p. 54.

¹⁶ March, James and Olsen, Johan. “Institutional Perspective on Political Institutions.” in March, James. *The Pursuit of Organizational Intelligence*. Oxford: Blackwell, 1999, p. 65.

¹⁷ Peters, Guy B. *Institutional Theory in Political Science. The ‘New Institutionalism.’* p. 67.

¹⁸ Hall, “*Political Science and the Three Institutionalisms*.” p. 957.

¹⁹ Scott, *Institutions and Organizations*. pp. 144-145.

²⁰ DiMaggio, Paul J. and Powell Walter W. “Introduction.” in DiMaggio, Paul J. and Powell Walter W. (eds.) *The New Institutionalism in Organizational Analysis*. Chicago: The University of Chicago Press, 1991.

cognitive processes in each institution in varying amounts. The second possibility refers to primary importance of any single process (regulative, normative, and cognitive) in particular institutions.²¹ These ideas provide a new perspective for institutional analysis. However, its drawback is a *static* dimension, i.e. institutions are seen as changeable within the single framework of pillars and carriers. A *diachronic synthesis*, I argue, merits more explanatory importance. The explanatory power is increasing in the case when we are to analyze and understand a large-scale change such as the post-communist transformation. The diachronic view of institutions helps to see better a dynamics of two-sided relationship between large-scale processes and institutions. First, how these processes affect the institutions and second, how institutions behave in the changing environment. Accepting Scott's idea about the synthetic view of institutions I argue that the major source of institutional change is an alternation in the ratio among the three (regulative, normative, cognitive) pillars. Correspondingly, relative importance of cultural, structural and routine carriers also changes. From these the first proposition follows:

Proposition 1. During the process of transformation the role of regulative and normative pillars diminishes and the main driving forces of the institutions are cognitive processes. Simultaneously, the role of cultural carrier is extended on the expense of structural and routine carriers.

To move from above theoretical consideration towards the practice, let us consider the unit of analysis of the informal economic activity. One possibility is a research on the micro level. In this case individual behavior within the households and firms is studied and actor's response to the transformation process is investigated along the formal/informal continuity.²² Another possibility is a firm-level analysis, when changes in the firm's behavior are studied and their possible reasons are examined.²³ However, the context of post-communist transformation and the distinctive features of transitional informal economy require a different approach. Firstly, any economic transaction, whether formal or informal, is embedded in the broader social context.²⁴ Secondly, informal economic activity in the post-communist context is characterized by complexity of production and transactions that goes beyond the individual behavior. The firm-level analysis can not explain the matter either. Rather, transactions involve different types of organizations, with varying structure, purpose and type of ownership. These two reasons increase the need for analyses on the broader level of organizational fields. As DiMaggio and Powell define, organizational field is a group of organizations that "constitutes a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies and other organizations that produce similar services or products"²⁵

²¹ Scott, *Institutions and Organizations*, p. 144.

²² Sik, *From Second Economy to Informal Economy: The Hungarian Case*. p.1.

²³ Johnson, Simon, Kaufmann, Daniel, MacMillan, John, and Woodruff, Christopher. "Why do Firms Hide? Bribes and Unofficial Activity after communism." EBRD Working Paper, No. 42, 1999.

²⁴ Hollingsworth, J. Rogers and Boyer, Robert. "Coordination of Economic Actors and Social Systems of Production." in Hollingsworth, J. Rogers and Boyer, Robert, (eds.) *Contemporary Capitalism. The Embeddedness of Institutions*. Cambridge: Cambridge University Press, 1997, p. 12.

²⁵ DiMaggio, Paul J. and Powell Walter W. "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality." in DiMaggio, Paul J. and Powell Walter W. (eds.) *The New Institutionalism in Organizational analysis*. Chicago: The university of Chicago Press. 1991, pp. 64-65.

Another promising angle of analysis is a dynamic understanding of organization. If we interpret organization as an activity, i.e. as a form of coordination and cooperation occurring not only inside, but also between formal/informal organizations,²⁶ then we can ask questions: how are informal and formal transactions organized? Why the organization of informal economy tends to be isomorphic across the post-communist countries? Or more specifically, why is the informal activity isomorphic across the sectors within the national economies? Why do formal organizations behave in the same manner in relation with the prevailed informality in the post-communist countries? Returning back to my diachronic argument, I maintain that the driving forces of isomorphism can not be uniform and unchanged through time. As DiMaggio and Powell point out, their typology of isomorphism (coercive, normative and mimetic) is analytical and not always distinguishable.²⁷ Thus the second proposition concerns the idea of changing importance of the driving forces of organizational isomorphism.

*Proposition 2. Transformation process under the weak state is characterized by diminishing importance of coercive and normative pressures and organizational isomorphism is achieved by mimetic processes.*²⁸

INFORMAL ECONOMIC ACTIVITY: THE GEORGIAN CASE

Dominant Approaches

Informal economic activity during the transformation has a twofold implication. Students of the phenomenon frequently underline paradoxical nature of the informal sector. On the one hand, informal activity contributes to peacefulness of transformation process, gives means of survival for the population, and proves the readiness of post-socialist societies to adopt market relations. On the other, it is the cause of behavioral patterns such as questioning the state-imposed regulations, short-term gain strategies and poor tax-paying morality.²⁹ Recently it has been argued that the study of informal economy can be used for assessment of the institutional performance. The advantage of this perspective is the possibility to measure the informal economy more or less correctly. In this regard, the

²⁶ Brunson, "Standardization as Organization." in *Organizing Political Institutions. Essays for Johan P. Olsen*. Lagreid, Per. (ed.) Oslo: Scandinavian University Press, 1999, p. 112.

²⁷ DiMaggio and Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality." p. 67.

²⁸ Conducting such a generalization one must take into consideration social construction of scientific knowledge. Mizruchi and Fein show how the social construction of organizational knowledge was resulted in emphasizing only the mimetic aspects of organizational isomorphism, while the role of others were downplayed. See Mizruchi, Mark S. and Fein, Lisa C. "the Social Construction of Organizational Knowledge: A Study of Uses of Coercive, Mimetic, and Normative Isomorphism." *Administrative Science Quarterly* 44, 4, 1999.

²⁹ These controversies can be seen in: Sik, "From Second Economy to Informal Economy." pp.30-32; Kaufmann, Daniel and Kaliberda, Aleksander. "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies. A framework of Analysis and Evidence." in Bartłomiej Kaminski. (ed.) *Economic Transition in Russia and the New States of Eurasia*. New York: M.E. Sharpe, 1996, 108-109; Grabher, Gernot and Stark, David. "Organizing Diversity: Evolutionary Theory, Network Analysis and Post-Socialism." in *Theorizing Transition: The Political Economy of Post-Communist Transformations*, ed. John Pickles and Adrian Smith. London and New York: Routledge, 1998, p. 9.

informal economy is argued to be more objective indicator than specially designed indicators of the institutional performance.³⁰

The assessment of the informal economy in the positive or negative way, however, depends on the broader underlying theory of a particular approach. There are variety of approaches dealing with reasons, forms and state-informal sector relations. Variety of approaches to the informal economic activity can be classified in the structuralist, legalist and institutional groups. Within the *structuralist* framework two major streams can be identified. The first is known as the *International Labor Organization (ILO)* approach and is followed mainly by economists. The followers of the ILO line contrast informal activity with modernity. According to their view, informal activity is conducted in small firms with unsophisticated technology and low productivity. Informal activity is seen as the segment of labor market. Correspondingly, its reasons are sought in the specific characteristics of industrialization (excess supply of the labor force and low demand of well-paid jobs, rural-urban migration). However, scholars acting in this framework acknowledge that laws and regulations also affect informality.³¹

The second approach is based on the *neo-Marxist* and *dependency* theories. Sociologists and cultural anthropologists that follow to this approach, analyze informality in relation to organization and reorganization of production under the changing economic and institutional conditions. Although the majority informal actors are poor, they argue, the phenomenon cuts across the whole social structure and shows uneven development of capitalism in peripheral societies. The neo-Marxists argue that firms start and maintain the informal activities to reduce costs imposed by the protective labor legislation. Thus the informal sector reflects class struggle with the aim to alter class structure and privilege. Both the ILO and the neo-Marxist approaches claim that government must intervene to reduce inequality and exploitation and to support entrepreneurs.³²

The emergence of *Legalist* approach is associated with the name of the famous student of the informal economy - Hernando de Soto. The approach emphasizes that informal cleavages are not structural but legal. Its reason lies in high costs of legality imposed by the bureaucracy and the state. Economic actors are forced to go underground because they do not have the access to the public goods due to lack of property rights. The legalists see informal sector as a rational response to the state's discriminatory policy. They argue against the state intervention, as the informal economic activity is treated as a democratic, popular response to the unfair predatory state. To encourage these activities the state must simplify the rules, decentralize the decision making and deregulate business.³³

³⁰ Heinrich, Hans-Georg. "Towards a Cultural Theory of Transition: The Strange Architecture of Post-Communist Societies." in Heinrich, Hans-Georg. (ed.) *Institutional Building in the New Democracies: Studies in Post-Post-Communism*. Collegium Budapest, 1999, p. 135. For instance, Putnam's indicators are seen as less objective than informal economy measurements. Putnam, Robert. *Making Democracy Work*, Princeton: Princeton University Press, 1993, p. 65-76.

³¹ Rakowski, Cathy A. "Convergence and Divergence in the Informal Sector Debate: A Focus on Latin America, 1984-92." *World Development* 22, 4, 1994, pp. 503-504.

³² Portes, Alejandro. "The Informal Economy and Its Paradoxes."; Rakowski, "Convergence and Divergence in the Informal Sector Debate: A Focus on Latin America, 1984-92." p. 504.

³³ de Soto, Hernando. *The Other Path. The Invisible Revolution in the Third World*. New York: Harper & Row, 1989, pp. 247-249.; Rakowski, "Convergence and Divergence in the Informal Sector Debate: A Focus on Latin America, 1984-92." pp 505-507.

The revival of institutional theory in the 1970s affected the study of informal economy too. Within the institutional theory, however, there are varieties of approaches. Correspondingly, this variation is reflected in dealing with the informal economic activity. Some authors emphasize the organizational characteristics of the state that support to persistence of informal activity. For example, in Italian case institutions like clientelism and reliance on the informal ties in political and economic life are seen as the factors assisting the increasing size of the informal sector.³⁴ Others argue that an irrational element of the informal institutions as the basis of the informal economic activity.³⁵ Anthropological perspective goes even further and argues that the roots of the informal activity lie in the system of values of the society. These studies see positive association between informal economy on the one hand, and the strength of family ties, the high value of risk-taking, the importance of face-to-face trust on the other.³⁶ The argument of Edgar Feige relies on the idea of historical institutionalism that previous institutions and behavioral patterns shape future actions and choices. He claims that Soviet legacy is the main reason of non-compliance and distrust to the state institutions. This pushes the actors in the realm of informality even after the collapse of the Communist political system and centrally planned economy.³⁷

Table 1. The main approaches to informal economy

	Structuralism	Legalism	Institutionalism
Reasons	Excessive labor supply, High costs of labor legislation	High costs of legality	Rational calculus of the actors, Informal institutions
Forms	Survival strategies of the poor, Microentrepreneurship	Any non-regulated activity	continuity along formal/informal line, large scale production
State Policy	Decreasing poverty, Encouraging entrepreneurs	Simplification, decentralization, deregulation	Building of market- supporting institutions
Theory	Neo-Marxism	Neoliberalism	Various Institutionalisms

However, majority of studies dealing with the informal economy in the post-socialist countries is conducted in the framework of rational choice institutional analysis. These studies consider informal economic activity in the context of actors' rational calculus. Their cross-country analysis shows that informal sector is greater in the countries where provision of public goods by the state is poor, corruption is high and taxes are unfair. In this state of affairs, the scholars argue, firms naturally will stay in the informal sector or

³⁴ Weiss, Linda. "Explaining the Underground Economy: State and Social Structure." *The British Journal of Sociology* 38, 2, 1987, p. 231.

³⁵ Papava, V. and Khaduri, N. "On the Shadow Political Economy of the Post-Communist Transformation." *Problems of Economic Transition* 40, 6, 1997.

³⁶ Mars, Gerald and Altman, Yochanan. "The Cultural Basis of Soviet Georgia's Informal Economy." *Soviet Studies* 25, 4, 1983.

³⁷ Feige, Edgar L. "Underground Activity and Institutional Change: Productive, Protective, and Predatory Behavior in Transition Economies", in Nelson, Joan M. Tilly, Charles, and Walker, Lee. (eds.) *Transforming Post-Communist Political Economies*. Washington D. C. National Academy Press, 1997.

even shift from formal to informal one. Therefore, if the state creates market-supporting institutions, enforces the rule of law and contracts, firms will find more rational to act formally and the informal sector will automatically decrease.³⁸

Informal Economic Activity in Different Economic Systems

Informal economy exists in every kind of society. However, its social function is never the same across national economies. But even more important differences can be found across the different economic systems. These differences seem to be quite natural as its roots lay in fundamental differences between the economic systems. In this section I will describe the post-Soviet dynamics of the informal economy that make it different from that of centrally planned and market economies.

In macroeconomic terms differences between the centrally planned and the market economies lie in the supply-demand dimension. In the former, supply of the goods and services is always lower than demand, while in the latter supply and demand is in equilibrium. Therefore, in the Soviet economic system people buy informally produced goods either because of their better quality or because of non-availability of formally produced similar goods and services. For example, the study of Georgian second economy shows that the factory manager produced low quality products to meet the plan, while informally produces one was of the regular quality.³⁹ In contrast, in market economy informally produced goods and services are competitive as they are offered at a lower price.⁴⁰ In the transitional countries too, informal sector offers cheaper goods and services. However, at the same time the quality is reduced for at least two reasons: 1. After the collapse of the centrally planned economy firms' competitiveness have decreased. Simultaneously, their markets have shrunk. Therefore, there was a need for the reduction of the price. 2. Due to low purchasing capacity of the population low quality but cheap goods and services were nevertheless sold.⁴¹

Another difference is derived from the absence of the property rights under the Soviet regime. As a result, all the enterprises based on the private ownership were considered as illegal not because of tax evasion as it happens in market economies, but because of illegality of private property. That is why informal economic activity in privately owned illegal enterprises was relatively rare. However, in the state owned factories surplus output produced informally was to the profit of factory managers and not to the state. These activities had economic as well as social functions: on the one hand, informal activity compensated drawbacks of centrally planned economy and was additional source of income for quite a few people. On the other hand, it gave the opportunity of employment

³⁸ Johnson, Simon, Kaufmann, Daniel, and Shleifer, Andrei. "The Unofficial Economy in Transition." *Brookings Papers on Economic Activity* 2, 1997.

³⁹ Mars, Gerald and Altman, Yochanan. "Case Studies in Second Economy Production and Transportation in Soviet Georgia." and "Case Studies in Second Economy Distribution in Soviet Georgia." in Alessandrini, Sergio and Dallago, Bruno. (eds.) *The Unofficial Economy. Consequences and Perspectives in Different Economic Systems*. Gower Publishing Company, 1987.

⁴⁰ Dallago, Bruno. "The Underground Economy in the West and the East: A Comparative Approach." in Alessandrini, Sergio and Dallago, Bruno. (eds.) *The Underground Economy*. Gower Publishing Company, 1987, p. 151.

⁴¹ Sik, *From Second Economy to Informal Economy: The Hungarian Case*, p. 14.

to those people who could not find their place in the official economic or political structures of the regime.⁴²

The Soviet second economy included three sets of illicit activities that differed according to their violation of the Soviet rules: first, relatively “light” activity like fictitious labor, the second, illegitimate entrepreneurship (legitimate in market economies) and third, criminal activity.⁴³ The important differences between the first and second economies can be seen in their incentives: the former was oriented on meeting plans, while the latter was oriented on the maximization of profit.

Not only the preconditions and the ways of functioning, but also consequences of the informal economy in the centrally planned and the market economies are different. In the former, although the informal sector partially contributes to cope with shortages derived from the drawbacks of the central planning, it nevertheless continuously distorts the real picture of economic performance. Therefore, the government possesses a misleading data for the further planning and providing economic policy.⁴⁴ In the developed market economies, however, informal economic activity creates incentives for formal enterprises to invest more. On the other hand, increasing the state budget deficit through tax evasion, informal economy leads the government to increase taxes and thus depress the overall economic activity.⁴⁵

On the theoretical level it can be argued that extended informal economy can serve as an advantage to national economies in the transformation process. Endre Sik argues that relation between the transformation process and the informal economy is two directional: on the one hand, transformation altered the nature of the informal economy by legalizing private property. On the other, the informal economy contributed to the regime change and property redistribution a non-violent way. But, although informal economy undermined the centrally planned economy, it also threatens to the market relations. The reason is persistence of behavioral patterns of the second economy: continuously hiding something and questioning state-imposed regulations.⁴⁶

Legalists would argue that informal economic activity during the Soviet period was a result of actors’ response to the unfairness of forbidden property rights. Institutionalists would claim that the reason lied in the incoherence of the centrally planned economic institutions. During the transformation many obstacles to the economic action have vanished. Thus above mentioned perspectives call for expectations that the size of informal sector would diminish. But paradoxically, first years of the transformation witnessed increasing volume of the informal economy all over the post-socialist countries.⁴⁷ However, from the mid-1990s informal economic activity in some countries started decreasing, while in others the upper trend has been kept. Georgian informal

⁴² Kosals, L. “The Shadow Economy as a Specific Feature of Russian Capitalism.” *Problems of Economic Transition* 41, 12, 1999, p. 8.

⁴³ Ibid., p. 10.

⁴⁴ Dallago, “The Underground Economy in the west and the East: A Comparative Approach.” p. 160

⁴⁵ Ibid., 161-162

⁴⁶ Sik, *From Second Economy to Informal Economy: The Hungarian Case*. p. 30.

⁴⁷ Ibid., p. 21; Johnson, Simon, Kaufmann, Daniel, and Shleifer, Andrei. “The Unofficial Economy in Transition.” p. 183, Table 1.

economy falls in the latter case. In the following parts I will analyze the reasons of the persistence of Georgian informal economy.

The Georgian Case: Data and Controversies

The measurement dilemma

One of the most widespread synonyms for informal economic activity - unmeasurable - implies that identifying its size is impossible. Nevertheless, students of the phenomenon developed a number of measurement methods. These methods can be classified into two broad types. One group relies on the analysis of the already existing statistical data, while the other conducts special surveys for data collection on which a further estimate depends. The first group precludes *Monetaristic* and *National Account* approaches. The Monetaristic approach implies that informal economic activity involves monetary transactions and thus monetary aggregates can be used for its measurement. The method contrasts long-term trends to short-term oscillations. However, transitional countries like Georgia have a relatively short period of monetary independence and therefore this method can not be reliable.⁴⁸ Even more, it is argued that a significant part of the informal economy is not monetarized, i.e. household economy, inter-household barter.⁴⁹ The National Accounts approach assumes that when the size of the informal economy is considerable, expenditure will be greater than income. Thus the difference between the GDP calculated on the basis of expenditure and the GDP calculated from income data will show the size of the informal economy.⁵⁰ The accuracy of this method, however, depends on the reliability of the statistical data in a particular country. But in Georgia reliability of statistical methods is of a limited quality. For example, in 1999 the statistical calculations of GDP were updated and the difference between the old and the new was 30%.⁵¹

The unreliability of the official statistical data made some scholars look for proxies for the overall economic activity. Kaufmann and Kaliberda proposed to use electricity consumption elasticity as a proxy for the total GDP growth. The difference between the total and official GDPs, they argue, reflects the size of the informal economy.⁵² Recently, there has been an attempt to calculate the size of Georgian informal economy on the basis of electricity consumption, but without any success. The obstacle was the unreliability of electricity consumption data, which is not surprising as the electricity generation and distribution agencies are among the most corrupted organizations in Georgia.⁵³

⁴⁸ Leiter, Sharon and Tedstrom, John. *Russia's Informal Economy: A Framework for Analysis*. 1997, p. 24.
[Http://www.rand.org/organization/nsrd/russ.economy/report1.html](http://www.rand.org/organization/nsrd/russ.economy/report1.html)

⁴⁹ Sik, Endre. "Measuring the Unregistered Economy in Post-Communist Transformation." *Eurosocal Report* 52, 1995, p. 38.

⁵⁰ Ibid, p. 25.

⁵¹ Otinashvili, Ramaz. "The Meaning, Reasons and Outcomes of shadow Economy." *Bulletin of Georgian Center on Strategic Research and development* May, 2000, p. 18.

⁵² Kaufmann and Kaliberda, "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies. A framework of Analysis and Evidence." p. 89.

⁵³ The information about the unsuccessful attempt to use the electricity consumption as a GDP proxy is received from International Association Civitas Georgica. For the data about the corruption in the energy sector see: Muskhelishvili, Marina and Niauri, Nato. "Entrepreneurs on Corruption". in *Business and Corruption in Georgia*. Tbilisi, 1998, pp. 14, 19.

As it was already mentioned, some measurement methods combine micro-level surveys and data interpretation. These approaches study households and investigate differences between official income and actual expenditure.⁵⁴ Sik argues that measurement of informal economy is more reliable if a combination of micro-level survey and macro-data is applied. In this case fieldwork is the most important element of data gathering and much depends on the skills and ability of the researcher to disclose hidden information.⁵⁵ Fieldwork could have been promising in the Georgian context. However, Shadow Economy Legalization Department within Ministry of Economy of Georgia did adopt this approach. Without trying to have a clear picture about the size of the informal economy, the Department initiated a creation of commissions in governmental organizations and regions to combat the informal sector.⁵⁶ Ironically, many members of the commissions were the very state officials that participate in the informal transactions themselves.

From the above discussion it is not surprising that empirical data about the size of Georgian informal economy are highly controversial. The problem immediately arises when dealing with the starting point of measurement. As it is crucial to see the dynamics of the informal economy, there is a need for the estimation of its size before the collapse of the centrally planned economy. Two different data are available: 1. Johnson, Kaufmann and Schleifer estimated the size of informal economy in the USSR uniformly, - 12% of GDP in 1989.⁵⁷ However, earlier studies indicate that the second economy in Georgia was much more developed than in the other Soviet republics. Referring to other authors, Mars and Altman mention that Georgian informal economy is 25 % of GNP.⁵⁸ An indirect indicator of higher level of the informal economy in Soviet Georgia is the Gini coefficient of income distribution. The coefficient equals 0 when a distribution is equal, and it is 1 if the income is concentrated in the hands of one person. In 1989-1990 Georgia's score was 0.3 and in 1995-1997 - 0.5.⁵⁹ Both scores are the highest among the countries under transition. One can argue that the high concentration of income is a reflection of developed Georgian informal economy both in the Soviet and transitional periods.

The second problem concerns the method. As it was already mentioned, there are varieties of more or less reliable methods. However, Shadow Economy Legalization Department reports that they do not have an accepted method of measurement and rely on expert evaluations only. The result of this methodological uncertainty is controversial data. For instance, the State Department on Statistics of Georgia reports that informal economy was 30% of GDP in 1997-1998. In contrast, the Budget Office of the Parliament of Georgia

⁵⁴ Leiter, and Tedstrom, *Russia's Informal Economy: A Framework for Analysis*, p. 27.

⁵⁵ Sik, "Measuring the Unregistered Economy in Post-Communist Transformation." pp. 40-41.

⁵⁶ Report of the Shadow Economy Legalization Department, Tbilisi, 1999. (in Georgian Language).

⁵⁷ Johnson, Simon, Kaufmann, Daniel, and Shleifer, Andrei. "The Unofficial Economy in Transition." p.183, Table 1.

⁵⁸ Mars, Gerald and Altman, Yochanan. "Case Studies in Second Economy Production and Transportation in Soviet Georgia." in Alessandrini, Sergio and Dallago, Bruno. (eds.) *The Unofficial Economy*. Gower Publishing Company, 1987, p. 197-198; Mars, Gerald and Altman, Yochanan. "The Cultural Basis of Soviet Georgia's Informal Economy." *Soviet Studies* 25, 4, 1983, p. 546. Marshall I. Goldman mentions a widely accepted argument about the highest level of the informal economy in the South Caucasian Republics during the Soviet regime, Goldman, Marshall I. "Comments and Discussion." *Brookings Papers on Economic Activity* 2, 1997, p. 224.

⁵⁹ European Bank for Reconstruction and Development, Transition Report, 1999, p. 18.

argues that in these years the share of the informal sector in GDP was 45-50%. In 1999 the government of Georgia and the World Bank conducted a three-day observation on the selected firms. The results of the observation were compared to reported transactions of these firms and the difference appeared to be 55-60%.⁶⁰ However, one can argue that even these high figures do not reflect the reality, since investigation was conducted on registered firms only. Transactions in the unregistered firms are still impossible to measure.

The persistence of the Georgian informal economy and underestimation of official figures is supported by the cash turnover method. It was estimated that in 1997 65% of the cash turnover was unreported.⁶¹ Data from different sectors also prove that the informal economy develops in a stable way. Agriculture is the main branch of Georgian economy and 9/10 of the output is produced in the informal sector. In the industrial sector, however, the share of informal production is between 48 and 59%.⁶²

Table 2 shows the growth of GDP and informal economy's share in the GDP. These data are derived from different sources. Correspondingly, their credibility levels are also different.

Table 2. Georgian GDP and informal economy growth

Year		1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Real GDP Growth		-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	2.9	3.0
Real GDP Index		100	87.6	69.6	38.4	28.6	25.4	26.0	28.7	31.8	32.8	33.8
Inf.Econ. Share in GDP		12.0 ^a	24.9 ^a	36.0 ^a	52.3 ^a	61.0 ^a	63.5 ^a	62.6 ^a	33 ^b / 47.5 ^c	33 ^b / 47.5 ^c	47.5 ^c	57.5 ^d
Informal Economy Index		100	207.5	144.5	145.3	116.6	104.1	98.6	52.7/ 153.9	52.7/ 153.9	143.9	121.1

Sources: GDP data: European Bank for Reconstruction and Development, Transition Report, 1999.

The share of the Informal Economy in GDP:

- a. Johnson, Simon, Kaufmann, Daniel, and Shleifer, Andrei. "The Unofficial Economy in Transition." *Brookings Papers on Economic Activity* 2, 1997.
- b. The State Department on Statistics
- c. The Economic Digest of Georgia
- d. International Association Civitas Georgica

⁶⁰ Corruption in Georgia: Forms and Measures, Tbilisi, 1998, p.14. Also data collection of the International Association Civitas Georgica.

⁶¹ Akhvlediani, Anna. "Corruption and Economics." in *Business and Corruption in Georgia*. Tbilisi, 1998, p. 37. (In Georgian Language). According to the data from The State department of Statistics, 57.8 % of Georgian Economically active population is self-employed. Majority of them work in the informal sector. See Socio-economic Conditions of Georgia, 1998. The State Department of Statistics, Tbilisi, 1999. (In georgian language).

⁶² Turnava, Nathia. "The Foundations of Anti-Corruption Expertise of the Georgian Legislation" *Bulletin of Georgian Center on Strategic Research and development* May, 2000, p. 26.

Forms of informal economic activity

In general informal economic activity is conducted in four major sectors. According to Thomas,⁶³ these are household, informal, irregular and criminal sectors. In the household sector both the output and the distribution are legal, but there are no market transactions. The informal sector also precludes small-scale production and self-employment that is not reported in the national accounts. Activities in the irregular sector involve tax evasion, regulation avoidance and other illegal activities. The criminal sector, however, is illegal both in terms of the production and the distribution.⁶⁴

The Georgian case, however, consists of several forms: 1. *Legal but unregistered* activities in both production and services. In this case the firms are not registered and therefore are not paying taxes to the state budget. 2. *Unreported or underreported* production in registered firms, and deviations from state standards. As the purchasing power of the population is very low, producers try to reduce prices. This is possible either by decreasing quality or by underreporting income. 3. *Illegal* activities that can not be reported and/or registered due to their illegality. 4. *Smuggling* that takes various forms: import of banned goods, import avoiding customs checks, import of falsified or low quality goods, underreporting the quantity of goods, deliberate manipulation with different customs regimes. 5. *Substituting state agencies by the private firms*, i. e. state officials establish firms for the same services, which a state agency is supposed to provide. However, the firm has monopolized the market, as its owner officials are responsible for providing licenses. On balance, the firm serves as a state agency, but private owners earn profit. 6. *Selling information by bureaucrats* that is accessible only to them but legally must be available to everybody.⁶⁵

The Georgian Case: Analysis

The development of the Georgian informal economy can be divided into three periods. In the first period (1991-1995) it contributed to the survival of the population while the state was occupied with civil wars and ethnic conflicts. The second period (1995-1999) witnessed persistence of the informal economy despite the political and macroeconomic stabilization. The last period is characterized by the institutionalization of the informal economic activity. This means blurring the margins between the formal and informal activities/institutions, which leads to the criminalization of the government.⁶⁶

Data on Georgian informal economy, though controversial, can be analyzed from different perspectives. Each approach analyzed above may offer its own explanation of the Georgian case. However, I argue that each of them has a limited explanatory importance only. The Structuralist approach is particularly unsuitable for the Georgian case for at least two reasons: 1. The labor supply-labor demand approach suggests that informal actors are mainly poor unemployed people. In the Georgian context, however, state and large factory employers participate in the informal transaction more actively. 2. The neo-Marxist

⁶³ Thomas, J.J. *Informal Economic Activity*. 1992.

⁶⁴ Ibid., pp.3-5.

⁶⁵ Otinashvili, Ramaz. "The Meaning, Reasons and Outcomes of Shadow Economy." pp. 3-4.

⁶⁶ Otinashvili, Ramaz. "The Meaning, Reasons and Outcomes of shadow Economy." p. 6.

explanation is not appropriate to the Georgian case, as labor union is very weak in Georgia and labor legislation can not be enforced. Furthermore, average monthly salary is about 25\$ (22.7% of the subsistence wage). However, in the informal sector salaries are much higher⁶⁷ and therefore, there is no need to go underground to reduce labor costs. The legal perspective can not explain the persistence of Georgian informal economy either. If we contrast the two halves of the decade, one might argue that legal environment has improved and thus costs of acting legally should have reduced. However, as the above-presented data show there is no decrease in the size of the informal economy during the decade.

Referring back to the revival of the institutional analysis in both economics and sociology, I argue that the institutional theory provides the best explanatory framework for analysis of informal economy. Here I will discuss the arguments of the rational choice institutional approach to the informal economy, which is the most widely used approach in the transitional economies. Recently World Bank experts argued that stabilization is not sufficient for the economic growth. Market-supporting institution building must be also present.⁶⁸ They conducted the research across transitional countries and concluded that in the countries where market institutions function better, economic growth is higher, informal economy is smaller and public finances are healthier. Johnson, Kaufman and Shleifer developed a simple model to describe relationship between the informal and formal sectors. According to this model large size of the informal sector is a response to politicians' attempt to regulate and influence economic life. As a result a vicious cycle is created: the informal economy diminishes public finances and lowers the state capacity to provide public goods and rule of law in the official sector. This, in turn, makes formal sector even less attractive for the firms and they seek public good providers among the private Mafia-like organizations. Even more, in this state of affairs firms from the formal sector will shift to the informal one. Thus to decrease the size of the informal economy, the state must outcompete the Mafia by providing better public goods and lower tax burdens.⁶⁹

The discussed model is based on the assumptions that the formal/informal continuum is operating along rationality/irrationality line. It overestimates the rational calculus of the economic actor and does not take into consideration non-economic motives of economic action. However, besides this theoretical fallacy the approach has also methodological problems. The first drawback is its static perspective. The authors examined the relationship between the share of informal economy and different indicators of institutional performance in 17 transitional countries. For 1995 they identified high correlation but this is not enough for the prediction that for instance, reducing tax rates will necessarily reduce the informal economy. Furthermore, in some cases their independent and dependent variables depend on the third variable. In Georgian case, I argue, informal economic activity, bad tax administration and low law enforcement are the outcomes of the same factors that will be discussed below.

⁶⁷ Ibid., pp. 5, 12.

⁶⁸ Johnson, Simon, Kaufmann, Daniel, and Shleifer, Andrei. "The Unofficial Economy in Transition." p. 163.

⁶⁹ Ibid., pp. 159-160.

In order to see whether there is an association between the informal economy and indicators of institutional performance I will use a diachronic perspective. On the one hand, I presented the data showing the persistence of Georgian informal economy (Table 2). On the other, I will use transition indicators Central European Economic Review (Table 3).

Table 3. CEER indicators about Georgia

Social and political upheavals as well as the steps towards the building of democratic institutions in Georgia of 1990s are described elsewhere.⁷⁰ Above presented figures also prove that institutional environment for economic action has improved. However, the size of the informal sector is not decreasing. The persistence of informal economy shows that economic and political reforms in Georgia have failed. The third proposition deals with the general reasons of these incoherent reforms:

<i>Indicator</i>	<i>1995</i>	<i>1998</i>
Price stability	2.8	6.0
Currency stability	2	5.0
Legal safeguards	2.3	4.0
Productivity	3.3	4.4
Infrastructure	2	4.0
Ease of portfolio investment	1.3	3.1
Banking System	1.8	3.4
Corruption and Crime	2.4	5.9
Tax burden	3.7	4.3
Average	2.4	4.5

Proposition 3. In the heterogeneous society with a weak state and strong informal networks macro-level reforms alone will not lead to decreasing informality (and thus to a sustainable growth), if micro-level interests are not taken into account.

I identify several factors that made Georgian informal economy persistent. These factors, I argue, operate not on the basis of *ceteris paribus* principle, but simultaneously. However, the main factor is a system of cultural values. The Soviet regime created fruitful environment for these values to persist and strengthen. In addition, the post-Soviet path of development contributed to the prevalence of informality by the incoherent institutional building.

PERSISTENCE OF GEORGIAN INFORMAL ECONOMY

The System of Cultural Values

In the early 1980s Gerald Mars and Yochanan Altman devoted number of studies to the Georgian second economy⁷¹. Their perspective was anthropological and thus precluded long-term participatory research among newly immigrated Georgian Jews to Israel. The authors than examined their hypothesis while visiting Georgia. The findings showed that Jews were integrated among Georgians and there was no difference between the behavioral patterns of these two ethnic groups. I will use this study to show how the

⁷⁰ Sleider, Darrell. "Democratization in Georgia." in Dawisha, Karen and Parott, Bruce. (eds.) *Conflict, Cleavage and Change in Central Asia and Caucasus*. Cambridge: Cambridge University Press, 1997.

⁷¹ Mars, Gerald and Altman, Yochanan. "The Cultural Basis of Soviet Georgia's Informal Economy." pp. 547-559; "Case Studies in Second Economy Production and Transportation in Soviet Georgia." pp. 197-219; "Case Studies in Second Economy Distribution in Soviet Georgia." pp. 220-254.

operation of informal economy in the Soviet period was based on the cultural values. Then I will examine if these values are still present after the two decades of political and social upheavals.

The main argument of Mars and Altman is that one can not understand the informal economy without studying social institutions and cultural values of the society. The Georgian institutions and value systems, however, are not unique and find parallels in the societies all along the shores of the Mediterranean.⁷² The main findings of the authors concern characteristics of Georgian family, networks and interpersonal relationships. The families are bilateral, they descent on both sides but stress the male line. Personal action is bound to the family's honor and thus is assessed in the context of the family. Individual roles in family are not competitive, everybody has its own role and knows its place. Beyond the family relations, however, personal relationships are not stable. Re-ranking of statuses is a norm, and therefore, males constantly have to prove themselves as man. But how can one prove his manliness? Georgians believe that a man must have an honor. The man is required to have an ability of excessive feasting and displaying goods ("if you are poor and the house is empty - then where is your pride?"). Another precondition of having honor is trustworthiness: if one is not trustworthy, he can not have honor and thus can not be the member of the society. Deviants are not only personally disqualified from the society, but so are their families and broader networks as well. The size of personal network is also very important for both being respected and having successful carrier. The networks are based on the obligations and reciprocity: each member of the network takes it for granted to help the other member in trouble. The Georgian society highly respects risk-taking. However, as Mars and Altman identified, there is a negative relationship between the size of the network and the probability of risk. Therefore, person with strong networks could occupy high-risk positions.⁷³

These socially constructed values are enforced by the normative processes. The man behaves in a way what is *expected* from him. Otherwise he will be excluded from the society and so will the members of his network. However, the cognitive processes, I argue, are the major driving forces of construction and application of these values. I assume the prevalence of the cognitive processes for two reasons. Firstly, the validity of purely constructed symbols and symbolic actions are taken for granted. Secondly, individual as well as collective actors are socially constructed identities and they create the environment where such a symbolism makes sense.⁷⁴ On balance, cultural meaningfulness of broad networks, trustworthiness, reciprocity, the ability to take a risk, preconditioned the emergence of the Georgian informal economy. Mars and Altman argue that there was a discrepancy between the model of the Soviet economy and the nepotistic, highly personalized entrepreneurial nature of Georgia's economy.⁷⁵ However, are these values and structures still present in Georgian society of the 1990s? If yes, are there any discrepancies between these values and the market economy?

⁷² Mars and Altman, "The Cultural Basis of Soviet Georgia's Informal Economy." p. 547.

⁷³ Ibid., pp.548-550.

⁷⁴ For the summary of the cognitive processes in the institutions see: Scott, *Institutions and Organizations*, pp. 40-45.

⁷⁵ Scott, *Institutions and Organizations*, p. 557.

Some evidences show that these values are still there. Business-league & Social Research Center survey interviewed businessmen from registered firms only. As two decades earlier from person holding the position a bribe was expected and this behavior is still taken for granted as a meaningful action. It is also evident that if one has strong network she can cope with Tax Collection Office as well as it was decades ago with the Soviet controlling agencies.⁷⁶ Giving and accepting bribes, clientelism and nepotism are still taken for granted as socially accepted, meaningful, and appropriate behavioral patterns.⁷⁷ The official who refuses to accept a bribe is said to “waist the place” as this is considered deviation from the appropriate behavior.⁷⁸ Some authors believe that these behavioral patterns are the outcomes of adaptation to the Soviet system.⁷⁹ Parallels with the Mediterranean societies, however, indicate that they are older and thus more difficult to alter.⁸⁰

The Sources of State Weakness

Post-socialist countries come to the present conditions through different historical experiences. History matters, as past behavioral and institutional practices shape present and future choices of the society.⁸¹ Therefore, the trajectories of transitions must vary across countries. Indeed, countries differ dramatically in economic performances, political systems or institutional settings. Yet there is a possibility to identify a group of states which I will refer as a weak ones. In general, post-communist weak state is characterized by lack of civil society⁸², poor enforcement of the rule of law and incapacity to deliver services and to cope with pressures from different interest groups. Causes of the state disruption in the post-socialist context are manifold: the collapse of party-state and the centrally planned economy is the general reason operating in every country. But this is added by more specific reasons that vary across the countries (pre-Communist path of development, ethnic and civil conflicts, fragmentation of national elites, territorial disintegration, etc.). To understand the sources of the state weakness I will consider characteristics of historical legacies, state capacities, and forms of networks.

Some approaches to the transition do not require that all the legacies of the Soviet time must be destroyed in order to provide a successful transformation politics.⁸³ However, I intend to show that particular kinds of legacies does not create preferable conditions

⁷⁶ For comparison see: Mars and Altman, “Case Studies in Second Economy Production and Transportation in Soviet Georgia.” p. 216, and Muskhelishvili and Niauri, “Entrepreneurs about Corruption.” pp. 9-24.

⁷⁷ Muskhelishvili, Marina. “Social Aspects of Corruption”. in *Business and Corruption in Georgia*. Tbilisi, 1998, p. 24-25.

⁷⁸ Akhvlediani, “Corruption and Economics.” p. 32.

⁷⁹ Feige, Edgar L. “Underground Activity and Institutional Change: Productive, Protective, and Predatory Behavior in Transition Economies.” p. 5-7.

⁸⁰ The Italian cultural values and behavioral patterns comparable to the Georgia case can be found in: Weiss. “Explaining the Underground Economy: State and Social Structure.” pp. 229-229.

⁸¹ North, Douglass. *Institutions, Institutional Change and Economic Performance*. p. vii.

⁸² Generally, there is no necessary association between the state weakness and the civil society weakness. However, in the post-communist context this correlation exists, as one of the reason of state incapacity to say no to the rent seeking networks for example, is the weakness of civil society, which can not monitor the state action and thus allow for arbitrariness.

⁸³ Stark, “Recombinant Property in East European Capitalism.” pp. 54-55.

neither for recombination of existing structures and practices nor for institutional/organizational bricolage. Once again referring to the North's claim that history matters I argue that in the Georgian context the historical experience is the main source of the popular attitude to the state. Before the Soviet regime Georgia did not have the state institutions in the modern sense. Except the period of short-lived Georgian Republic (1918-1921) the formal institutions were violently imposed to the society. As a result, the "stateness" of the nation has become associated with the patrimonialism, i.e. the system when the ruler not only ruled but also owned the nation, its citizens and resources.⁸⁴ The importance of historical experience in the law-based state building is well documented in the Central European context.⁸⁵ In the former USSR space, however, the lack of the experience in the state building has limited the institutional choice. As a result, strong presidential regimes, high concentration of executive authority and limited accountability has emerged in many countries.

The limit of accountability and over-concentration of power is possible due to very weak civil society which in its turn, is another outcome of the Soviet system. A civil society is fostered if the state recognizes non-state voluntary institutions. However, these civic institutions also operate in the public interest. In a civic democracy political integration is a "bottom up" process. According to Putnam, in a civil society individuals participate in public affairs through different social institutions. Horizontal cooperation on the local level creates social capital that promotes political participation.⁸⁶ Under the Soviet regime, however, civic association lacked a voluntary basis as it was highly politicized. Reaction on the state's attempt to mobilize citizens was a shift from *organizational* to *informal* networks, i. e. instead being engaged in formal organizations citizens relied solely on the face-to-face relations. Thus, in the Soviet society there was no connecting middle between ruling elite and informally organized networks.⁸⁷

Legacies of the Soviet era mentioned above resulted in peculiarities of modern networks in a weak state. The individuals responded to the transformation in two ways: either they increased reciprocity and enforce informal networks in order to sustain their own households survives, or they formed illegal Mafia-like organizations.⁸⁸ Predominantly informal character of networks contributes to disappearance boundaries between the public and private spheres: the power and influence of the network is proportional to its informal connections with representatives of political and financial elites.⁸⁹ The cases of the Russian Financial Industrial Groups show the extent of merge between private and

⁸⁴ Marwick, Roger D. "What Kind of State is the Russian State if There is One?" *Journal of Communist Studies and Transition Politics* 15, 4, 1999, p. 119.

⁸⁵ Rub, Friedbert, "Selling-Off or Rebuilding the State: A Comparative Framework for Analyzing the State of State Building." in Heinrich, Hans-Georg. (ed.) *Institutional Building in the New Democracies: Studies in Post-Post-Communism*. Collegium Budapest, 1999, p. 237.

⁸⁶ Putnam, Robert. *Making Democracy Work*, Princeton: Princeton University Press, 1993, p. 87.

⁸⁷ Rose, Richard & Mishler, William. "Social Capital in Civic and Stressful Societies." *Studies in Comparative International Development* 32, 3, 1997. The authors call this kind of society "Hourglass" society.

⁸⁸ Smith, Adrian and Pickles, John. "Theorizing Transition and the Political Economy of Transformation", in Pickles, John and Smith Adrian. (eds.) *Theorizing Transition: The Political Economy of Post-Communist Transformations* London and New York: Routledge, 1998, p. 7.

⁸⁹ Modern state of affairs in Russia is compared to the Western feudalism of early Middle Ages by Shlapenkokh or to European State of eighteenth century. See Marwick, Op.cit. p.116.

public spheres. The FIGs lobby in the federal and regional governments for special privileges and always achieve their goals. By this strategy FIGs control most of Russian material and financial resources as well as media and communication. In Georgia case, however, GIG-like quasi-private firms are under the patronage of the state agencies and maintain the monopolies in the most profitable sectors.⁹⁰ In this respect it is interesting to contrast Georgian class structure with that of Russia and Central European countries. In Hungary and Poland the class structure compatible with Western Societies was identified (entrepreneurial class is the most important There).⁹¹ Russian class structure is comparable with that of Third World countries: bourgeoisie is concentrated in the financial and resource-industry sectors (banking, raw materials export, money laundering, and speculation).⁹² Georgian structure tends to be more Russian-like. It is argued that most of modern entrepreneurs, who are former directors of the state-owned Soviet factories, lead their business in the same manner as they did during the planned economy. They still rely on the informal networks through which they manage distortions of financial accountability, bribe, padding and so forth. Even more, they at the same time participate in political decision-making either directly or by lobbying.⁹³

Some scholars argue that because of (1) unprecedented depression, (2) criminalization of politics, (3) inability to collect taxes, (4) inability to maintain integrity, it is hard to consider Russia as a state.⁹⁴ I think, however, that the state of affairs is not much different in Georgia, as the state can not fulfill any of these four functions.

In this section I outlined some characteristics of a weak state. Weak civil society, domination of informal networks, isolation of the ruling elite from citizens, popular distrust and skepticism to the public institutions, state incapability to say no to rent-seeking networks seem to be the main characteristics.

Social Capital and Trust

In this part of the thesis I will focus on the importance of social capital and trust in post-Communist states. I will emphasize the impact of the Soviet legacy on the deceased social capital and distrust to the formal institutions. Finally, I will analyze the process how this state of affairs contributes to increased size of the informal economy.

The importance of social capital for both building democracy and market economy is well known. Modern democracies are based on the formal and positive law derived from the modifiable decisions of political legislature. Positive law must be legitimate: it must be derived from the preconditions when its addressees respect and pursue the rule of law⁹⁵.

⁹⁰ Johnson, Juliet. "Russia's Emerging Financial-Industrial Groups." *Post-Soviet Affairs* 12, 4, 1997. For comparison see: Otinashvili, "The Meaning, Reasons and Outcomes of Shadow Economy." p. 21.

⁹¹ Evans, Geoffrey and Mills, Colin. "Are There Classes in post-Communist societies? A New Approach to Identifying Class Structure." *Sociology*, 33, 1, 1999, pp. 41-42.

⁹² Marwick, "What Kind of State is the Russian State if There is One?" p.121.

⁹³ Papava, V. and N. Khaduri. "On the Shadow Political economy of the Post-Communist Transformation", *Problems of economic transition* 40, 6, 1997, p. 28.

⁹⁴ Marwick, "What Kind of State is the Russian State if There is One?" pp.112-113.

⁹⁵ Habermas, Jürgen, "Struggles for Recognition in the Democratic Constitutional State." in Taylor, Charles and Gutman, Amy (eds.) *Multiculturalism*. Princeton: Princeton University Press, 1994, p.121.

This process requires political participation and representation as well as the monitoring of the state's action by the public. That is not possible without substantial level of social capital. I use the concept of "social capital" in Francis Fukuyama's sense: "[Social capital is] instantiated informal norm that promotes cooperation between two or more individuals."⁹⁶ The level of social capital can be better understood referring to the *radius of trust*. Radius of trust measures the extent of circle in which cooperative norms operate. Traditional societies are based on the in-group solidarity that restricts the ability of the group to cooperate with others. Therefore, very important dimension of social capital is group's attitude towards the actors outside their radius of trust.⁹⁷ In this societies trust is "ascribed", i.e. cooperation operates along the face-to-face relations, among the kinship members.⁹⁸ In contrast, modern societies consist of many overlapping social groups that permit "weak ties" among the members of the group. Due to weak ties multiple membership and identities are permitted that is a source of innovations and development. In modern societies actors enter into a transaction having limited information about each other's interest. This kind of trust is "generalized" or "extended". Between ascribed and extended trust, however, lies "process-based" trust. This kind of trust is generated when actors know each other for a long time but are not sharing the same group membership. While business transactions may be based on the process-based trust, for the generation of extended trust third party enforcement is necessary and this is the function of the state.⁹⁹

Mishler and Rose differentiate social network capital (face-to-face informal social network) from organizational capital (impersonal, rule bound organization). They claim that the post-Soviet era is characterized by increased trust in local social networks and distrust in formal institutions. Network capital has a positive importance when formal institutions do not serve their functions effectively (social security is derived from these networks in many countries). However if there is no trust, there is no connection between informal social networks and impersonal formal institutions.¹⁰⁰

What was the role of the Soviet past in decreasing of Social capital and extended trust? As Gambetta argues, trust is backward looking: it comes from the cooperation and highly relies on the past.¹⁰¹ From this perspective it is maintained that in the centrally planned economy a process-based trust dominated. While the suppliers under the central planning were not reliable, managers were looking for informal networks. In the Georgian context the high value of the trustworthiness created favorable conditions for the development of these informal networks. In addition, the system created the necessity of the further extension of these networks. As a result, informal networks connected producers both with the suppliers and the state officials on the basis of process-based trust. These connections were vital for supporting and protecting informal economic activity.¹⁰²

⁹⁶ As Fukuyama claims, frequently discussed trust, however, is an epiphenomenon of social capital.

Fukuyama, Francis. "Social Capital and Civil Society." IMF Working Paper, WP/00/74, 2000, p. 3.

⁹⁷ Fukuyama, "Social Capital and Civil Society." 5.

⁹⁸ Raiser, Martin. "Trust in Transition." EBRD Working Paper #39, 1999, p. 4.

⁹⁹ Ibid., 5.

¹⁰⁰ Raiser, "Trust in Transition." p.9.

¹⁰¹ Gambetta, Diego. "Can We Trust Trust?" in Gambetta, Diego. (ed.) *Trust: Making and Breaking Corporate relations*. Oxford: Basil Blackwell, 1988, p. 230.

¹⁰² Raiser, "Trust in Transition." p. 8.

How the past experience affects the behavior of modern actors? There are two major competing theories that tries to explain formation of trust. A cultural theory argues that political value and believes, including trust, are results of political socialization experiences. Political values and believes are learned usually through early life experiences. However, these experiences also depend on the status and position of individual in a society. In contrast, rational theories of political behavior claim that trust depends upon individual evaluations of the success with which political and social institutions provide valued social, economic and political benefits. Mishler and Rose argue that both perspectives give a decisive importance to experience. Though there is a time difference. The first theory emphasizes early socialization, while the second focuses on recent experience. The authors propose an integration of these two views into “lifetime learning model”, which suggest that developing trust begins from the early time of individuals development and evolves continuously. In the short run, early socialization may have a priority. But in the long run, evaluation of performance is more important¹⁰³. Empirical study conducted by the authors did not show significant importance of the Communist legacy. Only indirect impact was apparent as citizens compare present institutional performance to that of Communist times. For instance, individuals evaluate their degree of freedom in the post-Communist higher than it was in the past. This positive attitude is reflected in a modest trust, which they show towards institutions.¹⁰⁴

What should be done, if anything, to increase the level of social capital by fostering trust? Some authors argue that two preconditions are necessary for building trustworthiness: 1. *Institutional constraints* like laws and contracts, to enhance trust and induce more productive cooperation. However, it is noted that institutional enhancement of trustworthiness works better in economic relations then in non economic ones, as economic relations are relatively easier to institutionalize. 2. Other sources of trustworthiness are *social constraints*. Conventions that establishes the general framework for institutionalization of one specific set of behavioral pattern. Establishment of the specific set of behavioral patterns and its regular practice allows for trust to be socially constructed. This can lead to a type of a ‘band-wagoning’ effect, where expectation for more of the same behavior increases.¹⁰⁵

In the process of trust building the role of informal institutions are crucial. Investigations show that the level of social capital can not be fully explained by rational choice game theories. Rather, its generator is religion, culture, and particular historical path of development.¹⁰⁶ Putnam is also in favor of path-dependency in the sense that the level of social capital is preconditioned by the historical development and there is no room for deliberative design. Raiser, however, identifies three strategies: first two can be implemented in the context of the strong state: either by gradual reforms maintaining political stability or changing formal institutions rapidly. The third strategy had to do with the weak state and is path dependent: institutional change will be easier in the case where there is little need to change actors’ behavior.¹⁰⁷ Informal institutions can play a positive

¹⁰³ Mishler William and Rose, Richard. “Trust, Distrust and Skepticism: Popular Evaluation of Civil and Political Institutions in Post-Communist Societies.” *The Journal of Politics*, 59, 2, 1997, p. 434.

¹⁰⁴ Ibid, p. 441.

¹⁰⁵ Hardin, Russel. “Trustworthiness.” *Ethics* 107, 1, 1996, pp. 31-36.

¹⁰⁶ Fukuyama, “Social Capital and Civil Society.” p.14.

¹⁰⁷ Raiser, Martin. “Informal Institutions, Social Capital and Economic Transition: Reflections on a

role in the process of reforms if there is a strong state and top-down process. For instance, Chinese economic success relies on the economic decentralization that was based on the informal institutions such as Chinese extended family.¹⁰⁸

It is argued that extended trust can not be fostered due to the state weakness. The crucial point is persistence of old ties, state officials are reluctant to go beyond inherited process-based trust. Trust related issues are extremely difficult in the heterogeneous society. The cases of homogenous societies like Poland and Hungary show that elites can re-establish state capacity to enforce contracts referring to shared history and traditions of nationhood. Heterogeneous societies, however, prefer to rely on the ascribed and process-based ties as Vietnamese, Chinese, Russian cases indicate.¹⁰⁹

Above discussion calls for the pessimistic view of the possibility of extended trust in the context of weak state. I argue, however, that ascribed trust can be the basis of sustainable economic development through economic decentralization. Humphrey and Schmitz show that in the transitional economies the starting point is ascribed trust. Revival of the Soviet networks sometimes leads to process-based trust but the radius of trust in the latter case is smaller than it was in the times of previous regime.¹¹⁰ On balance, I argue that for increasing the radius of trust and thus to achieve the higher level of social capital trust in state institutions is preferable but not necessary condition. What a weak state can and must do is to exploit the cultural values in the society and foster process-based trust between economic actors. This is possible through associative politics, which will be discussed below.

AGAINST INFORMALITY: STATE AND INSTITUTIONAL CHANGE

James March claims that “if the habit of slipping from the language of observers to the language of reformers without changing the worlds is an academic sin, then academic hell is crowded with students of organizations”.¹¹¹ This is true for the students of the informal economy too. Observing association between the level of taxes and the size of the informal economy, some scholars argue lower taxes will automatically decrease the informal economy.¹¹² Or as the higher level corruption is associated with the bigger informal economy, fighting against the corruption is seen as the precondition of the formalization of the informal sector.¹¹³ Here I am not going to offer recommendations of the policy reform. Rather, the aim of this part is more modest. It deals with the possibility of institutional change that makes the volume of the informal activity decrease. However, the emphasis will be on the role of the state in this process.

Neglected Dimension.” EBRD Working paper No 25, August 1997, p.12.

¹⁰⁸ Ibid., p. 15.

¹⁰⁹ Ibid., 11-13.

¹¹⁰ Humphrey, John and Schmitz, Hubert. “Trust and Economic Development.” Institute of Development Studies at the University of Sussex. Discussion Paper No. 355. Brighton, 1996, p.21-22.

¹¹¹ March, James G. *The Pursuit of Organizational Intelligence*. Oxford: Blackwell, 1999, p. 8.

¹¹² Johnson, Kaufmann, and Shleifer, “The Unofficial Economy in Transition.” pp. 209-212.

¹¹³ Kaufmann, and Kaliberda, “Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies. A framework of Analysis and Evidence.” p. 112; Turnava, Nathia. “The Foundations of Anti-Corruption Expertize of the Georgian Legislation.” pp. 26-33.

The results of the analysis on the Georgian informal economy can be interpreted in several ways. The first possibility is to consider the informal economic activity as the main reason of a modest economic growth of the country. This, in turn, affects the state capacity to provide public goods and thus a vicious cycle is created. The second way is to see the growing informal economy and the incapable state as results of the orthogonal factors. Alternatively, high level of informal economy and low level of “stateness” can be the outcome of the same reasons. No matter which of these interpretations is closer to the truth, this state of affairs leads to decrease organizational adaptability to the changing environment. As an individual actor finds the means of adaptation to the changing circumstances acting within the limited radius of trust, the mechanisms of adaptation shift from formal to informal institutions. However, it is argued that in the shaping of economic development and political reforms the state is the central actor.¹¹⁴ The role of the state is especially emphasized in the period of transformation, when there is a need for constituting market relations and ensuring competitiveness.¹¹⁵ Therefore, there is an expectation that the nation having a weak state and entrenched in informal relations finds itself non-competitive and non-adaptable to newly emerged conditions.

The above discourse leads to the question of how to build institutions that increases organizational adaptability. The problem is related to the old Greek-Roman dilemma: Greeks saw the leader as a builder of institutions, thus above the structure. While Romans viewed the structure above all, expecting the leader to conform to the institutions.¹¹⁶ In modern terms, the dilemma has to do with structure-agency relationships. Is any action shaped by already existing institutions as Douglass North claims?¹¹⁷ Or alternatively: is there any chance for the agent to change the structure?

Based on the theory of structuration, it is argued that there is a two-side relationship between the structure and the agency.¹¹⁸ Another important claim for my analysis is the need for the right policy and the right institutions.¹¹⁹ But how can one define each of them? Following to the ideas of *associative politics*, I maintain that the right policy in relation to institutional design and reform has to be coherent, - close to the actual processes.¹²⁰ The associative approach concerns both *process* and *politics*. On the level of process it investigates what are dominant properties of transformation process, identifies the main actors, and on this basis seeks for right units of analysis. The level of political design derives from the right understanding of transformation process. Policy cohesiveness is estimated from this perspective. Taking into consideration above discussed increased importance of cognitive processes in the transformation period, the fourth proposition is offered:

¹¹⁴ Skocpol, Theda. “Bringing the State Back In: Strategies of Analysis in Current Research.” in Evans, Peter B. Rueschemeyer, Dietrich, and Skocpol, Theda. (eds.) *Bringing the State Back in*. Cambridge: Cambridge University Press, 1985, p. 3.

¹¹⁵ Bruszt, Laszlo. “Constituting Markets: The Case of Russia and the Czech Republic.” Unpublished work. 1999, p. 4.

¹¹⁶ Brusson, N. and Olsen, J. P. *The Reforming Organization*. London: Routledge, 1993, p. 5.

¹¹⁷ North, *Institutions, Institutional Change and Economic Performance*. p. 3.

¹¹⁸ Scott, W.Richard. *Institutions and Organizations*. p. 52.

¹¹⁹ Bruszt, “Constituting Markets: The Case of Russia and the Czech Republic.” p. 4.

¹²⁰ Stark, David and Bruszt, Laszlo. *Post-Communist Pathways: Transforming Policy and Property in Eastern Europe*, New York: Cambridge University Press, 1998.

Proposition 4. In the context of relatively weak state and strong informal networks coherent institutional change may occur only in the punctuated equilibrium way.

The concept of punctuated equilibrium originates from evolutionary biology and is used to describe long term development of species with occasional abrupt emergencies of the new ones. The concept is borrowed by the political scientists¹²¹ to describe stable development of institutions and the role of crisis for their change. Before going into the details of the nature of institutional change I will analyse the associative politics that seems to be the right policy for the Georgian context.

Beyond Markets and Hierarchies: An Outline of Associative Politics

Possible models of post-socialist transformation have been highly debated. From the very beginning of the transformation a neo-liberal approach was particularly popular. Followers of the view believed that marketization of economic relations with minimal regulative role of the state would transform socialist societies into capitalist ones. The parallel between East European entrepreneurs with the American settlers who “come first and the law followed” can be said to be neo-liberal slogan in the early 1990s.¹²² In contrast, neo-statists argued that the macroeconomic policy and planning led by the state were the main precondition of successful transformation. The hope of the state capacity was based on the quality of East European human capital - precondition of efficient bureaucracy.¹²³ The correlation between the cohesive bureaucracy and economic growth is well known from Weber and is well confirmed by the recent research.¹²⁴ In fact, the first approach failed in practice. Neither of the countries adopted neo-liberal project of transition got away without crisis and economic decline. The neo-statism was popular due to the state’s success in the East Asian context. However, it was apparent, that East Asian conditions of 50s and 60s were dramatically different from the East European context of 90s.¹²⁵ The failure of the neo-liberal project on the one hand, and closer empirical examination of Eastern and Central European cases, on the other, contributed to advancement of the alternative, associative view. The approach is based on the studies, which claim that social systems of production are embedded in broader social and institutional context. Therefore, export of particular institutions and/or organizational forms from one model of capitalism

¹²¹ Krasner, Stephen D. “Approaches to the State. Alternative Conceptions and Historical Dynamics.” *Comparative Politics* 16, 1984; Cortell, Andrew P. and Peterson, Susan. “Altered States: Explaining Domestic Institutional Change.” *British Journal of Political Science* 29, 1, 1999.

¹²² The words of Vaclav Klaus (“the settlers come first and the law followed”), the former prime minister of the Czech Republic. As quoted in Tucker, Aviezer. “Beyond Economic Absolutism: The Post-Communist Transition from a Sociological Perspective.” *The Journal of Social, Political and Economic Studies* 23, 3, 1998. p. 349.

¹²³ Amsden, A. H., Kochanovicz, J. and Taylor, L. *The Market Meets its Match: Restructuring the Economies of Eastern Europe*. Cambridge, MA: Harvard University Press, 1994, pp. 208-210.

¹²⁴ Evans, Peter & Rauch, James E. “Analysis of “Weberian” State Structure and Economic Growth” *American Sociological Review* 64, 5, 1999, p. 572.

¹²⁵ The importance of temporal dimension in the economic development is described in: Gereffi, Gary. “Rethinking Development Theory Insights from East Asia and Latin America.” in Kincaid, A. D. and Portes, A. (eds.) *Comparative National Development: Society and Economy in the New Global Order*. Chapel Hill: University of North Carolina Press, 1994, pp. 43-51.

into another can not be efficient.¹²⁶ Here I will consider the main contributions of associative politics to transformation, concerned general view on economic development, the role of the state and networks in the transformation process, units of analysis and main directions of transformative politics.

Bringing the networks back in

When designing the reform what should be the aim of the reformer? The associative politics argues that the goal must be the reshaping of the institutional and organizational structure to make it adaptable to changing circumstances. Evolution process allows for diversity: there is multiplicity of paths of development and less efficient forms coexist with more efficient ones. Fitness must be considered in two dimensions: synchronically and diachronically. As fitness is environment-dependent, synchronic adaptability may turn into diachronic maladaptation as environment changes in unpredictable way.¹²⁷ Thus borrowed institutional and organizational forms contain can be efficient in the short run, but not necessarily in the long run.

As it was mentioned the central roles in transformation process were attributed either to markets or to hierarchies. In contrast, associative politics is based on the assumption that economic action can not be explained solely from the rational interest of atomized actors. Economic goals are nor pursued by economic mechanisms only, but non-economic reasons associated with sociability, status, power also affects. That is why explanation must be deducted from the social embeddedness in the networks of interpersonal and interorganizational relations.¹²⁸ Therefore, neither isolated organizations nor isolated institutions possess an explanatory importance in the process of transformation. Rather, changes happen through organizational networks and thus process must be examined through investigating coordinating mechanisms.¹²⁹ This theoretical claims, however, is well founded in the East European context, where societies lack both strong markets (what is required by neo-liberals) and strong states (what neo-statists wish to reestablish there). So the only feasible point of departure in reform politics is a strong network.¹³⁰

Both neo-liberals and neo-statists are in favor of regulation on the level of national economy. Associative politics, however, focuses on the realities derived from the collapse of the centrally planned economy. The collapse disintegrated economy and as a result

¹²⁶ Boyer, Robert. "French Statism at Crossroads", in Colin Crouch and Wolfgang Streeck. (eds.) *Political Economy of Modern Capitalism. Mapping Divergence and Convergence*, Sage Publications, 1997, p. 98-101.

¹²⁷ Grabher, Gernot and Stark, David. "Organizing Diversity: Evolutionary Theory, Network Analysis and Post-Socialism." in *Theorizing Transition: The Political Economy of Post-Communist Transformations*, ed. John Pickles and Adrian Smith. London and New York: Routledge, 1998, p. 11.

¹²⁸ Smith, Adrian and Swain, Adam. "Regulating and Institutionalizing Capitalisms: the Micro-foundations of Transformation in Eastern and Central Europe." in Pickles, John and Smith, Adrian. *Theorizing Transition: The Political Economy of Post-Communist Transformations*. London and New York: Routledge, 1998, pp. 30-31.

¹²⁹ Grabher, and Stark, "Organizing Diversity: Evolutionary Theory, Network Analysis and Post-Socialism." p. 3.

¹³⁰ Stark, and Bruszt, *Post-Communist Pathways: Transforming Policy and Property in Eastern Europe*, 122.

distinct, regional post-socialist economies emerged. Through preservation of the old, creation of the new and recombination of both, variety of governance mechanisms of these regional economies has been shaped. At the same time, local actors come out of their economic and political interests and are capable to mobilize them.¹³¹ Therefore, associative approach gives the main importance to localities and regulations on the local level. The approach gives importance to the non- and para-statal institutions and regulations on the local level of development.¹³²

The state and politics

The associative politics argues that “market” and “market orientation” are not natural phenomena. Rather, they are socially constructed and constituted by the state. In order to constitute the market there is a need for the state capable to enforce the rule of law and fair competition. The first principle is guaranteed by strengthening expectations that (1) contracts will be enforced, (2) profit will not be taken by the state, (3) the state will not help economic actors in the case they fail their business. Fair competition is established if the state guarantees that misuse of informational and economic capital will not be allowed.¹³³ The key in understanding coherence of reform policy is the place of executive authority in the system of government. The more concentrated is the executive authority the less bounded is it to particular interest representations and correspondingly, the less coherent is the reform policy.¹³⁴

Post-Communist transition is a simultaneous process: along with changes in property rights, political rights are also extended. The associative approach claims that the only successful politics must cope with the both issues. However, no state has a superior knowledge to economic actors and therefore, no state has a right to define what public good is. There is a multiplicity in definition of public goods and nobody can define it ignoring these heterogeneity of representation of public goods (nobody can monopolize the political field). Social interests, however, should be mediated by the institutions outside the state bureaucracy. Bureaucracy will be accountable only if there is an autonomous political field where demonstration of political support dominates. From this perspective, in the course of reforms politicians are the key actors and political programs are the bases of competition. Coherency of policy is achieved if the politicians are (1) bound to their programs, (2) embedded in the network of distributed authority, where mutually monitoring institutions are operating. Bounded to programs and embedded into networks, the state should regulate context by legislation, enabling economic actors to cooperate on the long-term basis.¹³⁵ These principles lead to preferences to bicameral parliament, coalition government, separation of powers, mixed electoral systems.¹³⁶

¹³¹ Smith, and Pickles, “Theorizing Transition and the Political Economy of Transformation”, p. 20.

¹³² Smith, and Swain, “Regulating and Institutionalizing Capitalisms: the Micro-foundations of Transformation in Eastern and Central Europe.” p. 29.

¹³³ Bruszt, “Constituting Markets: The Case of Russia and the Czech Republic.” Unpublished work. 1999, pp. 4-5.

¹³⁴ Stark, and Bruszt, *Post-Communist Pathways: Transforming Policy and Property in Eastern Europe*, p. 169.

¹³⁵ Ibid., pp. 196-200.

¹³⁶ Bruszt, “Constituting Markets: The Case of Russia and the Czech Republic.” pp. 27-28.

On the Ruins or with the Ruins?

The associative politics argues that it is neither necessary, nor desirable to destroy the old heritage in order to build the new. Empirical research in the Central Europe shows that sustenance of the old ways of transactions does not linger the change.¹³⁷ Transitional period is not characterized by the institutional vacuum. Rather, since the old and the new forms coexist there is a diversity of forms and structures. It is argued that Diversity of forms coupled with ambiguity of assets (which is also a characteristic of transformation period) creates favorable conditions for long run adaptability.¹³⁸ The new institutions and network relations thus do not emerge by replacement of the old with the new. Alternatively, way of recombination of old and new elements was identifies.¹³⁹ So, in the process of transformation a change takes form of institutional *bricolage*: there is an unplanned change through using old components and structures to perform new functions, putting them in a new combinations.¹⁴⁰

I will briefly discuss the path of transformation in Georgia to show whether the incremental change and institutional bricolage is possible. The first difference between the Georgian and Central European context is the violent way of government change in the former. In the context of heterogeneity this decreased the legitimacy of the central government. On the other hand, there is a great need for the decentralization in contemporary Georgia. Indeed, the government introduced the local-government reform. However, local government did not received property rights and thus its hands are bound. The central government is also reluctant to make final decision about the status of the regional administrations. Another incoherence between the process and the policy has to do with political participation. Neglecting heterogeneity and local interests, Georgian legislation restricts the creation of regional parties.¹⁴¹ On the other hand, political participation is constantly decreasing.¹⁴²

I think it is evident that enabling existing networks to enter associations, focus on the local interests' representation, allowing non-state economic regulations and emphasizing the need for the system adaptability make the associative politics particularly fit to the Georgian conditions. However, weak and non-autonomous state, strong informal networks and incoherent policy and in more general terms dominance of the cognitive processes in institutional performance do not allow for changes. However, I argue that *punctuated equilibrium* approach provides the best theoretical framework for understanding the context of change. The followers of this approach claim the direction of institutional

¹³⁷ Stark, "Recombinant Property in East European Capitalism." p. 46.

¹³⁸ Grabher, and Stark, "Organizing Diversity: Evolutionary Theory, Network Analysis and Post-Socialism." p. 11.

¹³⁹ Stark, "Recombinant Property in East European Capitalism." p. 46.

¹⁴⁰ Lauzara, G. F. "Self-destructive Processes in Institution Building and some Modest Countervailing Mechanisms", *European Journal of Political Research* 33, 1, 1998, p. 28.

¹⁴¹ The Georgian Law on Political Parties. See: <http://www.parliament.ge>

¹⁴² Sleider, Darrell. "Democratization in Georgia." in Dawisha, Karen and Parott, Bruce. (eds.) *Conflict, Cleavage and Change in Central Asia and Caucasus*. Cambridge: Cambridge University Press, 1997. For further decreasing of participation after introducing of the 7% threshold see the results of the parliamentary elections, 1999: <http://www.parliament.ge>

change is unpredictable. Rather, its mechanisms can be investigated only after the punctuation has already occurred. My use of punctuated equilibrium, however, deals with the opening of the window of opportunity.¹⁴³ Thus I argue that in the Georgian context the crisis is necessary precondition of coherent institutional change. It is argued that although institutional change frequently occurs incrementally, only the crisis opens wider window of opportunity for changes.¹⁴⁴

CONCLUSIONS

In this thesis I have discussed the case of Georgian informal economy. I have indicated the controversial nature of the phenomenon in the Georgian context. On the one hand, in the period of economic hardship and political uncertainty the informal economy has been an important contributor to the survival of the population. On the other hand, increased informality presents a serious danger of invading the government by the informally organized interest groups. The case of the Georgian informal economy shows that the trend has been from this one extreme towards another. My concern has been to investigate the reasons for the persistence of the Georgian informal economy with the focus on the possible directions of change. Based on the modern trends towards closer collaboration between economics and sociology on the one hand, and revival of the institutional theory on the other, I have analyzed the informal economic activity within the institutional framework. However, instead of the *static* view of institutions I have proposed the *diachronic* one. The diachronic view implies that the proportion of regulative, normative and cognitive processed in the institutions are changing through time and this constitutes the main driving force of institutional change. On the basis of this assumption I have offered two propositions dealing with the Georgian case. The first proposition claims that in institutional performance during the transformation the cognitive processes prevail. The second proposition deals with the dominance of mimetic processes in the organizational behavior.

My argument has been that the level of the informal economic activity in Georgia can be used as a coherency indicator of economic and political reforms. Analyzing the empirical data about the Georgia informal economy I found both the measurements and the outcomes highly controversial. Nevertheless, it is evident that in spite of the economic and political stabilization, the Georgian informal economy develops in a stable way. Looking for the possible reasons I have examined a variety of approaches. I have argued that the structuralist and the legalist perspectives can not be applied in the Georgian context. In the post-Communist countries, however, the rational choice institutional approach is the most influential. This perspective is based on the claim that the building of the market supporting institutions will decrease the informal economy. The approach identifies a positive association between the high level of the informal economy and the low level of performance of the market supporting institutions. However, these results derived from the synchronic cross-country analysis and thus failed to understand the causal relationships between the informal economy and the market supporting institutions.

¹⁴³ Krasner, Stephen D. "Approaches to the State. Alternative Conceptions and Historical Dynamics." *Comparative Politics* 16, 1984, p. 234.

¹⁴⁴ Cortell, Andrew P. and Peterson, Susan. "Altered States: Explaining Domestic Institutional Change." *British Journal of Political Science* 29, 1, 1999.

I used the Georgian case to examine the development of these two phenomena during the transformation. The analysis has shown that despite the progress in the building of the market supporting institutions, the volume of the Georgian informal economy did not decrease. Thus I have concluded that the informal economy and the formal institutions are affected by different, orthogonal factors and changes in the one can not predict the change into the other. The persistence of the system of cultural values has been identified as the alternative solution to the persistence of the Georgian informal economy. Furthermore, I have examined the factors that contributed to the persistence of cultural values and thus to the flourishing of the informal activity.

Georgian informal economy had a considerable size even during the Soviet regime. Comparing contemporary patterns of the informal behavior to the studies during the same period I have concluded that in these two periods the informal economy was guided by the same cultural values. Furthermore, I have shown that due to diminishing importance of regulative and normative processes of institutions, these taken-for-granted behavioral patterns have been penetrating into the formal institutions and organizations. In contrast with the scholars who argue that the behavioral patterns of the informal economy was the outcome of the limits of the centrally planned economy, I have argued that cultural bases of the informal economy goes beyond the Soviet legacy. The parallels between the value systems of those of Mediterranean societies that did not experienced the Soviet-type economy, support this proposition.

The above-mentioned argument however, does imply that the Soviet legacy has been neglected. I have considered the importance of the Soviet legacy in two ways. On the one hand, it created the favorable conditions for the persistence of cultural values. On the other hand, it shaped the adaptive characteristics of these cultural traits. There could be twofold explanation of the persistence of the cultural values. The historical institutionalists would argue that the patterns shaped in the past survived by the inertia. Sociological institutionalists would claim that socially constructed values proved themselves as stable and adaptable and thus persisted through mimetic processes.

Another impact of the Soviet legacy on the post-Communist economic performance is a low level of social capital and non-autonomous state. In the period of economic and political upheavals the first has failed to connect the informal and formal institutions, while the other allowed the informal networks to invade the formal organizations. A further factors deal with the transitional path of the Georgia. The violent and illegitimate change of the government made the perception of the authority illegitimate. This illegitimate was further strengthen by the failure of the state to secure the national integrity. These factors are added by the institutional incoherence: while the trends in the society are towards the decentralization the formal institutions are still overcentralized. On balance, I have argued the simultaneous operation of persistent cultural values, the soviet legacies of the non-autonomous state and limited radius of trust, and incoherent institutional building made the Georgia informal economy one of the biggest among the transitional countries.

These analyses call for the investigation of the possibilities of changes. The Georgian starting point to the right policy is characterized by the weak state, low level of social capital and institutionalized informal economy. I have argued that in this state of affairs the associative policy offers promising solutions. Enabling and encouraging the already

existing networks to enter associations would make the networks accountable against each other. On the other hand, these associations can become the source of the process-based trust. The aim of the associative politics to enable localities organize themselves also is favorable to the Georgian context. However, the path to this process I argue goes through the crisis as the punctuated equilibrium approach suggests.

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