

# **Introduction**

## CHAPTER 1

# **The Informal Economy in Central and Eastern Europe – Obstacle to European Integration or Bridge Between the EU Member States and the Accession Countries?**

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When you receive a cash payment do you always report it to the authorities? How many people pay the taxes due on such income and how many do not? In fact, is it not easier to do business informally than to follow all the rules prescribed by the state and the society? Is informality not more characteristic of emerging markets than of developed economies? Is this way of doing business a feature of economic and social backwardness or a sign of efficiency? Is the gray economy good or bad for the society – for instance, lower prices on smuggled consumer goods? How should a national government fight shady business given the fact that it originates from beyond the boundaries of its country? By taking radical measures against groups of its citizens involved in illegal activities (for instance, drug dealing, human trafficking and prostitution) will the government not support implicitly these groups' foreign competitors given the fact that such activities have an international dimension? Questions of this kind have recently attracted the attention of academics, policy makers and representatives of civil society; answers have come through interdisciplinary or single field analysis from different perspectives to show that the informal economy is part of everybody's life. A large amount of data has been accumulated for the last couple of decades; studies of causal relationships between different facets of informal business as well as between informal activities and government policies have improved our understanding of the causes, mechanisms and implications of the informal economy for the state and society.

The concept of informality has been at the center of the analysis - it can be defined as an attribute of any phenomenon that has fallen beyond the scope of government control or regulation. We can think of informality with regard to relationships, attitudes, physical presence or many other things. There have been multiple definitions of the term “informal economy” – for our purposes it could be defined in general as economic activities not fully taken into account by national statistics, taxed by the government, sanctioned, regulated or protected by the state. In the literature as well as in popular discourse one can come across different terms used to signify more or less similar phenomena, for instance, “gray economy” or “underground economy”, but the notion of informality seems to be the most general and inclusive of most of the content specific for the various terms used in one or another context; this is the reason why the focus of this project is “the informal economy” and not anything else.

For analytical purposes we can regard the concept of informality as a variable, which can take different values along a continuum. If an economic activity is viewed at its positive end, then it is sanctioned by the state and can be considered as fully formal; if an economic activity is at the negative end, then it can be considered as subversive or directed against the state. In the context of what was mentioned above on the use of synonymous terms, various shades of color between black and white can be used for symbolic representation of the varying degrees of informality; depending on the potential or real consequences for society or the effectiveness of government regulation the state can undertake different measures to address informal activities.

Closest to the positive end of this continuum we find legitimate business activities, duly reported to the authorities and taxed by the government but not complying with certain regulations (e.g. quality controls) – for this reason although the products of such activities or services are legally sold on the market, there is an element of informality involved. Government response is rare, or, if it happens, it is mostly in the form of statements of facts or recommendations; it is triggered only if a negatively affected firm or individual brings the existing flaws explicitly to the attention of regulators and thus initiates some kind of action. Further along the continuum we get to legitimate business activities, which are not reported for statistical purposes, although taxes on such products and services may be fully paid. In this case, the authorities give instructions as to how to proceed in the future in full compliance with the existing regulations. A next level of informality involves generally legal activities, on which the full amount of taxes due has not been paid. In this case government response is conditioned on the magnitude of the phenomenon or the tax loss suffered by the state and may include sanctions and penalties; the authorities also initiate measures expected to preclude the occurrence of such practices in the future.

Informal activities reach a new point on the continuum when informal or illegal labor is involved either in the form of a second job (the phenomenon of moonlighting) or through illegal employment (for instance, with the involvement of illegal immigrants or legal non-immigrant foreigners). From this point government reaction through

special regulations becomes more pronounced as informality has moved from the product markets to the more sensitive labor markets and penalties can be harsher. Further along the continuum informal business is represented by corrupt practices of different kinds (e.g. giving and taking of bribes, cross-border smuggling of goods with full or partial non-payment of customs duties, non-monetary exchange of services or favors against the existing rules). At this point informality has already penetrated very deeply into the state-society relations as well as the interaction among individuals and/or societal groups; phenomena of this type already represent a serious threat to the existing order and the integrity of the society. The negative end of the continuum, for which the symbol of “(totally) black economy” is used, includes activities which are explicitly banned and prosecuted by the government, such as organized crime, drug dealing, trafficking of human beings, prostitution, and illegal arms dealing, i.e. activities which seriously undermine the legitimacy of the state institutions and which may even put the survival of the state in question.

As already mentioned, the use of colors, or gradations of black and white, represents another way of illustrating the various points along the continuum of informality; in addition, it can offer a different way of conceptualizing the same or slightly different phenomena or variables. As it will be seen further in this volume, some of the authors working on the subject prefer this approach if it helps them achieve a better understanding of the specific causal relationships they analyze.

Although the upsurge of attention to the informal economy is rather recent, the study of this phenomenon can be considered as both old and new. First, there is a significant body of literature on each of the mentioned shades of black and white, i.e. the individual points on the continuum discussed above – tax avoidance, illegal labor (quite often analyzed in the context of illegal migration), corruption, different types of crime related to specific business activities, etc. Most of this literature comes from specific fields and provides important analytical tools and knowledge to policy makers for designing specific responses to the challenges for both governments and society.<sup>1</sup>

Second, the formal study of the informal economy is a recent phenomenon because of the effort to get a holistic view, in which the individual problems mentioned above are just the constituting elements. These elements are supposed to have their logical places in this big picture; knowing what these places are and how these elements interact with each other is an essential part of our understanding of the phenomenon. Thus, an identifying mark of this recent work is the attempt to put the individual elements together, look for common causes and explanations, try to make valid generalizations and come up with new tools of analysis, which can help further explore

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<sup>1</sup> This introductory chapter cannot offer a review of the work done in the individual issue areas, which could be included under the heading of the informal economy. It is worth mentioning, however, a review of the contemporary research on corruption, which covers, in fact, a wider spectrum of issues, i.e. includes important theoretical literature on the informal economy in general – Andvig and Fjeldstad (2001), as well as two related publications: Amundsen (2000) and Amundsen and Fjeldstad (2001).

the informal economy from this perspective. This new wave of scholarship makes a special effort to better place its analysis in the context of the state/society interaction by focusing on state policies and society's spontaneous responses to the informal economy as well as on the societal responses to government actions addressing this phenomenon; it views the informal economy in the context of the interaction among social groups, i.e. takes social dynamics into account; and last, but not least, it explores the phenomenon in the context of international exchanges. In other words, it tries to take into account the role of multiple actors, both state and societal, cross-border movements and activities, and its transnational implications. We do not claim that all the contributions to this book represent perfect examples of this kind of scholarship, but a large part of the content goes in this direction.

Third, this book brings an element of novelty to the field in the sense that it tries to draw theoretical generalizations from the experience of Central and Eastern Europe, which has not been sufficiently analyzed in the existing literature. Fifteen years since the beginning of the democratic transitions in this region is not a period long enough for accumulating a critical mass of social science research and policy analysis on the subject. For obvious reasons, before 1989 the various shades of black and white in Central and Eastern Europe had not been studied as well as they had been, for instance, in Western Europe or North America. Officially, there was no space for informal activities under a centrally-planned economy, so these activities were considered as either illegal (and therefore had to be prosecuted), or not existent or not important enough to warrant any methodical study (e.g. production with tax avoidance). Even if informal activities admittedly existed, the analytical tool kit for their study was missing or underdeveloped.

In addition to its theoretical significance, the analytical work on the informal economy reported in this book has particular policy relevance for the following reasons. The conventional justification for this kind of work is that governments need to know better the multiple avatars of the informal economy and understand the logic of its dynamics in order to design and successfully implement policies addressing its implications and targeting its causes and sources. As the realities in Central and Eastern Europe draw a growing attention in the context of the coming enlargement of the European Union, for the current EU members it is imperative to get to better know their future partners and the risks associated with the enlargement of the union. Immediately after the start of the transitions in 1989 the countries in CEE experienced strong incentives toward liberalization. In the new environment economic activities grew spontaneously; adequate regulation was missing and parallel to the flourishing private enterprise informality underwent an explosive expansion. As state interaction with society had to be re-legitimized on a new basis and the capacity of the states in the region to interact with private business had to be built practically from scratch, the opportunities for informal activities were abundant. In spite of the growing efforts of governments to get a grip on the economic activities, the informal sector reached a size

of over 30 percent of GDP in some CEE countries. In this situation, it is logical to ask a number of questions – for instance, how these realities will fit into the highly regulated economic and social space of the EU, what threats will the integration of strong informal economies bring to the integrity of the union, will this integration not make it hard to address some of the adverse consequences of the large informal sector (for instance, cross-border crime and illegal labor movements)? The governments of the current EU member states need to be able to convince their constituencies that as a result of moving the union borders eastward economic prosperity and social stability will not be jeopardized in the long run and that the costs of the enlargement will not be too great.

In the same EU enlargement context the policy relevance of the study of the informal economy for the candidate countries is perhaps even greater as these countries are supposed to bear the larger part of the burden associated with their integration in the union. An important issue in this regard is whether the informal economy will represent an obstacle on their way to European integration. A closer look into the phenomenon, however, shows that integration is also happening through the channels of informality, i.e. that the informal economies in CEE have already achieved a level of integration with their counterparts in the EU member states which may be even greater than the level of integration of the formal ones. Cross-border movements of people, organized crime, drug dealing, trafficking of human beings and smuggling of goods have rules of their own and exist in a space which is not governed by regulations made in Brussels or in the national capitals of the candidate countries. It is no wonder that a number of specific phenomena existing all over Europe and conceptualized with the darker shades of the black/white continuum have national and ethnic names to signify not only their origin but also the directions of the current informal dynamics and movements of people, capital and influences. Thus, specific types of crime in Western Europe are associated with ethnic groups (immigrants or non-immigrants) from candidate or other countries – the term *Russian mafia*, for instance, illustrates a phenomenon in organized crime for the spread of which national borders have proved to be ineffective as a barrier.

At the beginning of the 1990s, when transitions to democracy and a market economy was picking up speed, policy makers in CEE were concerned that the informal sectors in their countries had become practically overnight too large; informality in this region was perceived as a sign of backwardness, a major drawback which would make these countries ineligible for EU membership. This perception was magnified, on the one hand, by their inadequate knowledge of the realities in Western Europe and the other industrialized countries; on the other hand, they faced the protectionist attitude of the average West-European consumer toward future EU enlargement and growing negative stereotypes of the candidate countries in the member states. Some of these policy makers' ambitions were to present the large informal sectors in their countries as remnants of the communist past, which would be overcome along the way to democratization and consolidation of competitive markets – this is how they wanted to

prevent their colleagues in the EU member states from reaching the conclusion that CEE was just not good and civilized enough to be accepted in the EU.

Later developments helped get rid of some of the fears in this respect but brought new ones. It became clear that informality was not a new phenomenon for Western Europe – in fact, the research done over the last decade showed that certain EU countries had informal sectors large enough to be comparable to those in the candidate countries, and moreover - that the informal sectors in some EU countries were even larger than such sectors in some of the candidate countries.<sup>2</sup> Thus, both sides faced an important dilemma: will the informal economy become too large and too hard to control as a result of the additional inflow of informality following the enlargement of the union? In this case, on the one hand, one will have to proceed with caution along the way to include new members of the union, i.e. for Central and Eastern Europe (CEE) the prospects for enlargement were getting dimmer; on the other hand, the informal economy may not be a significant obstacle and enlargement may even be facilitated by informality – the integration of the informal sectors will be easier as harmonization of the existing rules is not needed; common economic spaces in the gray areas of the continuum will not be hard to create and the fight against the phenomena in the black areas will be easier as criminals will find it harder to hide behind the poor fit of norms in national jurisdictions. The bottom line of this dilemma is that the informal economy can be either an obstacle to integration or a bridge between the current EU member states and the candidate countries; therefore, it may create both problems and opportunities for policy makers working toward further European integration.

In this context a better understanding of the role of the informal economy and its implications for unified Europe is a serious challenge for theorists and practitioners. An important task in this regard is to achieve an effective cooperation among academics and policy analysts from EU member states and candidate countries studying the phenomenon of informality in Central and Eastern Europe. Such cooperation in sharing local knowledge, adapting generally accepted tools of analysis to the specific environment of CEE, building new theories and methods of inquiry and formulating recommendations for policy makers can represent a meaningful contribution of this epistemic community to achieving the goals of European integration.

The efforts to address the phenomenon of the informal economy in CEE and its implications for European integration can constitute taking on multiple tasks and clarification of a number of ideas. Thus, the following questions need to be answered:

- 1) How do we measure the informal economy in general and that in CEE in particular? What are the general characteristics of the informal economy in CEE (size, scope, trends, major actors, etc.)? What are the causes of informality?

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<sup>2</sup> The numbers quoted in Friedrich Schneider's contribution to this volume are eloquent – for instance, 18.4 percent and 18.3 percent respectively for the Czech Republic and Slovakia versus 28.5 and 27 percent respectively for Greece and Italy in the year 2000-01.

- 2) What is the impact of the informal economy on the formal economy in general, on society and on the state/society interaction? How do formal institutions interact with the various aspects of informality?
- 3) What policies should governments design to adequately address the sources and outcomes of the informal economy? How should these policies be implemented in order to neutralize its adverse consequences and take advantage of the opportunities it creates?

Accomplishing the tasks mentioned above requires involvement of research centers, scholars and policy analysts from both EU member states and candidate countries. The beginning of this effort was marked by the Center for the Study of Democracy (Bulgaria), the Bertelsmann Foundation (Germany) and the World Bank, which tried to address the first of the three sets of questions. Within the framework of the EU integration network of economic and political research institutes and think tanks in the Central and Eastern European accession countries they held in April 2002 in Sofia a Round Table entitled “The Informal Economy in the EU-Accession and Stability Pact Countries: Size, Scope, Trends and Challenges to the Process of EU Enlargement and Integration”. This event brought together researchers and experts in policy making from EU member states (Austria, Germany, Italy and the United Kingdom), accession countries (Bulgaria, the Czech Republic, Hungary, Lithuania, Poland, Romania and Slovenia), states participating in the Stability Pact for Southeast Europe (Albania, Bosnia, Croatia, Moldova and Serbia) and other countries (Canada and Russia) as well as representatives of international organizations, multinational and bilateral donor agencies. The importance of this project was recognized by the European Commission and supported through the Fifth Framework Program for Community Research.

This book contains the papers presented at the round table.<sup>3</sup> It attempts to make some broad theoretical generalizations on the size and scope of the informal economy, the methods of its assessment, risk reporting and early warning for good governance and against corruption through cross-country comparisons and individual case studies from Central Europe, the Baltic republics and the Balkans. The individual contributions bring different perspectives on the informal economy in CEE – general theoretical or case-specific based on the empirical data from CEE countries, academic or expressing the point of view of civil society, perspectives from inside as well as from outside. Of course, all papers are not equal in analytical depth and scope, in richness of data and statistical evidence in support of the formulated claims, in methodological consistency, nor in originality of the approaches used. Such projects have obvious general limitations; individual contributions may also be subjected to criticism. Still, this book has special significance - it represents the first effort of this kind and one should focus on the important questions it raises rather than on the flaws of the answers it provides.

<sup>3</sup> Previous publications following similar projects of the network include: Funk and Pizzati (2002), Drulak (2001) and Tang (2000).



The effort of the Sofia round table resulted in a blend of global and local knowledge, *de facto* launched a thematic network, helped clarify the future research and policy agenda on the subject of the informal economy and the opportunities for future cooperation in analysis and dissemination of best practices around and outside the region of CEE. Among the outcomes we should also note the opportunities for replication of the experience and extension of the effort to related fields and other regions.

The content of the book is divided into four sections which reflect the major themes debated at the round table, namely: 1) methods of measurement of the informal economy; 2) the informal economy in Central Europe and the Baltics; 3) the informal economy in Southeast Europe; and 4) early warning and risk reporting for good governance and against corruption.

In the first section of the book Friedrich Schneider sets the general framework for the discussion with an overview of the size and the evolution of the shadow economy and the shadow labor force in 22 transition countries and 21 OECD members. He presents estimates for 2001/2002 based on the DYMIMIC method and ranging from 18 to 45 percent of GDP for Central and Eastern Europe and from 29 to 66 percent for the republics of the former Soviet Union. At the same time the average size of the shadow economy in the OECD countries, estimated on the basis of the currency demand method, ranged from 8 to 27 percent of GDP. The average size of the shadow economy labor force as a percentage of the population of working age in 1998/99 ranged between 12 and 35 percent for the CEE countries, between 29 and 63 percent for the former USSR and between 6 and 48 percent for 7 OECD countries. In the transition countries both the shadow economy *per se* and the shadow economy labor force have been on the rise for the last dozen of years while in most of the OECD countries the size of the shadow economy has been decreasing although the corresponding labor force has been steadily growing. The increase of the taxation burden and the social security contributions ranging from 39 to 78 percent of all income for the OECD countries, combined with rising state regulatory activities rather than improved enforcement, have been the driving forces for the above mentioned trends. Schneider gives a short overview of the *pros* and *cons* of the most widely used methods of assessment – the direct approaches, based either on surveys or samples of tax audits showing the discrepancy between the income declared for tax purposes and the income measured through selective checks, and the indirect approaches, based on currency demand, the physical input (of electricity) and multifactor modeling. He concludes that the shadow economy is a complex phenomenon, equally present and largely observed both in the industrialized and the developing countries; that is why governments trying to control such activities should first and foremost turn to the complex and frequently contradictory consequences of their own policy decisions.

The paper by Simeon Djankov, Ira Lieberman, Joyita Mukherjee and Tatiana Nenova deals with the cost/benefit considerations in the choice in favor of or against informality. The main benefit of staying informal is the avoidance of (some) taxes and

burdensome government regulations, which impose both direct costs (fees or bribes to officials) and indirect costs (measured in the entrepreneur's time spent on fulfilling various requirements and submitting documents). Nevertheless, informality comes at a cost too – these include the need to stay small, uncertainty in the prospects for the future, absence of safety nets, inability to tap formal credit channels and, more generally, the various types of SME assistance programs available to the private sector. A cost-benefit analysis leads to the conclusion that some activities will always stay informal - illegal activities like drug trafficking, for instance, as no improvement in the regulatory environment for doing business will change their status. The authors discuss further the costs and benefits of informality for the government. The negative effect of the reduction of the tax base is exaggerated as a concern – greater costs are brought by the numerous social programs, especially those dealing with poverty alleviation (subsidized healthcare, subsidized or free housing, large unemployment benefits, free training, etc.) as the beneficiaries of these programs are the same individuals or societal groups that are most often involved in the informal economy and do not achieve adequate social protection through the channels of the formal economy. Many informal or semi-formal activities currently taking place in transition countries can be legalized if the costs of informality rise and the benefits fall. Djankov et al. formulate policy recommendations in this regard, including a reduction of the number of business licenses, permits and approvals, streamlining administrative procedures, adopting uniform taxes and enhancing access to capital, easing operating constraints on existing micro-finance institutions, reforming banking regulations to encourage lending to small firms, avoiding state-sponsored financial intermediation, etc.

Dominik Enste's paper throws light on the role of the shadow economy in the process of institutional change in the countries with economies in transition. He notes that in popular discourse the assessment of the role of the shadow economy fluctuates between two extremes: it is either blamed for the many problems of the economy (unemployment, high public debt, recession, etc.) or "regarded as a legitimate free space in an economic system characterized by high taxes and excessive regulation and focuses on the causes and consequences of the increase of the shadow economic activities". Enste outlines an evolutionary theory of the development of the shadow economy, based on the understanding that it is a "reaction of individuals who feel overburdened by the state and who choose the "exit option" rather than the "voice option". Thus, the general causes of the increase of the shadow economy include: 1) the rise of the taxation and social security contributions burden combined with the increase in the density and intensity of regulations in the official economy, especially in labor markets; 2) the (forced) reduction of weekly working time, early retirement and growing unemployment; and 3) the long-term decline of civic virtue and loyalty towards public institutions. In addition, Enste brings up a number of factors specific of the socio-economic environment in Eastern Europe. The effect of the shadow economy on the official economy is quite difficult to assess as comprehensive empirical evidence

is not available and none of the available theoretical models provides a perfect explanation. Although most of the studies done so far focus on the impact on the allocation of resources and the loss of revenue for the state, the impact on the official institutions, norms and rules is more important and still understudied. In this context, the shadow economy can be seen as an indicator of a serious deficit of legitimacy of the present social order and the current rules of official economic activities as the “exit” option of the shadow economy puts serious limitations on the Leviathan state’s ability to secure economic freedom and liberty. Enste advocates a two-pillar strategy for government response, including lowering the attractiveness of the “exit” option and strengthening the “voice” option.

The paper by Alexandre Marc and Zeynep Kudatgobilik explores the relationship between poverty and informality drawing on evidence primarily from the countries of Southeast Europe. While the economic, social and political reforms of the transition to a market economy and a western-style democracy have created multiple opportunities, a large part of the action, in fact, takes place outside the realm of official channels and through informal relations and activities. Using the concept of “informality” and not that of “the informal economy”, the authors note that the former represents a major survival mechanism for the poor – a way of coping with the many aspects of poverty and social exclusion beyond the common dimension of income. Using data from social and poverty assessments done through specific World Bank projects or sector work, they suggest that the drive of the poor towards informality stems from the failures of the formal channels for social inclusion, namely: 1) the lack of resources and government capacity to provide adequate social security, education, healthcare and retirement income and the difficult enforcement of the provisions of the related legislation, which stimulates informal payments; 2) the lack of outreach and support capacity manifested in difficulties in implementing specific program for the poor for which funding is available (for instance, provision of subsidies for the poor and introduction of user fees for the wealthy), the inability of NGOs and civil society in general to substitute for government agencies in providing this kind of support and outreach; and 3) the lack of formal channels for support of small business and economic activities at a community level as well as the increased regional imbalances as an unintended consequence of the transition to a market economy, following the substantial reduction of subsidies supporting poor and isolated regions. Marc and Kudatgobilik provide justification for their arguments with a detailed analysis of informality in three aspects: i) access to social services; ii) access to revenue and employment; and iii) obtaining favors, justice and security.

The next two sections of the book offer examples of the application of specific assessment methods to individual country cases. The one on Central Europe and the Baltic republics starts with a comparison of the informal economies in the Czech and the Slovak Republic by Jan Hanousek and Filip Palda – two country cases likened to identical twins separated at birth and undergoing divergent paths of evolution. The

general question asked by the authors is why people in these two republics evade taxes. On the basis of surveys done in both countries in the year 2000 the authors search for a link between evasion and variations in demographics, and between beliefs about the morality of evasion and the chances of apprehension. Evasion seems to be mainly the business of men in both the Czech and the Slovak Republics; households whose head is married are strong evaders; after the age of retirement tax evasion drops radically; no clear relationship exists between evasion and education; the unemployed or people with business of their own tend to be the most active evaders. With regard to the perceived penalties and audit probabilities people tend to grossly overestimate the probability of getting audited; those who evade more often have a much clearer idea of the probability of getting caught than those who evade occasionally or not at all; education is uncorrelated with the assessment of the likelihood of being caught; estimated penalties are much greater (five times on average) than the ones actually imposed. On the ethics of tax evasion Hanousek and Palda find a very strong correlation between whether an individual evades taxes and what percentage of people in his/her neighborhood he/she believes to be evading; they also find that "the most frequent evaders are those who believe that there is little difference between how much people in their neighborhood evade and how much countrywide evasion there is". They note that Slovakia's average tax morality is higher than that of the Czech Republic, although Slovaks believe that a greater number of their countrymen are involved in the shadow economy than do Czechs. As to the effect of tax rates on tax evasion, Czechs were found to evade more intensively than Slovaks even though their tax rates are lower. Last but not least, Czechs seem to evade more taxes than Slovaks, but more Slovaks work in the underground economy. As a whole, Hanousek and Palda provide extensive data in support of their hypotheses and their conclusions are very well placed in the context of the current theoretical debates in the literature.

Maciej Grabowski's paper gives the Polish perspective on the informal economy and the informal labor market in a transition context. If before 1989 the informal sector in Poland was driven mainly by excessive limitations on business, including the prohibition of certain activities, the need for licenses and limited access to the means of production, since 1989 the main motive for firms to stay informal has been improvement of their competitive position, for instance, by reducing costs. Grabowski discusses the *pros* and *cons* of two direct methods: 1) the method of labor force surveys, which are done quarterly in Poland; these surveys have obvious limitations as people working legally and illegally after working hours as well as people working abroad and non-immigrant foreign residents are not included; and 2) the special surveys on informal labor conducted in 1995 and 1998 which helped reveal many important aspects of informal labor, including working hours, seasonal character, temporary illegal jobs, regional characteristics, etc. Informal labor in Poland has shown a decrease from 7.3 percent to 4.8 percent of the total population above the age of 15. "The reduction of the number of illegal workers is explained by the increase of legal

employment from 15.48 million in 1995 to 16.27 million in 1998 and by the reduction of unemployed in the country from 2.23 million to 1.83 million.” Informal jobs are usually temporary and seasonal and primarily taken by people with vocational education. Men are twice as likely to get involved as women; young and middle-aged people are most attractive for such jobs. Using a different method – small samples – Grabowski found that in 1994 and 1997, 29.6 percent and 14.1 percent respectively of the people were involved in unregistered work. It is interesting to note that households are the major employer of informal labor (86 percent versus 14 percent for firms), although firms’ black workers are more often permanently employed, i.e. these jobs are their principal ones. In general, there is a steady decrease of the shadow economy as a percentage of GDP from 16.6 percent in 1995 to 14.5 percent in 1999 – these numbers are rather low and comparable to the numbers for most of the OECD countries. The trend towards decrease in the size of informal labor in Poland in 1994-1999 may be explained by the strong economic growth during this period and the improved quality of the labor market data. Grabowski also notes that informal and regular labor markets are inter-related, which should be taken into account by policy makers in the design and implementation of policies toward limiting the size of informal labor.

In her presentation of the informal sector in Lithuania Guoda Steponavičienė argues that if official statistics fail to reflect all the activities in the national economy it is because this sector is flexible in reacting to changes in the regulatory framework and its ultimate goal is to escape from being measured and captured; for this reason definitions and methodologies should be treated only as a way of approximation. Thus, on the one hand, the Lithuanian Department of Statistics (LDS) normally adjusts GDP in an upward direction to include informal activities, but so far its size *per se* has been measured only once - in 1995 when it was 23.4 percent of GDP. In this number 16 percentage points were included for economic reasons and 7.4 points for statistical reasons, for instance, when companies fail to submit periodic reports to the Department of Statistics. Illegal activities were excluded from the analysis on the grounds that they are largely of international nature. The main method used by the LDS in measuring the informal economy was an anonymous opinion poll of tax inspectors and state social insurance fund employees; interviews with randomly picked individuals were also included. On the other hand, the regular, semi-annual surveys of market participants’ expectations, conducted by the Lithuanian Free Market Institute since 1997, have shown that the informal economy has been shrinking steadily – from 22 percent of GDP in 1997 to 19 percent in 2001. Surprisingly, Steponavičienė finds that one of the causes of this downward trend can be the lack of entrepreneurship in Lithuanian society.

Laszlo Kallay places the discussion of the informal sector in Hungary in the context of the rapid liberalization of the economy right after 1989, when certain restrictions and state controls over foreign trade, currency exchange, licensing, investment and employment were eased, but enforcement efforts on the part of the government were not particularly intense. The major form of informality at that time

was tax evasion by registered businesses as the benefits of having a legal business were higher than the costs of registration and legal operations. Later, however, the costs of registering and operating a business (money, time and effort) slowly, but steadily, started to grow for two reasons: a) regulation of licensing became more extensive; and b) enforcement on declaring a larger portion of the income earned became stricter. At the same time, most of the estimates show that the share of the informal sector in the Hungarian economy has decreased during this period. Kallay addresses this obvious contradiction by considering the transaction costs in relative terms, i.e. not as amounts of time and money required in order to follow the rules; he also takes into account the role of the learning process. Over the same period competition became a more important problem – businesses had to expend more effort to struggle for their markets and less effort to struggle against tax collectors. In addition, formality became more attractive as a result of the reduction in income redistribution. Although the government only declared intentions and never developed a comprehensive strategy to push back the informal sector and attract more activity to the formal one, this seems, in fact, to be happening. The key points here are minimizing registration costs at the beginning of the transition process, providing an opportunity to deduct costs from the tax base, and compensating high tax rates by being not very strict on tax collection. Later, however, when the early transition crisis was over economic growth started to pick up and the number of registered businesses stabilized, the government began to send signals indicating the expected level of declared income; most of the entrepreneurs got the message and stated income just above this expected level. The result was a gradual increase of the portion of formally declared income. Another element of this strategy has been raising the level of minimum social security contributions every year.

In the section of the book devoted to the Balkans Lucian-Liviu Albu and Mariana Nicolae present their application of one of the methods of assessment of the informal economy – the use of household survey data – in the estimation of its size in Romania. The Integrated Household Survey, including a sample of approximately 36,000 observation units from about 500 urban and rural research areas, is their main source of information for the study of household behaviour; in addition, they have used the results of a Supplementary Survey of Household Informal Economy Activities with a sample size of 2,600 households, focusing on informal economic activities carried out by households. Among the most significant findings of the study one should note the following: 1) informal activities account for 20.4-26.2 percent of the structure of total household income and represent a safety valve within the survival strategies adopted especially by the poorest households; 2) both poor and rich people are involved in informal activities; 3) the reasons for which people work in the informal sector may be different but income is the most important. The poor are “forced” to operate in the informal economy (“subsistence” criterion) while the rich are “invited” to participate in it (“enterprise” criterion); 4) during the latest stages of the transition process the environment stimulated people to enter the informal sector due to a persistent crisis in

the formal sector, legislative incoherence, a feeble penalty system, corruption, over-bureaucratization, etc.; 5) depending on the average monthly income per person, household behaviour varies from predominance of informal and secondary activities to predominance of the main official activity.

Tania Chavdarova offers her own conceptualization of the phenomenon of the informal economy from an institutionalist perspective on the basis of the differences between formal and informal institutions. She presents a taxonomy of the various legal and illegal informal activities and analyzes the types of production and exchange associated with these activities. Although her empirical data is from only one country (Bulgaria in the 1990s), the purpose of her paper is to make theoretical generalizations about the short- and long-term consequences of the spread of informal economic activities. Addressing the issue of the *pros* and *cons* of such activities, Chavdarova notes that impoverishment and unemployment represent the main motives for people to get involved in the informal sector. Although firms and individuals benefit in the short run from informal operations, the total economic effect of the informal economy is generally negative. At a micro level, participation in the hidden economy of illegal transactions has turned out to be the most successful profit- and rent-seeking strategy. At a macro level, the enormous pervasiveness of the hidden economy has blurred the boundary between public and private business; the latter has penetrated the state economy, which seems to be one of the most important features of post-socialist capitalism. Social, non-regulated and black economies appear to differ greatly from the generally hidden economic activities and form the backbone of an individual's survival strategy including involvement in more and more work, often seen as self-exploitation. Such activities cannot bring dynamics to the national economy as a whole and mirror the reality of an enormous tightening of the market, a shift towards in-kind production and exchange regardless of the claims that a transition to the market is taking place. These activities lower the competitiveness of the national economy as a whole, slow down economic growth and prevent effective implementation of coherent state policies and labor regulations.

Andrey Zahariev explores one of the features of the informal economy – tax avoidance – by focusing on the motivation of taxpayers as rational actors to preserve their investments in their human capital. He argues that the state can have legitimate claims on an individual's income only to the extent of the percentage of utilized public investment in the creation of his/her human capital through the public education system. Zahariev hypothesizes that “under the conditions of high unemployment and high business risk firms and their employees undertake common, low-conflict actions for reduction of fiscal and insurance payments related to labor contracts. The threshold level for this process to kick in decreases with the increase of the size of the firm as a taxpayer, measured by the number of employees. The influence of local labor unions and the policy of fixed-term labor contracting can serve as additional factors for these outcomes.” The study confirms that Bulgarian private companies (17 to 68 percent of

the cases), especially SMEs, largely avoid paying taxes and benefits. Zahariev mentions some specific factors for this behavior: 1) employees tacitly accept corporate policies of non-payment of taxes and benefits as these payments reduce the return from the investment in human capital through education in an environment of high unemployment risk; 2) the lack of labor unions allows the management to increase the extent of tax avoidance with or without the agreement of the employees; 3) the reduced payments to the state and social insurance funds free resources for new corporate investments and for certain increase of the disposable income of employees; 4) due to the small size of the companies the local tax offices perform tax audits quite rarely, thus reducing the probability for firms to get caught for tax-avoidance to a risk level acceptable for the corporate management. Larger taxpayers (firms with over 350 employees), however, are audited very often and as a result prefer to pay a fair level of salaries, income taxes and social insurance contributions rather than pay penalties.

Genç Ruli offers an overview of the evolution of the informal economy in Albania, based on empirical studies conducted over several years. The informal sector in the country is “neither entirely legal nor completely illegal” - “it operates extensively in a gray area ranging from fully within the law to entirely outside it” and constitutes between 30 and 45 percent of the GDP, depending on the method of assessment. The depth of informality varies – in agriculture, for instance, it is hard to say how far informality goes as the state explicitly tolerates agricultural production outside the regulated and taxed zone of economy as consumption based on in-kind production from private plots constitutes a major safety net for almost 50 percent of the Albanian population. Structural characteristics of the Albanian economy circumscribe some of the general features of informality in the country – almost all enterprises can be defined as micro-, or small, with 76 percent having just one employee. The banking sector continues to remain underdeveloped and has limited influence on the economic development in general; capital market is practically non-existent. The Albanian economy can be characterized as “a cash economy” – in 2001 the cash held outside the banking system accounts for 77 percent of the monetary base (or 30 percent of M3); only one third of the monetary transactions is channeled through the banking system. An important factor for the growth of the informal sector has been the intensive migration for the last decade. Almost 20 percent of the population has already emigrated, mainly to Greece and Italy. Migrants are the source of significant remittances, which rarely go through the formal banking system. In addition, the major foreign trade and investment partners of Albania are Greece and Italy, whose informal economies are probably the largest among the EU member states. Imports from these two countries, partially subsidized by the EU, represent an important link between the informal sectors on both sides of the border.

The fourth section of the book focuses on the efforts to contain the informal economy and the spread of corruption through the mechanisms of early warning and risk reporting. Wim van Meurs analyzes the risks of corruption and the role of specific



UNDP projects for adoption of effective anti-corruption strategies. While early warning as a concept focuses on the identification and analysis of national risks rather than on a policy advice approach, risk reporting is supposed to suggest answers to structural (regional) problems related to European integration rather than in-depth analysis of specific risks and developments for the Eastern and Southeastern neighbourhoods of an enlarged, post-2004 EU. In this context, the consequences of the informal economy and corruption as well as the policies of anti-corruption and good governance are part and parcel of the dilemma of weak states and strong international support, faced by the countries in Southeast Europe. Van Meurs notes that “anti-corruption tends to become shorthand for good governance and a litmus test for a country’s qualification for EU membership in terms of the political Copenhagen Criteria”. Building an adequate institutional framework is just the beginning in designing anti-corruption strategies as informal institutions (e.g. the business culture and its corruption-resistance as well as the legacies of the past and the specifics of the transition period) are an important factor for their success. Thus, although it seems that the 1990s have been a decade “marked by a boom in corruption, embezzlement, cronyism and conflicts of interest” in transition countries, this perception may be a result of the “boom in anti-corruption strategies and rhetoric rather than corruption” itself as governments have been under pressure from international organizations and domestic civil society to turn to the problem of corruption. Van Meurs concludes, however, that what is perceived as corruption in transitional economies and government institutions is an integral part of the process of transition, not one single evil generally explaining economic and political distress. Consequently, anti-corruption strategies by themselves cannot isolate or even resolve the problem of corruption; moreover, ill-designed measures in this direction may have adverse unintended consequences.

Alina Mungiu-Pippidi analyzes corruption from a modernization perspective in the post-transition context of three East European countries (Romania, Bulgaria and Slovakia). She argues that “a different paradigm, broader than that of ‘corruption culture’, is needed to explain, not just describe, the ‘informal’ essence of post-Communist societies and conceive a policy against it” and thus shed light on the nature of state/society interaction in post-communist Eastern Europe. According to her, widespread bribing in dealing with the public administration needs to be understood as part of a more complex design. Rural post-communist societies have never reached a stage of full modernization and their administrations never achieved the degree of impartiality, impersonality and fairness characteristic of modern bureaucracies. Thus, corruption often manifests itself not just in the use of public position for personal gain, but more broadly as widespread infringement on the norms of impersonality and fairness. Providing discriminative public service, as a general rule, may not be motivated by a pursuit of financial gain only, but stem from the norms of status-based societies. Pippidi argues that “the slow, modest, often contradictory or ill-aimed reforms in post-Soviet or South-East European countries since 1990 have been unable to pin

down this structural problem and address it fully and this is the main reason why so many of them failed miserably to achieve any difference". Unwritten rules prevail over written ones not only because of habit, but also due to a specific kind of bounded rationality. In this context, corruption can be seen as part of the more complex environment of 'an informal society', i.e. a society in which informal institutions and power arrangements are stronger than the formal ones and produce different outcomes. In line with this theoretical argument the following hypotheses are formulated: 1) state failure is a more general problem to deal with than corruption itself as the latter is only a symptom; 2) business-related corruption is an element of administrative corruption in general; 3) the public attitude of resignation to abuse and mistreatment has become part of the problem; and 4) "institutional social capital lingers at a worrying level for the legitimacy of these political regimes" precisely because of the state failure to meet public expectations. The paper advocates a set of measures to overcome this state of affairs, addressed to governments as well as to international donors and civil society.

To conclude, the contributions to this volume give answers to questions, such as how large the informal economy in the accession countries is, what its scope and proportions vis-à-vis the formal economy are, what methods we can use to get the most accurate idea of these activities, what are the causes in general and the specific factors in the countries under consideration, to what extent it creates dividing lines between the EU member states and the accession countries. It is more important, however, that the individual papers provoke questions worth thinking about and outline testable hypotheses to explore in future work. Such efforts should focus on possible causal relationships, which can throw light on the implications of the informal economy for specific socio-economic activities as well as for the state regulation in the process of transition as better understanding of the nature of this phenomenon is imperative for designing adequate policy measures for the benefit of each of these countries as well as for the success of the process of European integration.

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