

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.¹

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

¹ 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.² 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?

² 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.³ 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.

³ 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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**THE INFORMAL ECONOMY
IN THE EU ACCESSION
COUNTRIES**

*Size, Scope, Trends and Challenges
to the Process of EU Enlargement*

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Editor



Funding for this publication was provided by the Bertelsmann Foundation and the World Bank.

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ISBN 954-477-105-0

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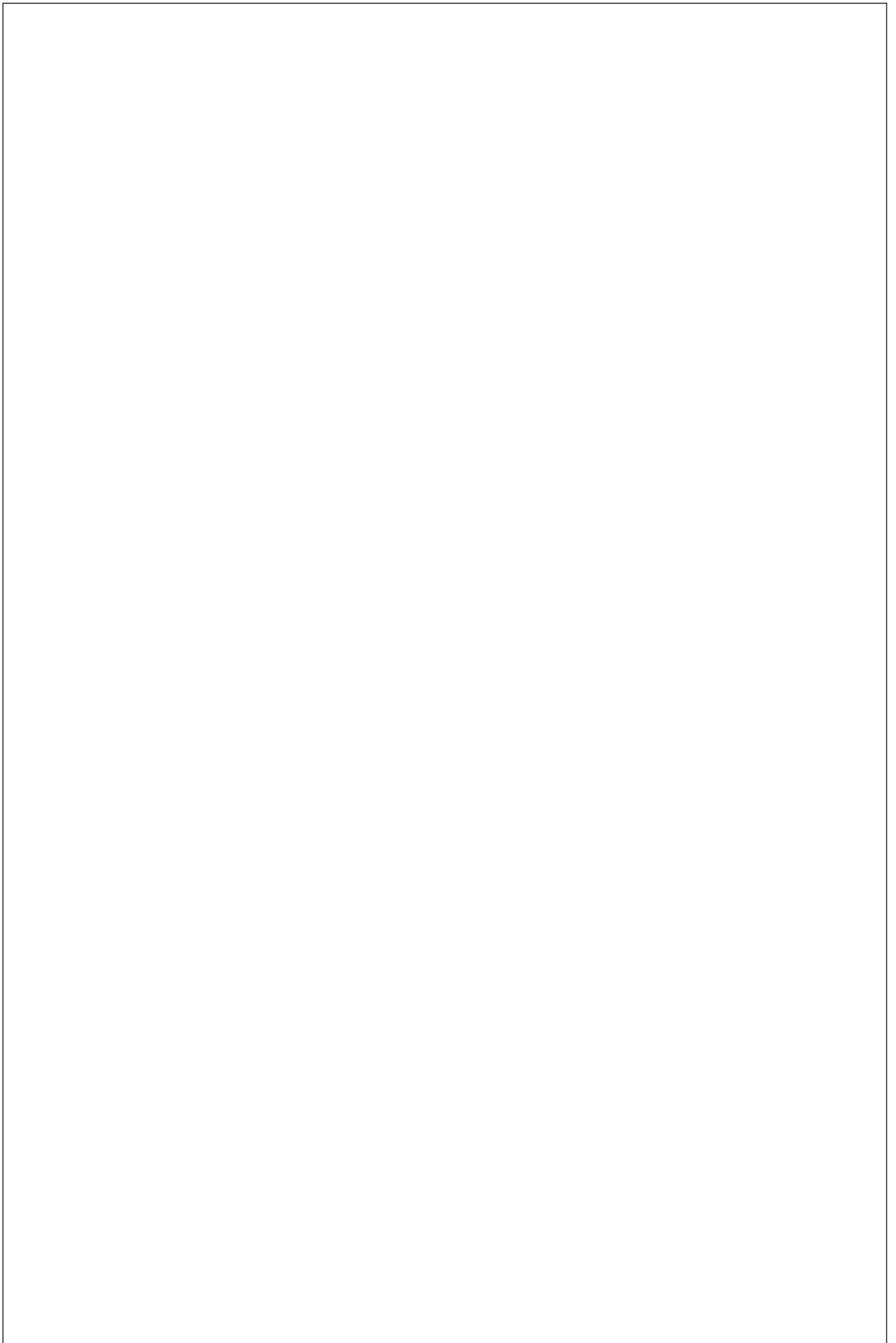
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**Assessment of
the Informal Economy:
Methods and Approaches**



CHAPTER 2

The Size and Development of the Shadow Economies and Shadow Economy Labor Force of 22 Transition and 21 OECD Countries: What Do We Really Know?

Friedrich Schneider

Introduction

As crime and other underground economic activities (including shadow economic ones) are a fact of life around the world, most societies attempt to control these activities through various measures like punishment, prosecution, economic growth or education. Gathering statistics about who is engaged in underground (or crime) activities, the frequencies with which these activities occur and their magnitude are crucial factors for making effective and efficient decisions regarding the allocations of a country's resources. Unfortunately, it is very difficult to get accurate information about these underground (or as a subset shadow economy) activities in terms of value added and of labor market, because all individuals engaged in these activities wish not to be identified.

¹ The literature about the "shadow", "underground", "informal", "second", "cash" or "parallel", economy is growing. It covers various topics, including its measurements, causes and effects on the official economy. See, for example, survey-type publications by Frey and Pommerehne (1984), Thomas (1992), Loayza (1996), Pozo (1996), Lippert and Walker (1997), Schneider (1994a, 1994b, 1997, 1998a), Johnson, Kaufmann, and Shleifer (1997) and Johnson, Kaufmann and Zoido-Lobaton (1998a). For an overall survey of the global evidence of its size in terms of value-added, see Schneider and Enste (2000).

Although quite a large body of literature¹ on individual aspects of the hidden (shadow) economy exists and a comprehensive survey has just been written by Schneider (the author of this paper) and Enste concentrating on the size of the shadow economy in terms of value added, the subject is still quite controversial² and there are disagreements about the definition of shadow-economy activities, the estimation procedures and the use of the estimates in economic analysis and policy making.³ In spite of these difficulties in transition and OECD countries, there have been strong indications for an increase of the shadow economy since the late 1980s, but little is known of the size and development of the shadow economies in transition and OECD countries over the 1990s.

The scientific fascination with the underground economy has inspired me to tackle this difficult question and undertake the challenging task to estimate the shadow economy in transition and OECD-countries over the 1990s. In section 2, an attempt is made to define the shadow economy. Section 3 presents the empirical results of the size of the shadow economy in 22 transition and 21 OECD countries as well as first and preliminary empirical results of the size of the shadow economy labor force (informal employment) in some of these countries. Section 4 examines the main causes of the shadow economy. In section 5, some methods for estimation of the size of the shadow economy are shortly presented; section 6 gives a summary and draws some conclusions.

The Definition of a Shadow Economy: An Attempt

Most authors trying to measure the shadow economy face the difficulty of how to define it. One commonly used working definition is: all currently unregistered economic activities, which contribute to the officially calculated (or observed) Gross National Product.⁴ Smith (1985, p. 18) defines it as “market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP.” As these definitions still leave a lot of questions open, table 1 may be helpful for developing a better idea of what could be a reasonable consensus definition of the legal and illegal underground or shadow economy.

From table 1, it becomes clear that the shadow economy includes unreported income from the production of legal goods and services either from monetary or barter transactions – hence, all economic activities which would generally be taxable were they reported to the state (tax) authorities. In general, a precise definition seems quite difficult, if not impossible, as “the shadow economy develops all the time according to the ‘principle of running water’: it adjusts to changes in taxes, to sanctions from the tax authorities and to general moral attitudes, etc.” (Mogensen et. al., 1995, p. 5).

² See, for instance, the feature “Controversy: On the Hidden Economy” in the *Economic Journal*, vol. 109, no. 456, June 1999.

³ See the different opinions of Tanzi (1999), Thomas (1999) and Giles (1999a,b).

⁴ This definition is used for example, by Feige (1989, 1994), Schneider (1994a), Frey and Pommerehne (1984), and Lubell (1991).

TABLE 1: A TAXONOMY OF TYPES OF UNDERGROUND ECONOMIC ACTIVITIES*

<i>Type of Activity</i>	<i>Monetary Transactions</i>		<i>Non-Monetary Transactions</i>	
<i>Illegal Activities</i>	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling and fraud.		Barter of drugs, stolen goods, smuggling, etc. Produce or growing drugs for own use. Theft for own use.	
	<i>Tax Evasion</i>	<i>Tax Avoidance</i>	<i>Tax Evasion</i>	<i>Tax Avoidance</i>
<i>Legal Activities</i>	Unreported income from self-employment; wages, salaries and assets from unreported work related to legal service and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

* The structure of the table is based on Lippert and Walker (1997, p. 5).

The Size of the Shadow Economies (Labor Force) in 22 Transition and 21 OECD Countries

22 Transition Countries

The physical input (electricity) method and the DYMIMIC method have been applied to the transition countries in Central and Eastern Europe, and to states of the former Soviet Union. The results are shown in table 2 and in figures 2.1 to 2.4; they cover the periods 1990-93, 1994-95 and 2000-2001. On the basis of the physical input method by Johnson et. al, out of the countries of the former Soviet Union over the period 1990-93 Georgia was found to have the largest shadow economy with 43.6 percent of "official" GDP, followed by Azerbaijan with 33.8 percent and Moldova 29.1 percent. Russia can be found in the middle with a shadow economy of 27 percent. According to Johnson et. al., Belarus with 14 percent and Uzbekistan with 10.3 percent have the lowest values. Except for Uzbekistan, all former Soviet Union republics experienced a strong increase in the shadow economy from an average of 25.7 percent for 1990-93 to 35.3 percent for 1994-95. Turning to the transition countries of Central and Eastern Europe for the period 1990-93 Johnson et. al. find that Hungary has the largest shadow economy with 30.7 percent of GDP, followed by Bulgaria with 26.3 percent. The lowest numbers are for the Czech Republic with 13.4 percent and Slovakia with 14.2 percent. The Johnson et. al figures show an average shadow economy of the Central and Eastern European states of 22.4 percent over 1990-93 and 25.1 percent for 1994-95. Using the DYMIMIC method for the 13 former Soviet Union republics, the average size of the informal economy is 32.9 percent, and for the 9 Central and Eastern European countries the average

percentage is 23.4 for 1990-1993. Both values are in a similar range as compared to the ones from the physical input method; most single country estimates come quite close to the estimates by Johnson et.al. (1997). In 2000-2001, Georgia has the largest shadow economy with 66.1 percent of the official GDP, followed by Azerbaijan with 60.1 percent and Ukraine with 51.2 percent. Uzbekistan has the lowest percentage of the shadow economy in the former Soviet Union with 33.4 percent of the official GDP, Kyrgyzstan with 39.4 percent and Latvia with 39.6 percent. On average, the shadow economy has reached the value of 44.8 percent of the official GDP for 2000-2001, which is a considerable increase as compared to the average for the years 1990-1993. If we turn now to Central and Eastern Europe using the DYMIMIC method, we see that in 2000-2001 Macedonia has the largest shadow economy with 45.1 percent of the official GDP, followed by Bulgaria with 36.4 percent and Romania with 33.4 percent. Slovakia and the Czech Republic have the lowest numbers, respectively 18.3 percent and 18.4 percent of the official GDP. The average size of the shadow economy in the 9 Central and Eastern European Transition Countries has increased from 23.4 percent for the years 1990-1993 to 29.2 percent in 2000-2001. With regard to the size of the shadow economy labor force as percentage of the population, we see that in the former Soviet Union republics Georgia has the largest shadow economy labor force with 53.2 percent, followed by Azerbaijan with 50.7 percent and Ukraine with 41.2 percent. Lithuania and Kyrgyzstan have the lowest numbers respectively with 20.3 percent and 29.4 percent. Turning to Central and Eastern Europe, the shadow economy labor force in the Czech Republic is the lowest at 12.6 percent, followed by Slovakia at 16.3 percent, while the largest is in Macedonia - 35.1 percent, followed by Bulgaria - 30.4 percent and Croatia - 27.4 percent. In general, the size of the shadow economy and also the size of the shadow-economy labor force is quite remarkable for the 22 transition countries – strangely, it has been on the rise up to 2000-2001.

21 OECD Countries

For the 21 OECD countries, the currency demand method or the DYMIMIC method are used to estimate the size of the shadow economy. The results for the period 1989-90 to 2000-2001 are shown in table 3 and figures 2.1 to 2.3. Considering again the latest year 2000-2001, Greece has the largest shadow economy with 28.5 percent of the official GDP, followed by Italy with 27.0 percent and Portugal with 22.5 percent. In the middle of the range we find Germany with a shadow economy of 16.3 percent, followed by Ireland with 15.7 percent and France with 15.0 percent. At the lower end we find Austria with 10.6 percent of the official GDP, Switzerland with 9.4 percent and the United States with 8.7 percent. In the OECD countries there was an increase of the shadow-economic activities in the 1990s - on average, these activities amounted to 13.2 percent in 1989-1990 and increased to 16.7 percent in 2001-2002, i.e. by 3.5 percentage points. We can also see that this increase is considerably smaller compared to the one

TABLE 2: THE SIZE OF THE SHADOW ECONOMY IN TRANSITION COUNTRIES

Transition Countries	Size of the Shadow Economy (in % of GDP) Shadow Economy			Labor Force in % of Working-Age* Population 1998-99	
	Physical Input (Electricity) Method		DYMIMIC Method		
	Using Values from Johnson et. al. (1997)	Average 1990-93			
	Average 1990-93	Average 1994-95	Average 1990-93	Average 2000-01	
<i>Former Soviet Union</i>					
1. Armenia	39.4	40.3	40.1	45.3	40.3
2. Azerbaijan	43.8	59.3	45.1	60.1	50.7
3. Belarus	34.0	39.1	35.6	47.1	40.9
4. Estonia	33.9	38.5	34.3	39.1	33.4
5. Georgia	43.6	63.0	45.1	66.1	53.2
6. Kazakhstan	32.2	34.2	31.9	42.2	33.6
7. Kyrgyzstan	34.1	37.2	35.2	39.4	29.4
8. Latvia	24.3	34.8	25.7	39.6	29.6
9. Lithuania	26.0	25.2	26.0	29.4	20.3
10. Moldavia	29.1	37.7	29.3	44.1	35.1
11. Russia	27.0	41.0	27.8	45.1	40.9
12. Ukraine	38.4	47.3	29.4	51.2	41.2
13. Uzbekistan	20.3	28.0	22.1	33.4	33.2
Unweighted Average: former Soviet Union republics	32.8	40.4	32.9	44.8	37.1
<i>Central and Eastern Europe</i>					
1. Bulgaria	26.3	32.7	27.1	36.4	30.4
2. Croatia	23.5	28.5	24.6	32.4	27.4
3. Czech Republic	13.4	14.5	13.1	18.4	12.6
4. Hungary	20.7	28.4	22.3	24.4	20.9
5. Macedonia	34.5	40.3	35.6	45.1	35.1
6. Poland	20.3	13.9	22.3	27.4	20.9
7. Romania	26.0	28.3	27.3	33.4	24.3
8. Slovakia	14.2	15.2	15.1	18.3	16.3
9. Slovenia	22.4	23.9	22.9	26.7	21.6
Unweighted Average: Central and East European Countries	22.4	25.1	23.4	29.2	23.3

* Working-age population means population between the age of 16 and 65.

Sources: Own calculations using the DYMIMIC method; values using the Physical input method come from Johnson, Kaufmann, and Shleifer (1997, table 1, p. 182-183), Johnson, Kaufmann, and Zoida-Lobaton (1998a, p. 351).

FIGURE 1.1: SHADOW ECONOMY LABOR FORCE IN PERCENTAGE OF (WORKING-AGE) POPULATION IN TRANSITION COUNTRIES – FORMER SOVIET UNION, 1998-1999

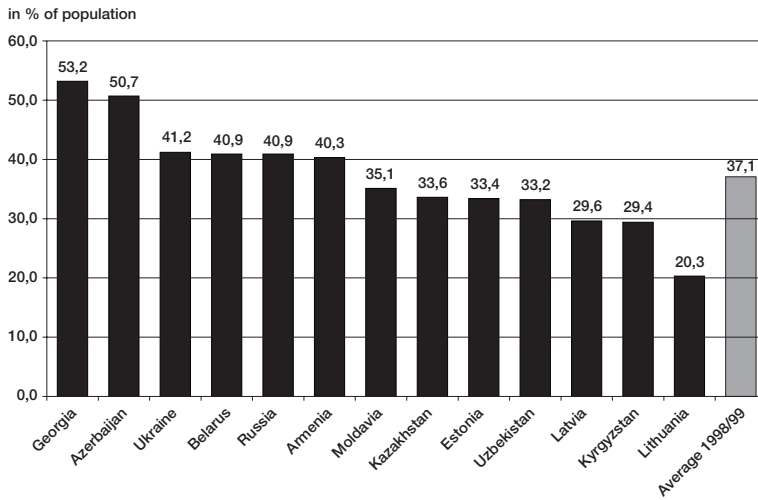


FIGURE 1.2: SHADOW ECONOMY LABOR FORCE IN PERCENTAGE OF (WORKING-AGE) POPULATION IN TRANSITION COUNTRIES – CENTRAL AND EASTERN EUROPE, 1998-1999

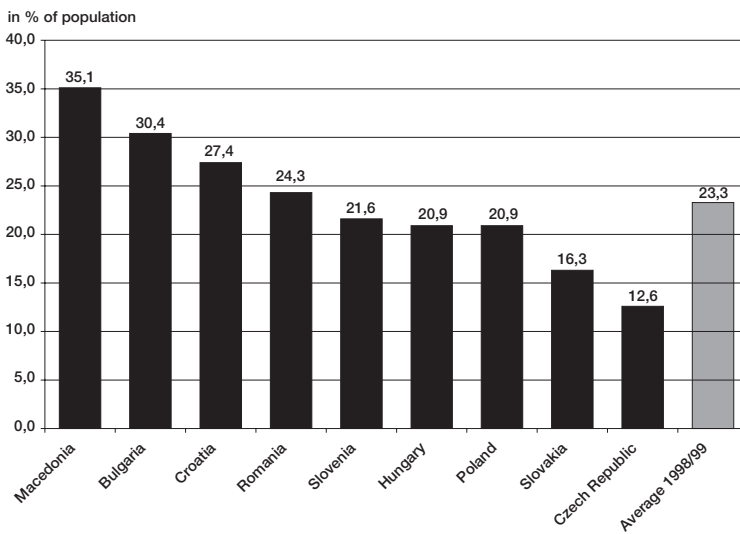


FIGURE 1.3: SIZE OF THE SHADOW ECONOMY (IN PERCENT OF GDP)
IN THE FORMER SOVIET UNION – AVERAGE 2000-2001

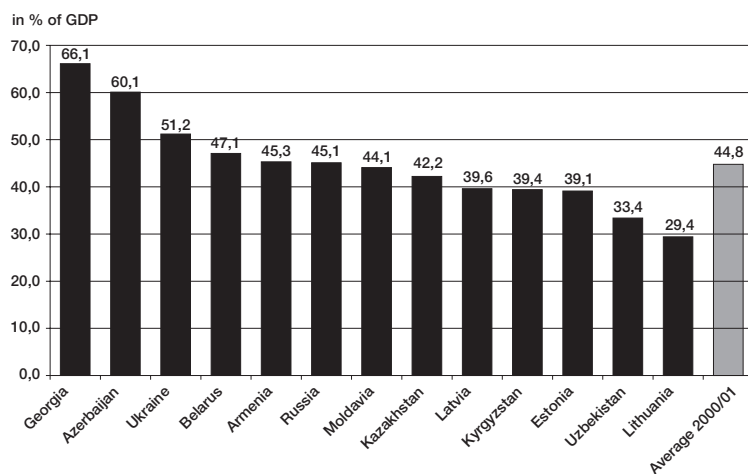
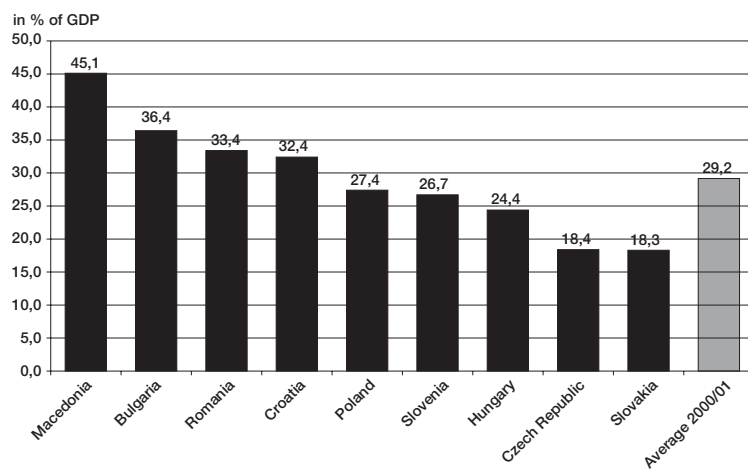


FIGURE 1.4: SIZE OF THE SHADOW ECONOMY (IN PERCENT OF GDP)
IN CENTRAL AND EASTERN EUROPE – AVERAGE 2000-2001



in the 22 transition countries, where it was 9.9 percentage points of the official GDP for the same period. If we consider the second half of the 1990s, we realize that for 14 out of the 21 OECD countries the shadow economy is not increasing any further – it is even slightly decreasing, for instance, in Belgium from 22.5 percent (1997-1998) to 22.0 percent (2001-2002), in Denmark from 18.3 percent (1997-1998) to 17.9 percent (2001-2002) or in Finland from 18.9 percent (1997-1998) to 18.0 percent (2001-2002). In 6 out of the 21 OECD countries, in New Zealand, for instance, it is still increasing from 11.9 percent (1997-1998) to 12.6 percent (2001-2002), or in Germany from 14.9 percent (1997-1998) to 16.3 percent (2001-2002) or in Austria from 9.0 percent (1997-1998) to 10.6 percent (2001-2002). Hence, one can draw the conclusion that for 14 out of 21 countries the shadow economy has been decreasing slightly at the end of the 1990s. The decrease differs from country to country but in some of them efforts have been made to stabilize (or to decrease) the size of the shadow economy although these efforts have not been successful everywhere, for instance, in Germany.

Having examined the size and the rise of the shadow economy in terms of value added over time, the analysis focuses further on the shadow labor market, as within the official labor market there is a particularly tight relationship and “social network” between people who are active in the shadow economy.⁵ Moreover, by definition every activity in the shadow economy involves a shadow labor market to some extent: hence, the shadow labor market includes all cases, in which the employees or the employers, or both, occupy a shadow economy position. Why do people work in the shadow economy? In the official labor market, the costs firms (and individuals) have to pay when “officially” hiring someone increase tremendously as a result of the tax burden and the social security contributions on wages as well as by the legal and administrative regulations for control of economic activities.⁶ In various OECD countries these costs are greater than the wages effectively earned by the worker, thus providing a strong incentive to work in the shadow economy. More detailed theoretical analysis on the labor supply in the underground economy is given by Lemieux, Fortin, and Fréchette (1994) who use micro-data from a survey conducted in Quebec City (Canada). Their study provides in particular some economic insight into the size of the distortion caused by taxation of income and the welfare system. The results of this study suggest that the hours worked in the shadow economy are quite responsive to changes in the net wage in the regular (official) sector. The empirical results attribute this to a (miss-)allocation of work from the official to the informal sector, in which it is not taxed. In this case, the substitution of labor-market activities between the two sectors is quite high. These empirical findings clearly indicate that “participation rates and hours worked in the underground sector also tend to be inversely related to the number of hours worked in the regular sector“ (Lemieux, Fortin, and Fréchette 1994, p. 235). The findings also

⁵ Pioneering work in this area has been done by L. Frey (1972, 1975, 1978, 1980), Cappiello (1986), Lubell (1991), Pozo (1996), Bartlett (1998) and Tanzi (1999).

⁶ This is especially true in Europe (e.g. in Germany and Austria), where the total tax and social security burden adds up to 100 percent on top of the wage effectively earned; see also section 5.1.

TABLE 3: SIZE OF THE SHADOW ECONOMY IN OECD COUNTRIES

OECD-Countries	Size of the Shadow Economy (in % of GDP) using the Currency Demand Method								Increase (+) or Decrease of the shad. econ. (-) from 1997-98 to 2001-02
	Average 1989-90	Average 1991-92	Average 1994-95	Average 1997-98	Average 1999-2000	Average 2001-02*			
1. Australia	10.1	13.0	13.5	14.0	14.3	14.1		+0.1	
2. Austria	6.9	7.1	8.6	9.0	9.8	10.6		+1.6	
3. Belgium	19.3	20.8	21.5	22.5	22.2	22.0		-0.5	
4. Canada	12.8	13.5	14.8	16.2	16.0	15.8		-0.4	
5. Denmark	10.8	15.0	17.8	18.3	18.0	17.9		-0.4	
6. Finland	13.4	16.1	18.2	18.9	18.1	18.0		-0.9	
7. France	9.0	13.8	14.5	14.9	15.2	15.0		+0.1	
8. Germany	11.8	12.5	13.5	14.9	16.0	16.3		+1.4	
9. Great Britain	9.6	11.2	12.5	13.0	12.7	12.5		-0.5	
10. Greece	22.6	24.9	28.6	29.0	28.7	28.5		-0.5	
11. Ireland	11.0	14.2	15.4	16.2	15.9	15.7		-0.5	
12. Italy	22.8	24.0	26.0	27.3	27.1	27.0		-0.3	
13. Japan	8.8	9.5	10.6	11.1	11.2	11.1		0.0	
14. Netherlands	11.9	12.7	13.7	13.5	13.1	13.0		-0.5	
15. New Zealand**	9.2	9.0	11.3	11.9	12.8	12.6		+0.7	
16. Norway	14.8	16.7	18.2	19.6	19.1	19.0		-0.6	
17. Portugal	15.9	17.2	22.1	23.1	22.7	22.5		-0.6	
18. Spain ***	16.1	17.3	22.4	23.1	22.7	22.5		-0.6	
19. Sweden	15.8	17.0	19.5	19.9	19.2	19.1		-0.8	
20. Switzerland	6.7	6.9	7.8	8.1	8.6	9.4		+1.3	
21. USA	6.7	8.2	8.8	8.9	8.7	8.7		-0.2	
Unweighted Average over 21 OECD countries	13.2	14.3	15.7	16.7	16.8	16.7		-0.1	

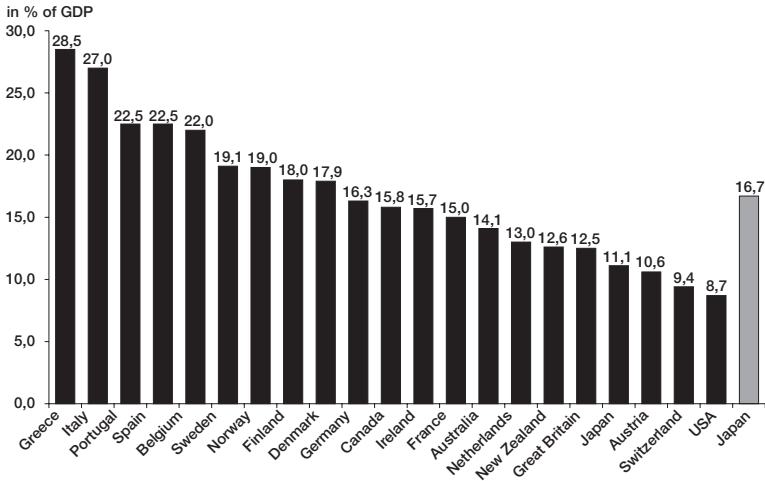
Sources: Currency demand approach, own calculations

* Preliminary values.

** The figures are calculated using the MIMIC-method and Currency demand approach. Source: Giles (1999b).

*** The figures have been calculated for 1989-90, 1990-93 and 1994-95 from Mauleon (1998), and for 1997-98, 1999-2000 and 2001-02 own calculations.

FIGURE 2.1: SIZE OF THE SHADOW ECONOMY IN 21 OECD COUNTRIES IN PERCENT OF GDP AVERAGE OVER 2001-02



Source: Own calculations.

FIGURE 2.2: INCREASE OF THE SIZE OF THE SHADOW ECONOMY IN 21 OECD COUNTRIES IN PERCENT OF GDP OVER 2001-02

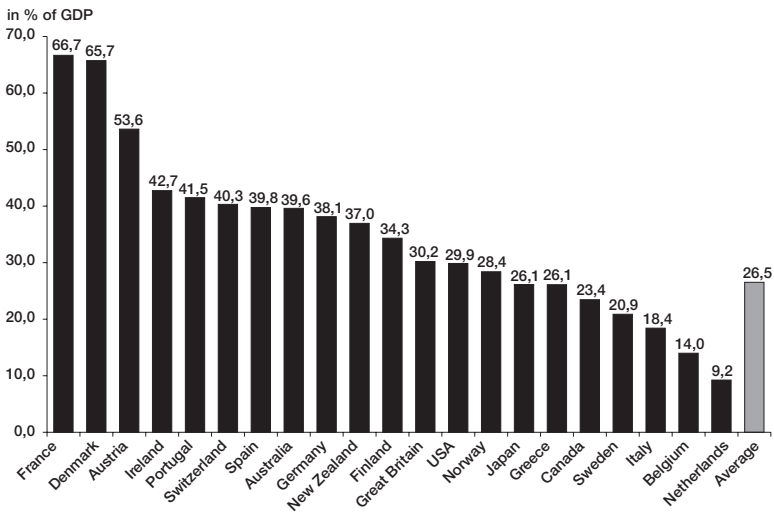
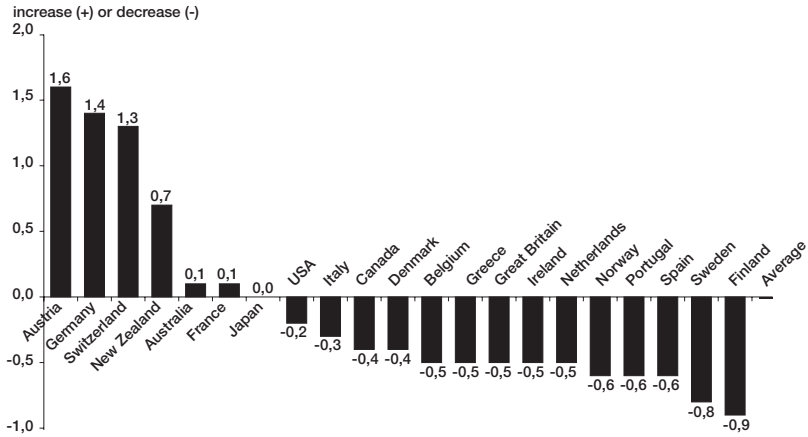


FIGURE 2.3: INCREASE (+) OR OF DECREASE (-) OF THE SHADOW ECONOMY IN 21 OECD COUNTRIES FROM 1997-98 TO 2001-02



Source: Own calculations.

demonstrate a large negative elasticity of the hours worked in the shadow economy with respect both to the wage rate in the regular sector and a high mobility between the sectors.

Illicit work can take many shapes. The underground use of labor may consist of a second job after (or even during) regular working hours. A second form is shadow-economy work by individuals who do not participate in the official labor market. A third component is the employment of people (e.g. clandestine or illegal immigrants), who are not allowed to work in the official economy. Empirical research on the shadow-economy labor market is even more difficult than that on the shadow-economy value added, since one has very little knowledge about how many hours an average “shadow economy worker” actually puts in (from full time to just a few hours); hence, it is not easy to provide empirical data.⁷

The estimates for the shadow economy labor force in 7 OECD countries (Austria, Denmark, France, Germany, Italy, Spain and Sweden) are shown in table 4. In Austria, the shadow economy labor force has reached 500,000 to 750,000 or 16 percent of the official labor force (mean value) in the years 1997-1998. In Denmark the course of events in the 1980s and 1990s shows that the part of the Danish population engaged in the shadow economy ranged from 8.3 percent of the total labor force in 1980 to 15.4 percent in 1994 – an increase of the shadow-economy labor force which is quite remarkable, i.e. it almost doubled over the period of 15 years. In France in 1997-1998

⁷ For developing countries there is some literature about the shadow labour market, e.g. the latest works by Dallago (1990), Pozo (1996), Loayza (1996), and especially by Chickering and Salahdine (1991).

the shadow economy labor force reached a size of between 6 and 12 percent of the official labor force or in absolute figures - between 1.4 and 3.2 million. In Germany, this figure rose from 8 to 12 percent in 1974 to 1982, and to 22 percent (18 million) in 1997-98. For France and Germany there is again a very strong increase in the shadow-economy labor force. In other countries, the amount of shadow economy labor is quite large too: in Italy - 30-48 percent (1997-98), in Spain - 11.5-32 percent (1997-98) and in Sweden - 19.8 percent (1997-98). In the European Union, about 30 million people were engaged in shadow economy activities in 1997-1998, while in all European OECD countries 48 million worked illicitly.

These figures demonstrate that the shadow-economy labor market is lively, and may provide an explanation why, for example, in Germany one can observe such a high and persistent unemployment. Table 4 offers a first and preliminary calculation of the official GNP per capita and the shadow economy GDP per capita (in US dollars). One can easily realize that in all countries under investigation, the shadow economy GDP per capita is much higher - around 40 percent on average in all countries.⁸ This clearly shows that the productivity in the shadow economy is quite likely to be considerably higher than in the official economy - a clear indication that the work effort, i.e. the incentive to work effectively, is stronger in the shadow economy. In general, these very preliminary results clearly demonstrate that the shadow-economy labor force has reached a remarkable size in the developed OECD countries too, even when the calculations might still have many errors, but the picture shows again that shadow-economy labor market has reached a sizeable figure.

Further Results for the German-Speaking Countries⁹

Table 5 presents the evolution of the shadow economy in Austria, Germany and Switzerland over time.

With regard to Germany, one can see that in the year 1975 the German shadow economy had a size of 5.75 percent of the official GDP, which rose to 16.49 percent in year 2002. In Austria in 1975 the shadow economy was 2.04 percent and increased to 10.69 percent in year 2002. A similar change took place in Switzerland where the shadow economy in 1975 was 3.2 percent and rose to 9.48 percent in 2002. In all three German-speaking countries, one can observe a strong growth of the shadow economy, but by far the strongest was in Germany, where it amounted to 350,4 billion EUR in 2002.

⁸ This is an astonishing result, which has to be further checked, because in the official per capita GDP figures the whole economy is included with mostly productive sectors (like electronics, steel, machinery, etc.) and the shadow-economy figures traditionally reflect mostly activities in the service sector as well as in construction. Hence, one could also expect exactly the opposite result as the productivity in the service sector is usually much lower than in the other sectors mentioned above. Sources of error may be either underestimation of the shadow-economy labor force or overestimation of the shadow economy in terms of value added.

⁹ This part closely follows Mummert and Schneider (2002).

TABLE 4: ESTIMATES OF THE SIZE OF THE SHADOW-ECONOMY LABOR FORCE AND OF THE OFFICIAL AND SHADOW-ECONOMY PRODUCTIVITY IN SOME OECD COUNTRIES, 1974-1998

Countries	Year	Official GDP per capita in US-\$*	Shadow Economy GDP in US-\$ per capita	Size of the Shadow Economy (in % of official GDP) Currency** Demand Approach**	Shadow- Economy Labor Force in 1000 people***	Shadow- Economy Participants in % of official Labor Force****	Sources of Shadow Economy Labour Force
Austria	1990-91	20,636	25,382	5.47	300-380	9.6	Schneider (1998) and own calculations
	1997-98	25,874	29,630	8.93	500-750	16.0	
Denmark	1980	13,233	18,658	8.6	250	8.3	Mogensen, et. al. (1995) and own calculations
	1986	18,496	26,356	9.8	390	13.0	
	1991	25,946	36,558	11.2	410	14.3	
	1994	34,441	48,562	17.6	420	15.4	
France	1975-82	12,539	17,542	6.9	800-1500	3.0-6.0	De Grazia (1983) and own calculations
	1997-98	24,363	34,379	14.9	1400-3200	6.0-12.0	
Germany	1974-82	11,940	17,911	10.6	3000-4000	8.0-12.0	De Grazia (1983), F. Schneider (1998b) and own calculations
	1997-98	26,080	39,634	14.7	7000-9000	19.0-23.0	De Grazia (1983), F. Schneider (1998b) and own calculations
Italy	1979	8,040	11,736	16.7	4000-7000	20.0-35.0	Gaetani and d'Aragona (1979) and own calculations
	1997-98	20,361	29,425	27.3	6600-11400	30.0-48.0	
Spain	1979-80	5,640	7,868	19.0	1250-3500	9.6-26.5	Ruesga (1984) and own calculations
	1997-98	13,791	19,927	23.1	1500-4200	11.5-32.3	
Sweden	1978	15,107	21,981	13.0	750	13.0-14.0	De Grazia (1983) and own calculations
	1997-98	25,685	37,331	19.8	1150	19.8	
European Union	1978	9,930	14,458	14.5	15 000	-	De Grazia (1983) and own calculations
	1997-98	22,179	32,226	19.6	30 000	-	
OECD (Europe)	1978	9,576	14,162	15.0	26 000	-	De Grazia (1983) and own calculations
	1997-98	22,880	33,176	20.2	48 000	-	

* Source: OECD, Paris, various years

** Source: Own calculations.

*** Estimated full-time jobs, including unregistered workers and illegal immigrants, and second jobs.

**** Percentage of the population aged 20-69, survey method.

TABLE 5: SIZE AND EVOLUTION OF THE SHADOW ECONOMY IN GERMANY, AUSTRIA AND SWITZERLAND IN 1975-2002*

Year	Size of the Shadow Economy (% of official GDP) Using the Currency Demand Approach					
	Germany		Austria		Switzerland	
	in %	bill. EUR	in %	bill. EUR	in %	bill. CHF
1975	5.75	29.6	2.04	0.9	3.20	12
1980	10.80	80.2	2.69	2.0	4.90	14
1985	11.20	102.3	3.92	3.9	4.60	17
1990	12.20	147.9	5.47	7.2	6.20	22
1995	13.90	241.1**	7.32	12.4	6.89	25
1996	14.50	257.6**	8.32	14.6	7.51	27
1997	15.00	274.7**	8.93	16.0	8.04	29
1998	14.80	280.7**	9.09	16.9	7.98	30
1999	15.51	301.8**	9.56	18.2	8.34	32
2000	16.03	322.3**	10.07	19.8	8.87	35
(2001)***	16.00	329.8**	10.52	21.1	9.28	37.5
(2002)***	16.49	350.4**	10.69	21.8	9.48	38.7

* Explanations: The size of the shadow economy can only roughly be compared among the three countries, as the currency demand equation is specified differently for the three countries and the independent "cause" variables (taxation regulation, for instance) are not the same in the three countries.

** From 1995 values for the United Germany.

*** Forecast, as official values are not available.

Source: Own calculations.

The figures presented above allow for the assumption of constantly rising shadow economic activities in Germany. Measurement results taken via microeconomic approaches point in the same direction; several estimates of the size of the shadow economic labor force in Europe also underline the (probably growing) relevance of shadow-economic activities within economic systems (De Grazia, 1983, Schneider and Enste, 2000b). In a survey conducted through telephone interviews by IFAK in March 1998 in Germany with a representative sample of 1.000, persons 22 percent of the respondents admitted that they indeed had been working in the shadow economy.¹⁰ Though microeconomic measurement approaches give information with respect to the overall size of shadow-economic activities, it is the detailed information on the different activities and on the people involved in particular that are of interest in the present context. Shadow-economic activities seem to form a natural part of market activities in Germany: in the IFAK-survey only 31.2 percent of the respondents thought that nearly none of their friends or acquaintances had at least once been buying goods or services in the shadow economy. At the same time, more than 60 percent assumed that from at least a quarter of their friends and acquaintances (23.1 percent) up to almost all (13.2 percent) had once or several times accepted an offer of black labor.

But who are the people offering black labor and what kind of labor is this? Most surveys point to the average supplier of black labor as holding a regular job in the official economy and thus being only part-time involved in shadow economic activities (Dallago, 1990; Lemieux, Fortin and Fréchette, 1994 and Mogensen et al., 1995). Around 60 percent of the suppliers of black labor in the IFAK survey worked in the official economy too. Still, it is generally assumed that, although most of the black labor is offered by people holding an official job, unemployed people students and social welfare recipients are to a greater extent involved in shadow-economic activities than regular job holders (see e.g., Lemieux, Fortin & Fréchette, 1994).

In congruence with other empirical results on shadow economies (e.g. Dallago, 1990) shadow-economic activities in Germany seem to be mostly concentrated in the areas of house construction, renovation, car repairs and servicing. Most of these services presuppose a certain income level. Correspondingly, the demand of black labor has its roots in the middle class rather than in low-income groups (see also Gretschmann, 1984, p. 115).

In addition to the empirical results presented so far, the already mentioned IFAK survey holds some interesting information on the shadow-economic activities in East and West Germany too. The representative sample includes the responses from 797 people in West Germany and 170 in East Germany, all aged 14 years and over. Only 12.9 percent of

¹⁰ The survey was undertaken in the name of B.A.C. Burda, Munich. I would like to thank Burda Press for their kind cooperation. Some of the empirical results of the IFAK study can be found in *Focus*, 1998. With only 26.3 percent of the households refusing to be interviewed, the response rate is rather good. This is really good in comparison with the non-response rate of other surveys - e.g., 48 percent in Canada (see Lemieux, Fortin and Fréchette, 1994), between 50 and 60 percent in the Netherlands and Denmark (see Mogensen et al., 1995, pp. 7-9). For a detailed discussion on quality matters, see Mummert and Schneider (2002).

the respondents living in the Eastern part of Germany admitted that they had been working in the shadow economy in contrast to 24.5 percent in West Germany (see table 6).

TABLE 6: SUPPLY OF SHADOW-ECONOMIC ACTIVITIES
"Honestly, have you ever done Schwarzarbeit?"

	<i>Western Germans</i>	<i>Eastern Germans</i>
Yes	24.5 %	12.9 %
No	73.5 %	85.3 %
No response	2.0 %	1.8 %

East-West differences statistically significant: 2-Tailed P 0.0023; Z -3.0515.

Source: IFAK, 1998, own calculations.

This significant difference with respect to the extent of black labour between West Germany and East Germany holds for the amount of purchases of goods and services in the shadow economy as well: being asked to assess how many people in their circle of acquaintances and friends have used at least once services in the shadow economy the respondents answered in the following ways (table 7):

TABLE 7: DEMAND FOR BLACK LABOUR IN THE CIRCLE OF ACQUAINTANCES AND FRIENDS
(PERCENTAGE)
"How many of your friends or acquaintances do you think have made use of Schwarzarbeit at least once?"

	<i>Western Germans</i>	<i>Eastern Germans</i>
<i>Almost none of them</i>	25.5 %	56.5 %
<i>About 1/4 of them</i>	23.2 %	21.8 %
<i>About half of them</i>	18.9 %	11.8 %
<i>About 3/4 of them</i>	10.2 %	2.4 %
<i>All or almost all</i>	15.7 %	2.9 %
<i>I do not know</i>	6.5 %;	4.7 %

East-West differences statistically significant: 2-Tailed P 0.0001; Z -7.2749.

Source: IFAK, 1998, own calculations.

More than 50 percent of the respondents in East Germany were sure that their acquaintances and friends had not purchased goods and services in the shadow economy compared to only 25 percent in the West. A similar contrast between the actions of people in East Germany and West Germany can be noted with regard to the involvement in shadow-economic activities. While 26 percent of the respondents in West Germany believed that from about three quarters up to nearly all of their acquaintances and friends had at least once bought goods and services in the shadow economy, only 5 percent in the East answered the same way. Again, looking at the

differences in the answers of East and West Germans, we see a statistical significance at the 0.01 level.

Interestingly, there also seems to be a lesser willingness of suppliers in the Eastern official economy to offer unreported services to their clients (table 8).

TABLE 8: UNSOLICITED OFFER OF BLACK LABOUR (PERCENTAGE)
 "Has anyone ever made you an unsolicited offer to provide you with a gray market service rather than a legal one?"

	<i>Western Germans</i>	<i>Eastern Germans</i>
Yes, once	9.5 %	12.4 %
Yes, repeatedly	32.7 %	12.4 %
No, never	56.0 %	74.7 %
No response	1.8 %	0.6 %

East-West differences statistically significant: 2-Tailed P 0.0015; Z -3.1655..

Source: IFAK, 1998, own calculations.

Especially with respect to the answer "Yes, repeatedly" there is a difference between the Western and the Eastern part of Germany because in the East only 12.4 percent have this experience as compared to 32.7 percent in the West.

In table 9 the shadow economy of the German states ("Länder") is presented¹¹. This has been done to provide further empirical evidence that the shadow economy in the former GDR (or "Neue Bundesländer") is lower than in West Germany (or in the "Alten Bundesländer"). Table 8 confirms that on average the East German "Bundesländer" have a smaller shadow economy as compared to the overall shadow economy in Germany and to the shadow economies of most West German lands. For example, for the year 1999 the shadow economy of East Berlin is 1.6 percent below the average level of the shadow economy, the one of Sachsen – 1.1 percent lower and the one of Thüringen – 1.5 percent lower. In general, these results show that the shadow economy in Germany is growing and that there are some differences between East and West Germany; they also show that the shadow economy in the East German "Länder" is smaller.

Main Causes for the Increase of the Shadow Economy

Increase of the Tax and Social Security Contribution Burden

In almost all studies,¹² it has been found out that the increase of the tax and social-security-contributions burden is one of the main causes for the increase of the shadow economy.

¹¹ The estimation method is explained in detail in Schneider (2001).

¹² See Thomas (1992), Lippert and Walker (1997), Schneider (1994a, 1994b, 1997, 1998, 2000), Johnson, Kaufmann, and Zoido-Lobaton (1998a, 1998b), Tanzi (1999) and Giles (1999a) to quote just a few recent ones.

German "Länder"	Size of the shadow economy in million EUR and in % of official GDP		Difference as compared to the size of the shadow economy in Germany as a whole (% of GDP) for 1999
	1995	1999	
Baden-Württemberg	31.064	37.777	- 2.15
Bayern	12,55	13,38	- 1.03
Berlin West	39.034	47.904	+ 6.20
Berlin Ost	13,47	14,5	- 1.61
Brandenburg	10.280	12.290	- 1.41
Bremen	17,99	21,73	+ 0.95
Hamburg	1.934	2.693	- 2.45
Hessen	10,1	13,92	- 1.33
Mecklenburg-Vorpommern	4.532	5.659	- 0.04
Niedersachsen	2.707	3.474	+ 2.83
Nordrhein-Westfalen	13,24	14,12	+ 1.03
Rheinland-Pfalz	2.707	3.474	+ 0.93
Sachsen	13,99	16,48	- 1.06
Sachsen-Anhalt	6.970	9.097	- 0.07
Schleswig-Holstein	10,45	13,08	+ 2.28
Thüringen	19.298	24.898	- 1.50
All countries together	11,74	14,2	0,0
	3.460	4.343	
	15,28	15,49	
	25,145	31,555	
	16,65	18,36	
	56,647	71,747	
	14,67	16,56	
	11,271	14,230	
	14,86	16,46	
	3,241	4,111	
	14,9	17,28	
	8,239	10,279	
	14,19	14,47	
	5,020	6,216	
	14,99	15,46	
	8,619	11,087	
	15,98	17,81	
	4,425	5,375	
	14,74	14,03	
	241,887	302,736	
	13,97	15,53	

Source: Schneider (2001).

Since taxes affect labor-leisure choices and also stimulate labor supply in the shadow economy, or the untaxed sector of the economy, the distortion of this choice is a major concern for economists. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings (from work), the greater the incentive to avoid this difference and to work in the shadow economy. As this difference depends broadly on the social security system and the overall tax burden, these are key features of the existence and the increase of the shadow economy. But even major tax reforms with tax rate reduction will not lead to a substantial decrease of the shadow economy. They will only be able to stabilize the size of the shadow economy and avoid a further increase. Social networks and personal relationships, the high profit from irregular activities and associated investments in real and human capital prevent people from transferring to the official economy. For Canada, for instance, Spiro (1993) expected similar reactions of people facing an increase in indirect taxes (VAT, GST). After the introduction of the GST in 1991 in the midst of a recession, individuals suffering from economic hardship because of the recession turned to the shadow economy, which led to a substantial loss in tax revenue. "Unfortunately, once this habit is developed, it is unlikely that it will be abandoned merely because economic growth resumes." (Spiro 1993, p. 255). They may not return to the formal sector, even in the long run. This fact makes it even more difficult for politicians to carry out major reforms because they may not gain a lot from them.¹³

In neoclassical models the most important factor is the marginal tax rate. The higher the marginal tax rate, the greater the substitution effect and the larger the distortion of the labor-leisure decision. Especially when taking into account that an individual can also receive income in the shadow economy, the substitution effect is definitely larger than the income effect¹⁴ and hence, this individual works less in the official sector. The overall efficiency of the economy is, therefore (*ceteris paribus*) lower and the distortion leads to a welfare loss (according to the official GNP and taxation.) Nevertheless, welfare might also be seen as increasing, if the welfare of those, who are working in the shadow economy, were taken into account too (Thomas, 1992, pp. 134-137).

Empirical results of the influence of the tax burden on the shadow economy is provided in the studies of Schneider (1994b, 2000) and Johnson, Kaufmann and Zoido-Lobaton (1998a, 1998b). All of these studies found strong evidence of the general influence of taxation on the shadow economy. This strong influence of indirect and direct taxation on the shadow economy will be further demonstrated by discussing empirical results in the case of Austria and the Scandinavian countries. For Austria the driving force for shadow-economic activities is the direct tax burden, including social

¹³ See Schneider (1994b, 1998b) for a similar result of the effects of a major tax reform in Austria on the shadow economy. Schneider shows that a major reduction in the direct tax burden did not lead to a major reduction in the shadow economy. Legal tax avoidance was abolished and other factors, like regulations, were not changed, hence, for a considerable part of the taxpayers the actual tax and regulation burden remained unchanged.

¹⁴ If leisure is assumed to be a normal good.

security payments - it has the strongest impact, followed by the intensity of regulation and complexity of the tax system. A similar result has been achieved by Schneider (1986) for the Scandinavian countries (Denmark, Norway and Sweden). In all three countries various tax variables, such as average direct tax rate, average total tax rate (indirect and direct tax rates), and marginal tax rates have the expected positive sign (on currency demand) and are highly statistically significant. Similar results are reached by Kirchgassner (1983, 1984) for Germany and by Kloveland (1984) for Norway and Sweden.

Several other recent studies provide further evidence of the influence of income tax rates on the shadow economy: Cebula (1997), using Feige's data for the shadow economy, found evidence of the impact of government income tax rates, IRS audit probabilities and IRS penalty policies on the relative size of the shadow economy in the United States. Cebula concludes that a restraint of any further increase of the top marginal income tax rate may, at least, not lead to a further increase of the shadow economy, while increased IRS audits and penalties might reduce the size of the shadow economy. His findings indicate that there is generally a strong influence of state activities on the size of the shadow economy - for example, if the marginal federal personal income tax rate increases by one percentage point, *ceteris paribus*, the shadow economy rises by 1.4 percentage points. In another investigation, Hill and Kabir (1996) found empirical evidence that marginal tax rates are more relevant than average tax rates and that substitution of direct taxes by indirect taxes seems unlikely to improve tax compliance. Further evidence of the effect of taxation on the shadow economy is presented by Johnson, Kaufmann, and Zoido-Lobaton (1998b), who come to the conclusion that it is not higher tax rates *per se* that increase the size of the shadow economy, but the ineffective and discretionary application of the tax system and the regulations by governments. Their finding that there is a *negative* correlation¹⁵ between the size of the unofficial economy and the *top* (marginal) tax rates might be unexpected. But since other factors like tax deductibility, tax reliefs, tax exemptions, the choice between different tax systems and various other options for legal tax avoidance were not taken into account, it is not all that surprising.¹⁶ At the same time, Johnson, Kaufmann and Zoido-Lobaton (1998b) find a *positive* correlation between the size of the shadow economy and the corporate tax burden. They come to the overall conclusion that there is a large difference between the impact of direct taxes that of the corporate tax burden. Institutional aspects, like the efficiency of the administration, the extent of control rights held by politicians and bureaucrats and the amount of bribery and especially corruption, therefore, play a major role in this "bargaining game" between the government and taxpayers.

¹⁵ The higher the top marginal tax rate, the lower the size of the shadow economy.

¹⁶ Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) found a similar result in a cross country analysis that higher tax rates are associated with less official activity as percent of GDP. They argue that entrepreneurs go underground not to avoid official taxes but to reduce the burden of bureaucracy and corruption. Nevertheless, looking at their empirical (regression) results the finding that higher tax rates are correlated with a lower share of the unofficial economy is not very robust and in most cases, using different tax rates, they do not find a statistically significant result.

Table 10 provides an illustration of the different sizes of the shadow economies of some of the 21 OECD countries by comparing the overall tax and social security contributions with the size of the shadow economy of the different countries for 1996.¹⁷

With the exception of Spain (shadow economy 22.9 percent, tax and social security burden 67.2 percent), Greece, Italy, Belgium and Sweden, which had the largest shadow economies in 1996, also had the highest tax and social security burden respectively 72.3, 72.9, 76.0 and 78.6 percent, whereas countries like Switzerland and U.S., which have the lowest overall tax and social security burden (39.7 and 41.4 percent), had the lowest shadow economies too with 7.5 and 8.8 percent. Of course, there are exceptions, like the United Kingdom and Austria, with quite high overall taxes and social security burden (54.9 and 70.4 percent) and a quite low shadow-economic activities (13.1 and 8.3 percent), but the overall picture seems to fit - the higher the overall social security and tax burden, the larger the shadow economy, *ceteris paribus*. The strong positive relationship between rising tax and social security contributions burden and a larger shadow economy is also demonstrated in figures 3.1 and 3.2.

If one calculates the correlation coefficient between the tax and social security contribution burden and the size of the shadow economy, the coefficient has a value of 0.61, which is clearly statistically significant.

Intensity of Regulations

The increase of the intensity of regulations, often measured by the numbers of laws and regulations, like license requirements, is another important factor, which reduces the freedom of choice for individuals engaged in the official economy.¹⁸ In this context one can think of labor-market regulations, trade barriers and labor restrictions for foreigners. Johnson, Kaufmann, and Zoido-Lobaton (1998b) find an overall significant empirical evidence of the influence of (labor) regulations on the shadow economy, the impact is clearly described and theoretically derived in other studies, e.g. for Germany (Deregulation Commission 1990-91). Regulations lead to a substantial increase of labor costs in the official economy. But since most of these costs can be shifted to the employees, they provide another incentive to work in the shadow economy, where they can be avoided. Empirical evidence supporting the model of Johnson, Kaufmann, and Shleifer (1997), which predicts, *inter alia*, that countries with more general regulation of their economies tend to have a higher share of the unofficial economy in total GDP, is found in their empirical analysis. A one-point increase of the regulation index

¹⁷ In almost all studies the rise of the tax and social security contributions burden is one of the most important causes for the increase of the shadow economy. See, for example, Frey and Pommerehne (1984), Lipert and Walker (1997), Schneider (1994a, 1994b, 1997, 2000), Thomas (1992, 1999), Tanzi (1999), Giles (1999a), and Schneider and Enste (2000).

¹⁸ For a socio-psychological theoretical foundation of this phenomenon, see Brehm (1966, 1972), and for a (first) application to the shadow economy - Pelzmann (1988).

TABLE 10: THE SIZE OF THE SHADOW ECONOMY AND THE BURDEN OF TAXES AND SOCIAL SECURITY CONTRIBUTIONS IN OECD COUNTRIES IN 1996

Country	Size of the shadow economy (% of GDP)	Value added tax rate (%)*	Average direct tax rate (%)**	Social security contributions by employees (%)	Social security contributions by employers (%)	Total social security contributions (% sum of (4)+(5))	Total social security contributions + direct tax burden: sum (4)+(5)+(3) (in %)	Total tax and social security burden: sum (2)+(3)+(4)+(5)
	1996 (1)	1996 (2)	1996 (3)	1996 (4)	1996 (5)	1996 (6)	1996 (7)	1996 (8)
Greece	28.5	18.0	11.0	15.8	27.5	43.3	54.3	72.3
Italy	27.0	19.0	12.0	9.9	32.0	41.9	53.9	72.9
Spain	22.9	16.0	13.0	6.6	31.6	38.2	51.2	67.2
Belgium	21.9	21.0	19.0	10.0	26.0	36.0	55.0	76.0
Sweden	19.2	25.0	20.0	4.0	29.6	33.6	53.6	78.6
Norway	18.9	23.0	19.0	7.0	12.8	19.8	38.8	61.8
Denmark	18.3	25.0	36.0	9.0	0.0	9.0	45.0	70.0
Ireland	15.9	21.0	20.0	7.2	12.3	19.5	39.5	60.5
Canada	14.6	7.0	21.0	7.0	8.0	15.0	36.0	43.0
Germany	14.5	15.0	18.0	16.1	16.1	32.2	50.2	65.2
France	14.3	20.6	6.0	13.0	31.0	44.0	50.0	70.6
Netherlands	14.0	17.5	10.0	31.0	8.8	39.8	49.8	67.3
U.K.	13.1	17.5	16.0	10.7	10.2	21.4	37.4	54.9
USA	8.8	3.0	17.0	7.6	13.8	21.4	38.4	41.4
Austria	8.3	20.0	8.0	18.2	24.2	42.4	50.4	70.4
Switzerland	7.5	6.5	10.0	11.6	11.6	23.2	33.2	39.7

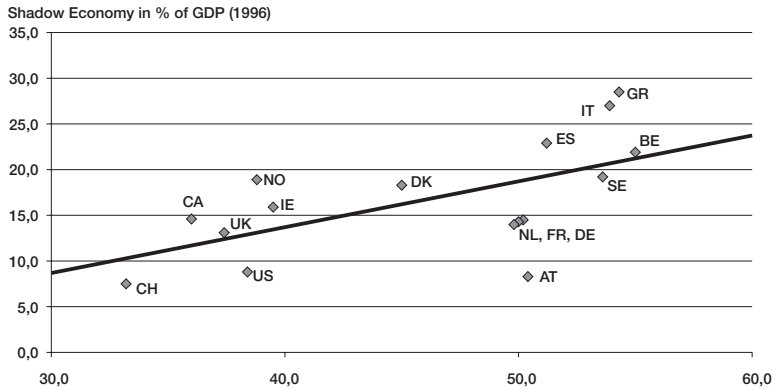
* Rates of year 1996; USA: Average sales tax

** Average direct tax rate is calculated as the sum of all income taxes (+ payroll and manpower taxes) paid on wages and salaries (including income of self-employed) divided by gross labor costs of an average income earner in the respective country.

*** The rate is calculated on the basis of the annual gross earnings of an average income earner in the respective country.

Source: Own calculations and OECD Working Paper 176, 1997.

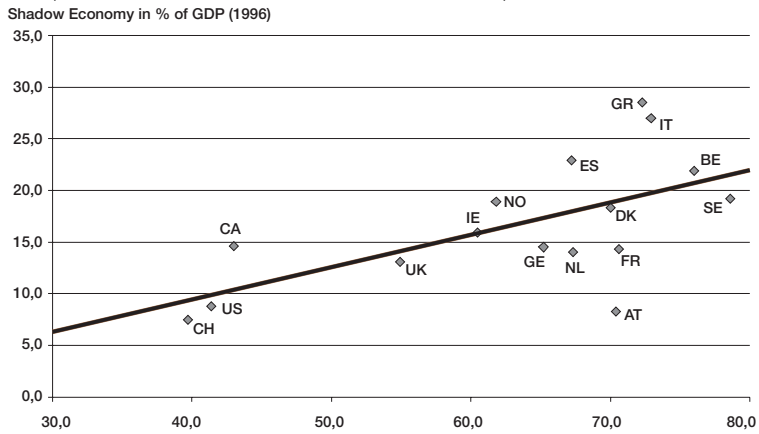
FIGURE 3.1: SIZE OF THE SHADOW ECONOMY VERSUS TOTAL SOCIAL SECURITY CONTRIBUTIONS + DIRECT TAX BURDEN*, YEAR 1996
(Correlation Coefficient with AT=0,61, without AT=0,72)



TOTAL SOCIAL SECURITY CONTRIBUTIONS + DIRECT TAX BURDEN IN %

* Sum of all income taxes paid on wages and salaries (income of self-employed) divided by gross labor costs of an average income earner

FIGURE 3.2: SIZE OF THE SHADOW ECONOMY VERSUS TOTAL TAX* AND SOCIAL SECURITY BURDEN, YEAR 1996
(Correlation Coefficient with AT=0,62, without AT=0,74)



TOTAL TAX* AND SOCIAL SECURITY BURDEN IN %

*Value added tax rate and average direct tax rate in %

(ranging from 1 to 5, with 5 = the most regulation in a country), *ceteris paribus*, is associated with an 8.1 percentage point increase in the share of the shadow economy when controlled for GDP per capita (Johnson et. al., 1998b, p. 18). They conclude that it is the enforcement of regulation, which is the key factor for the burden levied on firms and individuals, and not the overall extent of regulation - mostly not enforced - which drives firms into the shadow economy. Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) reach a similar conclusion. In their study every available measure of regulation is significantly correlated with the share of the unofficial economy and the sign of the relationship is unambiguous: more regulation is correlated with a larger shadow economy. A one point increase in an index of regulation (ranging from 1-5) is associated with a 10 percent increase in the shadow economy for 76 developing, transition and developed countries.

These findings demonstrate that governments should put more emphasis on improving enforcement of laws and regulations, rather than increasing their number. Some governments, however, prefer this policy option (more regulations and laws), when trying to reduce the shadow economy, mostly because it leads to an increase in the power of the bureaucrats and a higher rate of employment in the public sector.

Some Methods to Estimate the Size of the Shadow Economy¹⁹

As has already been mentioned in section 2, undertaking attempts to measure the size of a shadow economy is a difficult and challenging task. This section presents a short overview of the current knowledge of some procedures for estimating the shadow economy. Three different types of methods are most widely used for measuring the size and evolution of the shadow economy - they are briefly discussed in the following three subsections.

Direct Approaches

These are micro approaches, which employ either well designed surveys and samples based on voluntary replies or tax auditing and other compliance methods. Sample surveys designed for estimation of the shadow economy are widely used in a number of countries²⁰ to measure the shadow economy. The main disadvantage of this method is that it presents the flaws of all surveys: the average precision and results depend greatly on the respondents' willingness to cooperate. It is difficult to assess the rise of the

¹⁹ This section closely follows Schneider and Enste (2000), who give a more detailed critical analysis of all methods used to estimate the shadow economy.

²⁰ The direct method of voluntary sample surveys has been extensively used for Norway by Isachsen, Klovland and Strom (1982), and Isachsen and Strom (1985). For Denmark this method is used by Mogensen et al., (1995) in which they report "estimates" of the shadow economy of 2.7 percent of GDP for 1989, 4.2 percent of GDP for 1991, 3.0 percent of GDP for 1993 and 3.1 percent of GDP for 1994.

undeclared work from a direct questionnaire. Most people interviewed hesitate to confess a fraudulent behavior and the responses are rarely reliable, so that it is difficult from this type of answers to calculate a real estimate – in monetary terms – of the extent of the undeclared work. The main advantage of this method lies in the detailed information about the structure of the shadow economy, but the results from this kind of surveys are very sensitive to the way the questionnaire is formulated²¹.

Estimates of the shadow economy can also be based on the discrepancy between income declared for tax purposes and that measured by selective checks. Fiscal auditing programs have been particularly effective in this regard. Designed to measure the amount of undeclared taxable income, they have been used to calculate the shadow economy in several countries.²² A number of difficulties beset this approach. First, using tax compliance data is equivalent to using a (possibly biased) sample of the population. Nevertheless, since in general a selection of taxpayers for tax audit is not random, but based on the properties of submitted (tax) returns, which indicate a certain likelihood of (tax) fraud, such a sample is not a random one. This factor is likely to bias compliance-based estimates of the black economy. Second, estimates based on tax audits reflect the portion of black economy income that the authorities succeeded in discovering and this is likely to be only a fraction of the hidden income.

A further disadvantage of the two direct methods (surveys and tax auditing) is that they lead only to point estimates in time. Moreover, it is unlikely that they capture all “shadow” activities, so they can be seen as providing lower bound estimates. They are unable, at least at present, to provide estimates of the evolution and the growth of the shadow economy over a longer period of time. As already argued, they have, however, at least one considerable advantage - they can provide detailed information about shadow-economy activities and the structure and composition of those who work in the shadow economy.

Indirect Approaches

These approaches, also called “indicator” approaches, are mostly macroeconomic ones and use various economic and other indicators, which contain information about the evolution of shadow economy over time. Currently, there are five indicators, which leave some traces of the evolution of the shadow economy.²³

²¹ The advantages and disadvantages of this method are extensively dealt with by Mogensen et al. (1995) in their excellent and very carefully done investigation.

²² On the United States see, for instance, IRS (1979, 1983), Simon and Witte (1982), Witte (1987), Clotefelter (1983) and Feige (1986). For a more detailed discussion, see Dallago (1990) and Thomas (1992).

²³ Out of these five indicator approaches only two are discussed here; hence, the discrepancy between national expenditure and income method, the discrepancy between official and actual labor force, and the transactions approach are not presented; see Schneider and Enste (2000) for details.

The Currency Demand Approach

The currency demand approach was first used by Cagan (1958), who calculated a correlation of the currency demand and the tax pressure (as one cause of the shadow economy) for the United States over the period 1919 to 1955. 20 years later, Gutmann (1977) used the same approach, but did not apply any statistical procedures; instead he “only” looked at the ratio between currency and demand deposits over the years 1937 to 1976.

Cagan’s approach was further developed by Tanzi (1980, 1983), who econometrically estimated a currency demand function for the United States for the period 1929 to 1980 in order to estimate the size of the shadow economy. His approach assumes that shadow (or hidden) transactions are undertaken in the form of cash payments, so as to leave no observable trace for the authorities. An increase in the size of the shadow economy will, therefore, increase the demand for currency. To isolate this resulting “excess” demand for currency, an equation for currency demand is econometrically estimated over time. All possible conventional factors, such as the evolution of income, payment habits, interest rates, and so on, are controlled for. Additionally, variables, such as the direct and indirect tax burden, government regulation and the complexity of the tax system, which are assumed to be the major factors causing people to work in the shadow economy, are included in the estimation equation.²⁴

The “excess” increase in currency, which is the amount unexplained by the conventional or normal factors mentioned above, is then attributed to the rising tax burden and the other reasons leading people to work in the shadow economy. Figures for the size and evolution of the shadow economy can be calculated by firstly comparing the difference between the development of currency when the direct and indirect tax burden (and government regulations) are held at their lowest value, and the development of currency with the current (much higher) burden of taxation and government regulations. Assuming the same income velocity for currency used in the shadow economy as for legal M1 in the official economy, the size of the shadow economy can then be computed and compared to the official GDP.

- (i) The currency demand approach is one of the most commonly used approaches. It has been applied to many OECD countries (Schneider, 1997, 1998a; Johnson, Kaufmann and Zoido-Lobaton, 1998a; and Williams and Windebank, 1995) but has, nevertheless, been criticized on various grounds (Thomas, 1992, 1999; Feige, 1986 and Pozo, 1996). The most commonly raised objections to this method are:

²⁴ The estimation of such a currency demand equation has been criticized by Thomas (1999), but part of this criticism has been considered by the work of Giles (1999a, 1999b) and Bhattacharyya (1999), who both use the latest econometric techniques.

- (ii) Not all transactions in the shadow economy are paid in cash. Isachsen and Strom (1985) used the survey method to find out that in Norway, in 1980, roughly 80 percent of all transactions in the hidden sector were paid in cash. The size of the total shadow economy (including barter) may thus be even larger than previously estimated.
- (iii) Most studies consider only one particular factor – the tax burden as the cause of the shadow economy. But others (such as the impact of regulation, taxpayers' attitudes toward the state, "tax morality" and so on) are not considered, because reliable data for most countries is not available. If, as it seems likely, these other factors also have an impact on the extent of the hidden economy, it might again be higher than reported in most studies.²⁵
- (iv) A further weakness of this approach, at least when applied to the United States, is discussed by Garcia (1978), Park (1979), and Feige (1996), who point out that increases in currency demand deposits are due largely to a slowdown in demand deposits rather than to an increase in currency caused by activities in the shadow economy.
- (v) Blades (1982) and Feige (1986, 1996) criticize Tanzi's studies on the grounds that the US dollar is used as an international currency. Tanzi should have considered (and controlled for) the US dollars, which are used as an international currency and held in cash abroad.²⁶ Moreover, Frey and Pommerehne (1984) and Thomas (1986, 1992, 1999) claim that Tanzi's parameter estimates are not very stable.²⁷
- (vi) In most studies another weak point of this procedure is the assumption of the same velocity of money in both types of economies. As Hill and Kabir (1996) for Canada and Klovland (1984) for the Scandinavian countries argue, there is already a considerable uncertainty about the velocity of money in the official economy; the velocity of money in the hidden sector is even more difficult to estimate. Without knowledge about the velocity of currency in the shadow economy one has to accept the assumption of an "equal" money velocity in both sectors.

²⁵ One (weak) justification for the use of only the tax variable is that this variable has had by far the strongest impact on the size of the shadow economy in the studies known to the authors. The only exception is the study by Frey and Weck-Hannemann (1984), in which the variable "tax immorality" has a quantitatively larger and statistically stronger influence than the direct tax share in the model approach. In the study of Pommerehne and Schneider (1985) for the U.S., besides various tax measures, data for regulation and tax immorality, minimum wage rates are available and the tax variable has a dominating influence and contributes roughly 60-70 percent to the size of the shadow economy. See also Zilberfarb (1986).

²⁶ In another study by Tanzi (1982, esp. pp. 110-113) he explicitly deals with this criticism. A very careful investigation of the amount of US dollars used abroad and the US currency used in the shadow economy and to "classical" crime activities has been undertaken by Rogoff (1998), who concludes that large denomination bills are a major driving force for the growth of the shadow economy and classical crime activities due to reduced transactions costs.

²⁷ Nevertheless, in studies on European countries, Kirchgassner (1983, 1984) and Schneider (1986) reach the conclusion that the estimation results for Germany, Denmark, Norway and Sweden are quite robust when using the currency demand method. Hill and Kabir (1996) find that the rise of the shadow economy in Canada varies with respect to the tax variable used; they conclude that "when the theoretically best tax rates are selected and a range of plausible velocity values is used, this method estimates underground economic growth between 1964 and 1995 at between 3 and 11 percent of GDP." (Hill and Kabir, 1996, p. 1553).

Finally, the assumption of no shadow economy in a base year is open to criticism. Relaxing this assumption would again imply an upward adjustment of the figures attained in the bulk of the studies already undertaken.

The Physical Input (Electricity) Method

*(1) The Kaufmann - Kaliberda method*²⁸

To measure overall (official and unofficial) economic activity in an economy Kaufmann and Kaliberda (1996) assume that electric-power consumption is regarded as the single best physical indicator of the overall economic activity. Overall (official and unofficial) economic activity and electricity consumption have been empirically observed throughout the world to move in lockstep with an electricity-GDP elasticity usually close to one. By having a proxy measurement for the overall economy and subtracting it from estimates of official GDP, Kaufmann and Kaliberda derive an estimate of unofficial GDP. In other words, Kaufmann and Kaliberda suggest that the growth of total electricity consumption is an indicator for the growth of official and unofficial GDP. According to this approach the difference between the gross rate of registered (official) GDP and the cross rate of total electricity consumption can be attributed to the growth of the shadow economy. This method is very simple and appealing, however, it can also be criticized on a number of grounds:

- (i) Not all shadow economy activities require a considerable amount of electricity (e.g. personal services); other energy sources can also be used (gas, oil, coal, etc.), so that only a part of the shadow economy can be captured this way.
- (ii) Over time, there has been considerable technical progress. Both production and use of electricity are more efficient than in the past, which has implications for both official and unofficial use.
- (iii) There may be considerable differences or changes in the elasticity of electricity-GDP across countries and over time.²⁹

(2) The Lackò method

Lackò (1996, 1998 and 1999) assumes that a certain part of the shadow economy is associated with the household consumption of electricity. It comprises, among others, the so-called household production, do-it-yourself activities and other non-registered production and services. Lackò assumes that in countries, in which the section of the shadow economy associated with the household electricity consumption is high, the rest

²⁸ This method was used earlier by Lizzeri (1979), Del Boca and Forte (1982), and then much later by Portes (1996), Kaufmann and Kaliberda (1996), and Johnson, Kaufmann and Shleifer (1997). For a critique see Lackò (1996, 1997a, 1997b and 1998).

²⁹ Johnson, Kaufmann and Shleifer (1997) make an attempt to adjust for changes in the elasticity of electricity/GDP.

of the hidden economy, i.e. the part Lackò cannot measure, will also be high. Lackò (1996, pp.19 ff.) assumes that in each country a part of the household consumption of electricity is used in the shadow economy.

Lackò's approach (1998, p.133) can be described by the following two equations:

$$\ln E_i = \alpha_1 \ln C_i + \alpha_2 \ln PR_i + \alpha_3 G_i + \alpha_4 Q_i + \alpha_5 H_i + u_i \quad (1)$$

$$\text{with } \alpha_1 > 0, \alpha_2 < 0, \alpha_3 > 0, \alpha_4 < 0, \alpha_5 > 0$$

$$H_i = \beta_1 T_i + \beta_2 (S_i - T_i) + \beta_3 D_i \quad (2)$$

$$\text{with } \beta_1 > 0, \beta_2 < 0, \beta_3 > 0$$

where

i: the number assigned to the country.

E_i: per capita household electricity consumption in country *i* in Mtoe,

C_i: per capita real consumption of households without the consumption of electricity in country *i* in US dollars (at purchasing power parity),

PR_i: the real price of consumption of 1 kWh of residential electricity in US dollars (at purchasing power parity),

G_i: the relative frequency of months with the need of heating in houses in country *i*,

Q_i: the ratio of energy sources other than electricity energy to all energy sources in household energy consumption,

H_i: the per capita output of the hidden economy,

T_i: the ratio of the sum of paid personal income, corporate profit and taxes on goods and services to GDP,

S_i: the ratio of public social welfare expenditures to GDP, and

D_i: the sum of number of dependants over 14 years and of inactive earners, both per 100 active earners.

In a cross-country study she econometrically estimates equation (1) substituting H_i by equation (2). The econometric estimation results can then be used to establish an ordering of the countries with respect to electricity use in their shadow economies. For the calculation of the actual size (value added) of the shadow economy, Lackò should know how much GDP is produced by one unit of electricity in the shadow economy of each country. Since such data is not available she takes the result of one of the known shadow-economy estimations, carried out for a market economy for the early 1990s through another approach, and applies this proportion to the other countries. Lackò uses the shadow economy of the United States as such a base - the shadow economy value of 10.5 percent of GDP taken from Morris(1993); then she calculates the size of the shadow economy for other countries. Lackò's method is also open to the following criticism:

- (i) Not all shadow-economy activities require a considerable amount of electricity; in addition, other energy sources can be used;
- (ii) Shadow-economic activities do not take place only in the household sector;
- (iii) It is doubtful whether the ratio of social welfare expenditures can be used as an explanatory factor for the shadow economy, especially in transition and developing countries.

There are disagreements on indentifying the most reliable base value of the shadow economy for the calculation of the size of the shadow economy in all other countries, especially in transition and developing countries.

*The model approach*³⁰

All methods, designed to estimate the size and development of the shadow economy and described so far, consider just one indicator, which “must” capture all effects of the shadow economy. It is obvious, however, that its effects show up simultaneously in the production, labor and money markets. An even more important critique is that the causes, which determine the size of the hidden economy, are taken into account only in some of the monetary approach studies, which usually consider one cause - the burden of taxation. The model approach explicitly considers multiple causes leading to the existence and growth as well as the multiple effects of the shadow economy over time. The empirical method used here is quite different from those discussed so far. It is based on the statistical theory of unobserved variables, which takes into account multiple causes and multiple indicators of the phenomenon to be measured. For the estimation a factor-analytic approach is used to measure the hidden economy as an unobserved variable over time. The unknown coefficients are estimated in a set of structural equations, within which the “unobserved” variable cannot be measured directly. The DYMIMIC (dynamic multiple-indicators multiple-causes) model consists in general of two parts - the measurement model links the unobserved variables to observed indicators. The structural equations model specifies causal relationships among the unobserved variables. In this case, there is one unobserved variable - the size of the shadow economy. It is assumed to be influenced by a set of indicators for the shadow economy’s size, thus capturing the structural dependence of the shadow economy on variables that may be useful in predicting its movement and size in the future. The interaction over time between the causes Z_{it} ($i = 1, 2, \dots, k$), the size of the shadow economy X_t , and the indicators Y_{jt} ($j = 1, 2, \dots, p$) is shown in figure 4.

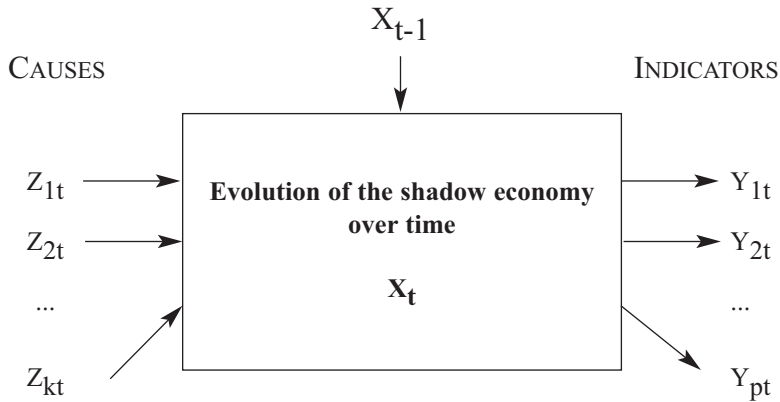
There is a large body of literature (Thomas, 1992; Schneider, 1994a, 1997; Pozo, 1996; Johnson, Kaufmann and Zoido-Lobaton, 1998a, 1998b; and Giles, 1999a, 1999b) on the possible causes and indicators of the shadow economy, in which the following three types of causes are distinguished:

Causes

- (i) The burden of direct and indirect taxation, both actual and perceived: a rising burden of taxation provides a strong incentive to work in the shadow economy.
- (ii) The burden of regulation as proxy for all other state activities: it is assumed that increases in the burden of regulation give a strong incentive to enter the shadow economy.

³⁰ This part is a summarized version of a longer study by Aigner, Schneider, and Ghosh (1988, p. 303), applying this approach for the United States over time. The pioneers of this approach are Weck (1983) and Frey and Weck-Hannemann (1984), who applied this approach to cross-section data from the 24 OECD countries for a number of years. Before turning to this approach, they developed the concept of “soft modeling” (Frey, Weck, and Pommerehne, 1982; Frey and Weck, 1983a and 1983b) – an approach, which has been used to provide a ranking of the relative size of the shadow economy in different countries.

FIGURE 4: EVOLUTION OF THE SHADOW ECONOMY OVER TIME.



- (iii) The “tax morality” (citizens’ attitudes toward the state), which describes the readiness of individuals (at least partly) to leave their official occupations and enter the shadow economy: it is assumed that a declining tax morality tends to increase the size of the shadow economy.³¹

Indicators

A change in the size of the shadow economy may be reflected in the following indicators:

- (i) Changes in monetary indicators: if activities in the shadow economy rise, additional monetary transactions are required.
- (ii) Changes in the labor market: increasing participation of workers in the hidden sector results in a decrease in participation in the official economy. Similarly, increased activities in the hidden sector may be expected to be reflected in shorter working hours in the official economy.
- (iii) Changes in the product market: an increase in the shadow economy means that inputs, especially labor, move out, at least partly, of the official economy; this displacement might have a depressing effect on the official growth rate of the economy.

³¹ When applying this approach to European countries, Frey and Weck-Hannemann (1984) had the difficulty in obtaining reliable data for the cause series, except for the ones of direct and indirect tax burden. Hence, their study was criticized by Helberger and Knepel (1988), who argue that the results were unstable with respect to changing variables in the model and over the years.

The latest use of the model approach has been undertaken by Giles (1999a, 1999b) and by Giles, Linsey and Gupsa (1999). They basically estimate a comprehensive (dynamic) DYMIMIC (multiple indicators and multiple causes) model to get a time series index of the hidden/measured output of New Zealand or Canada; then they estimate a separate “cash-demand model” to obtain a benchmark for converting this index into percentage units. Unlike earlier empirical studies of the hidden economy, they pay proper attention to the non-stationary and possible cointegration of time series data in both models. Again this DYMIMIC model treats hidden output as a latent variable and uses several (measurable) causal and indicator variables. The former include measures of the average and marginal tax rates, inflation, real income and the degree of regulation in the economy. The latter include changes in the (male) labor force participation rate and in the cash/money supply ratio. In their cash-demand equation they allow for different velocities of currency circulation in the hidden and recorded economies. Their cash-demand equation is not used as an input to determine the variation in the hidden economy over time – it is used only to obtain a long-run average value of hidden/measured output, so that the index for this ratio predicted by the DYMIMIC model can be used to calculate a level and the percentage units of the shadow economy. Giles’ latest combination of the currency demand and DYMIMIC approach clearly shows that some progress in the estimation technique of the shadow economy has been achieved and a number of weaknesses of the model have been overcome.

Summary and Conclusions

Although significant progress has been made, there are many obstacles to overcome in the process of measuring the size of the shadow economy (either in value added and/or in the labor force units) and analyzing its consequences on the official economy. This paper shows that, though it is difficult to estimate the size of the shadow economy, it is not impossible. It has been demonstrated that with various methods, e.g. the currency demand and the model approach, some insights can be provided into the size and evolution of the shadow economy (labor force) of 22 transition and 21 OECD countries. The general impression is that for all countries studied the shadow economy (labor force) has reached a remarkably large size. In 2000-2001 the shadow economy in terms of value added (labor force) was 38 percent (30.2 percent) on average in these transition countries and 16.7 percent (15.3 percent) of the official GDP in the OECD countries.

To summarize, it is worth getting back to the question what we really know. There is much evidence that the size of the shadow economies for the 22 transition and the 21 OECD countries has been growing over the decade of the 1990s. A similar conclusion can be made on the “shadow labor market“, which is attracting a growing attention, due to the high unemployment in European OECD countries. Furthermore, the results of this study show that an increasing burden of taxation and social security payments,

combined with rising state regulatory activities, represent the major driving force for the growth of the shadow economy. And a final conclusion: shadow economies are complex phenomena, largely observed even in the industrialized and the developed economies. People engage in shadow economic activities for a variety of reasons, the most important include government policies, most notably taxation and regulation. With these two insights, goes a third, no less important one: a government trying to decrease shadow economic activities has to first and foremost analyze the complex and frequently contradictory relationships among the consequences of its own policy decisions.

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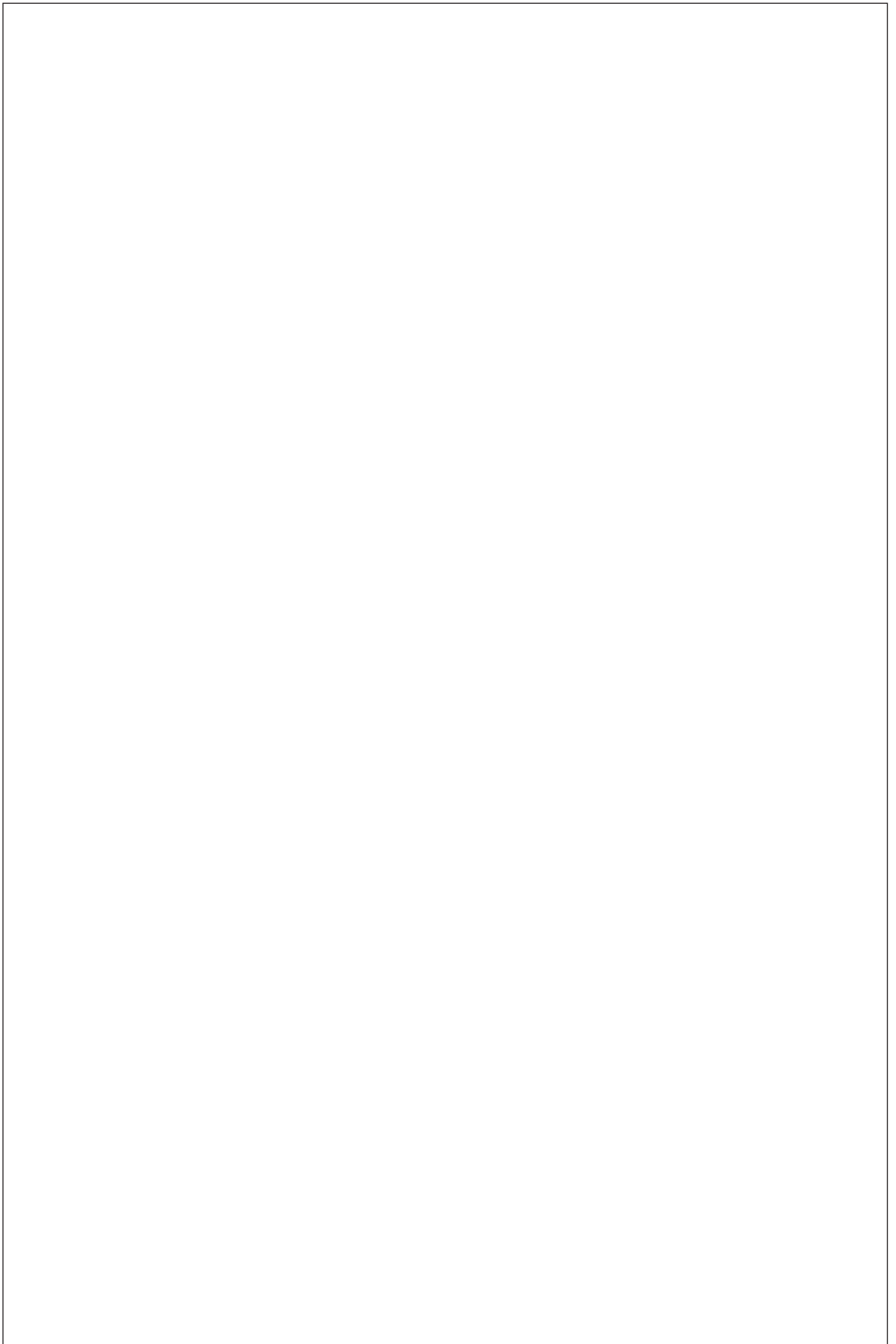
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CHAPTER 3

Going Informal: Benefits and Costs

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Introduction

All informal activity has one common feature: the entrepreneurs who operate in the informal economy perceive the benefits of doing so to outweigh the costs of going formal. Recent studies have identified a number of reasons why some business activity may take place in the shadows. The most important determinants are the prevalence of burdensome and costly government regulations (Johnson, Kaufmann, and Shleifer, 1997; Johnson, Kaufmann, McMillan, and Woodruff, 2000) and the level and administrative complexity of taxation (Enste and Schneider, 2000).

Informality comes at a cost: the inability to use government and some private sector services available to firms that fully comply with regulations. In countries where such services, for example, credit services by state-owned or private banks, infrastructure services, organization of trade fairs, training of employees and managers, etc, entrepreneurs may well choose to be formal, even if regulations are many and taxes are high. This explains why Belgium does not have a large informal sector, even though the tax burden on corporations is among the highest in the world. In contrast, entrepreneurs in countries where the quality of public services to businesses is poor have a much easier choice. In the absence of discernible benefits of going formal, they prefer to save their time and money and stay informal.

Many transition economies have experienced surging share of business activity in the informal sector.¹ Some of this activity is illegal (criminal), for example, arms trafficking. Such activity will not become formal, regardless of improvements in the business climate. Other activities, like mom-and-pop retail trade or small production units operate merely for the subsistence of their owners and do not generate enough revenue to make their inclusion in the tax base meaningful. However, there exists a considerable

¹ See Anderson (1998) for a summary of the evidence.

share of business activity that is semi-formal, e.g. the company is registered but most employees are not, and can become formal with appropriate policy changes. In this paper we cover only informal activity that takes place in urban areas. Informality in rural areas is not addressed, since it has a number of additional determinants, including the lack of labor mobility. Also, many rural activities do not use electricity, which is one of the main ways to measure informal output.

Table 1 presents the best available evidence on the size of the informal sector in transition economies. Informality is least prevalent in the Czech Republic and Slovakia, at less than 20 percent in terms of both GDP and employment shares. Azerbaijan and Georgia have the highest shares, with more than half of production and employment operating in the informal sector. Some fairly advanced reformers like Estonia and Lithuania still have more than a third of their economy being informal.

TABLE 1: SIZE OF THE INFORMAL ECONOMY IN TRANSITION
Share of GDP (in 2001) and Employment (in 1999)

<i>Country</i>	<i>Share of GDP</i>	<i>Share of Employment</i>
<i>Armenia</i>	<i>45.3</i>	<i>40.3</i>
<i>Azerbaijan</i>	<i>60.1</i>	<i>50.7</i>
<i>Belarus</i>	<i>47.1</i>	<i>40.9</i>
<i>Bulgaria</i>	<i>36.4</i>	<i>30.4</i>
<i>Croatia</i>	<i>32.4</i>	<i>27.4</i>
<i>Czech Republic</i>	<i>18.4</i>	<i>12.6</i>
<i>Estonia</i>	<i>39.1</i>	<i>33.4</i>
<i>Georgia</i>	<i>66.1</i>	<i>53.2</i>
<i>Hungary</i>	<i>24.4</i>	<i>20.9</i>
<i>Kazakhstan</i>	<i>42.2</i>	<i>33.6</i>
<i>Kyrgyzstan</i>	<i>39.4</i>	<i>29.4</i>
<i>Latvia</i>	<i>39.6</i>	<i>29.6</i>
<i>Lithuania</i>	<i>29.4</i>	<i>20.3</i>
<i>Macedonia</i>	<i>45.1</i>	<i>35.1</i>
<i>Moldavia</i>	<i>44.1</i>	<i>35.1</i>
<i>Poland</i>	<i>27.4</i>	<i>20.9</i>
<i>Romania</i>	<i>33.4</i>	<i>24.3</i>
<i>Russia</i>	<i>45.1</i>	<i>40.9</i>
<i>Serbia</i>	<i>34.5</i>	<i>34.6</i>
<i>Slovakia</i>	<i>18.3</i>	<i>16.3</i>
<i>Slovenia</i>	<i>26.7</i>	<i>21.6</i>
<i>Ukraine</i>	<i>51.2</i>	<i>41.2</i>
<i>Uzbekistan</i>	<i>33.4</i>	<i>33.2</i>

Working age population between the ages of 16 and 65.

Source: Report on Hidden Economy by Ekonomski Institut (1997).

Source: Schneider (2002).

This paper discusses the policy changes that are necessary for companies to go formal. We prioritize these changes using a cost-benefit analysis of informality. Entrepreneurs make choices based on their perceptions of what services they are foregoing by being informal and what they gain by avoiding various regulations and taxes. This trade-off can be influenced by increasing the benefits and reducing the costs of formal business activity. Both the government and firms stand to gain from moving to a new equilibrium of low level of informality.

Types of Informality

Informal businesses usually fall into three broad categories: underground enterprises, subsistence enterprises and unofficial enterprises. Underground enterprises comprise largely criminal activity and are out of the scope and focus of this paper. Subsistence enterprises result from ‘coping strategies’ adopted by families to compensate for low wages or external shocks (unemployment, etc.). Unofficial enterprises generally result from the desire to escape or avoid the administrative and/or financial burden of regulation (license and permit regimes, taxes, labor regulations, etc.).

Firms around the world lie on a spectrum of business activity, ranging from informal to formal. One crucial difference about informal sector enterprises in ECA compared to other parts of the world is the size of the businesses. In most parts of the world, certainly in OECD countries, informal sector enterprises are almost always small in terms of assets and employees, which allows them to remain relatively invisible to authorities. In the ECA region, however, unofficial enterprises can be medium or even large enterprises with sophisticated activities. This happens because an enterprise is able to keep activities “blended” i.e. part formal and part informal or unofficial (Kaufman and Kaliberda, 1996). A typology of the informal sector is presented in Table 2.

Businesses in the subsistence end of the informal sector spectrum hold little potential for “graduating” to the next levels. Business failure rates are high because of high localized competition and lack of information or access to other markets. Moreover, many of these enterprises are short-lived until the household finds other sources of income that enables it to recover or surpass its living standards.

Unofficial enterprises in the small and medium end of the informal sector whose owners and employees are highly educated and have sophisticated skills hold the greatest potential to ‘break through’ to the formal sector. This sub-sector is where there is a great deal of mixed activity, enterprises that may be formally registered, but some of their activities or employees are not officially reported. Improvements to the business and regulatory environment will provide incentives for these potentially dynamic enterprises to go formal.

TABLE 2: TYPOLOGY OF INFORMAL SECTOR ENTERPRISES

	<i>Informal sector</i>		<i>Formal</i>
	<i>Subsistence enterprises</i>	<i>Unofficial enterprises</i>	<i>Official enterprises</i>
<i>Degree of Informality</i>	100%	High Proportion of sales workers not registered	Some proportion of sales undeclared and workers unregistered.
<i>Type of activity</i>	Single street traders, cottage/micro enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers, software firms
<i>Technology</i>	Labor intensive	Mostly labor intensive	Knowledge and capital intensive
<i>Owner profile</i>	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills
<i>Markets</i>	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche
<i>Finance needs</i>	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit
<i>Other needs</i>	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services
	Least dynamic Completely informal		Highly dynamic Partially formal

The Benefits and Costs of Informality for Entrepreneurs

Benefits

The main benefit from staying informal is the avoidance of (some) taxes and burdensome government regulations. Regulations impose both a direct cost in terms of

fees or bribes to officials, and indirect costs measured in the entrepreneur's time spent on fulfilling various requirements and submitting documents. These costs differ enormously across countries. One example of regulations is business registration. In previous work (Djankov et al., 2002), we record the procedures related to obtaining all the necessary permits and licenses, and completing all the required inscriptions, verifications and notifications for the company to be legally in operation. When there are multiple ways to begin operating legally, we choose the fastest set of procedures available to the entrepreneur. In some countries, entrepreneurs may not bother to follow official procedures or bypass them by paying bribes or hiring the services of "facilitators". An entrepreneur in Georgia can start up a company after going through 13 procedures in 69 business days and paying \$375 in fees. Alternatively, he may hire a legal advisory firm that completes the start-up process for \$610 in 3 business days. In the analysis, we use the first set of numbers. We do so because we are primarily interested in understanding the structure of official regulation.

Regulations of start-up companies vary across regions within a country, across industries, and across firm sizes. For concreteness, we focus on a "standardized" firm, which has the following characteristics: it performs general industrial or commercial activities, it operates in the largest city (by population), it is exempt from industry-specific requirements (including environmental ones), it does not participate in foreign trade and does not trade in goods that are subject to excise taxes (e.g., liquor, tobacco, gas), it is a domestically-owned limited liability company, its capital is subscribed in cash (not in-kind contributions) and is the higher of (i) 10 times GNP per capita in 2001 or (ii) the minimum capital requirement for the particular type of business entity, it rents (i.e. does not own) land and business premises, it has between 5 and 50 employees one month after the commencement of operations all of whom are nationals, it has turnover of up to 10 times its start-up capital, and it does not qualify for investment incentives. Although different legal forms are used in different countries to set up the simplest firm, to make comparisons we need to look at the same form.

Our data almost surely underestimate the cost and complexity of entry. Start-up procedures in the provinces are often slower than in the capital. Industry-specific requirements add procedures. Foreign ownership frequently involves additional verifications and procedures. Contributions in kind often require assessment of value, a complex procedure that depends on the quality of property registries. Finally, purchasing land can be quite difficult and even impossible in some of the countries of the sample (for example, in Croatia).

We use three measures of entry regulation: the number of procedures that firms must go through, the official time required to complete the process and its official cost. We keep track of all the procedures required by law to start a business. A separate activity in the start-up process is a "procedure" only if it requires the entrepreneur to interact with outside entities: state and local government offices, lawyers, auditors, company seal manufacturers, notaries, etc. For example, all limited liability companies

need to hold an inaugural meeting of shareholders to formally adopt the Company Articles and Bylaws. Since this activity involves only the entrepreneurs, we do not count it as a procedure. Similarly, most companies hire a lawyer to draft their Articles of Association. However, we do not count that as a procedure unless the law requires that a lawyer be involved. In the same vein, we ignore procedures that the entrepreneur can avoid altogether (e.g. reserving exclusive rights over a proposed company name until registration is completed) or that can be performed after business commences. Finally, when obtaining a document requires several separate procedures involving different officials, we count each as a procedure. For example, a Bulgarian entrepreneur receives her registration certificate from the Company Registry in Sofia, and then has to pay the associated fee at an officially designated bank. Even though both activities are related to “obtaining the registration certificate,” they count as two separate procedures in the data.

To measure time, we collect information on the sequence in which procedures are to be completed and rely on official figures as to how many business days it takes to complete each procedure. We ignore the time spent to gather information, and assume that all procedures are known from the very beginning. We also assume that procedures are taken simultaneously whenever possible, for maximum efficiency. Since entrepreneurs may have trouble visiting several different institutions within the same day (especially if they come from out-of-town), we set the minimum time required to visit an institution to be one day.

We estimate the cost of entry regulation based on all identifiable official expenses: fees, costs of procedures and forms, photocopies, fiscal stamps, legal and notary charges, etc. All cost figures are official and do not include bribes, which can be significant. Setup fees often vary with the level of start-up capital. As indicated, we report the costs associated with starting to operate legally a firm with capital equivalent to the larger of (i) ten times per capita GNP in 2001 or (ii) the minimum capital requirement stipulated in the law.

Our basic cost estimates ignore the opportunity cost of the entrepreneur’s time and the foregone profits associated with bureaucratic delay. To address this concern, we calculate a “full cost” measure, which adds up the official expenses and an estimate of the value of the entrepreneur’s time, valuing his time at the country’s per capita income per working day.

The business registration procedures are divided by their function: screening (a residual category, which generally aims to keep out “unattractive” projects or entrepreneurs), health and safety, labor, taxes, and environment. The basic procedure in starting up a business, present everywhere, is registering with the Companies’ Registry. This can take more than one procedure; sometimes there is a “preliminary license” and a “final” license. Combined with that procedure, or as a separate procedure, is the check for uniqueness of the proposed company name. Add-on procedures comprise the requirements to notarize the Company Deeds, to open a bank account and deposit the

start-up capital, and to publish a notification of the company's establishment in an official or business paper. Additional screening procedures that include obtaining different certificates and filing with agencies other than the Registry may add up to 97 days in delays, as is the case in Madagascar. Another set of basic screening requirements, present in almost every country in the data set, covers certain mandatory municipal procedures, registrations with statistical offices and with Chambers of Commerce and Industry (or respective ministries). In the Dominican Republic, these procedures take 7 procedures and 14 days. There is large cross-country variation in terms of the number, time, and cost of screening procedures as the Company Registry performs many of these tasks automatically in the most efficient countries but the entrepreneur does much of the leg work in the less efficient ones. Additional procedures appear in four areas: tax-related procedures, labor regulations, health and safety regulations, and environmental regulations.

The data show enormous variation in entry regulation across countries. The total number of procedures ranges from 2 in Australia to 20 in Belarus and the Dominican Republic and averages 10.32 for the whole sample. Very few entry regulations cover tax and labor issues. Procedures involving environmental issues and safety and health matters are even more rare. Instead, much of what governments do to regulate entry falls into the category of screening procedures. The worldwide average number of such procedures facing a new entrant is 6.26.

Business registration is only one of the various regulations that companies need to comply with. Enterprise surveys indicate that it is seldom the most problematic one for businesses. Acquiring business licenses in specific industries, obtaining permissions to export, registering property as collateral are among the more burdensome processes that an entrepreneur needs to go through. In most countries around the world, the costs of these processes are so high that business can only operate informally.

Who gains from having high barriers to entry and operations imposed by various regulations? Economic theories of regulation differ in their predictions as to who gets the benefits. The public interest theory predicts that stricter regulation is associated with higher measured consumer welfare. In contrast, the public choice theory sees regulation as a tool to create rents for bureaucrats and/or incumbent firms. Stricter regulation should then be associated with higher corruption and less competition. We have addressed this question empirically in previous research and find that the countries with less limited, less democratic, and more interventionist governments regulate more heavily, even controlling for the level of economic development. This evidence is difficult to reconcile with public interest theories of regulation but supports the public choice approach that emphasizes rent extraction by politicians (McChesney, 1987; Shleifer and Vishny, 1993). Entry and operations of businesses are regulated more heavily by less democratic governments, and such regulation does not yield visible social benefits. The principal beneficiaries appear to be the politicians and bureaucrats themselves.

TABLE 3: NUMBER OF PROCEDURES, TIME AND COST FOR REGISTERING A NEW BUSINESS
(Time is presented in business days; cost as a share of GNP per person)

<i>Country</i>	<i>Procedures</i>	<i>Time</i>	<i>Cost</i>
<i>Albania</i>	11	55	64
<i>Armenia</i>	11	55	12
<i>Azerbaijan</i>	15	79	19
<i>Belarus</i>	20	105	16
<i>Bosnia</i>	12	54	54
<i>Bulgaria</i>	10	24	8
<i>Croatia</i>	13	39	17
<i>Czech Republic</i>	10	62	5
<i>Georgia</i>	12	48	39
<i>Hungary</i>	7	65	64
<i>Kazakhstan</i>	12	42	38
<i>Kyrgyz Republic</i>	9	22	14
<i>Latvia</i>	7	23	34
<i>Lithuania</i>	11	47	5
<i>Moldova</i>	11	31	32
<i>Poland</i>	11	58	23
<i>Romania</i>	11	133	30
<i>Russia</i>	18	48	6
<i>Serbia&Montenegro</i>	16	62	21
<i>Slovakia</i>	11	89	13
<i>Slovenia</i>	8	54	12
<i>Ukraine</i>	13	30	23
<i>Uzbekistan</i>	7	29	34

Source: World Bank (forthcoming).

Costs

Informality comes at a cost. First and foremost, informal enterprises need to stay small lest they become the target of government inspectors. Such firms are much more vulnerable to harassment by bureaucrats and are willing to pay higher bribes so that inspectors can look away. Surveys done by the World Bank estimate that informal firms in transition economies pay around 20 percent of their revenues to government officials in the form of bribes. Put differently, there is an implicit tax of 20 percent of revenues for being informal.

As stated earlier, this tax is still smaller than the taxes the entrepreneur would have to pay if they went formal. In addition to corporate income taxes, legitimate businesses also pay social security taxes, VAT or turnover taxes, public service taxes, insurance for

employees, etc. Hence, many entrepreneurs put up with harassment and continue informal operations.

While the cost of informality in terms of implicit taxes is high, the main problem comes from the uncertainty in the prospects of the enterprise. Informal enterprises are highly vulnerable, and can be closed at the whim of bureaucrats once they have been “located.” While a small business can in principle move and avoid excessive harassment, in practice people lack the resources to relocate. Also, often informal businesses depend on being known by word-of-mouth advertising. A move to new premises would disrupt the demand for their product.

In normal circumstance, a business would be able to file a complaint against a zealous inspector. Not so if the business is informal. The services of the courts or the police are only at the disposal of legally operating companies. In countries where the courts and the police are inefficient and corrupt anyway, there is really no recourse for entrepreneurs of any kind, formal or not. However, in countries with reasonably functioning law and justice systems, entrepreneurs have a lot to lose by operating informally. The obvious channels for enforcing contracts and defending their property rights against competitors and government bureaucrats are not available to them. This suggests that one of the most powerful ways, perhaps the most powerful, to reduce informality is to improve the functioning of law and justice.

Another consideration of being informal, and the one most relevant for employees in such enterprises, is the absence of a safety net. Employees are not covered by the insurance and pension systems that the government and/or formal enterprises offer. If the firm fails, so do the prospects of its employees. Household surveys indicate that employees are willing to forego a 40 percent cut in wages in order to move to formal enterprises. This should not be surprising: in the average developing country social security benefits account for over half of official salaries.

The costs of informality also include the inability to tap formal credit channels and more generally the various types of SME assistance programs available to the private sector. Much of the literature on the development of small firms puts the lack of access to financing as the main problem for new enterprises. More recent work, e.g., Johnson, McMillan, and Woodruff (2002), disputes these results and ascertains that the enforcement of property rights, i.e., the institutions discussed in the previous paragraph, are most important. Whether it be the number one or two factor, access to financing is key for the growth of businesses.

Many governments have recognized this need and have provided, with mixed results at best, vehicles for financing new and small firms. In all cases, a requirement is for the firm to be registered and to show certified financial statements for a given number of years. This precludes access by informal firms.

Instead, as shown in a number of empirical studies, informal sector businesses rely largely on informal sources (personal savings, family or friends, moneylenders, pawn shops and remittances from family members abroad) to obtain financial resources. While

the existence and ease of access to these sources provide a good reason to stay informal, the costs of borrowing from some of these sources can be high enough to raise operating costs significantly and threaten a business' financial viability. For example, moneylenders interest rates in many transition countries range from 5-10 percent a month. Finance from friends and family is unreliable, untimely and can bear significant non-financial costs.

Informal sector entrepreneurs often need to build their own (as well as their employees') human capital as their businesses grow. 'Breakthrough' businesses that are poised to grow from small to medium and beyond are in need of services that can help upgrade the owners' skills. These services include assistance with business planning, information about markets and resources, marketing strategies, and financial management. Yet these types of business development services are either prohibitively expensive or unavailable to informal sector businesses.

The Benefits and Costs of Informality for Governments

Governments often lament the increase in informal sector activity since it reduces the tax base. While true, this concern is exaggerated. Many of the businesses that operate informally, e.g. the mom-and-pop operations described earlier, would not be able to run officially since the additional costs outweigh profits. If forced into the formal economy, many firms will fold. Only through the introduction of a simpler tax regimes and less regulations will the tax base increase.

The real economic cost to governments is in the numerous programs that they implement to deal with poverty – from subsidized health care, to subsidized or free housing, large unemployment benefits, free training, etc. These programs target the very same strata of society that often operate in the informal economy and, for reasons already mentioned, are not adequately protected. Recent research, e.g. Glaeser and Gyourko (2002), suggests that governments may do well to shift their focus from subsidizing particular programs, such as basic housing, to creating an environment where businesses can grow and prosper.

The social cost can be large as well – people in the informal economy are the first to be hit by worsening economic conditions and also have little to lose from staging protests and demanding support by the government. History is replete with cases of governments that have failed to appreciate the dynamics of poverty. Many studies identify the poor as working in the informal economy. Perhaps the greatest contribution in this area is that of Hernando de Soto and his work on informality in Peru. The basic argument is that formal businesses depend on secure property rights which in turn stem from well-functioning institutions that define and enforce contracts. Entrepreneurs need the government to maintain such institutions, and would support any government that does so.

How to Go Formal?

Several changes need to take place in transition economies to improve the environment for operating a formal business. Here, we focus on four of them, although the reader can think of a number of additional areas where reform is necessary. The four areas we cover constitute, in our view, relatively painless reforms that would not meet strong political resistance and can be seen as win-win changes for government and business alike.

Reducing the number of business licenses, permits, approvals. There are many good reasons why governments regulate business activity. Those relate to ensuring the health and safety of employees and consumers; clean environment; standardization of products; fair disclosure, etc. At the same time, many countries have a multitude of regulations that are archaic and do not serve a useful purpose anymore. Also, government agencies or institutions often manage to impose regulations that benefit them at the expense of businesses and the rest of the government: by collecting fees to supplement their budgets or by creating additional responsibilities for their staff and thereby maintaining or increasing employment. Reviews and updates of existing regulations and a procedure for streamlining the regulatory burden are highly desirable, but extraordinarily difficult. The most dramatic regulatory reviews took place in leading transition countries (Czech Republic, Hungary, and Poland) undergoing fundamental transformation from central planning to market systems, and simultaneously integrating the 80,000 pages of the European *aquis communautaire* as part of EU accession. In Hungary, for example, 799 of the 983 existing laws were adopted after 1990. Substantial reviews of existing laws and other regulations have also been carried out in OECD countries, most notably Korea, Mexico, and Australia. Korea succeeded in eliminating 50 percent of its regulations in less than a year, while Mexico revised over 90 percent of its national legislation in about six years. Of these countries, though, only Australia designed and launched a national review of regulations without facing a substantial economic crisis.

Examples of successful multi-year generalized reviews can be found in Hungary, Australia, and Korea.² For lack of space, only the Hungarian experience is summarized here. The Hungarian government-wide regulatory review of 1995-1998 was coordinated by a central unit, the Government Commissioner, assisted by a small secretariat and advised by a Deregulation Council. The review was based on a three-year planned schedule of ministerial submissions and included subordinated regulations as well as laws. The revision was divided into two stages. The first 18 months concentrated on laws and regulations existing before 30 June 1990; the next 18 months focused on the review of regulations enacted after that date. An important element of the program was the preparation by the Ministry of Justice of a precise inventory of

² The section is based almost entirely on work by Scott Jacobs at the OECD.

existing laws and regulations. Based on this inventory, the Government Commissioner and the horizontal ministries presented a detailed schedule covering the whole three-year government's period. A submission process was designed which in theory included a RIA checklist. A special justification memorandum was requested for maintaining regulations enacted before 23 October 1989. The Government Commissioner could recommend that the government reject such regulations or could ask for further analysis. Last, the Ministry of Justice was charged with preparing a specific "deregulation instrument" to be issued by the government or presented to the Parliament listing unnecessary regulations abrogated.

In parallel to this item-by-item approach, the Hungarian government took a comprehensive approach to a few key policy areas vital to the proper functioning of democratic and market-oriented systems. For example, the civil code was reviewed in its entirety under the "deregulation of merit" process. Due to the size, complexity and impact of such codes or "codex", the revision was organized through working groups that worked for two or three years. The reviews consisted not only of amending and replacing whole sections but also of re-organizing texts which in some cases, like the Civil Code of 1959, had been reformed more than twenty times since 1990.

According to the government, the 1995-1998 review was more successful than earlier attempts. Clear timetables and program objectives, leading up to omnibus "deregulation measures," concentrated ministries' efforts and provided greater visibility and accountability to achievements. Mechanisms were used to boost the outreach of the program and implicate a wider public in the national effort. The Deregulation Council and the Government Commissioner commissioned from academics and researchers a series of studies on deregulation. To encourage public involvement in the program, they launched massive public campaigns to "turn deregulation into a national event", through hearings and consultation meetings at national and regional level. They arranged a national contest in the newspapers where nearly 400 proposals were presented. Prizes of up to 100,000 Forints rewarded useful ideas. "Deregulation days" were launched, with the participation of regulators, professional organisations, and citizens, where the best presentations and proposals were published in the "Deregulatory Forum" column of the "*Magyar Közigazgatás*" newspaper.

Another successful variant has been targeted reviews, which focus on particular sectors (*i.e.* building codes) or kinds of regulations (permits and licences, see following section on reducing formalities). In Italy, for example, independent reviews by the Antitrust Authority of general aspects of regulatory reform, such as reports about the use of licences and "concessions" restricting market access, have been useful in identifying where reform is needed, although persuading the ministries to actually reform is another matter entirely.

Failures abound. In Greece, for example, a recent regulatory review was conducted by the Ministry of the National Economy. This program, begun in 1999, systematically reviewed all regulations made over the last five years within the ministry. The assessment

involved the establishment of a regulatory reform group, composed of senior officers from divisions within the ministry, who prepared the first inventory of regulations including legislation, presidential and ministerial decisions. The review concluded that all legislation, presidential decrees, and ministerial decisions within the Ministry were effective and necessary. This included the 54 ministerial orders that govern the financial sector (these make up more than half the ministerial orders for the Ministry) and the 23 ministerial orders that governed capital markets. The only negative conclusion was that more could have been done to ensure the success of the one-stop-shop investment promotion agency. The review lacked an independent and rigorous assessment of the impact of regulations, the key information needed to test regulatory quality, and instead began with qualitative statements about what the laws require. Without independent input, self-assessment rarely yields critical conclusions, which supports the argument that regulatory reform should be coordinated by a central agency or at arms-length of the ministries being reviewed. A review of business licenses is currently ongoing in Bulgaria. This process, like the one in Greece, also lacks transparency and does not sufficiently involve the business community in the discussions. Not surprisingly, of the 512 licensing regimes discussed prior to April 8, 2002 only 63 were slated for removal and 81 were revised.

Streamlining the administrative process. Once the business licensing regime is reviewed and updated, some thought needs to be put into the administrative process that accompanies the obtaining of such licenses. In most developing countries around the world, and certainly in the majority of transition economies, the process that an entrepreneur needs to go through to get a license borders on harassment. This is the case in a country like Belarus, where an entrepreneur must simultaneously receive a license, a permit, and a letter of accreditation to open up a shoe repair shop (these are alongside the 20 regular steps for opening up any type of business). In several transition economies, the company registry is kept at the Ministry or Department of Statistics, while the Trade Registry is kept at the local courts. Essentially, the same procedure is repeated twice, with a loss of significant time. In Bulgaria, the overall procedure for registering a new firm takes about a month, of which three weeks are taken by waiting for the court clerk to process the Trade Registry number. Such procedures are duplicative and should be streamlined.

The administrative process can be significantly improved if the latest internet-based technologies are utilized. Many of the face-to-face interactions between government officials and entrepreneurs would be rendered unnecessary if applications can be processed electronically. Many countries have moved in this direction. The most successful reformers include Australia, New Zealand, Singapore, Norway and Sweden. Many developing countries have introduced electronic processing for at least some interactions between regulators and businesses. Examples include filling in electronic tax forms in Bulgaria and Slovenia. Much remains to be done.

The availability of internet technology also allows the government to provide detailed information on all the necessary requirements to formalize different types of business activity. This can be a huge impetus to reducing discretionary behavior on the

part of bureaucrats and to giving entrepreneurs, and more generally consumers of public services, a stronger position as they demand timely and high-quality services. Various firm-level surveys in transition and developing countries show that knowing the precise requirements and also having the government officials know you know how the administrative process is supposed to work speeds up public service delivery considerably, without reducing quality. In short, information cuts slack in the bureaucracy, as well as reduces the possibility to extract bribes.

Adopting uniform taxes. High levels of taxes and burdensome tax administration have been mentioned earlier as important determinants of the decision to stay in the informal economy. A number of countries have experimented with reforms in their tax laws and the organization of tax collection. The prevailing experience suggests that a move towards a unified corporate tax rate, set at a reasonable level, does away with much of the costs involved in filing separate tax declarations with separate agencies or separate parts of the Tax Office. Interestingly, and this is shown across transition economies as well, a unified corporate tax, even if set below the prevailing average corporate tax burden, increases tax collection. This is for two reasons: the tax base is increased, as firms at the margin of the unofficial economy see their benefits of formality increase; and current tax-payers become more compliant, as it is easier for the tax inspector to spot under-reporting.

Enhancing access to capital. As mentioned earlier, because banks in the region have provided few financial services to even formal SMEs and for most part have generally ignored micro and informal SMEs, microfinance institutions (MFIs) have emerged as a source of financing for these enterprises. MFIs use specific methods that are tailored to meet the needs of these micro and small entrepreneurs such as using non-secured and unconventional collateral, “graduated lending” techniques (very small initial loans that can be increased gradually based on the client’s repayment history), quick response (time between loan application and loan approval is 2-5 days), easy access, and labor-intensive loan screening and collection procedures.

For transition economies, the average outstanding balance for MFIs ranges between US \$600 – \$5,000 indicating that these clients are small businesses. But these small numbers add up. For example, the loan portfolio of Bosnia’s leading microfinance bank MEB BiH is nearly US \$15 million while that of Poland’s Fundusz Micro is about US \$9 million.

A recent survey of the microfinance sector in the ECA region reveals that it is a fast-growing industry. Institutions providing microfinance services are less than 10 years old, with a number of specialized institutions operating for only 3-5 years (Forster and Pytkowska, 2002). Preliminary data suggests that MFI clients are growing by about 30 percent a year. This kind of dramatic growth in clientele with corresponding growth in loan portfolio and savings deposits is evidence that there is strong demand for microfinance products. Moreover, people are willing and able to pay relatively high prices (around 2-3 percent a month) to have access to these services.

Traditionally MFIs serve both the formal and informal sector businesses, thus in a sense serving as a bridge between the two. To allow for the healthy development of this sector, policymakers should focus on three key areas:

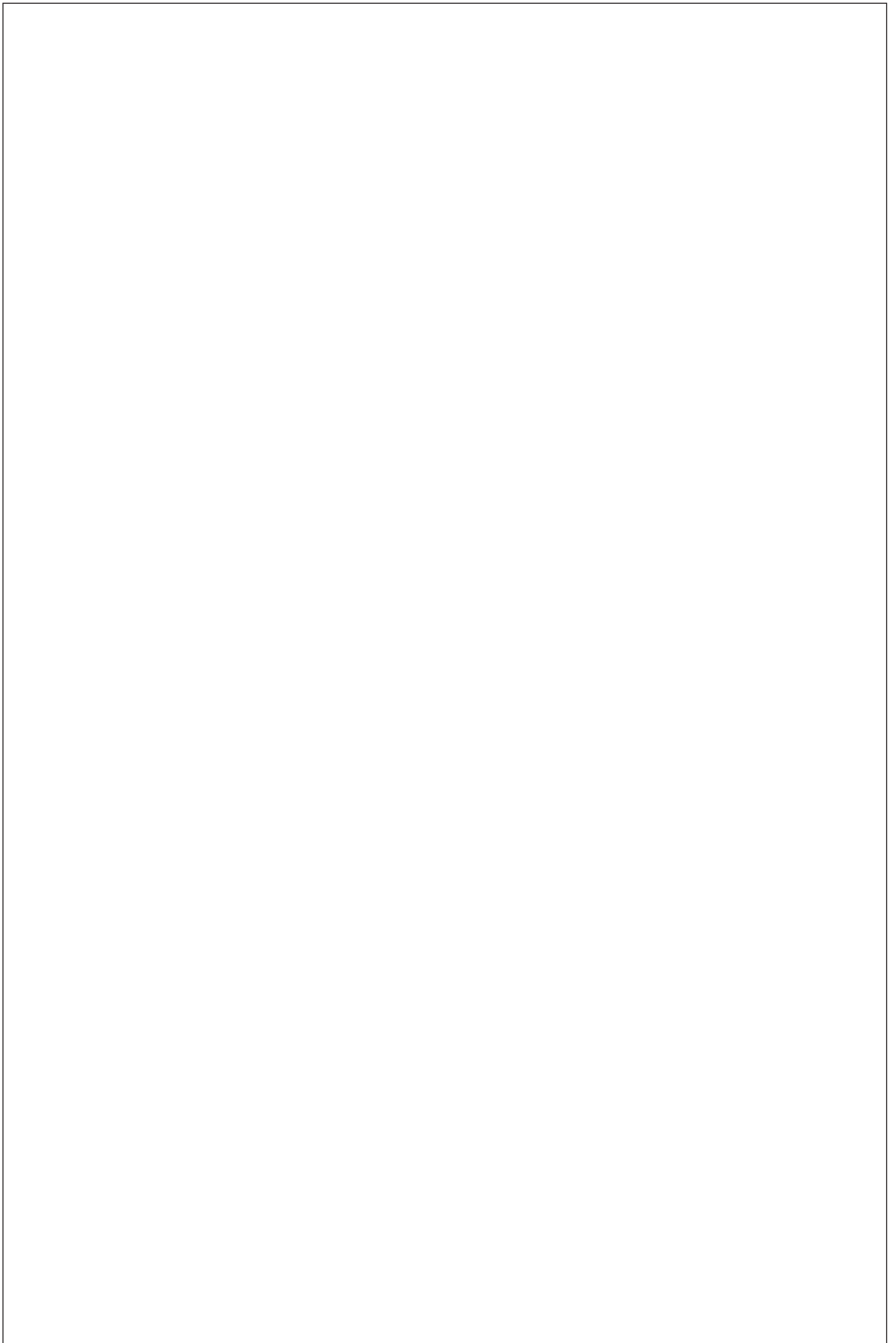
- (i) Ease operating constraints on existing MFIs. As mentioned earlier, MFIs use non-traditional methods to provide services to their clients in a commercially sustainable and competent manner. To encourage non-bank financial intermediaries to provide existing microfinance services and experiment with new products, policymakers should address key elements in the legal environment that constrain the operations of MFIs in the region, such as:
 - Allowing for a range of institutions under various legal forms to provide financial services;
 - Clearing up ambiguities related to the legal status of some non-bank financial intermediaries, such as NGO-MFIs;
 - Easing restrictions on activity and ownership of existing MFIs that may or may not require 'heavy' governance and internal reporting structures;
 - Lowering minimum capitalization requirements depending on type of MFI (bank or non-bank financial intermediary) and services it provides (non-deposit taking MFI versus deposit-taking MFI).
- (ii) Examine and change existing banking regulations to encourage small firms' lending. The formal private sector has been starved for capital. Greater access to financial services will provide a powerful incentive for high dynamic informal firms to enter the formal sector. Yet formal financial institutions are often legally restricted by prudential norms, or absence of, enforcement mechanisms to lend to small firms. To encourage banks to provide financing, current regulations governing these institutions may need some changes, such as:
 - Strengthening debt collection laws and enforcement mechanisms;
 - Changing collateral laws to recognize non-traditional collateral or accept personal guarantees;
 - Raising limits on unsecured lending. Typically, these limits are too low to enable banks to undertake non-collateralized lending;
 - Improving property registration so that borrowers can use their land or house as collateral;
 - Revising leasing legislation so that financial institutions can more effectively use this service;
 - Lifting interest rate ceilings. Because the administrative costs of smaller loans and the risk of lending to clients without established credit history are higher, banks must be allowed to charge higher rates of interest to small firms to provide them with services in a commercially sustainable manner;
 - Establishing small claims courts that will enable financial institutions to easily enforce a loan contract by seizing and liquidating assets offered as collateral.

- (iii) Avoid state-sponsored financial intermediation. In transition economies and other parts of the world, government-backed efforts to provide financial and other services to small firms and informal sector enterprises have typically failed. Most of these efforts are distortionary, require huge levels of subsidy, and fail to reach the target audience. Rather than being a provider, the state should play the role of an ‘enabler’ that allows for private sector institutions meet these needs in a commercially sustainable manner.

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CHAPTER 4

Shadow Economy and Institutional Change in Transition Countries

Dominik H. Enste

The Shadow Economy – A Challenge for Economic and Social Policy

The causes, effects and problems generated by increasing shadow-economic activities are extensively and controversially discussed in OECD and transition countries. Attention is drawn to the shadow economy due to the dramatically rising unemployment (e.g. in the EU), and the financing problems of public expenditure, as well as the rising vexation and disappointment with economic and social policies. Broad initiatives on behalf of the EU Commission and the EU Parliament as well as initiatives at national level show that politicians eventually felt the need to act (EU Commission, 1998 and EU Parliament, 2000).

But they face a dilemma. While the fact that the wealthy are evading taxes leads to widespread public indignation, illicit workers are often much less criticised, although, as some politicians argue, they are behaving anti-socially and represent a source of growing unemployment and social injustice. This opinion is broadly shared with regard to social fraud, illegal employment and extensive tax evasion. But what about part time illicit work in the evening (“moonlighting”), which roughly half of the population of Germany would tolerate, or even take advantage of, if these people had the opportunity to make use of it (Enste, 2001a, pp.158f; 2002)? Can more sanctions and control combined with more regulation become the ultimate solution to combat illicit work, or what is the right way to deal with undeclared work?

In popular scientific media and daily newspapers, the discussion about the nature of the shadow economy fluctuates between two extremes: the shadow economy is either

blamed for many problems of the economy, such as unemployment, high public debt and recession, or it is regarded as a legitimate free space in an economic system characterized by high taxes and excessive regulation. In social science, articles and papers dealing with the shadow economy often focus only on a single aspect, mostly the difficulties and challenges to measure its size. In addition, the basis of the analysis of the causes and consequences of the increasing shadow economy is often quite narrow and does not take into account the results and insights of the work of other social sciences. Therefore, a comprehensive overview and scientific analysis of this complex phenomenon is necessary.¹

Research on the shadow economy focuses on three of its major aspects, which will be analyzed in more detail here:²

- a) In *economic and social policy*, the driving force in dealing with illicit work is the fact that these illegal and semi-legal activities are undesirable to official institutions. A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the “exit option” rather than the “voice option”. If the increase of the shadow economy is caused by a rise in the overall tax and social security burden together with “institutional sclerosis” (Olson, 1985), then the “consecutive flight” into the underground may erode the tax and social security bases. The result can be a vicious circle of additional increase of budget deficit or tax rates, further growth of the shadow economy and gradual weakening of the economic and social fundament of collective arrangements.

In addition, the effects of the shadow economy on the official one should also be taken into consideration because illicit work can be a source of allocation distortions, since resources and production factors are not used in the most efficient way. On the one hand, a growing shadow economy may attract (domestic and foreign) workers away from the official labour market and create competition for official firms. On the other hand, at least two-thirds of the income earned in the shadow economy is spent in the official economy, thereby having a positive and stimulating effect on the official economy.³

Furthermore, a prospering shadow economy may cause severe difficulties for politicians because official indicators, e.g. on unemployment, labour force, income, GDP and consumption, are distorted. Policy based on erroneous indicators is likely to be ineffective, or even worse. Therefore, the reciprocal effects between the shadow and the official economy have to be considered when planning measures of economic

¹ For a comprehensive and more detailed analysis, see Enste (2002).

² For more details, see also Weck, Pommerehne and Frey (1984), Gaertner and Wenig (1985), Petry and Wied-Nebbeling (1987), Feige (1989) and Thomas (1992).

³ This figure has been derived from polls of the German and Austrian population about the effects of the shadow economy. For further information see Schneider (1998b). Moreover, the results of these polls show that two-thirds of the value added produced in the shadow economy would not be produced in the official economy if the shadow economy did not exist.

policy, especially fiscal policy. Due to underground economic activities, the tax revenue might reach the negatively sloped part of the Laffer Curve where higher tax rates result in a lower tax yield.

- b) In *social sciences*, the shadow economy is foremost a challenge both for economic theory and economic policy as answers have to be found to questions, such as why people work illicitly, why transactions are made in the shadow economy and what are the effects resulting from this behaviour. Currently, there are theoretical approaches in different social sciences which concentrate on individual aspects of this complex phenomenon. As a coherent, integrative and interdisciplinary approach for the analysis of the causes is missing, however, it is necessary to develop a basic systematic model.

Empirical studies have to test the methods for measuring the size and conceptualising the development of the shadow economy; the theoretically derived causes and consequences of shadow-economic activities have to be verified; reverse effects on the official economy as well as the interaction between the two sectors have to be analyzed.⁴

- c) The most difficult task for *economic policy analysts* is to convey the often not very much appreciated results of their work to politicians and to convince them that the findings are correct and relevant. But our suggestions with regard to specific economic policies are based on an analysis of the relationship between the causes and the effects of the shadow economy. They go far beyond the guidelines laid down by the EU Commission in their pan-European employment strategy for combating illicit work calling for exchange of “good practice models” and coordination at the EU level to combat illicit work, including stricter controls and harsher sanctions.⁵ Unfortunately, these ideas are not new and hardly go beyond trying to cure the symptoms. Instead, reforms of the tax system and the social security system are necessary to improve the dynamics of the official economy and make the official institutions more competitive within the different institutional arrangements at national and international level.

The discussion about adequate economic policies is often influenced by various ideological preferences. One can come across contradictory arguments ranging from a forced denial of the phenomenon “shadow economy” to imaginative exaggerations of its size and impact. The starting point of nearly all controversies are the different

⁴ See Schneider and Enste (2000a and 2000b), Cowell (1990), Thomas (1992), Pozo (1996), Spiro (1997), and Lippert and Walker (1997).

⁵ In Europe, illegally employed people take between 10 and 28 million regular employment positions. See EU Kommission (1998).

estimates of the size of the shadow economy which makes the assessment of the validity of the findings really hard. Due to this attitude, unfortunately, research efforts are fixated on questions, such as which is the best method to estimate the extent of the shadow economy, how large is the shadow economy labour force and how it changes over time.

But the analysis of the causes and consequences of the increase of the shadow-economic activities is much more important. Knowledge of these causes and effects on resource allocation, income distribution and stabilization policies as well as on the official economy in general provides the foundations for proposals for policy change on treating illicit work as an economic and social challenge. I would argue for a “Two-Pillar-Strategy”, including two elements: (1) reducing the attractiveness of evading taxes and regulations (“exit” option), and (2) increasing the opportunities for influencing the formal institutions in the right direction (“voice” option).

Shadow Economy, Tax Evasion and Illicit Work

When examining the phenomenon of the shadow economy, its definition is of utmost importance. Many theoretical controversies and political discussions are due to the use of different or inadequate definitions.⁶ To analyze the causes and, above all, to estimate and evaluate the consequences of the increasing shadow economy it is necessary to clarify what is meant by the latter in different contexts.

Since the term “shadow economy” comprises numerous economic activities it is difficult to provide a formal definition. For example, one has to distinguish between goods and services produced and consumed within the household, “soft” forms of illicit work (“moonlighting”), illegal employment and social fraud, as well as criminal economic activities (Bhattacharyya, 1999; Dixon, 1999; Giles, 1999b; Tanzi, 1999; and Thomas, 1999).

In general, the shadow economy can be seen as the “emigration from the established ways of working” (Stützel, 1980, p. 453; own translation) or, as the German Council of Economic Experts defines it, it is “a decision against the official norms and formal institutions for economic activity.” (SVR, 1980, p.145, own translation)

Still, a more elaborate definition is needed for analysing the (il-)legality of economic activities as well as their connection to tax evasion. Pure tax evasion via financial transactions is excluded from this analysis as it does not render added value and is usually not taken into consideration when someone is talking about the shadow economy.⁷

⁶ Here is a small selection of terms used either synonymously or in different issue areas, according to the respective author: underground economy, illicit work, informal sector, irregular sector, leisure economy, alternative economy, black economy, hidden economy, unofficial economy, parallel economy, shadow economy, unobserved economy and unrecorded economy. See, amongst others, Thomas (1992, p.125).

⁷ Schmoelders, who invented the term in the 1980s, generally includes in the concept of shadow economy tax evasion and the gray to black markets, which are “expression and correction of the official market order” (Schmoelders, 1980, p. 372, own translation). In his opinion, the main categorization criterion is the secrecy of the financial transactions. Hence, the shadow economy comprises the entire turnover, obtained in this economic system with its specific markets, competition rules, customs, marketing strategies and investments.

The difference between “Pure Tax Evasion” and “Underground Economy” is explained clearly in Lippert/Walker (1997). Shadow-economic activities almost always imply the supply of goods and services, produced with resources, such as work, managerial or industrial activities and capital. In opposite to this, pure tax evasion usually results from financial transactions, carried out with the objective to conceal income, e.g. capital income. These aspects are especially important for fiscal policy and public finance and are studied by experts in these areas.

From the point of view of economic policy, particularly relevant are those shadow-economic activities related to the added value as well as their influence on the allocation of resources. Concerning the evaluation of the activities in the context of an economic order, one has to distinguish between the output of illegal and legal activities, on the one hand, and legal and illegal production and distribution of these activities, on the other. Yet, the boundaries between the sectors are not clearly defined and they change with the level of economic development (Asea, 1996; Mirus and Smith, 1997, p. 5; Smith, 1997, p. 13; Petry and Wied-Nebbeling, 1987, p. 14ff; Thomas, 1992, p. 6).

The underground economy can, in principle, be divided into four sectors. The informal economic activities may be defined in terms of the two concepts of market transactions and legality. Hence, the underground economy can be logically separated into a legal and an illegal sector (Thomas, 1992, pp. 4 and 6). The legal sector then can be defined as the self-sufficient economy while the illegal one as the shadow or hidden economy.

The self-sufficient economy has two parts which can be differentiated according to whether market transactions take place (informal sector, alternative economy) or not (household sector). The latter includes a Do-It-Yourself (DIY) segment. The informal sector is predominant in developing and transition countries, in which small firms produce a large share of the economic added value.⁸ The difference between the latter and the irregular sector is that these informal activities are not prosecuted in many countries, even though certain regulations and administrative rules are ignored or they act on the border of illegality. Thomas (1992, p. 4; pp. 87f) introduces “law enforcement” as a boundary criterion. Hence, it is not the existence of laws and regulation which is relevant but supervision and enforcement by the administration. The latter is hardly present in the informal sector whereas in the irregular sector there are intensive and effective control mechanisms. Thus, the activities in the informal sector are often not linked to tax evasion and lie mostly within the scope of legality.

As opposed to this, activities in the shadow economy in particular are linked to gainful employment accompanied by tax evasion or unlawful behaviour. The difference between the “Criminal Sector” and the “Irregular Sector” (Thomas, 1992, pp. 3f) stems from the fact that production/ distribution *and* output of criminal activities are illegal

⁸ De Soto (1989) describes this very well through the example of Peru. He also analyzes the difficulties faced by individuals who wish to switch into the official sector.

FIGURE 1: CATEGORISATION OF THE UNDERGROUND ECONOMY

<i>Sectors Criteria</i>	<i>Household sector</i>	<i>Informal sector</i>	<i>Irregular sector</i>	<i>Criminal sector</i>
<i>Production/ Distribution</i>	legal	legal	illegal	illegal
<i>Market transactions</i>	no	yes	yes	yes
<i>Output (goods/services)</i>	legal	legal	legal	illegal
<i>VGR- conventions</i>	<i>Self-sufficient economy (legal)</i>		<i>Shadow economy (illegal)</i>	
<i>Examples</i>	Do-it-yourself, home office work; baby-sitting; exchange of goods	Neighbourhood help;counselling centres; self- help; offence organisations honorary activities; network help	Illicit work: ⇒ because of offence against handicraft and trade regulations. ⇒ because of tax evasion ⇒ and abuse of benefits.	Trade with stolen goods and drugs; prohibited gambling; fraud; smug- gling; receiving stolen goods

(drugs trafficking, slave trade and prohibited gambling). In addition, occupation in the irregular sector becomes part of the shadow economy only if distribution and production related to it is illegal as the output is legal. Most of these irregular activities can be summarized under the term “Illicit Work”. Irregular actions include producing goods or offering services while receiving at the same time social insurance and not informing the labour office (social security fraud); being self-employed and operating an industrial enterprise without complying with the regulations of the relevant industrial code or practising a handicraft without being registered. Offences against this legislation are prosecuted as irregularities and are punished with a fine of up to 300.000 Euro as of 2002 in Germany.

In contrast to this, in a lot of OECD countries economic activities resulting from favours, neighbourhood assistance and small scale activities are explicitly excluded from prosecution. Still, these are part of the informal sector.

More attention should be paid to the irregular sector, which is characterized by market-type transactions. The production and distribution of these goods and services becomes unlawful either by illegal production or by prohibited trade or if combined with tax evasion. The produced goods or services themselves are not illegal. A paperhanger plastering wallpaper in Germany works illicitly only if he does this on a weekend and receives a cash payment without an invoice. Usually, a wide range of activities is summarized under the term “illicit work”, such as minor handicraft

services after regular working hours and organized illegal employment in combination with tax evasion, bypassing the laws of competition or craftsmanship, and social security fraud, etc. The irregular sector also includes activities carried out legally but still regarded as part of the shadow economy when combined with tax evasion, as the associated income is not registered by the inland-revenue office (e.g. the occasional freelancing, usually subject to income tax, as well as the non-declaration of tips and gifts).

As marked in grey in the figure, the production of private households as well as voluntary work for charities is excluded from further analysis. Following Tanzi's line of argumentation (1999, p. 338), activities, which do not generate added value but merely imply a financial gain for the individual, are also ruled out (prostitution, murder, kidnapping, etc.). Furthermore, pure tax evasion is not included in the following analysis either. Hence, the shadow economy, especially illicit work combined with tax evasion, is the subject of this study. Illicit work, carried out either on a part-time basis by individuals ("moonlighting") or as part of the activities of a firm ("sole job") constitutes the largest element of the shadow economy.⁹

An Evolutionary Theory of the Shadow Economy

A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the "exit" option rather than the "voice" option. As increase of the shadow economy is caused by a rise in the overall tax and social security burden coupled with institutional sclerosis, the increase of underground activities erodes the tax and social security bases. The result is a further increase in the budget deficit or tax rates, additional growth of the shadow economy and gradual weakening of the economic and social fundament of collective arrangements. This effect is illustrated in Figure 2.

Apart from the shadow economy, physical or economic migration into other countries are important "exit" options. The increasing mobility within the EU strengthens the effectiveness of these options, as long as there is no harmonization of the tax and social security systems. When dissatisfied with the public goods offered in his or her own country, a tax-payer can emigrate. Also, the possibility to engage in shadow-economic activities limits the taxation capacity of the government. Thus, the shadow-economy forms an endogenous boundary.

The correlation between individual reaction and taxation is illustrated in the following figure of modified Laffer Curve (1979), which originally shows the effect of tax evasion through additional leisure time. Gutmann (1981) modified the figure by integrating the possibility to engage in shadow-economic activities.

⁹ The most recent figures of the size and development of the shadow economy in OECD and transition countries should be added here. See Schneider's chapter in this volume for this data.

The top part of the graph shows the correlation between tax rate and tax yield which is in the centre of political debates, especially in the USA. Still, this has not yet been justified either theoretically or empirically. The axes show the aggregated tax rate in percentage of the income and the tax yield. The more the state increases the tax rates, the more opposition grows. If the yield maximum in S (tax rate t^*) is surpassed, the internal revenue decreases despite rising tax rates as citizens try to avoid paying. Lowering the rates would in this case even result in a higher yield as the negative incentives are no longer evident.

The lower part of the graph shows the link to the shadow economy.¹⁰ To simplify, the economy is divided into three sectors (public sector, official and shadow economy). With regard to the development of an economy over time we should note that at the beginning the informal sector is strong. The introduction of an extensive official economy is not possible without state activity. If the former grows, so does the latter as it requires resources.

When taxes are introduced positive effects predominate. There are positive incentives to switch to the official economy if the state actually guarantees property rights in exchange for taxation. If there are grounds for optimum lies, it cannot be generalized as the situation differs from country to country. One possibility is that citizens get accustomed to the increasing use of resources by the state, so that this does not necessarily result in a growing shadow economy.

But, since politicians and bureaucrats, as modelled in Public Choice Theory, act rationally, they try to maximise their utility. This finally leads to tax-yield maximization by politicians and budget maximization by bureaucrats, resulting in higher tax rates to finance the growing public sector. Frey und Weck (1983a) show that this also leads to an additional supply of jobs in the public sector. The rising tax burden means stronger incentives to work illicitly. Once the tax yield has reached its maximum, the public sector can no longer expand as taxpayers will increasingly engage in shadow-economic activities if tax rates are increased any further.

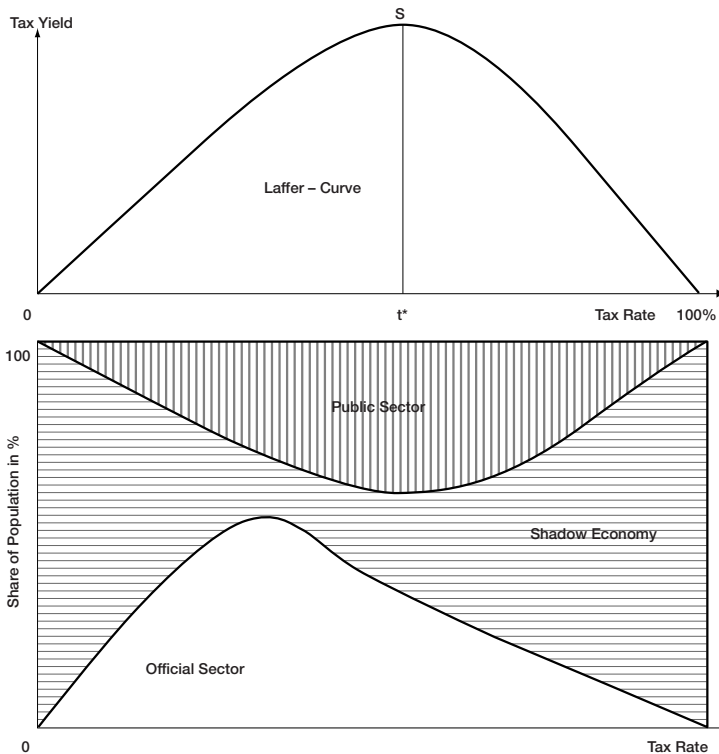
If the public sector is becoming larger and larger, then people might not accept this limitation of their freedom due to high tax rates and strict regulations any longer. The migration into the shadow economy is one way of showing opposition and resistance to the existing rules and institutions (like tax laws, regulations, etc.). A new set of rules and institutions is necessary. In extreme cases in history, revolutions changed the established institutions, replacing those who were in power. A new government, other laws and institutions will be implemented, because a situation without any state activity - anarchy - is not desirable for anybody as in such a situation all economic activities take place in the shadow economy (see figure 2). At this point of institutional change, the development of regulations and supplying resources for state activity is advantageous for all people. But the supply of public goods by the state (e.g. protection of property rights)

¹⁵ For a simplified figure, which ignores the effects of state activity, see Frey and Weck (1983a), Neck, Schneider and Hofreither (1989), Blankart (1998, pp. 240f) and Windisch (1984).

requires resources, so that some activities are transferred to the public sector. The process of institutional development starts again and the “new institutions” are supported by the people, because they increase their welfare and are perceived as legitimate.

These considerations show that the perception of public equivalents is an important criterion for the decision whether or not to work illicitly. If this perception is legitimate, it will not result in a rise of shadow-economic activity.

FIGURE 2: THE CORRELATION BETWEEN TAX YIELD, TAX RATE AND THE DEVELOPMENT OF THE SHADOW ECONOMY



The Income-Leisure Model is suitable for illustration of the basic economic idea that avoiding allocation distortions is always the main objective. Yet, there are some issues which need to be looked at critically, issues which can be explained with the help

of the Welfare Theory of Taxation. Welfare Economics assumes that a government acts as a “benevolent” dictator and wants to maximize aggregate welfare. For this purpose broad tax liabilities, low marginal tax rates, or ideally, even poll taxes are proposed to avoid allocation distortions and to optimize taxation. Through the prism of this theory, the issues of taxation and transfer payments have been thoroughly discussed in Public Finance. In addition to the constraining assumptions, the neglect for the behaviour of the government and other institutions is criticized. The optimistic assessment of the governing body, which does not maximize its own utility but that of society and thus acts entirely differently from what is otherwise assumed in economics does not seem plausible to the supporters of modern Public Finance.¹¹

Currently in Public Finance, the assumption of the welfare maximizing government is substituted by that of an egoistic one, whose objective is to maximize its budget to gain more influence over public funds and thus have greater power. In the Leviathan theory on taxation, it is assumed that the government raises more taxes than needed to supply the optimal amount of public goods, i.e. it reaps the full benefits of the taxation potential. The tax-payer has no possibility of reacting except via tax evasion. Therefore, Brennan and Buchanan (1980) refuse to support the idea of optimal taxation, even if allocation distortions could be avoided. A broad tax base with little possibilities of evasion would ultimately augment the taxation power of the government and the tax-payer would be at the mercy of the “Leviathan state” even more. Hence, Brennan and Buchanan find it necessary to develop clear boundaries for taxation, i.e. regulation for taxation and budgeting. Despite the critique of the Leviathan Model, which is related to the pessimistic assessment of the role of the government, the model has contributed to describing the politicians as actors and thus it counterbalances the Welfare Economic Theory.

In the context of the New Political Theory, numerous approaches are currently being developed, in which it is attempted to explain the behaviour of the governing body more realistically. Blankart (1998, p. 227f.) proposes the implementation of democratic elements to embank budget maximization and the waste of taxes. This is an alternative to the usual suggestion of introducing constitutional regulations as an effective control mechanism of the government. One possibility would be to introduce optional referendums on the total budget or on the public budgeting via taxes and loans. This form of control and protection is necessary in the context in which politicians are regarded as being self-interested economic actors as well as the considerations coming from the New Political Economy and the Leviathan State Model.¹²

¹¹ For a brief illustration of the various theoretical approaches, see Blankart (1998, pp. 201-248).

¹² This short review of the evolutionary approach to the implications of the shadow economy, which can serve as a normative foundation for the following analysis and the recommendations for economic policy, is elaborated in detail in Enste (2002).

What Are the Main Causes of the Growth of the Shadow Economy?

The growth of the shadow economy has been caused by many different factors but the most important and most often cited ones are:¹³

- the rise of the burden of taxes and social security contributions combined with the increase in the density and intensity of regulations in the official economy, especially on labor markets;
- the (forced) reduction of weekly working time, the early retirement and the growing unemployment rate, and
- the long-term decline of civic virtue and loyalty towards public institutions combined with a declining tax morale.

An interdisciplinary analysis of the causes of the increase of the shadow economy seems to be necessary as the economic factors can only partly explain this increase.¹⁴ Micro-sociological and psychological approaches can provide very interesting additional insights in individuals' decision process choosing to work in the underground. An interdisciplinary approach, similar to that applied in Economic Psychology, focuses on variables such as tax morale, which was first discussed by Günter Schmolders (1960, 1975), and other factors like acceptance and perceived fairness of the tax system.¹⁵

The Influence of Tax and Social Security Contribution Burden

In almost all studies, the rise of the tax and social security contribution burdens is one of the most important causes of the growth of the shadow-economy.¹⁶ Since taxes affect labor-leisure choices and stimulate labor supply in the shadow economy, or the untaxed sector of the economy, the distorting effect of this choice is a major concern of economists. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings from work, the greater the incentive to avoid this difference and to work in the shadow economy. Since this difference depends largely on the social security system and the overall tax burden, they are key factors of the existence and the growth of the shadow economy.

¹³ When dealing with the various causes in the following sections the most important references are given. For an overall view see the studies by Tanzi (1982); Frey and Pommerehne (1984); Thomas (1992) and Schneider and Enste (2000b).

¹⁴ Although interdisciplinary research has focused on tax compliance, for instance, Alm, McClelland and Schulze (1999), Cowell (1990), Pommerehne, Albert Hart and Frey (1994) and the special issue on "Economic Psychological Perspectives on Taxation" of the *Journal of Economic Psychology* (December 1992), there is a need to explain the factors for other (hidden) activities. See Frey (1997b) for details.

¹⁵ For a further discussion of the importance of interdisciplinary research, see Elster (1998) and Lewin (1996). For a broader view, see Frank (1988) and Frey (1997b).

¹⁶ See, for instance, studies by Tanzi (1982), Frey and Pommerehne (1984a/b), Feige (1989), Pozo (1996), Lippert and Walker (1997), Schneider (1994a, 1994b, 1997, 1998a), Thomas (1992), Hernando De Soto (1989), Zilberfarb (1986), Tanzi (1999), Giles (1999a), and Schneider and Enste (2000b).

A macroeconomic analysis of some of the causes for the increase of the shadow-economic activities is given by Loayza (1996). He presents a simple macroeconomic endogenous growth model in which production technology depends on congestable public services. The determinants and effects of excessive taxes and regulations on the informal sector are studied; in the model the government lacks the capability to enforce compliance. His empirical approach treats the informal sector as an unobserved variable for which multiple causes and multiple indicators exist, and he uses the Multiple Indicator Multiple Cause (MIMIC) model (see part 6.3). Loayza estimates the size of the informal sector in 14 Latin American countries and finds some evidence for three determinants being significantly relevant at the 10 percent confidence level. Tax burden (0.33) and labor-market restrictions (0.49) affect the relative size of the informal sector positively, while the strength and efficiency (0.42) of the government institutions have a negative influence leading to a decrease of the informal sector.¹⁷ As Loayza's work shows only statistical correlations and not exactly causal relationships, he can only partly provide answers to the following questions: Why do people choose to work in the shadow economy? What other factors (besides the income motive) cause an increase of informal activities? Can other theories provide further help in determining relevant factors? Since, according to the methodological individualism, only individuals can choose, it might be helpful to have a closer look at the individual decision to work in the shadow economy.

The strong influence of indirect and direct taxation on the shadow economy can be demonstrated by reviewing the empirical results in the case of Austria and the Scandinavian countries. Regarding Austria, Schneider (1994b) estimates a currency demand function including the following four types of variables as driving forces for the shadow economy:

- the burden of total direct taxation;
- the burden of indirect taxation;
- the complexity of the tax system;
- the intensity of government regulations.

The estimated coefficient of the independent variable, the direct tax burden (including social security payments), has the biggest influence, followed by the intensity of regulation and the complexity of the tax system. A similar result has been observed by Schneider (1986) for Scandinavia (Denmark, Norway and Sweden). In all three countries, different tax variables, namely, average direct tax rate, average total tax rate (indirect and direct tax rate) and marginal tax rates, have the expected positive influence on currency demand and have high statistical significance.¹⁸

¹⁷ The numbers indicate a change of the size of the informal sector (in standard-deviations) with a one-standard deviation increase in each of the determinants.

¹⁸ Similar results are observed by Kirchaessner (1983, 1984) for Germany and by Klovland (1984) for Norway and Sweden.

Two other recent studies provide strong evidence of the influence of income taxes on the shadow economy. Richard J. Cebula (1997), using Feige data on the shadow economy, found evidence of the impact of government income tax rates, IRS audit probabilities and IRS penalty policies on the relative size of the shadow economy in the United States. Cebula concludes that a restraint of any further increase of the top marginal income tax rate may at least not lead to a further increase of the shadow economy, while increased IRS audits and penalties might reduce the size of the shadow economy. His findings indicate that there is generally a strong influence of state activities on the size of the shadow economy: for example, if the marginal individual federal income tax rate increases by one percentage point, *ceteris paribus*, the shadow economy rises by 1.4 percentage points. In another study, Roderick Hill and Muhammed Kabir (1996) found empirical evidence that marginal tax rates are more relevant than average tax rates and that a substitution of direct taxes by indirect taxes seems unlikely to improve tax compliance with respect to the influence of the tax and social security burden.

More evidence on the effect of taxation on the shadow economy is presented by Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton (1998a, 1998b) who come to the conclusion that it is not higher tax rates *per se* that increase the size of the shadow economy, but the ineffective and the discretionary application of the tax system and the regulations by governments. Their finding that there is a *negative* correlation between the size of the unofficial economy and the *top* (marginal) tax rates, might be unexpected but as other factors, like tax deductibility, tax reliefs, tax exemptions, the choice between different tax systems and various other options for legal tax avoidance were not taken into account, it is not that surprising. Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) reached a similar conclusion in a cross-country analysis: *higher* tax rates are associated with *lower* unofficial activity as percentage of GDP. They argue that entrepreneurs go underground not to avoid official taxes, but in order to reduce the burden of bureaucracy and corruption. Still, looking at their empirical results (the regression), the finding that higher tax rates are correlated with a lower share of the unofficial economy is not very robust; in most cases when different tax rates are used they do not get to statistically significant results. The overall conclusion of these studies is that there is a large difference between the impact of either the direct tax or the corporate tax burden and the institutional factors, such as the efficiency of the administration, the extent of control rights held by politicians and bureaucrats, the amount of bribery and especially corruption. Johnson, Kaufmann, and Zoido-Lobaton (1998b) believe that these factors play a greater role in the “bargaining game” between the government and the taxpayers than the tax burden itself.

Intensity of Regulations

The increase of the intensity of regulations, often measured by the number of laws and regulations, such as licenses requirements, is another important factor which limits the freedom of choice for individuals engaged in the official economy.¹⁹ In this context one can think of labor market regulations, trade barriers and labor restrictions for foreigners. The influence of labor regulations on the shadow economy has also been analyzed in various studies.²⁰ Regulations lead to a substantial increase in labor costs in the official economy. Since most of these costs can be shifted to the employees, these costs provide another incentive to work in the shadow economy, where it is possible to avoid them.

Further empirical evidence is provided in the model of Johnson, Kaufmann and Andrei Shleifer (1997) which predicts, *inter alia*, that countries with more general regulation of their economies tend to have a higher share of the unofficial economy in the total GDP. A one-point increase of the regulation index (ranging from 1 to 5 from lowest to highest), *ceteris paribus*, is associated with an 8.1 percentage point increase in the share of the shadow economy, when controlled for GDP per capita (Johnson, Kaufmann, and Zoido-Lobaton (1998b, p. 18). They conclude that it is the enforcement of regulation, which is the key factor for the burden levied on firms and individuals, and not the overall extent of regulation, mostly not enforced, which drives firms into the shadow economy. Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) reach a similar conclusion. In their study, every available measure of regulation is significantly correlated with the share of the unofficial economy and the direction of the correlation is unambiguous: *more regulation is correlated with a larger shadow economy*. A one point increase in an index of regulation (ranging from 1 to 5) is associated with a 10 percent increase in the shadow economy for 76 developing, transition and developed countries.²¹

These findings show that governments should put a greater emphasis on the reduction of the density of regulations or, at least, on improving enforcement of laws and regulations, instead of increasing the number of regulations. Some governments, however, prefer this latter policy option (more regulations and laws) when trying to reduce the shadow economy, mostly because it leads to an increase in power of the bureaucrats and to a higher rate of employment in the public sector. In addition, politicians might not really have an interest in a substantial decrease of the shadow economy since a lot of voters stand to gain from unofficial activities. The slogan of “fighting for law and order” might therefore be more useful for getting re-elected in office than implementing radical reforms of the tax and the social security systems.²²

¹⁹ For a psychological explanation of this fracture (theory of reactance), see Brehm (1966, 1972); for an application of this theory to the shadow economy, see Pelzmann (1985). See also Enste (2002) for an integration of this theory in an interdisciplinary (rational choice) approach.

²⁰ With regard to Germany, see Deregulation Commission (1990/91) and Monopolkommission (1998).

²¹ De Soto (1989) analyzes in more detail the costs of regulation in Peru in his famous book.

²² See, for example, Frey (1989) for an application of the Public Choice Theory to the shadow economy and for a further discussion Enste (2001).

Labor Market

The numerous regulations on the official labor market and the total wage costs also represent driving forces for the shadow economy. Two main factors - the effects of the reduction in official working hours and the influence of the unemployment rate on the increase of the shadow economy - are discussed quite often in this context:

- As in most OECD countries unemployment is to a large extent caused by the fact that total labor costs are too high; this can be seen as a cause of the increase of the shadow economy.
- The reduction in working hours in the official economy was introduced by governments (e.g. France) and/or labor unions (e.g. Germany) in order to reduce the unemployment rate. An overview of these economic policy measures is given in OECD (1998, pp. 123-188). The idea behind this is that there is only a limited amount of work and that this quantity has to be “redistributed”. But this idea neglects a key factor - a forced reduction of working hours against the preferences of the employees increases the potential of hours that can be worked in the shadow economy.²³ Early retirement can also lead to more unofficial activities; part time work offers great opportunities to the individual to adopt another job in the untaxed, unregulated economy, as argued by De Gijssel (1984) and Riebel (1983, 1984). The redistribution of work can only be successful if the reduction is either in accordance to the individuals’ preferences and they want to maximize their leisure time or they are incapable of work, because otherwise they might choose to keep on working in the underground.²⁴

More detailed explanation of the labor supply in the underground economy is given by Lemieux, Fortin, and Fr chet te (1994) using micro data from a survey conducted in Quebec City (Canada). The results of their study suggest that the hours worked in the shadow economy are quite dependent on changes in the net wage in the regular (official) sector. Their empirical findings clearly indicate that “participation rates and hours worked in the underground sector also tend to be inversely related to the number of hours worked in the regular sector” (Lemieux, Fortin, and Fr chet te, 1994, p. 235). In total, their results emphasize a large negative elasticity of the hours worked in the shadow economy with respect to the wage rate in the regular sector and also a high mobility between the sectors. A further reduction of the official working hours can therefore lead to a growth of the shadow economy as, like the German example shows, almost all recent empirical studies show that most of the employees do not want a further reduction at all (Enste, 2002; DIW, 1998; Bosch and Lehdorff, 1998). Hence,

²³ See, for example, Jennifer Hunt (1999). After Volkswagen in Germany reduced the working hours considerably there is some evidence, until now basically anecdotal, that in the area around the firm much more reconstruction and renovation of houses took place compared to similar other regions.

²⁴ See Becker (1965) for a theoretical explanation, and Juster and Stafford (1991) for a more detailed analysis of the allocation of time.

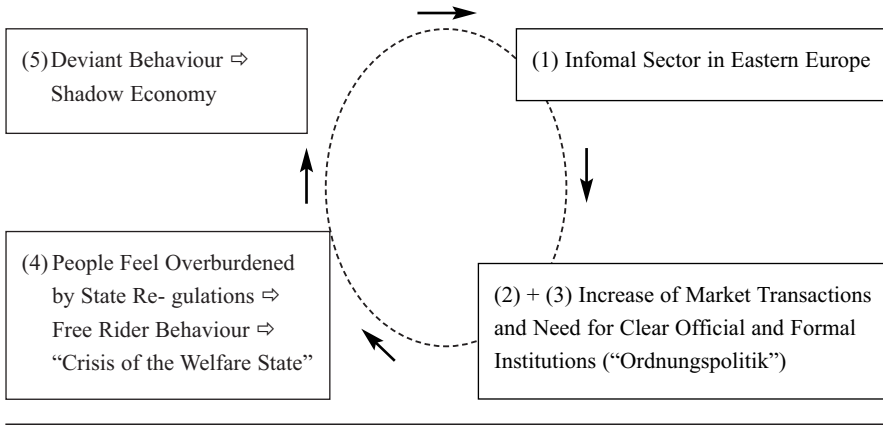
a reasonable economic policy suggestion is a higher flexibility of working hours in accordance with the preferences of the employees as this minimizes the distortion of the individual decision by this kind of labor-market restrictions.

Public Sector Services

The growth of the shadow economy leads to reduced state revenues which, in turn, reduces the quality and quantity of publicly provided goods and services. Ultimately, this can lead to an increase of the tax rates for firms and individuals in the official sector, quite often combined with a deterioration in the quality of the public goods (such as the public infrastructure) and of the administration, with the consequence of even stronger incentives to participate in the shadow economy. Johnson, Kaufmann, and Zoido-Lobaton (1998b) present a simple model of this relationship. Their findings show that smaller shadow economies exist in countries with higher tax revenues, if these revenues result from lower tax rates, fewer laws and regulations and less bribery facing enterprises. Countries with a better rule of the law in the collection of taxes also have smaller shadow economies. Transition countries have higher levels of regulation, leading to a significantly higher incidence of bribery, higher effective taxes on official activities and a large discretionary framework of regulations and consequently to a higher shadow economy. Johnson et al.'s overall conclusion is that "wealthier countries of the OECD, as well as some in Eastern Europe find themselves in the 'good equilibrium' of relatively low tax and regulatory burden, sizeable revenue mobilization, good rule of law and corruption control, and (relatively) small unofficial economy. By contrast, a number of countries in Latin American and the Former Soviet Union exhibit characteristics consistent with a 'bad equilibrium': tax and regulatory discretion and burden on the firm is high, the rule of law is weak, and there is a high incidence of bribery and a relatively high share of activities in the unofficial economy" (Johnson, Kaufmann and Zoido-Lobaton, 1998a, p. I).

Therefore, in a lot of countries the public sector is facing the challenge to impose substantial reforms of the social security and tax systems in order to prevent the total defeat of the protective welfare state, because the vicious circle of high tax and regulation burdens causes growth of the shadow economy, additional pressure on public finance resulting in higher tax rates, which, in turn, increase the incentives to evade taxes and to escape in the shadow economy and so on. The shadow economy can therefore be seen as a challenge to the welfare state. Since in a cumulative process, existing institutions and rules might lose their acceptance in the society, ending up with a situation, in which democratic voting ("voice") is less attractive than using the "exit" option of the shadow economy. Eventually, the loyalty to the democratic political institutions is abandoned, or can hardly be restored, as in some countries of the former Soviet Union. The institutional and economic change is described in the following, simplified figure.

FIGURE 3: ECONOMIC AND INSTITUTIONAL CHANGE



Main Causes in Eastern Europe

In Eastern Europe, in addition to the causes mentioned above, the following main factors for the growth of the shadow economy are important:

- Lack of competence and trust in official institutions (e.g. legislation, administration/ bureaucracy, courts, etc.).
- The administration is often inefficient and corrupt.
- Property rights cannot be guaranteed by the official institutions and people search for other options.
- The development of informal and unofficial institutions has negative side effects (for instance, greater power for the mafia); but also the positive side effect on the creation of informal social structure supporting the weak official structures.
- Inadequate enforcement of laws and regulations.
- High costs and administrative burden for entrepreneurs.
- High taxes – in combination with no adequate supply of public goods and infrastructure – lead to lower acceptance of formal rules and laws.
- A low probability of being caught as an illicit worker or tax evader results in a cost-benefit-calculation where illicit work is more attractive than regular and official work.
- Sometimes “hiding in the shadows” is essential for surviving or to establish a business.
- Finally, a broad acceptance of illicit work (e.g. access to credits and banks in the shadow economy) makes it difficult to fight this phenomenon.

The Effects of the Shadow Economy on the Official Economy

The analysis of the effects of a growing shadow economy is quite difficult and comprehensive empirical evidence is not available. Most studies focus on the influence on allocation of resources and the loss of revenue for the state. But the impact on the official institutions, norms and rules is even more important. The shadow economy can be seen as an indicator of a serious deficit of legitimacy of the present social order and the existing rules of official economic activities. The “exit” option of the shadow economy represents an important limitation on the Leviathan state to secure economic freedom and liberty.²⁵

Several studies attempt to integrate the underground economy into macroeconomic models in order to study their effects on the allocation of resources.²⁶ Houston (1987) develops a theoretical macro model of the business cycle as well as the tax and monetary policy linkages with the shadow economy. He concludes that, on the one hand, its effect should be taken into account in setting tax and regulatory policies, and on the other hand, the existence of a shadow economy could lead to an overstatement of the inflationary effects of fiscal or monetary stimulus. Adam and Ginsburgh (1985) focus on the implications of the shadow economy on “official” growth in their study of Belgium. They find a positive relationship between the growth of the shadow economy and the official one and under certain assumptions (i.e. very low entry costs into the shadow economy due to a low probability of enforcement) they conclude that an expansionary fiscal policy has a positive stimulus for both the formal and informal activities. A study for the United States by Fichtenbaum (1989) argues that the U. S. productivity slowdown over the period from 1970 to 1989 was vastly overstated, as the underreporting of income due to the more rapid growth of the U. S. shadow economy during this period was not taken into account.

Another hypothesis is that a substantial reduction of the shadow economy leads to a significant increase in tax revenues and, therefore, to a greater quantity and quality of public goods and services, which can ultimately stimulate economic growth. Some authors, for instance, Loayza (1996), found evidence in support of this hypothesis.

Depending on the prevailing view of the informal sector, the underground economy might be seen as optimal in the sense that it responds to the economic environment’s demand for urban services and small-scale manufacturing. From this point of view, the informal sector provides the economy with a dynamic and entrepreneurial spirit and can lead to greater competition, higher efficiency and strong boundaries and limits for government activities. The informal sector may also offer significant contributions “to the creation of markets, increase financial resources,

²⁵ On the importance of institutions and the impact of the shadow economy see, for example, Brennan and Buchanan (1980, 1985).

²⁶ On Austria this was done by Neck, Hofreither, and Schneider (1989). For further discussion of this aspect, see Quirk (1996) and Giles (1999a).

enhance entrepreneurship, and transform the legal, social, and economic institutions necessary for accumulation” (Asea, 1996, p. 166). The voluntary self-selection between the formal and informal sectors may provide a higher potential for economic growth and, hence, a positive correlation between the growth of the informal sector and economic growth in general. The effects of an increase of the shadow economic activities on economic growth remain, therefore, to a large extent ambiguous.

The empirical evidence in support of these opposite hypotheses is also not very clear. Since many Latin American countries had or still have a tradition of excessive regulations and weak government institutions, Loayza (1996) brings evidence of the implications of his growth model in the early 1990s in these countries. The increase in the size of the shadow economy negatively affects growth: (1) by reducing the availability of public services for everyone in the economy, and (2) by leading to a less efficient use of the existing public services, or not efficient at all. Still, the positive “side effects” of shadow-economy activities should be taken into account too. The findings in Schneider (1998b) show clearly that over 66 percent of the earnings in the shadow economy are practically spent in the official sector immediately. This additional expenditure has positive effects for economic growth and for the (indirect) tax revenues. Dilip K. Bhattacharyya (1993, 1999) found clear evidence for the United Kingdom (1960-1984) that the hidden economy has a positive effect on consumer expenditures of non-durable goods and services, and an even stronger positive effect on consumer expenditures of durable goods and services. The close interaction between official and unofficial economies is also emphasized in Giles (1999a) and in Tanzi (1999).

A summary of main consequences is presented in the following figure:

FIGURE 4: CONSEQUENCES OF THE INCREASING SHADOW ECONOMY

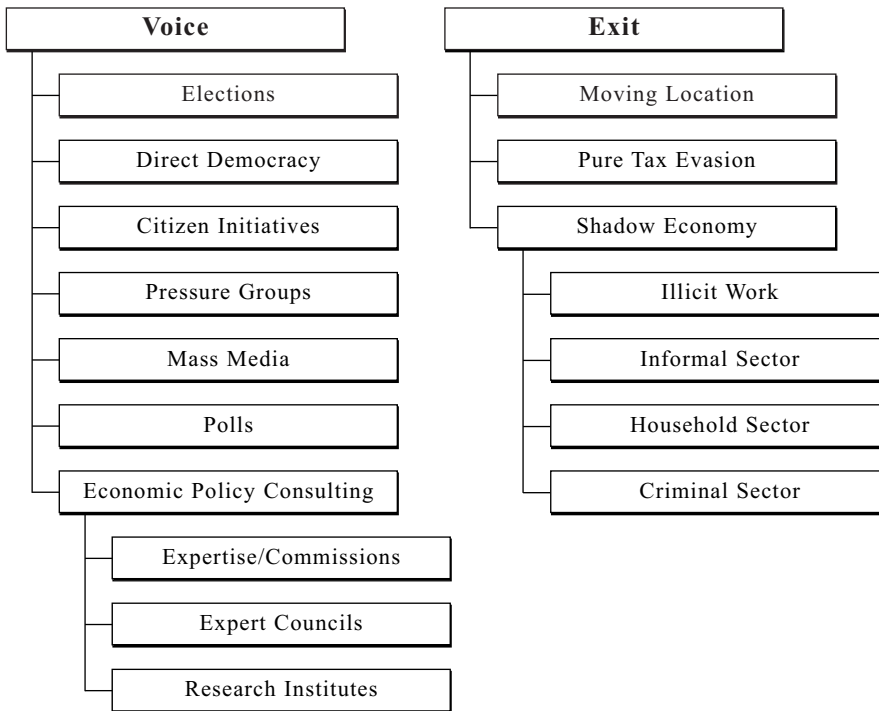
Consequences

- ⇒ Officially Unused Resources are Used for Production
 - ⇒ Additional Supply of Services and Goods
 - ⇒ Increase of Public Deficits and Decrease of Investments in Public Infrastructure
 - ⇒ Undermining of Official Institutions and State Power ⇒ High Risks for the Transformation Process
 - ⇒ Dangerous Development for the Welfare State ⇒ “Dual Economy” in a Longer Perspective
 - ⇒ More Crime and Less Support for Official Institutions
-

The “Two Pillar Strategy” - “Exit” and “Voice” as Behavioural Options

Following Hirschman (1974), the behavioural options for people can be divided into the “exit” and “voice” options which are the two aspects of the “Two-Pillar-Strategy”.

FIGURE 5: BEHAVIORAL OPTIONS BY HOUSEHOLDS AND FIRMS



In a democracy one has the possibility to voice one’s preferences on public goods through elections. One votes for the party whose policy corresponds best to one’s own attitude. To further influence economic order and policy choices one can either use non-democratic communication channels, e.g. referendums or direct elections, or organize citizens initiatives. Actively participating in pressure groups and unions has an even more intensive impact on the contents of the political process as they not only follow

their own interests but represent an important source of information for politicians (Kirchgässner and Frey, 1994, pp.201f, and Pommerehne and Weck-Hannemann, 1996).

Furthermore, mass media can be involved in manipulation. Even though the power of the media has not yet been fully explained in theory, its importance cannot be denied.²⁷ Its “Agenda Setting Function” is very well suited to bring certain topics to the public attention and raise public awareness (Enste, 2001, 2002, and Schneider and Enste, 2000a, pp.192-202). One example of such an influence is the discussion about the DM 630 jobs, actively fed by the media.²⁸ If the mass media publishes surveys, these could possibly influence the public opinion and election results.²⁹

Policy consulting also plays a significant role. Various expert councils and economic research institutes form an opinion on political decision on a regular basis and strive to influence politics through numerous publications. To complete the story of influencing policy choice, expert opinions by commissions and boards or committees are another possible avenue.³⁰

The alternative to this “voice” option, which is regarded as unsuccessful by many, is the market reaction of “exit”. Free trade firms have the option of changing locations to evade an unwanted economic, taxation or social security system, and households can decide to migrate.³¹ Engaging in shadow economic activities is another possibility. Here, the options are either tax evasion, for instance, through financial transactions or a fictitious change of location. Individuals can alternatively decide to work illicitly in the informal, the household or the criminal sector.

The fact that these options exist implies that the democratic state has a restricted number of options as it cannot ignore the preferences of its citizens. This internal pressure to correct economic policy is intensified by external pressure stemming from the globalization. Mobility is increased and so is the number of alternatives. The limits of loyalty are reached if the financial burden becomes too great. The political and social stability and the “bonum commune” are endangered by the rise of the shadow economy. This could cumulate in a malfunction of democracy (Biedenkopf, 1986; Enste, 2002; Rürup, 1983; Schmidt, 1988; and Pommerehne and Kirchgässner, 1994). Thus, the growth of the shadow economy represents a sign of considerable disruptions within the regulatory system in general.

²⁷ For an illustration of the theoretic approaches on media effects and their empirical results, see Schenk (1987).

²⁸ See Schneider and Enste (2000a, p.1-2) for a detailed record.

²⁹ See Noelle-Neumann (1982, 1989a/b) on the Theory of the “Silence Spiral”.

³⁰ Kirchgässner and Frey (1994) elaborate on the different methods available.

³¹ For a simple explanation of the implications of the four basic freedoms within the EU, see Sinn (1995).

Decreasing the Attractiveness of the “Exit” Option

Implementing the “Two-Pillar-Strategy” decreases the threats to society. For this purpose, our recommendations can be summarized as follows:

FIGURE 6: ECONOMIC POLICY RECOMMENDATIONS TO REDUCE THE ATTRACTIVENESS OF THE SHADOW ECONOMY

Reduction of Financial Incentives to Escape into the Shadow Economy (Exit - Option)

- ⇒ *Reduction of Tax Rates*
- ⇒ *Simplification of the Tax System*
- ⇒ *Substantial Reforms of Social Security Systems*
- ⇒ *Higher Efficiency in Administration and Combating Corruption*
- ⇒ *Focus on Transformation ⇒ Higher Growth Rate and Welfare Reduces the Pressure on Governments*
- ⇒ *Guarantee of Property Rights & Investment in Infrastructure (e.g. in Form of Private Public Partnership)*

Changing Official Norms and Institutions according to the Preferences of the People

- ⇒ *More Flexibility of Working Time for Employees and Employers (Individual Arrangements)*
- ⇒ *Less Regulation and Less Bureaucracy*
- ⇒ *Fighting the Symptoms does lead to more Action to Hide Shadow Economic Activities rather than to a Substantial Reduction of Illicit Work*
- ⇒ *Focus on Improvements and Reforms of Institutions and Systems and Explanation & Communication of the Necessity of Reforms*

Strengthening the “Voice-Option” by Allowing more Active Participation of the People

- ⇒ *Stabilization of the Society*
 - ⇒ *Less Centralization and More Subsidiarity*
 - ⇒ *Realization of More Direct Democratic Elements in Some Areas*
 - ⇒ *Increasing Participation of the Public leads to more Commitment and less “Free Rider” Behaviour*
-

Reducing the tax rate considerably is the main recommendation, as it has been determined to be the main cause of the rise of the shadow economy in the integrative model. In addition, the system has to be simplified in order to attain greater transparency and lower density in regulation. The latter has undermined the tax base and made tax laws

really complicated which results in misallocations, distortions with regard to input and welfare losses. In the long run, tax ethics is eroded. Furthermore, an extensive reform of the social security system is necessary to reduce the burden of contribution payments.

The Reactance Theory suggests the following opportunities to reduce the resistance against the tax burden: on the one hand, credibly setting a time limit to the burden could avoid reactance and negative economic consequences due to migration into the shadow economy;³² on the other hand, if the infringement on personal freedom is perceived as legitimate it will not lead to reactance. The demand for greater transparency of the taxation system and the expenditure policy are then based on the objective, positive social-psychological theory. The loyalty to the state can also be increased by curtailing corruption and waste of tax revenue within the public administration. A significant correlation between the two is confirmed by various surveys.³³

Transfer payments should be increasingly reviewed with regard to the indigence and simultaneously made subject to a time limit. This would add to the motivation of the people concerned and make them avoid many wasteful habits. At the same time, the transfer payers regard this as legitimate.

Reducing the density of regulation, while at the same time increasing its security, especially with regard to the labour market, is a further element of a rational economic policy. Competition would increase due to the lower market entry barriers and would thus produce its dynamic welfare effects. Considering the preferences of the employed individuals on working time would ensure that they would have less time to engage in illicit activities.

Strengthening the “Voice” Option

In principle, reactance can be dismantled by solidarity. In economic policy, this has been dealt with under the term “moral suasion”. This means that if the individual accepts the necessity of infringement on personal freedom, she/ he declares her/ his solidarity with society and perceives the benefits offered by the state as being reasonable. Still, if the state informs the citizens about the extent of tax evasion and illicit work, this may have a contradictory effect: citizens willing to pay taxes will only then be informed about the size of the shadow economy. The consequence might be, that they will also work illicitly because they then perceive an unjustness of the burden and hence will try to do something about it.

This negative process can successfully be stopped by an active participation of the people in question. An often cited example deals with vendors and politicians who

³² The introduction of the solidarity contribution in Germany was an example of this. Keeping the set time limit, however, once again poses a considerable problem.

³³ For a more recent overview, see Bardhan (1997), Rose-Ackerman (1999), Mauro (1995) and Tanzi (1998).

spiritualize the opinions of the persons they have to represent and make these their own, even if these differ from the opinion they had initially (Pelzmann, 1985, pp. 56f). Transferred onto the democratic decision procedures, this means that the federalism has to be strengthened and further instruments of the direct democracy (e.g. referendums, legal initiatives) have to be introduced, so that the citizens can increasingly contribute, for instance, to the design of the taxation system. The interest in local policy, including regional projects and citizen initiatives trying to influence decision making, may mean a desire to keep or regain control. An increased participation will always diminish the perception of being subject to unfair restrictions of personal freedom. At the same time, morality and loyalty gain ground which helps counteract the rise of the shadow economy.³⁴

One should act according to the subsidiarity principle on all levels and a further centralization should be impeded.³⁵ The increasing shift of decision making towards Brussels and justifying this with European pressures (e.g. the increase of VAT in Germany for reasons of harmonization) does not strengthen the perception of the taxpayers of control over spending. The rising centralization, often combined with harmonization, is not the correct way to deal with a growing shadow economy. An increasing fiscal federalism would counteract the “detachment of state activities from the desires of the citizens” (Pommerehne and Kirchgässner 1994, p. 860, own translation). Hence, Frey (1996, 1997a) demands a “new federalism for Europe”. The objective is a combination of federalism and direct democracy. The main features of his proposed new governmental units can be summarized by the term “Functional Overlapping Competing Jurisdictions (FOCJ)” (Frey, 1996, p. 275), characterized by functional differences in size and geographic over-lapping, resulting in a competition of regions or systems. Individuals can state their preferences in referendums or citizen initiatives. These measures correspond to the subsidiarity principle because they enable people to control politicians and bring back power to levels at which many problems can be solved.³⁶

The increased participation of the public raises the commitment, i.e. the personal contribution and the interest for governmental issues can, as a consequence, dam up “moral hazard behaviour”. Strengthening the participation right can reduce the “free-rider” problem, as state efforts are regarded as being a fair equivalent ultimately boosting tax moral. One important reason for the small extent of the Swiss shadow economy, as opposed to other OECD countries, is the considerable amount of direct democracy elements.³⁷ In the long run, this leads to a strengthening of social capital and

³⁴ The relatively small Swiss shadow economy can be accounted for by the extensive “voice” options. See Kirchgässner (1999), and Weck-Hannemann and Pommerehne (1989).

³⁵ In public finances and social policy, this principle is regarded as the axiom of the distributions of duties between the private and the public sector as well as communal institutions. Following the subsidiarity principle, one can conclude that the tasks can only be passed to a higher level if the lower level is unable to solve the problem. The state should assume social assignments only if the individual or the family is overburdened.

³⁶ For a theoretical explanation, see Pommerehne and Frey (1992).

³⁷ See Pommerehne, Hart and Frey (1994) for an explanation of the differences in tax ethics and honesty in direct and representative democracy.

the sense of community, both of which contribute considerably to the successful survival of societies and further supply of public goods.³⁸

Conclusion and Outlook

Failing economic policy was confirmed as the most important cause for the strong increase in shadow-economic activities. Not only the rising tax burden and regulation density are important factors for the migration into the hidden economy, but also the defensive labour-market policy directed at a re-distribution of working hours. In addition, the lack of clear and stable institutions in transition countries are a driving force of informal economic activities. In combination with a reduced tax moral and less loyalty to the government, the potential of these factors will be exploited increasingly which leads us to the conclusion that the causes of the phenomenon need to be addressed systematically.

This conclusion is supported by the analysis of the causes and consequences. Merely increasing the costs of illicit work by intensified controls and setting higher fines would not bring positive effects on the overall welfare. Empirical surveys show that a fundamental tax reform is much more apt to impede migration. Besides the allocation effects, the stabilization effects are important for the whole economy as the black market acts as a stabilizing factor and a buffer, slightly reducing cyclical fluctuations. This holds especially in the current situation with its sclerotic labour markets and strongly regulated industries.

The tax deficit and evasion of social security contributions are the main arguments, with which the state wishes to substantiate its fight against the shadow economy. Still, when taking a closer look at the further consequences, the yield losses are no longer as high as generally assumed. It was clarified that not only the economy profits from the black market through higher supply and demand, but also the state receives additional revenue, e.g. through VAT. Nevertheless, substantial deficits remain and are heavily lamented by politicians. In the long run, reforms are inevitable not only due to the globalization but also because of the rising importance of the shadow economy. The agents will increasingly opt for the “exit” option if the “voice” option is not strengthened by more direct democratic elements, such as referendums on budget decisions, for instance. They will either choose to work illicitly or search for another system which better fits their preferences.

In this context, the shadow economy can be regarded as part of an evolutionary process, making economic and societal development increasingly dynamic. On the one hand, the societal pressure on deregulation and tax reduction is increased and, on the other hand, new innovative forms of living together and economizing outside the restrictions are fashioned which could be regarded as a test for the official sector.

³⁸ On the importance of social capital, see, for instance, Coleman (1990, pp. 300f) and Hirschman (1994).

In the long run, however, a society cannot accept non-compliance with laws and rules as these form the basis of the state. Yet, it does not make much sense to fight illicit work with intensified controls and higher fines. The tendency to engage in shadow-economic activities should be perceived as a warning signal by politicians. There is an increased resistance against the existing norms and laws in the economy which can only be met with adoption of the two-pillar strategy.

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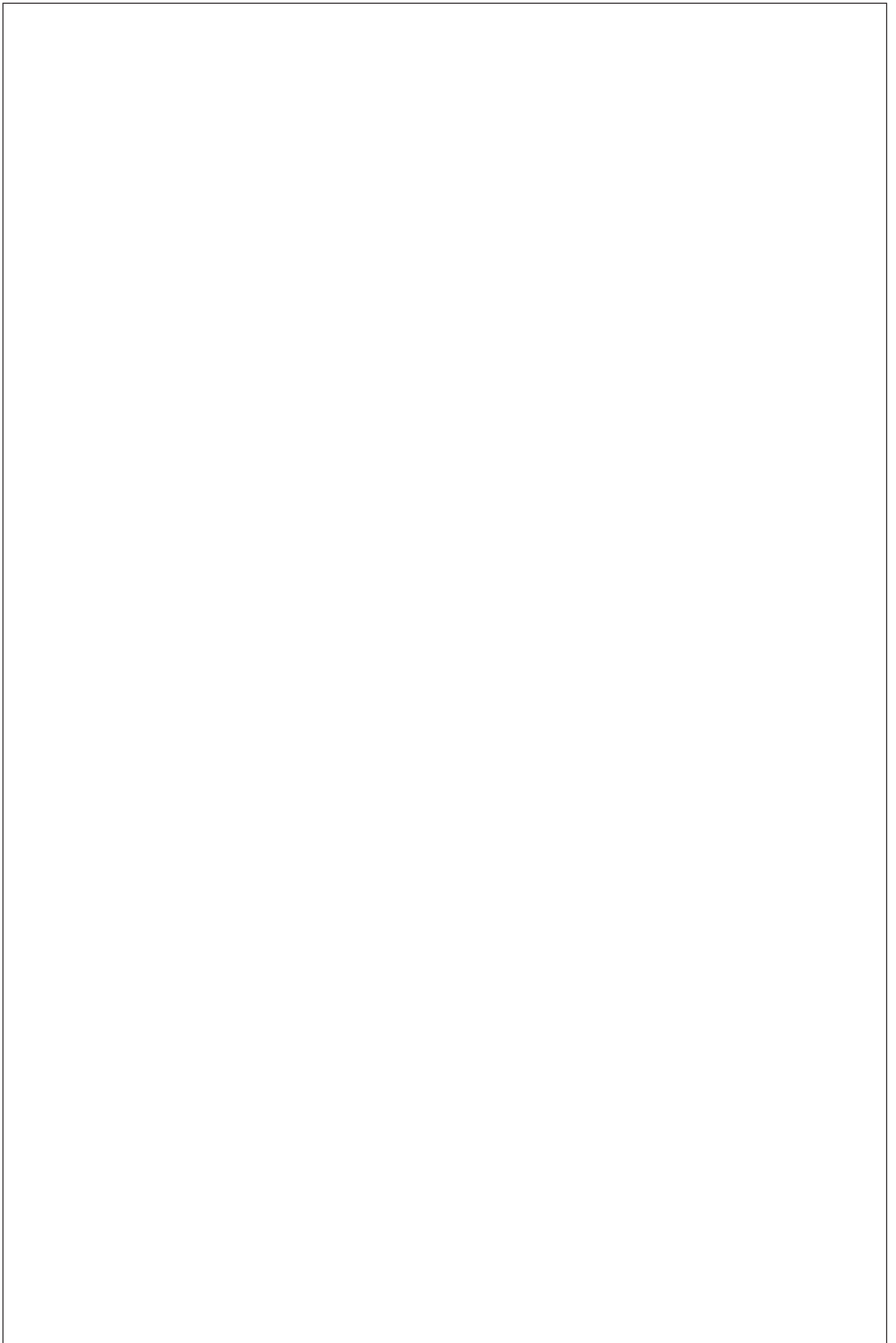
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CHAPTER 5

Poverty and Informality in Southeast Europe

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Introduction

This paper looks at the informal economy from the perspective of the poor. It tries to identify some possible directions for dealing with the problem of informality as part of poverty reduction strategy. The empirical evidence is very patchy and the paper does not try in any way to be exhaustive. The analysis is based on the empirical findings of qualitative and quantitative studies on poverty and social assessments carried out in Southeast Europe by the World Bank over the last six years and focuses on the region of Southeast Europe (SEE), including Albania, Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia (FRY), the Yugoslav Republic of Macedonia (FYR), Bulgaria, and Romania. It argues that the major coping mechanism of the poor in most of these countries is informality, a way of coping with the many dimensions of poverty, beyond the common dimension of income. Using the concept of “informality” and not of “the informal economy” we argue that it is important to make comprehensive recommendations for policies that would reduce poverty with regard to the “informal sector”. The poor have to deal with informality both in the economic sphere and for those concerns related to the access to social services, network of solidarity, security, etc. It is therefore important for policy-makers to look at coping mechanisms and not just economic activity, as an integral aspect of poverty.

The countries of Southeast Europe have experienced three transitions: from a socialist system to a market economy; from state control to democracy, or to democracies in the cases of newly created states, and for the majority of these states from war to peace. Southeast Europe is an extremely diverse region and the trends in economic change have been different. There are various reasons that are central to the divergent outcomes. One factor is the dissimilarities in historical legacies; other factors include the substantial variations in the patterns of corruption and cronyism, the considerable disparities in the development of civil society, political parties, and the reform policies of the governments.

TABLE 1: GROWTH IN REAL GDP IN SELECTED SOUTHEAST EUROPEAN COUNTRIES

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
<i>Albania</i>	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.8	7.0	6.0
<i>B-H</i>	na	-23.2	-12.1	-30.0	-40.0	-40.0	20.8	86.0	37.0	10.0	10.0	5.0	5.0	5.0
<i>Bulgaria</i>	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	5.8	4.0	3.5
<i>Croatia</i>	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.4	3.7	3.8	3.0
<i>FR Yugoslavia</i>	1.3	-7.9	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-15.7	5.0	5.0	5.0
<i>FYR Macedonia</i>	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.1	-4.0	1.0
<i>Romania</i>	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.6	4.0	3.5

Source: EBRD (2001), Transition Report. (*EBRD forecast.)

Most Southeast European countries experienced a very rapid fall in GDP at the beginning of the 1990's due to the collapse of trading systems and war. Since the process of transition began, large sectors of the population have been marginalized and their living standards fallen abruptly. Although country-specific poverty levels are different, poverty increased everywhere in the early 1990s.

Most Central and East European (CEE) and Southeast European countries have seen a surge in informal activities, despite the fact that informality was already high under socialism, mostly to cope with the imperfections of the economic system. The changes in the legal framework and the superposition of new market-oriented legislation over the old laws inherited from the socialist system, have created a legislative confusion favoring the development of informal activities.

EUROPEAN UNION ACCESSION OF SOUTH EAST EUROPEAN COUNTRIES

The move to accession to the European Union is a key political priority in almost all countries of SEE. This motivation stems from political and economic ambitions as well as security concerns. The requirement to become an accession country relates to the progress of liberalization of trade, market, macro-economic policy, and the development and democratization of institutions. There are different trends in the progress in transition of SEE countries. At the Helsinki European Council in December 1999, accession negotiations with Bulgaria and Romania began. Due to various concerns, the EU was unwilling to open up prospects of accession negotiations with Albania, Bosnia-Herzegovina, Croatia, FR Yugoslavia, and FYR Macedonia. Thus as an alternative, the Stabilization and Association Process (SAP) became a way to move forward towards negotiations. In 2001, FYR Macedonia signed a Stabilization and Association Agreement (SAA) and was followed closely by Croatia and Albania. As EU accession prospects improved, structural reforms accelerated and in recent years FDI increased in Bulgaria and Romania while lagging behind in the other SEE countries.

The transition countries have undertaken far-reaching liberalization of their markets as well as reducing the barriers to structural change. Most of them are effectively working on the adoption of the *acquis*. Recently, some of the Central and Eastern European (CEE) countries showed an effort to reduce administrative barriers to start-up firms, through increased attention to the needs of small and medium enterprises. On the other side, the financial system remains an issue in most of the SEE countries. It is very rare to get venture capital and the formal financial system has little patience with new enterprises asking for financing with little or no collateral. Still, informal financial arrangements are flourishing (Åslund and Warner, 2002, p.3). For instance, Bulgarian recovery from the financial crisis of 1996-7 appears to have been financed without a formal functioning banking system. One of the main systemic problem of the transition countries is often seen to be corruption. According to a 1999 EBRD survey, within the CEE the average bribe tax as a share of total enterprise turnover is 3.6 percent (Åslund and Warner, 2002, p.16). The SEE accession countries can look forward to more aid from the EU, larger inflow of FDI and benefit from free trade which will have a positive effect on growth. Conversely, accession is accelerating institutional convergence with EU, which may also bring labor market and fiscal policies that increase unemployment and slow growth.

Source: EBRD (2001).

The social and economic dislocation of transition, along with the resulting drop in output, government revenues, and household incomes, accelerated the emergence of informality as a coping mechanism. This is mostly because the formal support system collapsed or was seriously weakened and could not cope with the increasing number of the poor.

TABLE 2: ABSOLUTE POVERTY RATES OF SELECTED TRANSITION ECONOMIES, 1995-1999

	Survey Year	Headcount index	
		2.15/day	4.30/day
Albania	1996	11,5	58,6
Romania	1998	6,8	44,5
Macedonia. FYR	1996	6,7	43,9
Bulgaria	1995	3,1	18,2
Croatia	1998	0,2	4

Source: World Bank (2000b).

This paper will look at informality from three perspectives: informality in the access to social services; informality in the access to employment and revenues; and, informality in the access to favors, security, and justice. It will also consider some of the implications for adoption of policies to reduce poverty.

Coping with Informality

Looking at the various qualitative assessments undertaken by the World Bank and client countries in the region – assessments which registered the opinion of the people interviewed and in particular the poor – informality could exacerbate poverty, either directly or indirectly, through increasing inequality in the access to services and opportunities, increased vulnerability, and human abuse. It is also clear, however, that informality is an important coping mechanism when formal systems have collapsed or are under immense stress. People recognize that informality is harmful to their standards of living and to the distribution of income in general, but in most cases they have no choice because there are no viable formal alternatives. In some cases, however, there is a perception that through informal means it may be possible to get better deals by playing on connections or just by appealing directly for the understanding of the service provider. Indeed, in countries where formal cost recovery for services has been imposed to try and reduce under-the-table payments, it is not clear that the poor have been made better off. Regardless of this, informal payments are very important as a coping mechanism for the poor. In Bosnia and Herzegovina, for instance, according to the World Bank Diagnostic Surveys an average of 19.6 percent of the respondents who receive health care, education, police and judiciary services, pay bribes (money, gifts or counter service).

Around 7 percent of 600 respondents gave a bribe for education and 26.4 percent for health services (World Bank, 2001b). Obtaining a job is another argument found in some of the interviews to justify the fact that informality is not so bad after all for the poor (whereas if it was formal the job would not have been created in the first place because of the high indirect costs).

In the poorer Southeast European countries informality as a coping mechanism is prevalent due to a number of very straightforward factors. *First, the lack of fiscal capacity of governments, which has many consequences.* For example, social benefits and pensions are too low to survive on; in some cases they are lower than the poverty line. Health and education are insufficiently provided and staff employed in the social services is underpaid, which stimulates informal payments. Enforcement is very difficult, because the law enforcement personnel is generally underpaid.

Second, the lack of capacity of state institutions, where capability to target benefits is low in part because of the large-scale informal sector but also because the capacity for outreach and support is limited. Consequently, it is very difficult for the state to target subsidies for the poor and to introduce users fees for the wealthy. Moreover, non-governmental organizations (NGOs) and civil society in the region are also weak and not sufficiently organized to carry out the sort of support and outreach as they successfully do in the European Union countries.

Third, the lack of formal organizations to support trade and economic activity. Private sector activities are limited while the poor are numerous. This is both a cause and a consequence of poverty. Regional imbalances have increased dramatically with the transition to a market economy, mostly because the substantial subsidies supporting poor and isolated regions were sharply reduced. In addition, a large number of parastatal industries, which provided livelihood to whole regions in the past, suffered a decline or totally collapsed.

Small businesses, which have been so crucial for growth and employment in many countries, are still constrained in SEE by the lack of availability of formal credit for the poor. This is true for micro- and small enterprises in general because the banking sector is very weak. Micro-finance institutions have recently emerged in the region as a way to support informal sector activities, but the scale of these institutions is not yet adequate to meet the needs. Furthermore, there is an unclear legal and administrative framework for businesses: network connections for obtaining favors from the pre-socialist or war times persist. Their implications can be very negative: mafia, money laundering, and human trafficking are all based on such networks. There is much evidence that these networks, especially when they extend beyond particular communities, actually exclude the poor.

INFORMALITY AND ROMA MINORITY

Many studies show that the Roma have been more vulnerable to the social impact of the economic transition in the region than other groups. The Roma is by far the group for which informal coping mechanisms are the most widespread. This is partly due to cultural reasons but overwhelmingly because of poverty. The Roma generally have a low level of education and professional skills, and thus find it difficult to compete for jobs. "Due to these reasons, along with discrimination in the labor market, they were the first to be laid off from state-owned enterprises, mines, and agricultural cooperatives during restructuring. Their access to social services in the transition period has been challenged by the new entry barriers, such as the informal and formal payments. Cultural prejudice and discrimination have also had their toll and in many countries these have increased with the social tension related to transition and war. They frequently live in isolated areas, and may lack necessary documentation for schooling, claiming social assistance or health benefits." (Ringold, 2000, p. viii). Moreover, the high prevalence of the Roma in the informal sector employment limits their access to insurance-based benefits, including health care and unemployment insurance.

The Roma minority comprises a considerable part of the population in many Central and East European countries and the former Yugoslavia. "They represent 6 to 10 percent of the population in Hungary, Romania, Slovakia, the former Yugoslav Republic of Macedonia and the Czech Republic. The Roma have long been a marginalized group and they have entered the transition period with lower levels of welfare and access to social services than the non-Roma." (Ringold, 2000, p. 52). These gaps have widened during the transition. "Poverty data confirm that poverty rates for the Roma far exceed those of the overall population. In Hungary, for example, the Roma are about eight times more likely to be in long term poverty than the general population." (World Bank, 2000b, p. 43). Health status is affected by poor living conditions; Roma housing is overcrowded and public services are inadequate. Access to clean water, sanitary facilities, and waste removal is lacking. Infectious diseases associated with poor living conditions are prevalent.

Informality in Access to Social Services

Health Systems

It is now quite clear that throughout Eastern Europe informal payments for health services are becoming critical for gaining access to these services. "While there is hard evidence showing health outcomes for the poor are more negatively affected than the rest of the population, it is clear that access to health is becoming increasingly dependent on whether a household can afford the informal payments to doctors and others practicing in collapsed public institutions and that the poor have the least ability to pay." (World Bank, 2000b, p. 9) Most social assessments show that loss of access to free health care is a growing concern to the poor and contributes to their sense of hopelessness and vulnerability.

Within the region the growing pattern of informal payments to doctors, hospital administrators, nurses, and others related to healthcare delivery (where these payments are unaudited and unreported), has implications for governance, equity and access. Recent research has provided convincing evidence that informal payments and more

generally out-of-pocket payments constitute a substantial portion of the healthcare expenditures in many countries in Europe and Central Asia (ECA). The World Development Report of 1993 on healthcare gave an estimate of 25 percent of the spending in Romania and 20 percent in Hungary came from out-of-pocket payments and gratuities. A survey of urban residents in Bulgaria, conducted in 1994, found that 43 percent of those respondents who had used health services in the previous two years had paid cash for officially free services in state-owned medical facilities. Similarly, a 1992 Bulgarian survey had found that 34 percent of the respondents had used a “connection” to receive medical care.

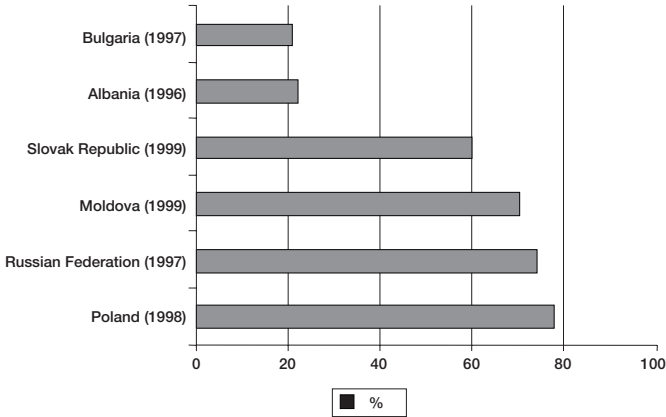
Another extremely common form of informal payment comes in the form of in-kind gifts to physicians. In Bulgaria the bulk of informal payments constitute gifts, including food. In many cases the value of the gifts is small – for instance, flowers or alcohol. Other types of in-kind payments, however, may include car repair or other services. Such payments, she argues, are often expressions of gratitude – given after successful or complex treatment. They may be given, however, as a form of insurance in order to guarantee security and good will in case of future illness. This is actually a widespread phenomenon in rural areas in the European Union and might not have particularly negative consequences.

Recent research has identified a number of potentially negative impacts that informal payments have had on health care, including decreased access to healthcare for women and the poor. These informal payments, however, also allow for services that the state cannot fund to continue to exist. The problem once again is not the informal payment but the under-funding of health services. The relationship between informal payments and access is complex. It may not make much difference to the poor whether high health fees are official or unofficial, as obstacles would be equal in both cases. Informal payments, however, make it impossible for the government to modulate health fees in order to facilitate access by the poor.

Health indicators and anecdotal evidence suggest that the increase in out-of-pocket payments has substantially brought down the utilization of healthcare facilities. People tend to utilize these facilities only under exceptional circumstances. The evidence on the effects of co-payments in the US suggests that prices have a stronger effect on the decision to initiate treatment than on the amount of care obtained once treatment has begun. Moreover, many of the studies show that the poor have been forced to pay an increasingly larger percentage of their income on healthcare over the last six years.

On the other hand, the demand for informal payments may simply arise out of the need to survive as in many Southeast European countries the official salaries of medical personnel are below the average of public sector employees, i.e. very close to the poverty line.

The introduction of health insurance systems also has a negative impact on access because of the large informal sector in these countries. As seen in Romania as well as many other countries in the region, the poor in the informal sector do not have formal

 FIGURE 1: SHARE OF PATIENTS MAKING INFORMAL PAYMENTS IN SELECTED ECA COUNTRIES


Source: World Bank (2000b).

labor contracts, so no contributions are made by their employer or by themselves to the state pension funds or for healthcare benefits. The result is that these individuals are not eligible for those services and that little money is actually paid for health insurance.

The recent qualitative poverty assessment for Albania has shown that the quality of health and access to healthcare is a serious issue in Albania. Some 41 percent of the people surveyed believe that the health of the households has worsened since 1990 (World Bank, 2001a, pp. 60-68). Principally, for those who are at the bottom of the socioeconomic ladder – those in rural areas without access to key infrastructure, such as water and sewage systems – health and healthcare conditions are worse. The quality of healthcare delivery has declined in cities, villages, and rural areas in general. Many doctors and nurses are leaving the profession due to low incomes. Without enough staff and sufficient funds, health care delivery in many rural areas has practically ceased to exist. As a result, many of the medical staff work informally out of their houses and charge informal fees for their services but most of the poor cannot afford to pay these fees. All of these factors contribute to the declining health of the population (ibid.).

Education Systems

The role of education is very influential in preventing people from falling into poverty. The link between education and poverty is similar to that between unemployment and poverty as unemployment rates fall with every additional level of education. There are poor people at all educational levels in the SEE. The education sector also suffers due to the under-funding and low wages for teachers, especially in primary education, with

the pre-school level having practically disappeared from whole areas in this region. Informal payments as well as formal fees are now widespread. The poor suffer from the larger level of bribes than the non-poor households. According to various World Bank poverty and social assessments, in most of the SEE countries the amount of per capita education subsidy is roughly the same across income groups.

Informal payments are made to support classroom maintenance, payment for heating or energy, and to purchase basic instruction materials in poorer regions. This is a practice that also exists in the EU. In the SEE countries informal payments are not just supposed to guarantee commitment by parents but rather to allow for basic functioning of the schools. Tension arises between those who can pay and those who cannot pay, thus creating an impression among the poor that they cannot contribute; as a result, a sense of being excluded appears among the latter.

Informal payments to teachers are another very important aspect of informality. In most cases they go for tutorials and evening classes. This phenomenon *per se* is not negative, but it can be if teachers pay much more attention to these evening classes than to their regular classes during the day. A more serious cause of concern are direct payments to teachers, or in some cases bribes, for passing grades or letting students advance from class to class. This penetration of informality into the classroom contributes greatly in limiting the access to quality education for the poor.

According to a recent qualitative poverty assessment for Albania, most people feel that the quality of education has declined over the past ten years. The overall decline in educational quality and education levels has highlighted some very worrying trends, such as emerging illiteracy in some rural and newly formed urban settlements. Teachers' salaries are very low and the social status of educators has declined in the past ten years. This reduces the incentives and hurts the motivation of many teachers, inducing them to look for informal payments and gifts. There is evidence that some people withdraw their children from school when they are at an age to work to cope with poverty. Some families cannot afford the incidental costs of sending their kids to school especially in an environment of reduced educational budgets for households. With the difficult economic conditions of transition, a number of people no longer value education as much as they did before the transition - their top priority is just to survive.

Social Protection

The interaction between informality and social protection raises two very different issues. First, the poor tend to rely on informal mechanisms in the traditional areas of social protection, including help for the elderly, the extended family, the handicapped and for those in extreme poverty. As it was mentioned above, the high demand for benefits from the state and the low level of public funds available for this purpose in many of the countries under review limit the effectiveness of social protection systems. Consequently, many people among the elderly, from large families, handicapped, or others have been

left with no other means than their own or family support. The second issue is that the high level of informal activities considerably limits the financing available for formal social protection, especially in countries, in which payroll taxes constitutes the largest source of funds for pensions and other forms of support, such as unemployment benefits.

The study on local level institutions in Bosnia and Herzegovina (World Bank, 2002, pp. iii-v) has identified a wide range of informal support mechanisms between neighbors and kin: “the main forms of material assistance are monetary assistance, donation of food and commodities, sharing of collective charges, cooperation in building and repair of houses, and cooperation in maintenance of apartment buildings. Monetary assistance is most frequently related to traumatic events such as fire, illness, accident, or death. Donations of food and commodities are closely linked to the impoverishment of the post-war period.” The study also shows that this type of solidarity varies according to regions and the period during which communities have lived together. This type of support is more widespread in countries, which have undergone major traumatic events, such as war, but it is also common in rural areas in Albania and particularly strong within some ethnic communities like the Roma, for instance.

The Bulgarian poverty assessment raises some serious concern about the state of social protection systems. With the exception of guaranteed employment Bulgaria’s pre-transition social protection system, consisting of pensions, short-term benefits for illness and maternity, family allowances, and in-kind social assistance programs and institutions, still remains intact. Since the beginning of the transition government policies involving early retirement options for laid-off workers and the benefits made available under new programs, have led to an increase of the number of people receiving income support through state social protection programs. Still, cumulative social insurance payroll tax rates today are higher than before. The rates were raised in an effort to cover rising costs and compensate for shrinking contributions – the result, in turn, was higher unemployment, arrears by state-owned enterprises, and non-compliance by the growing private sector (World Bank, 1999b, p. 48). Moreover, almost everywhere in Bulgaria it is a common practice that people use connections, patronage, family and friends networks to deal with everyday problems. Kinship and friends networks are seen more as moral support than functional. Some argue that your career depends on your resources especially on money and connections, rather than on skills and qualifications (World Bank, 1999d, p. 79).

Informality in Access to Revenue and Employment

Informal economy and unemployment

Unemployment has become a feature of the transition economies of Southeast Europe. Unemployment figures, however, do not account for the many people who work now in

the informal sector. Analyses of informal employment in social assessment and other qualitative studies have emphasized the insecurity, hard work, very long hours, extremely low wage rates and sometimes dangerous working conditions. The unemployed rarely choose to become involved in informality, preferring the security of formal employment. Nevertheless, the lack of formal employment, coupled with an inability to meet household needs in the absence of welfare benefits or because of the inadequacy of the available assistance, encourages people to turn to the informal economy in response. Others, likewise, see the informal employment strategies of the unemployed as a part of a survival strategy, through which some individuals develop alternative ways of working in the face of the existing limited opportunities and the failure of the welfare system. Informality enables the unemployed poor to get some basic income, but what is more important, it may help them maintain a sense of self-confidence.

Enterprise restructuring and the privatization process has led to painful worker layoffs in Romania. Even though the data on the size of the economy is questionable, Romania has a considerably large informal economy which is estimated at 40 percent of GDP by the US Treasury. In the qualitative research done by the World Bank staff, it was estimated that maybe up to 80 percent of the unemployed worked, in fact, in the informal sector. According to the qualitative and quantitative research done in December 2000 most of the informal sector work is in agriculture, construction, trade, and in some service sectors (World Bank, 2000c).

Most individuals work in the informal sector only if they have to, or if they can supplement their informal sector earnings with their unemployment benefits and the social services, such as health care, that are available with these benefits. First of all, for the vast majority, informal sector wages are very low. In Albania average monthly informal sector wages range from ROL 300,000 to ROL 750,000 (\$16.70 to \$41.65) per month for full-time work, which is only about half of the average monthly formal sector wage (World Bank, 2001a, p. 32). The more illegal the work, the higher the wages, as well as the higher risks and fines if caught. Second, informal sector employment is often irregular and uncertain. Employees believe that employers will only hire someone for a maximum of three months or less. In the qualitative research, "many unemployed workers claimed they could only find about five days of work per month" (World Bank, 2001a, p. 98).

A social assessment of poverty in Bulgaria shows that the changing situation of the labor market leads to an acceptance of illegal activities. The actual loss of jobs in the public sector and the collapse of state-guaranteed job security has made it acceptable not only to be involved in simply illegal acts but also in criminal activities for the purpose of survival. These include burglaries, pick pocketing, muggings, theft as well as prostitution and drug dealing. Some people argue that in the case of Varna, where in 1999 80 percent of the active population was unemployed, this was compensated by a very large involvement in the informal economy (World Bank, 1999d, p. 50). For

TABLE 3: UNEMPLOYMENT (ANNUAL AVERAGE, %)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
<i>Albania</i>	24.8	16.1	13.9	9.3	14.9	17.8	18.0	16.8	na
<i>B-H</i>	na	na	na	na	37.0	38.0	40.0	40.1	na
<i>Bulgaria</i>	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9	na
<i>Croatia</i>	14.8	14.5	14.5	10.0	9.9	11.4	13.6	16.1	na
<i>FR Yugoslavia</i>	23.1	23.1	24.6	25.8	25.8	25.1	26.5	27.3	na
<i>FYR Macedonia</i>	28.3	31.4	37.7	31.9	36.0	34.5	32.0	32.1	na
<i>Romania</i>	10.4	10.9	9.5	6.6	8.9	10.3	11.8	10.5	na

Source: EBRD (2001).

example, women in this community were all unemployed and engaged in informal and criminal activities because they did not have a choice. Moonlighting is another strategy for private households or businesses – they hire mostly Roma people and off the books.

Formal micro businesses and self-employment, which have been a very fast growing sector in recent years in the European Union, face very large constraints in Southeast Europe. “The underdeveloped market environment as well as the poor legal framework, the petty corruption among the law enforcement authorities and bureaucrats, and the lack of credit does not help the situation of the poor in spite of the recent emergence of micro-finance opportunities for a small percentage of the poor. All this leads to a vicious circle: the informal economy – dodging taxes and social contributions while taking advantage of public goods and services – increases the budget deficit and is an immediate cause for raising taxes and social contributions which are a heavy burden on lawful activities” (World Bank, 1999d, p. 52). In turn, high taxes depress economic activity and income stabilization, which brings us back to square one, making informality a mechanism of survival and coping, especially for the poor.

INFORMALITY AND WOMEN IN THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Recent qualitative assessment in FYR Macedonia suggests that women’s involvement in the informal sector is likely to exceed that of men. Emerging new barriers to women’s participation in the formal economy often create conditions for their involvement in informality. Many end up in the informal sector out of necessity rather than choice. Some of the opportunities available to women in the informal economy include the time flexibility it can offer to allow them to reduce the conflict between work and household life.

Recent trends in the newly developing private sector show that women earn less than men in the private sector, though at similar levels of education, experience, occupation and industry, particularly in rural areas. The gender wage gap is purely explained by discrimination, as women have on average much more industry, occupation and other factors. The lack of contract enforcement in the private sector, increasing informalization of the economy, the higher cost of hiring women (generous maternity benefits, etc.), and other discriminatory behavior towards women workers, are some reasons for the lower wages of women compared to men.

A small number of interviewed women were engaged in skilled work, knitting sweaters, weaving, or in making traditional garments (mostly in the western region) at home. Some women work in the informal sector as seamstresses. Women in urban areas most often work as cleaning ladies in buildings and apartments. In many households from the urban areas, prostitution was mentioned as a way of survival. In rural areas, poor people work as day laborers on other people’s land (cutting, digging, sawing and similar) or mind cattle, mainly during the summer months. The informal work described in household interviews is arduous, seasonal or occasional in nature, requiring a long search period, and is often available only during the summer months. Women selling traditional garments also cited reduced demand for their work as a result of increased competition from workers in Albania. Many women said that it was easier to find work a few years ago. They related that even seasonal work opportunities, for example, the extraction of sugar turnip; picking apples, sour cherries and other fruit in orchards; or work at hotels, are now few.

Source: World Bank (1999c).

In a poverty assessment of FYR Macedonia, carried out in the framework of the preparation of the poverty reduction strategy, most interviewed households claimed that it was not possible for them to obtain loans to start a small business, mainly because they could not obtain mortgage at affordable rates. Most of the unemployed have a lot of ideas and interest in what they would do (e.g. open cattle-breeding farms or craft workshops, or market products) if they could get credit on favorable terms. With no access to financing and credit, and unbearable unemployment, most households are led to engage in illegal or semi-legal trade to survive. Others, with a small amount of capital (savings from better times, loans from relatives), engage in smuggling. They buy goods, food, textile products, jewelry, alcohol or cigarettes from duty-free shops in Bulgaria and Turkey and sell them in the markets or on the streets (the so-called suitcase trade).

Informality in obtaining favors, justice, and security

The World Bank poverty assessments in Southeast Europe include many references to informality as an important way to obtain essential administrative documents, pressure the judicial system, and achieve the cooperation of the law enforcement personnel. Many poor people see the lack of fair access to the legal system and the lack of security as major components of poverty.

The lack of trust in the legal system and the possibility for people to have influence on it in a non-transparent way are major issues. It is very difficult to get precise information in this area but it is obvious that petty corruption of law enforcement officials is widespread in the poorer countries of Southeast Europe. In most of the social assessments lack of trust in the legal system and in law enforcement mechanisms are seen as the main obstacles for the poor to start a business. The development of micro, small and medium-size enterprises in the region is severely constrained in particular by poor and arbitrary enforcement of legal, regulatory and administrative rules. Excessive bureaucratic procedures and practices have a strong disincentive effect on the creation and growth of enterprises.

In Albania the qualitative poverty assessment has shown that the traditional form of justice is administered through the *fis* clan, based on a council of elders and the *canun* system (a traditional legal system), and is now widespread in the poorer Northeastern part of the country. This mechanism tends to provide some form of stability inside clans but is not effective in dealing with problems between clans; it also encourages blood feuds and revenge. In some areas, such as Skhodra and Northern Kukes, families reportedly are confined to their own homes to protect themselves during a feud, not even being able to get access to their land. These are quite extreme cases for Southeast Europe but they indicate how broadly informality has expanded to areas such as justice and security.

In terms of security, the interviews with the poor in Bulgaria, confirmed that in general poor people do not feel secure. It was implied that even if you are assaulted or

beaten up, nobody will intervene and it would be better to stay away from the police, or they will beat you up or laugh at you because they do not want to spoil their records by registering another crime on their territory. Only those who are rich and powerful are not afraid of anybody (World Bank, 1999d, pp. 29-30). Others saw humiliation, absence of rules, domestic violence and depression as major impacts of poverty.

Lessons for Policy

The difficulty of the transition and the post-war reconstruction in most of the Southeast European countries have pushed many social actors, individuals, firms and even public institutions to operate in the informal sector. This has been overwhelmingly the case for the poor. The complete elimination of the informal economy is unrealistic as European Union governments themselves realize. No significant reduction of the informal sector will occur unless there is improvement in the general economic situation and in the policies supporting those who are seeking survival within the informal sector.

For instance, the Romanian government attempted to reduce the size of the informal economy, but the emphasis has been on punishment rather than on prevention through use of incentives - laws and institutions were created to control and fight the black market and tax evasion. These policies have not really been effective and the informal economy continues to expand in this country. The business environment has not improved and the country has not become more attractive for foreign investors.

What is most important is to try to differentiate between the informal economy, which helps the poor to cope, and the informal economy, which has large negative externalities on the economy as a whole and on the welfare and basic rights of the poor. This differentiation is especially important in situations when the state cannot really take its full responsibility for social support and human development because of shortages of funds and weak capacity. In this case trying to reduce informal support and services would bring the risk of further excluding the poor.

Improving Access to Social Services

Incentives for promoting self-help among the poor are needed. Finding mechanisms allowing for flexible "officialization" of the informal coping mechanisms, which can have a positive impact on the poor should be part of the strategies to deal with informality. For example, give responsibility to parent-teacher associations for some part of school maintenance and teaching materials and at the same time create school funds, which include mechanisms to have the poor exempted. Encourage national NGOs to support school maintenance in particularly poor regions. Have community-based targeting systems that allow municipalities to exempt some households for payment for services but in a transparent and informed way. Encourage local associations to set-up food distribution and other programs.

Reforming Regulatory and Legal Frameworks

For these programs to work, it is essential to create a supportive environment for community based organizations, NGOs, and other civil society organizations and, in particular, to reduce to the minimum the administrative requirements for registration, reporting, licensing, etc. The mechanisms, however, need to be very clear, well defined and transparent enough. Very often for this to work the government needs to take action at the national level. Establishing an appropriate legislative framework for associations and the not-for-profit sector is very important. This framework needs to provide for flexibility and ease of registration but they also need to protect the right of the members and avoid abuse. In some countries, things can get quite complicated, especially if these associations are supposed to enter into partnership with central or local governments and use public funds.

On the other hand, law enforcement and prevention activities need to be strengthened in the area of drug and human trafficking as well as larger informal activities benefiting mafias. This is a very urgent issue in Southeast Europe, for which international assistance is definitively required.

Employment Creation

Sustainable poverty reduction for Southeast Europe is also dependant on positive economic growth, based on a vibrant private sector. Such a private sector should not only provide the necessary employment and higher income, but also the tax base for sustained funding of public health care, education, social safety nets, agricultural research and other critical programs, which have a positive impact on the poor. Improvement of the conditions for the poor, who are surviving via informality, will only occur in a favorable business and investment environment. The lack of an effective legal and regulatory framework remains a major impediment to successful private sector development.

In the employment-creation and revenue-generating area micro-credit has an important role to play. Many promising experiences should be better assessed to see the potential for replicability. In Croatia, the Catholic Relief Services (CRS) have very interesting credit and saving schemes. The World Bank is supporting a very successful program of micro-credit in Albania, which promotes credit and saving systems for village associations. The area of micro-credit offers very interesting potential for development and is certainly a way to compete with the informal credit system in a way that benefits the poor. Technical support is important for micro-enterprises. Here again the legislative framework is very important. Croatia has been preparing a law for the last two years to allow non-banking institutions to do some micro-lending and to expand some of the pilot projects, which have been started by NGOs and others. The development of the region's micro-, small- and medium-sized enterprises is severely

constrained by the poor business climate, lack of finance, and inadequate infrastructure. The legal and regulatory environment impacts differently on different enterprises, entrepreneurs and households. It can have a particularly negative effect on micro-enterprises, for which excessively bureaucratic procedures and practices have an important disincentive effect on start-up and growth. Programs to support SMEs and micro-enterprises are often thought of as key interventions to support the poor. Small enterprise, and in particular micro-enterprise development, is certainly an important way to increase employment, create a more regionally balanced development and empower people in general.

In the area of trade legislation needs to be changed in order not to criminalize people for doing small trade for survival. There is quite a rich experience in the EU in this area. Simplification is necessary for the tax and registration systems for small traders. Additionally, legislation should be enacted to reduce the level of taxation and provide clear rules of the game in order to reduce petty corruption from law enforcement officials, which can be a major source of difficulties for the poor.

Furthermore, for small businesses the intractable problem of corruption must be addressed through a mix of internal and external efforts that involve the state, the private sector and civil society. Donors could make substantial investments in civic monitoring efforts and in the creation of business coalitions, which promote good government, transparency in financial transactions, deregulation and simplification of registration, taxation and inspection procedures.

In the poor countries of Southeast Europe, in which potential for large savings is limited and informal activity is widespread, financing social protection and health insurance through payroll taxes does not seem to be appropriate. It can only increase the rigidity of the labor market, be very costly in terms of tax collection and ineffective in mobilizing savings. It also contributes to social exclusion by not covering people employed in the informal sector - this is particularly relevant for health insurance. A major effort in this area is needed by governments and donors to find more effective ways of financing social programs.

Improving Public-Private Partnerships

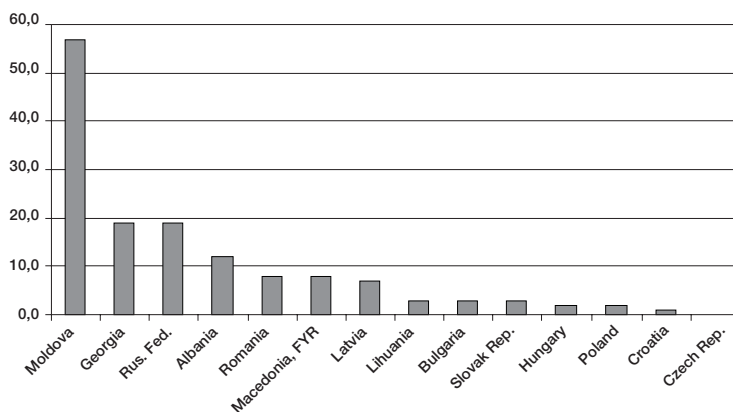
It is important to give a stronger voice to communities in order to fight petty corruption and devise mechanisms which would require local civil servants or municipal employees to be more accountable to the poor. This is an area where quite a lot could be done. In Tirana, for instance, the mayor is setting up a report card system on the delivery of basic services by the municipality. The mechanisms will get feedback from citizens on the quality of services through regular surveys and focus groups. Additionally, a mechanism of participatory monitoring and evaluation for health services is under preparation in Albania, involving users of healthcare services and aiming at providing feedback on the quality of these services.

We have tried to demonstrate that in the poorer EU accession countries, the poor cope mostly through informality. The governments are not capable of providing the adequate safety nets that would allow the poor to survive without informal relationships. It is therefore important to ensure that whatever measures are taken towards the informal sector they do not contribute to worsening the situation of the poor. In this paper we tried to indicate some possible ways for governments to reduce the negative impact of a large informal sector with pro-poor policies. More understanding is needed on these informal relationships to identify adequate policy measures. This is the reason the World Bank is launching a number of studies in the region on local-level institutions and social capital, which will hopefully improve our understanding of some of these issues.

ANNEX

Other Related Tables and Figures

FIGURE 1: PERCENTAGE OF THE POPULATION LIVING IN ABSOLUTE POVERTY IN VARIOUS ECA COUNTRIES



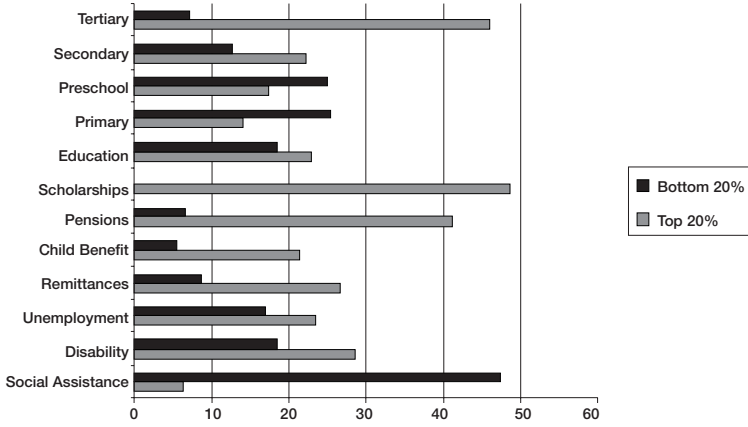
Source: World Bank (2000b).

TABLE 1: INCIDENCE OF PUBLIC EXPENDITURES ON EDUCATION IN SELECTED COUNTRIES

Country	Preschool	Primary	Secondary	Tertiary
<i>Romania (1997)</i>				
Bottom 20%	-	21	26	10
Top 20%	-	10	12	24
<i>Bulgaria (1997)</i>				
Bottom 20%	23	21	16	11
Top 20%	-	-	-	-
<i>FYR Macedonia (1996)</i>				
Bottom 20%	24,9	25,4	12,6	7,1
Top 20%	17,5	14	22,3	46
<i>Albania (1996)</i>				
Bottom 20%	-	27	7,2	7,5
Top 20%	-	11,8	32,3	31,6

Source: World Bank (2000b).

FIGURE 2: FORMER YUGOSLAV REPUBLIC OF MACEDONIA, COMPARATIVE EFFICIENCY OF TARGETING: SHARE OF TOTAL PUBLIC SPENDING RECEIVED BY THE POOR

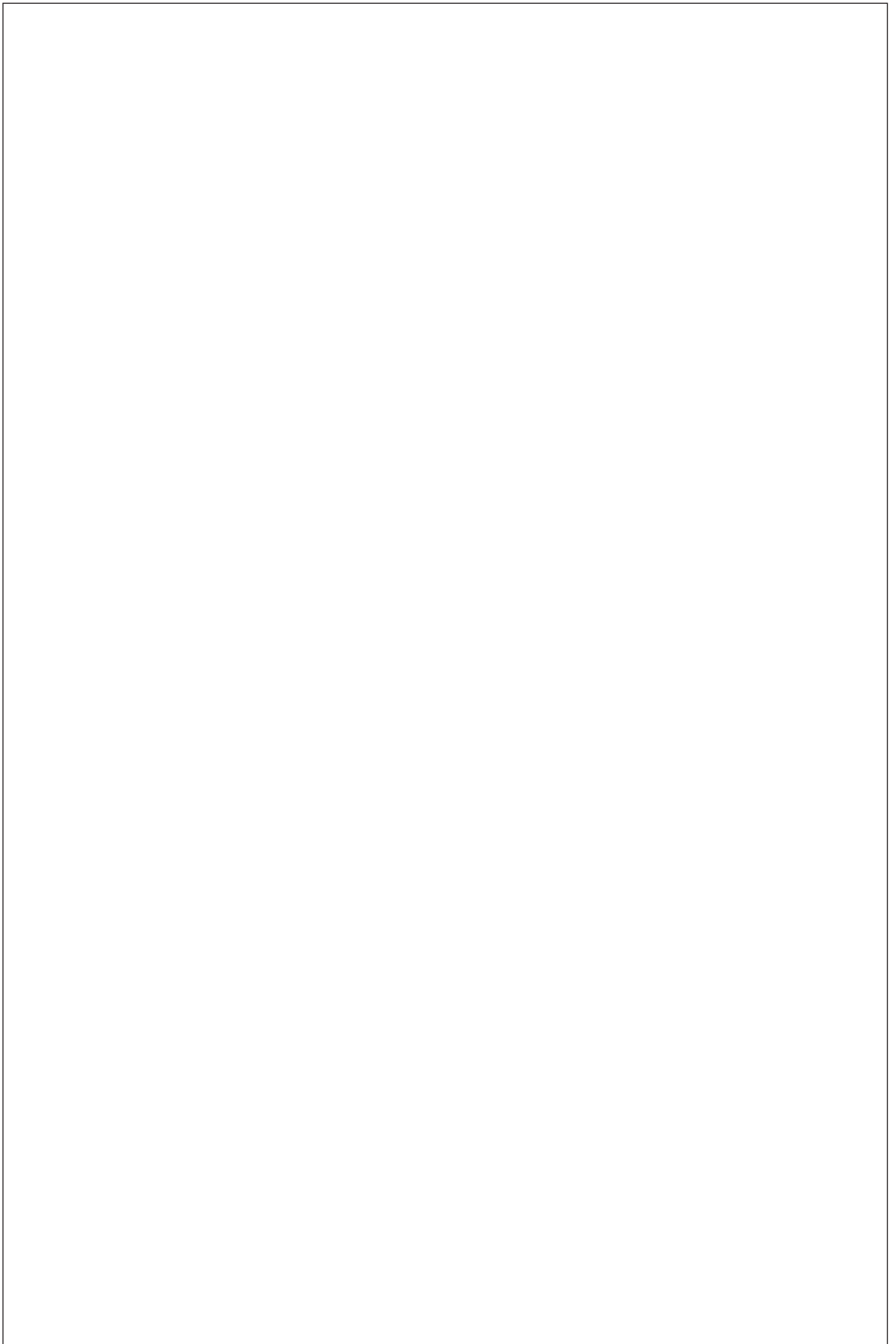


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**The Informal Economy
in Central Europe
and the Baltics**



CHAPTER 6

Why People Evade Taxes in the Czech and Slovak Republics: A Tale of Twins

Jan Hanousek and Filip Palda

Introduction

This paper asks why people in the Czech and Slovak Republics evade taxes. We find that taxes may be of secondary importance in determining why people evade. The morality of evaders and their opportunities for evasion may in practice take precedence in the decisions people make on evasion.

Why people evade is a growing field of empirical research which is usually carried out with the help of questionnaires, administered by professional survey departments. We followed the spirit of these past surveys and commissioned a survey of Czechs and Slovaks in the year 2000. Ours is the first one of this sort for both countries and as such it adds to the growing body of international evidence on tax evasion.

Our survey is unique - it studies two nearly identical countries which were parts of the same state and which broke apart in 1992. The Czech and Slovak Republics are an example of what Ashenfelter has called "twins." Twins separated at birth are ideal for the study of natural experiments: one of them can be viewed as the control and the other as the experimental subject. When the Czech Republic and Slovakia had officially split in 1993, they shared similar demographics, culture and language, but set out on different political and economic paths. Slovakia chose a policy of high taxes and stern enforcement while the Czech Republic decided to keep taxes low and enforced their payment laxly. This divergence in tax policies between two nearly identical countries allows us to examine, without complicated methods of control, how tax policy influences tax evasion.

Control and experimental groups can only answer questions about how different policy treatment of the groups leads outcomes to differ. If we wish to understand other

reasons why people evade taxes we must search our survey for a link between evasion and variations in demographics and in beliefs about the morality of evasion and the chance of apprehension. Using simple cross-tabulations as well as more complicated multivariate methods, we find much in our survey to confirm stylized facts about evasion, which Andreoni et al. (1998) have catalogued.

We begin our paper by giving an overview of tax evasion in the Czech and Slovak Republics. We want to closely compare what our data tell us with stylized facts about evasion that have emerged in the last 20 years of research. Our main benchmark against which we will compare our data is research done on US TCMP audits. US data are the best known and most studied. These data must figure in any comparison with data from transition countries. With several exceptions we find that Czechs and Slovaks evade in patterns similar to those of Americans. Once we have established the ways in which our sample compares to stylized facts about evasion, we see what light our sample sheds on the controversial questions in tax evasion.¹ One of the most contested issues in the analysis of tax evasion is whether high taxes encourage evasion. As Andreoni et al. (1998) write, "Theoretical models generate no clear predictions on the effects of tax rates on compliance. The presence of both income and substitution effects complicates the analysis, and special assumptions about the form of penalties, distribution of income, and shape of preferences are often required to identify any comparative statis." Complicated econometrics have generally been required to isolate the effect of taxes on evasion. We believe that Czech and Slovak data may, with less arduous treatment, yield information on the link between taxes and evasion because of the possibility that both countries were "twins" when they separated. The latter part of our paper explains why we believe the Czech and Slovak Republics are similar enough to warrant being called "twins". We explain that they resemble each other along dimensions which are relevant to tax evasion. We then discuss how separation between the two countries and the ensuing difference in tax policies influence tax evasion. We find that the most important determinant of tax evasion in the case of the Czech and Slovak Republics is not a divergence between tax rates, but rather the difference in opportunities for tax evasion in each country.

Data Challenges and Survey Methodology

As Giles (2000) explains, there are several ways to measure tax evasion: tax audit surveys, money demand methods, latent variable techniques, tax overhang methods, labour force surveys, and surveys asking individuals how much they evade. Surveys are useful for understanding why individuals evade taxes at any point in time whereas macro-methods, such as latent variable analysis and tax-overhang approaches, are more appropriate for time-series analysis of tax evasion.

¹ An overview of the related subject of corruption in the Czech Republic is offered in detail by Lizal and Kocenda (2001).

At present, the only official estimates of the underground economy for the Czech and Slovak Republics are those of the Ministry of Finance which is primarily concerned about collecting unpaid backtaxes from firms. Until our survey was done, there were few independent academic estimates of the size of tax evasion in the Czech and Slovak Republics. There is a similar dearth of such estimates for other transition countries, yet understanding how tax evasion is evolving and why it evolves as it does is crucial for governments wishing to provide public goods at a reasonable tax-plus-deadweight cost.

We have chosen the survey method of analyzing tax evasion because this method is rich in demographic information. We can use demographic information to see what characteristics of respondents are associated with evasion. The survey method also allows us to ask respondents what they believe the probability of being caught evading is and what penalties they believe they face, whether they believe evasion to be moral, and whether they believe their wealth needs to be safeguarded by tax evasion. These subjective data allow us to probe the effects of incentives on the decision to evade. Survey data suffer from the lies respondents tell. We shall see that, even though lying may pervade the data, solid relations emerged between the questions we asked and whether people evaded.

In Western countries survey companies usually call respondents on the telephone. Czechs and Slovaks distrust phone surveys. The firm MEDIA carried out face-to-face surveys on a random stratified sample of 1,062 Czechs and 524 Slovaks. We include the questionnaire in Appendix B to the present paper. The standard demographic questions need no explanation.

The main problem we faced was in knowing how much tax people evade. The obvious problem when asking people about their participation in the underground economy is that they will be reluctant to confess their participation. Our survey tackles this problem in stages. First, we ask respondents whether they know of anyone who has participated in the underground economy. Respondents might not feel ashamed about answering this question honestly. Knowing people who participated in the underground economy could be a weak signal that the respondent also participates. Next, we ask whether the respondent has ever bought goods or services in the underground economy. Finally, and this is perhaps the question to which respondents will give the least honest reply, we ask whether they have themselves ever participated in the underground economy and what is the nature of this participation.

Table 1 summarizes the first ("soft") level of inquiry of our survey. Rows 1 and 2 show the answer to what people thought about the size of the underground economy. If people are rational observers of their surroundings, their opinions about the size of the underground economy might be a fair estimate of the actual underground economy. Giving an opinion about the size of the underground economy is not likely to threaten a respondent, so that we can expect the answers to be honest. Slovaks had a significantly larger estimate of the size of the underground economy than Czechs. This is a first, tentative sign that Slovaks evaded more taxes by the end of the 1990's than did Czechs.

This judgment rests on the assumptions that people can form consistent estimates of the size of the underground economy and that Czechs and Slovaks are similar in the way they form their judgments. We will justify the latter assumption later in the present paper.

TABLE 1: "SOFT" MEASURES OF PARTICIPATION IN THE UNDERGROUND ECONOMY

<i>Survey question</i>	<i>CR</i>	<i>SL</i>	<i>Significant difference</i>
Percentage of adults in country having unreported income (variable A7 in appendix)	38.3	42.7	**
Percentage of neighbors having unreported income (variable A8 in appendix)	33.2	38.8	**
Ever bought undeclared goods/services (variable B1 in appendix)	9.4	5.0	

Source: Survey data, authors' computation

Row 3 of Table 1 summarizes the answers to more intimate questions than those summarized in rows 1 and 2. Here we ask whether the respondent has ever bought goods in the underground economy. The level of threat to respondents here is greater than in the questions in rows 1 and 2, but still fairly mild, as there is no effective legal sanction for those who buy goods from producers who evade taxes unless the law forbids the sale of these goods. There is no significant difference between what Czechs and Slovaks answered. Both groups claim with equal frequency to have bought from the underground sector. There is no contradiction between the finding that Czechs and Slovaks buy equally from the shadow sector and the earlier findings that Slovaks believe the percent of people with income from the shadow economy is higher than for the Czech Republic. Our questions to respondents up to this point in the discussion have been sufficiently vague to allow for several interpretations. Czechs and Slovaks may buy equally from the black market but Slovaks may spend more in their purchases. To get a more precise idea of how much tax people evade than the answers given to the questions in Table 1, we need to put the question of evasion to respondents baldly and hope that some respondents accept to answer our questions.

The most intimate questions in our survey ask the respondent with what frequency he has worked and not declared his income and how much money he earned from activities upon which he did not declare to the tax authorities. Table 2 shows that consistently throughout the 1990's Czechs declared working in the underground economy with greater frequency than did Slovaks. For all three categories and for each period the difference between the Czech and Slovak Republics was significant – at least 5 percent.

TABLE 2: PERCENT OF RESPONDENTS ANSWERING THE QUESTION "HAVE YOU EVER BEEN ENGAGED IN THE UNDECLARED SECTOR?" (Variable C01 in appendix)

<i>Intensity of participation</i>	<i>CR 2000</i>	<i>SR 2000</i>	<i>CR 1999</i>	<i>SR 1999</i>	<i>CR 1995</i>	<i>SR 1995</i>
Often	3.5	1.3	3.3	1.3	2.7	1.1
Occasionally	21.7	13.5	17.3	10.4	12.7	8.0
Never	74.8	85.2	79.4	88.3	85.4	90.9

Source: Survey data, authors' computation

Table 3 breaks down undeclared income into different income categories. Once again all differences are significant.

TABLE 3: PERCENT OF RESPONDENTS ADMITTING TO UNDECLARED INCOME WITHIN CERTAIN RANGES (Variable C12 in appendix)

<i>Income range</i>	<i>CR</i>	<i>SR</i>
<10,000 – 15,000 Crowns	34.8	44.8
10,000 – 15,000 Crowns	10.8	6.0
15,000 – 20,000 Crowns	11.1	7.0
20,000 – 25,000 Crowns	5.5	3.0
25,000 – 30,000 Crowns	7.3	4.4
30,000 – 35,000 Crowns	3.3	0.5
35,000 – 40,000 Crowns	4.6	4.1
>40,000 Crowns	5.6	3.6

Source: Survey data, authors' computation

Finally, we asked people the number of hours, on average, which they evaded per week. For the Czech Republic the average among those who answered this question was 3.2 hours and for the Slovak Republic this number was 5.7 hours. This result, combined with the data in Table 3, suggests that even though Slovaks work more hours on average in the underground economy Czechs engage to a greater degree of high level tax evasion than Slovaks. The columns in Table 3 do not add up to one hundred percent because some of those surveyed did not respond to our questions. How do we piece these findings together with the finding in Table 1 that Slovaks estimate the number of people deriving shadow income to be higher than what Czechs estimate? We can interpret these results saying that more people may be engaged in the shadow economy in Slovakia, but in the Czech Republic the level of tax evasion is higher.

Once again we must be careful not to consider the estimates of tax evasion in the above tables as 100 percent accurate. Respondents might tell us how much they evaded but there are two problems we must recognize while interpreting their responses. The first problem with the estimates in Table 3 is that people lie about their incomes. Horry,

Palda, and Walker (1992) found that in surveys of consumer finances for Canada respondents consistently underreported their incomes by 10 percent. They were able to arrive at this conclusion by comparing GDP imputed from the Canadian survey of consumer finances with GDP derived from the national accounts. If people lie about their legitimate income, chances are they will also lie about their shadow income. The second problem with the estimates in Table 3 is that some respondents chose to answer how much they evaded and others chose not to answer. The self-selection of responses is a warning that our sample of answers may not be representative of the population of answers. The direction in which this potential selection bias might go is not clear. Those who answer may have less to hide than those who do not answer. In this case answers would underestimate the size of tax evasion. If the biggest tax evaders are also the least risk averse people, then sample selection could have an upward bias on our estimates of the underground economy. If those who answered how much they evaded are a random mix of the above two types, then our estimate of the size of tax evasion will not be biased but may suffer from a large variance. These problems can damage attempts to measure the size of tax evasion but do not fuzz the answers to other questions. One question we seek to answer is whether the tax evasion of Czechs and Slovaks diverged after their countries split in 1992. Provided the direction of bias is the same in both countries, the bias will wash out when we measure differences between both countries.

Perhaps the most complicated problem posed by our measures of tax evasion is that it is difficult, if not impossible, in a survey to ask people exactly how much they evaded. We can pose questions about the range in which their evasion might fall but this form of question bunches all the highest evaders into one group. We have no idea of the upper limit of evasion in this highest group. Questions about how often people evade give us an idea of the number of people participating in the shadow economy but once again, their answers do not accurately weigh the degree of their involvement. These potentially frustrating aspects of the survey data are standard in this area of research and force us to dose our findings with a heavy degree of interpretation and nuance.

Comparison to Established Stylized Facts

Demographics

Now that we have explained how we measure evasion, we can look at simple averages in our data to see if evasion in the Czech and Slovak Republics is similar to what are now well-established stylized facts on international, and especially US evasion. The first question of interest is the influence of demographics on evasion. Tables 4(a) and 4(b) confirm several stylized facts known from analysis of US TCMP data. First, evasion seems to be mainly the business of men in both the Czech and Slovak Republics. This result is in line with Baldryis' (1987) experimental work. Households

whose head is married are strong evaders. In line with TCMP data is our finding that after the age of retirement tax evasion drops radically. The effect of education and age on evasion is not established in the research literature. We find no clear relationship between evasion and education, and age, at least, at this very basic level of analysis. We find that those who are unemployed or own their own businesses are categories of workers with the highest proportion of evaders. This finding is in strong agreement with General Accounting Office (1990) analysis of 1985 TCMP data.

Perceived Penalties and Audit Probabilities

Scholz and Pinney (1993) surveyed individuals and found little relationship to what people believed to be the probability of audit with the true probability of audit. In their expectations, people tend to grossly overestimate the probability of audit. Czechs cited an average probability of being caught evading taxes of 43.6 percent while Slovaks cited a probability of 43.9 percent. Whether this is an accurate estimate or not, it is hard to gauge. Though we were not able to establish an accurate figure, discussion with Ministry of Revenue officials revealed that a minuscule fraction of tax returns in the Czech and Slovak Republics are audited. The case is similar to that of the US where according to Andreoni et al. (1998) in the mid-1990s 1.7 percent of the returns were audited. Still, of those audited, a large fraction may be subject to penalty. Perhaps our respondents were thinking of the probability of being caught if one is audited. Our survey questions were not precise enough to refine our interpretation. Our data is not completely dumb on this point. Table 5 shows that those who evaded often had far more precise estimates of the probabilities of apprehension than those who evaded occasionally or not at all. This fits nicely with the view that those who are active in a market will have a better sense of the size of that market than those who prefer to get their news of the world from the morning papers. We also found that those who did not respond to the question of precisely how much undeclared income they earned had estimates of the penalties and probabilities of apprehension similar to those who responded that they evaded often or sometimes.

There are no studies, of which we are aware, which assess the accuracy of penalty assessments by taxpayers. In our survey we asked each respondent what he believed was the fine for delaying payment on 100,000 crowns of taxes owed to the state. The actual penalty is 20,000 crowns if the taxpayer himself brings his evasion to the attention of the authorities and 100,000 if the authorities discover his evasion. The average value cited by Czechs was 29,500 crowns while that cited by Slovaks was 28,600 crowns. Given that our survey question was not precise enough to distinguish between the two types of penalty, the answers given by Czechs and Slovaks seem remarkably well-informed. There was no statistical difference between the answers given by both groups. We were not able to establish the average penalty, but tax evasion officials confirmed with us that the estimates survey respondents gave us were not far off the mark.

TABLE 4A: STRUCTURE OF THE INFORMAL SECTOR IN THE CZECH REPUBLIC:
RELATIVE % SHARES

	Total Sample	Active engagement in informal activities				Purchase of informal goods/services	
		Total % of individuals	Informal Salary (CZK)*			Total % of individuals	
			< 10000	25000)	> = 25000		
<i>Total</i>	1062	267	93	73	54	524	
<i>% share of total sample</i>	100 %	25 %	9 %	7 %	5 %	49 %	
<i>% share of informal sector</i>		100 %	35 %	27 %	20 %		
	100 %	100 %	100 %	100 %	100 %	100 %	
<i>Sex</i>							
Male	530	50 %	67 %	59 %	71 %	76 %	52 %
Female	532	50 %	33 %	41 %	30 %	24 %	48 %
<i>Age</i>							
18 to 24 years	183	17 %	22 %	31 %	19 %	19 %	17 %
25 to 39 years	338	32 %	35 %	27 %	38 %	41 %	35 %
40 to 59 years	440	41 %	40 %	40 %	40 %	39 %	41 %
Older than 60	101	10 %	3 %	2 %	4 %	2 %	6 %
<i>Status</i>							
Married	635	60 %	55 %	46 %	62 %	59 %	60 %
Single w. partner	61	6 %	7 %	9 %	5 %	9 %	6 %
Divorced/widow (er)	152	14 %	13 %	14 %	15 %	9 %	15 %
Single w/out partner	214	20 %	25 %	32 %	18 %	20 %	19 %
<i>Level of education</i>							
Primary	256	24 %	26 %	27 %	26 %	24 %	25 %
Without GCE	396	37 %	51 %	45 %	58 %	56 %	40 %
With GCE	49	5 %	18 %	18 %	14 %	19 %	27 %
Higher	14	1 %	5 %	10 %	4 %	2 %	7 %
<i>Labor market position</i>							
Full time job	633	60 %	55 %	56 %	58 %	59 %	60 %
Part time job	35	3 %	4 %	4 %	5 %	6 %	4 %
Entrepreneur (no empl.)	68	6 %	12 %	12 %	5 %	13 %	9 %
Entrepreneur (w. empl.)	23	2 %	4 %	3 %	3 %	6 %	2 %
Pensioner working	19	2 %	2 %	0 %	3 %	0 %	2 %
Pensioner not working	120	11 %	4 %	4 %	5 %	2 %	8 %
Unemployed	59	6 %	10 %	8 %	16 %	13 %	7 %
Student	65	6 %	6 %	10 %	4 %	4 %	5 %
Wife working in household	28	3 %	2 %	3 %	1 %	2 %	3 %

* The response rate for income range is lower than 100%: 47 respondents, i.e. 4% in CR and 22 respondents, i.e. 4% in SR did not put down the income range

TABLE 4B: STRUCTURE OF THE INFORMAL SECTOR IN THE SLOVAK REPUBLIC:
RELATIVE % SHARES

	Total Sample	Active engagement in informal activities				Purchase of informal goods/services	
		Total % of individuals	Informal Salary (CZK)*			Total % of individuals	
			<10000, <10000	25000)	> = 25000		
<i>Total</i>	548	83	37	13	10	276	
<i>% share of total sample</i>	100 %	15 %	7 %	2 %	2 %	50 %	
<i>% share of informal sector</i>		100 %	45 %	16 %	12 %		
	100 %	100 %	100 %	100 %	100 %	100 %	
<i>Sex</i>							
Male	278	51 %	80 %	78 %	95 %	97 %	55 %
Female	270	49 %	20 %	22 %	5 %	3 %	45 %
<i>Age</i>							
18 to 24 years	104	19 %	22 %	27 %	0 %	40 %	18 %
25 to 39 years	192	35 %	35 %	19 %	69 %	50 %	38 %
40 to 59 years	199	36 %	35 %	41 %	31 %	10 %	37 %
Older than 60	53	10 %	8 %	11 %	8 %	0 %	8 %
<i>Status</i>							
Married	312	57 %	46 %	43 %	69 %	60 %	58 %
Single w. partner	18	3 %	11 %	8 %	8 %	0 %	6 %
Divorced/widow (er)	64	12 %	13 %	14 %	15 %	0 %	10 %
Single w/out partner	153	28 %	31 %	35 %	8 %	50 %	26 %
<i>Level of education</i>							
Primary	191	35 %	35 %	38 %	54 %	0 %	36 %
Without GCE	160	29 %	37 %	30 %	38 %	80 %	33 %
With GCE	146	27 %	28 %	30 %	8 %	30 %	24 %
Higher	51	9 %	1 %	0 %	0 %	0 %	7 %
<i>Labor market position</i>							
Full time job	285	52 %	46 %	41 %	46 %	40 %	55 %
Part time job	9	2 %	4 %	0 %	0 %	0 %	3 %
Entrepreneur (no empl.)	22	4 %	10 %	11 %	0 %	30 %	3 %
Entrepreneur (w. empl.)	2	0 %	2 %	0 %	0 %	0 %	1 %
Pensioner working	5	1 %	0 %	0 %	0 %	0 %	1 %
Pensioner not working	76	14 %	10 %	11 %	15 %	0 %	11 %
Unemployed	86	16 %	28 %	27 %	46 %	30 %	17 %
Student	40	7 %	5 %	8 %	0 %	0 %	7 %
Wife working in household	17	3 %	0 %	0 %	0 %	0 %	2 %

* The response rate for income range is lower than 100%: 47 respondents, i.e. 4% in CR and 22 respondents, i.e. 4% in SR did not put down the income range

TABLE 5: INDIVIDUAL'S ASSESSMENT OF THE SIZE OF THE UNDERGROUND ECONOMY CROSS-TABULATED WITH HIS/HER SELF-ASSESSED FREQUENCY OF EVASION. CZECH AND SLOVAK REPUBLICS, 2000

<i>Variable</i>	<i>TOTAL</i>	<i>Frequent evader</i>	<i>Evades sometimes</i>	<i>Never evades</i>
<i>Reaction of family and friends if they discover you have undeclared income (1=strongly agree, 5=strongly disagree) (variable A10 in appendix)</i>	2.98 (1.13)	1.79 (0.9)	2.4 (0.9)	3.2 (1.1)
<i>What is the penalty for not declaring 100,000 crowns? (variable A11 in appendix)</i>	30,200	32,800	30,800	30,000
<i>What is the probability of getting caught? (variable A12 in appendix)</i>	44.1	20.0	31.0	48.3
<i>Correlation between the above two cells (A11, A12)</i>	0.04	0.03	0.02	0.05
<i>How many hours a day are you engaged in undeclared work? (variable C05 in appendix)</i>	3.85 (6.6)	4.69 (4.12)	3.7 (7.0)	Not applicable

Note: Standard deviations in brackets.

In the literature the question of how precisely people estimate the penalty for evasion has taken a back seat to the question of whether the estimates of this penalty vary with the frequency of evasion. Elffers, Weigel, and Hessing (1987) studied evasion in the Netherlands and found in the responses to their surveys that the perceived severity of penalty was unrelated to whether someone evaded taxes. Elffers et al. (1987) also failed to find a correlation between the perceived severity of the penalty for evading and the perceived likelihood of apprehension. Our data show a result that differs from that of Elffers et al. (1987). Frequent evaders estimated an average penalty of 32,800 crowns whereas infrequent evaders cited 30,800 and non-evaders cited 30,000. There was also a positive and significant correlation (0.04) between the perceived likelihood of apprehension for tax evasion and the severity of the penalty for tax evasion. That experienced evaders tend to perceive a higher penalty goes against the notion of "penalty illusion" whereby those who underestimate the penalty tend to evade more than those who have a proper estimate of the penalty. The above figures may be telling us that experienced evaders know the two-tier structure of penalties for evasion and take an average of these two tiers weighted by some probability of apprehension to come up with their estimates. They may also be reporting the expected penalty for those who evade frequently, which is more likely to be 100,000 crowns than 20,000 crowns.

This is not a random speculation on our part. As the previous paragraph indicated, frequent evaders seem to have a shrewder assessment of the probability of apprehension than infrequent and non-evaders do. This is the context in which judgments of the

accuracy of penalties by class of evader must be assessed. If the frequency of evasion improves the assessment of the likelihood of being caught, then education might also have an effect, even if we do not hold all other forces constant. Our data did not confirm this speculation. Education was uncorrelated with the assessment of the likelihood of being caught for evading and, as one could expect given the negative education result, income also bore no relation with the assessment of the likelihood of being caught.

Morals

The influence of morals on tax evasion is a recent but growing field of study. The literature to date has focused on three possible social factors which influence evasion: feelings of guilt and shame, belief that tax burdens are unfairly distributed, feelings that the quality of government services is poor. Our survey allows us to address the first two factors and a third factor not studied to date (bandwagon effects).

Erard and Feinstein (1994) found that incorporating “moral sentiments”, such as guilt and shame, indirectly into an econometric model of tax evasion improved the model’s fit. Their analysis did not use explicit information about whether people feel guilty or ashamed and relied on restrictive assumptions about the form of the utility function. We asked several questions that might proxy for shame and guilt. A question that proxies for shame is what a person believes will be the reaction of friends and family should they discover he is evading taxes. Table 6 suggests that where the disapproval of friends and family is high, evasion tends to be low.

This was borne out in statistically significant correlation between family reaction and frequency of underground work for the Czech Republic and the Slovak Republic.

A second proxy for shame is whether other people are also evading heavily. We asked each individual what percentage of adults in his country was evading taxes and what percentage of adults in his neighborhood were evading taxes. As Table 7 shows, both bandwagon variables show a strong positive correlation with an individual’s evasion. Individuals who evaded frequently had by far the largest assessment of the underground economy. The most powerful correlation is between whether an individual evades and what percentage of people in his neighborhood he believes to be evading (0.23 correlation between the intensity of evasion and what percentage of individuals in the country the respondent believes to be evading—variable A07 in the appendix—and 0.31 correlation between the intensity of evasion and what percentage of individuals in his neighborhood the respondent believes to be evading—variable A08 in the appendix). The fact that the assessment of the underground economy falls as an individual evades less may be due to moral factors. An individual who believes few around him are evading may feel coerced by custom to evade little. Of course, the causality may run in the other direction. Those who evade frequently may justify their evasion by saying that it is alright because “everyone else is doing it.” Our data cannot resolve this point, but merely show a relationship worthy of further study. We also found that the most

TABLE 6: PERCENT OF RESPONDENTS CROSS-TABULATED BY FREQUENCY OF UNDERGROUND WORK AND THEIR ASSESSMENT OF FAMILY

REACTION	Frequency of underground work								
	Often			Occasionally			Never		
	CR	SR	Average	CR	SR	Average	CR	SR	Average
1	38.89	83.33	45.24	16.44	15.07	16.10	4.46	9.86	6.51
2	41.67	0	35.71	38.81	46.58	40.75	18.71	22.77	20.25
3	16.67	16.67	16.67	34.70	30.14	33.56	36.98	34.98	36.22
4	0	0	0	8.22	6.85	7.88	23.88	22.07	23.19
5	2.78	0	2.38	1.83	1.37	1.71	15.97	10.33	13.83

Family reaction (1 = surely agree,

3 = do not know, 4 = probably do

not agree, 5 = surely do not agree)

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. Frequent evaders may have wider contacts with the underground economy than infrequent or non-evaders, and thus assess that the field of evasion is equally well trampled on both sides of the fence. Those who have little experience of evasion may form tribal loyalties and believe that their neighborhood is less sinful than those that surround them.

TABLE 7: INDIVIDUAL'S ASSESSMENT OF THE SIZE OF THE UNDERGROUND ECONOMY CROSS-TABULATED WITH HIS SELF-ASSESSED FREQUENCY OF EVASION. CZECH AND SLOVAK REPUBLICS, 2000

<i>Variable</i>	<i>TOTAL</i>	<i>Frequent evader</i>	<i>Evades sometimes</i>	<i>Never evades</i>
<i>According to you, what percent of adults in the country have underground income? (variable A7 in appendix)</i>	34.4 (20.4)	45.3 (24.5)	38.8 (21.3)	32.2 (19.4)
<i>correlation with intensity of evasion</i>	-0.18			
<i>According to you, what percent of adults in your neighborhood have underground income? (variable A8 in appendix)</i>	23.4 (20.4)	39.2 (23.5)	30.4 (23.1)	20.1 (18.0)
<i>correlation with intensity of evasion</i>	-0.27			
<i>Difference between top cell and cell below (A7-A8)</i>	10.97 (15.6)	6.1 (12)	8.4 (15.8)	12.2 (15.6)

Note: Standard deviations in brackets

A more direct approach to morals is not to seek out measures of guilt or shame but simply to ask people whether they believe evasion is moral and then see if there is any link between this sentiment and the individual's evasion. Table 8 shows the correlation between the answer to whether the respondent works in the shadow economy often (value of 1), occasionally (value of 2), or never (value of 3), and the morality variable in which respondents rank between 1 to 5 whether having undeclared income is strongly immoral (5) or strongly moral (1).

Table 8 shows a positive tendency between evading taxes and the belief that such evasion is moral. We also calculated the correlation between the rows and columns of Table 8 and found it to be statistically significant. The strong correlation that emerges between morality and evasion may be due in part to the simultaneity of these quantities. A person who evades may justify his evasion by saying it is moral while a person who believes it is moral to evade may feel himself free to evade. This is how morality and evasion may amplify each other. This does not invalidate the above result but underlines that the above correlations may not be uncovering purely structural relations.

Slovakia's average reported morality was higher than that of the Czech Republic, yet Slovaks estimated more of their countrymen to be participating in the shadow

economy than did Czechs. For Czechs the correlation between the two rows of Table 8 was three times as high as that of Slovakia. Czechs who believed evading taxes was moral felt themselves far freer to evade those taxes than did Slovaks. What can we make of these seemingly contradictory findings? Without having performed a multivariate analysis, conclusions are premature. Our strategy of presenting evidence in tabular form is meant to give a first impression. We will introduce regressions later and discuss their meaning. For the moment, our conclusion is that morality is a force with contradictory and, perhaps, non-existent effects on tax evasion.

The Effect of Taxes on Evasion

As mentioned earlier, the effect of taxes on evasion is theoretically ambiguous and subject to contradictory empirical findings. In this section we tackle the question in a novel manner. We show how the separation in 1992 between the Czech and Slovak nations can be used as a natural experiment that reduces the number of control variables needed to answer this question.

Background

After separating in 1992, the Czech and Slovak Republics took their finances along different paths. In the Czech Republic Prime Minister Vaclav Klaus followed a policy of vigorous privatization, deregulation and low taxation. His opposite number in Slovakia was slow to privatize and followed a policy of vigorous taxation. Table 9 shows that throughout the 1990s the Czech government progressively lowered its tax burden while the Slovak government kept its taxes at relatively high levels right until the new millennium. Czechs lowered this burden by reducing the top marginal tax rate on income from 47 percent in 1992 to 40 percent in 1997 whereas it took the Slovaks until 2000 to lower this rate from 47 percent to 42 percent. Slovaks made up for the shortfall in revenue by increasing marginal tax rates in the middle ranges of income. Czechs have had constantly lower rates on these middle income levels than the Slovaks. The same is true of the value added tax which in its lower tier was 5 percent in the Czech Republic in 2000 and 10 percent in the Slovak Republic, and 22 percent in its upper tier in the Czech Republic and 23 percent in its upper tier in the Slovak Republic. Throughout the 1990s the Czechs lowered their VAT rate whereas Slovaks increased theirs. A more detailed view of the Czech and Slovak tax systems can be found in the appendix, though we must warn that the tables found there do not reflect the intensity with which tax authorities of the two countries enforce collection. To date no single summary statistic of a tax system exists, so that our statement that the Slovaks have a more intrusive tax system than the Czechs must be recognized to have a subjective, or at least a less than perfectly defined objective component.

TABLE 8: CROSS-TABULATION OF MORALITY WITH FREQUENCY OF EVASION FOR CZECH AND SLOVAK REPUBLICS 2000

Morality index (1 = strongly moral, 5 = strongly immoral)	Frequency of underground work											
	Often			Occasionally			Never			Average		
	CR	SR	Average	CR	SR	Average	CR	SR	Average	CR	SR	Average
1	17.65	16.67	17.50	2.70	0	2.03	0.41	2.32	1.13			
2	26.47	50	30	18.92	27.40	21.02	7.19	12.53	9.19			
3	50	33.33	47.50	59.01	61.64	59.66	43.57	50.35	46.10			
4	2.94	0	2.50	18.47	10.96	16.61	40.11	28.07	35.62			
5	2.94	0	2.50	0.90	0	0.68	8.71	6.73	7.97			

Source: Survey data, authors' computation

TABLE 9: RATIO TOTAL TAXES/GDP

Country	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	41.20	40.50	40.00	36.20	36.40	36.00	37.10	36.80
Slovakia	36.40	38.80	42.00	41.00	38.40	37.10	35.30	34.20

Source: Czech Statistical Office and Slovak Statistical Office

Differences in tax policies might lead to differences in tax compliance, though, as we have emphasized earlier, the theoretical literature is ambiguous on this point. The relatively larger incursion of the Slovak government into the Slovak economy may be cause for Slovaks to evade taxes more vigorously than Czechs. The brief survey of tax evasion in the Czech and Slovak Republics in section 2 suggests that Czechs evade more intensively than Slovaks even though their tax rates are lower. If we can believe that Czech and Slovak nations are identical in all but their tax policies, our findings that lower-tax Czechs evade more than higher-tax Slovaks may count as a further observation worthy of a notch in the international literature on the effect of taxes on evasion.

Before leaping to such a conclusion, we must be aware that simple comparisons of tax evasion may not be appropriate for drawing conclusions about behavior if the subjects tested differ along some dimensions relevant to tax evasion. Differences in tax evasion between Slovaks and Czechs may be due not simply to different tax levels, but also to variables for which we have not controlled. How can we test whether identical twins, subject to different tax levels, differed in the amount of tax they paid? If we can believe that the Czech Republic and Slovakia are “twins”, there is no need for complicated models which control for differences between the two countries. “All” we need to do is measure the degree to which Czechs and Slovaks evaded taxes ten years after separating and hope that our twins are truly identical. In the next section we justify why we believe that complicated controls are not necessary in our analysis of the differences in tax evasion between the two countries.

Justifying the Assumption that Czechs and Slovaks Are Twins

As explained earlier, the present paper explores how tax evasion changes under the pressure of changes in taxes. Our means of exploring these changes is to compare tax evasion in two countries that are similar but that fell under different government policies. If we can believe that both countries are the same, we need not worry that differences in demographics, wealth, and culture can explain any difference we might observe in tax evasion and morality. To make our exercise credible, we must give some evidence that in 1992, when the Czech Republic split from Slovakia, both countries were “twins.” Czechs and Slovaks speak a similar tongue. At the start of the 20th century this common cultural heritage of language was the main uniting feature of these

two peoples. On other dimensions, however, Slovaks and Czechs differed significantly. In 1920 Slovaks had a literacy rate of 72.3 percent whereas Czechs had a literacy rate of 96.7 percent. By the 1960s these literacy rates had converged to close to 100 percent. Literacy was not the only indicator on which Czechs and Slovaks converged. As Table 10 shows, newborn mortality converged over the century, as did the number of people per doctor, the number of high schools per thousand people and the average wage in both countries. The main message of Table 10 is that as the century wore on, Slovakia and the Czech lands converged on the above-mentioned indicators. The final great push toward convergence came during the communist era. Part of communist strategy for holding power was to flatten differences between groups of people, perhaps so that no concentrated interests could form to oppose their regime. By 1991 Czechs and Slovaks were so at ease with each other that they had a very high level of intermarriage. Of married Czech men 7.4 percent took Slovak wives.

TABLE 10(A): NEWBORN MORTALITY PER HUNDRED THOUSAND

<i>Years</i>	<i>Czechia</i>	<i>Slovakia</i>
1921-25	148.1	169.5
1936-40	92.0	142.0
1960's	20.0	28.0
1990's	10.8	12.0

Source: Czechoslovak statistical yearbooks 1921-1990

TABLE 10(B): NUMBER OF PEOPLE PER DOCTOR

<i>Years</i>	<i>Czechia</i>	<i>Slovakia</i>
1960's	535.0	675.0
1990's	265.0	274.0

Source: Czechoslovak statistical yearbooks 1960-1990

TABLE 10(C): NUMBER OF PUPILS IN MIDDLE SCHOOL

<i>Years</i>	<i>Czechia</i>	<i>Slovakia</i>
1960's	221,657	90,322
1990's	304,748	149,385

Source: Czechoslovak statistical yearbooks 1960-1990

Table 11 gives some summary statistics from our survey on demographic and economic variables for the Czech and Slovak Republics.

TABLE 10(D): AVERAGE WAGE IN SLOVAKIA AS PERCENTAGE OF CZECH REPUBLIC WAGE

<i>Year</i>	
1920	64.33%
1947	81.15%
1960	96.73%
1990	99.08%

Source: Czechoslovak statistical yearbooks 1921-1990

TABLE 11

<i>Sample characteristics</i>	<i>2000 Czech Republic</i>	<i>2000 Slovak Republic</i>	<i>Significant difference</i>
<i>Divorce rate</i>	10.5	7.3	**
<i>% working full-time</i>	59.5	51.1	
<i>% Gypsies</i>	0.2	0.6	
<i>% ethnic</i>	6.4	10.3	*
<i>Average age</i>	39.9	38.6	*
<i>% population with high school or greater</i>	9.2	9.2	
<i>% living in towns of more than 20,000 inhabitants</i>	45.7	40.9	*
<i>% women</i>	49.9	50.7	
<i>Average size of household</i>	3.0	3.7	**

Source: Survey, authors' computation

Table 11 shows that there are some differences in our survey between Slovaks and Czechs. There is a slightly higher percentage of ethnic populations in Slovakia than in the Czech Republic. Slovaks tend to be more "rural," though this must be qualified by noting that a detailed cross-tabulation shows that the difference arises largely from the fact that there are fewer towns of more than 100,000 in Slovakia. Detailed cross-tabulation showed that the percentage living in villages of fewer than 1000 inhabitants – the true rural setting – are identical in Slovakia and the Czech Republic. Slovaks have lower divorce rates in our survey and larger families than do Czechs. Whether these differences disqualify our sample as representing twins is not clear, but the possibility must be kept in mind. Variables that seem likely to be associated with tax evasion such as education, job satisfaction, and percentage of Gypsies, are the same in our sample for both countries. The main difference arises from the structure of incomes – detailed cross-tabulation showed lower average income for Slovaks.

The above tables show that the Czech Republic and Slovakia were twins only on some very broad demographic and economic aggregates. Since our study focuses on all factors, which might influence tax evasion, we must also consider moral factors. There are objective and subjective variables which can cast light on morality in both countries at the start of the 1990's. One objective variable to consider is adherence to religion. Table 12 shows that even as far back as the 1930's there did not seem to be strong differences between the countries, except in the percent of people who claimed to have no beliefs. Far more Czechs claimed to be without belief than Slovaks. On this score at least there is some call to be concerned that the twins differ in their moral outlook. This conclusion softens when we consider the answers given by Czechs and Slovaks to *subjective* questions about their views on society. Examination of a social survey from 1992 shows that for most questions Czechs and Slovaks have similar answers.

The list of variables we have presented in Tables 10 – 12 is not exhaustive. An important critique of our list is that it fails to measure some intangible barrier, such as “national spirit”, which may come between the twins in our story and make them as different from each other as France is from England. Why did Slovakia and the Czech Republic split if not for some deep-rooted difference between the two countries? Was the similarity between the two not an artificial condition embalmed by a dictatorial communist regime? To answer such a question in detail it, would take us deep into the annals of historical scholarship, but some answer must be given to the critique that both countries split because they were fundamentally different. In 1992 the Czech Republic and Slovakia separated suddenly. Slovak politicians asked Czech politicians for the right to separate and Czech politicians granted their wish with little hesitation. No referendum was held to decide the future of both parts of Czechoslovakia and many Czechs and Slovaks were genuinely surprised that their country was breaking in two. According to the Institute for Public Opinion Research, the majority of citizens would not have voted for the breakup of Czechoslovakia. Those citizens who did not agree with separation tended to see separation as the work of distant politicians belonging to the Civic Democratic Party on the Czech side and the Movement for a Democratic Slovakia on the Slovak side. Forty-five percent of Czechs and forty-four percent of Slovaks believed that a referendum was the only acceptable way of dissolving their country.

TABLE 12: STRUCTURE BY RELIGION IN 1947

<i>Religion</i>	<i>Czechia (Moravia)</i>	<i>Slovakia</i>
Catholic	74.78% (78.40%)	71.61%
Orthodox Catholic	0.11% (1.90%)	6.42%
Missing or without belief	5.2% (10.04%)	0.61%

Source: Czechoslovak statistical yearbooks, 1950

The experience of Quebec's two referendum campaigns on separation in 1980 and 1995 suggests that as campaigns unfold and information about the consequences of separation are revealed, popular support for separation plummets. Referendum campaigns on separation present an opportunity to discuss the grievances of all parts of the country and to come to some form of understanding and accommodation. Much of the surprise and dismay with separation was seen on the faces of Czech businessmen who had sold goods on credit to Slovak businesses. After the split Slovak businesses defaulted heavily on their obligations to their creditors. This anecdote is one of many which suggests that Slovaks and Czechs were not seriously thinking about separation, and that the split was engineered or perhaps stumbled over by a few politicians.

By the end of the millennium Czechs and Slovaks still resembled each other on demographic and social dimensions, but differed in their average incomes and unemployment rates. By 2000 Slovakia's average income had fallen below that of the Czech Republic and Slovakia's unemployment rate was higher. These differences in economic variables pose a problem for our analysis. We wish to ask how changes in taxes change tax evasion in the Czech and Slovak twins. If the incomes of both countries differ significantly, how can we know that changes in tax evasion and tax morality are due truly to changes in taxes and are not to changes in income? Czech incomes are higher on average than Slovak incomes and it is well established in the evasion literature that evasion rises with incomes. We can meet the critique head-on by controlling for income through some statistical technique such as regression. This, of course, is what we had wished to avoid. Perfect twins need no statistical controls to establish the effect of an outside force which drives a wedge in the behavior of the twins. All is not lost. Having control on just a few dimensions is always preferable to controlling on many dimensions because one can never be quite confident of the quality of controls one is using.

Untangling the Effects on Evasion of Income and Taxes

The results of this paper so far are that Czechs seem to evade more taxes than do Slovaks but also that more Slovaks work in the underground economy than do Czechs. Why do these twin countries differ in their degree of tax evasion? More precisely, why, if taxes are so much higher in the Slovak than in the Czech Republic, is the Slovak Republic not a clear-cut leader on all dimensions of tax evasion? We have already seen that Slovaks seem more bound by morality than Czechs, but we also noted the possibility of a strong simultaneity between self-reported morality and self-reported evasion. This leaves income as the major divider between the Czech and Slovak twins. Perhaps this difference in income accounts for the difference in tax evasion more than does the difference in taxes. As mentioned earlier, theory and empirical research are in agreement that evasion rises with income.

Table 13 is a cross-tabulation of income and the frequency of underground work where row percentages appear above each column percentage.

TABLE 13

<i>Income third</i>	<i>Frequency of underground work</i>		
	<i>Often</i>	<i>Occasionally</i>	<i>Never</i>
<i>Lowest</i>	3.3	20.1	76.6
	90.5	87.4	88.4
<i>Middle</i>	2.4	22.1	75.5
	8.4	12.6	11.4
<i>Highest</i>	20.3	n.a.	79.7
	1.2	n.a.	0.2

Source: Survey data, authors' computation

Table 13 shows that among those who evaded often and occasionally the intensity of evasion drops off with income, and that, controlling for the number of people in each income group (looking at row percentages), those with high incomes tend to evade most. This suggests that the tendency for the Czechs to intensively evade taxes is high because the Czech Republic has more high income people than does the Slovak Republic.

So far we have been content to present our results in tabular form because of our confidence in the “twinness” of the Czech and Slovak Republics. The value of the twins analogy comes from taking the Czech and Slovak Republics as our units of analysis. Our survey allows us to deepen our insight into the reasons for tax evasion by turning our heads from the perspective of countries and focusing on the individual. The natural experiment we explored for the Czech and Slovak Republics was one which allowed us to see whether changes in taxes led to changes in tax evasion. The only variable for which we had to control was income. Our natural experiment did not allow us to delve into the many reasons for which individuals in both the Czech and Slovak Republics evade. A multivariate analysis of both countries allows us to seek such knowledge. While we would expect the results from our natural experiment at the macro-level to carry over to the individual level, we must also be careful not to fall into the “fallacy of composition,” also known as the “ecological fallacy” which researchers make when they leap to conclusions about the whole from findings on the individual, or vice versa. Table 14 shows probits taking intensity of work on the underground economy (1 – frequently, 2 – sometimes, 3 – never) as the dependent variable. We have chosen this as the dependent variable because it is the question on evasion to which we had the most responses. In fact, everyone answered this question. The large response to this question provides us with many observations on which to run our observation-hungry probit analysis, but leaves us with the uncomfortable feeling that many of the answers we were given were false. A more satisfying situation would have been one in which individuals who are prone to lie about their underground participation simply refuse to answer. In these circumstances, we could have performed a two-stage Hausman correction analysis for self-selection.

The second column of the table shows the raw probit coefficient estimates. The third to fifth columns are estimates of the marginal effects of the independent variables on the dependent variable. The third column shows these marginal effects for the group of frequent evaders. The fourth column shows marginal effects for occasional evaders and the last column shows marginal effects for non-evaders. Variables of significance are age (the older one is, the more one tends to evade, except for the class of sometime evaders), being female (for the class of frequent and sometimes evaders, being female has a negative effect on the chance of moving up a class), education (which has a generally positive effect on the intensity of evasion), if one believes many others to be evading (the bandwagon variable A08 had a positive effect on evasion except for the class of non-evaders), whether one bought goods in the underground economy (this factor seems to push non-evaders into a higher level of evasion). Being Czech had a negative marginal effect on evasion except for those who declared themselves to be non-evaders. We did not include income because of its high positive correlation with education and age. The coefficients attached to these latter variables suggest that income, as in the tabular analysis, also bears a positive relationship to tax evasion.

Implications

So far, the results of our analysis have been that tax evasion tends to bear no clear relation to morality or tax levels, but rather corresponds to income. There is nothing in the Allingham-Sandmo model of tax evasion which would make this a surprising result. In fact, Christian (1994) found that in 1988 in the US evasion, as measured by underreported income, tended to rise with income, but less than proportionally. Christian's analysis, though, cannot be taken as general because he did not look at income from corporations and businesses, nor did he consider those who did not fill out tax forms. Attention has focused mainly on whether higher taxes lead to higher evasion. Clotfelter (1983), for example, found that noncompliance is strongly positively related to the marginal tax rate. Our analysis suggests that tax levels, past a certain threshold, may have little bearing on tax evasion. What is perhaps more surprising about our model is the inconclusive role that morals play in the decision to evade taxes.

The result that evasion seems to increase with income may fall out of an Allingham-Sandmo (1972) model of evasion with an appropriately specified utility function. If the taxpayer has decreasing absolute risk aversion, the rising incomes make it more attractive to risk tax evasion. Utility functions are difficult to observe and referring to them to explain behaviour gives the researcher perhaps too much freedom in drawing conclusions. A more observable possibility is that income and tax evasion technology are somehow linked. The "rich" may have better access to tax shelters and dodges. This possibility may explain the broad consensus among economists, as expounded by Sorensen (1994), and governments that income taxes are becoming a thing of the past and that the more enforceable value added tax is the tax of the future.

TABLE 14: PROBIT ESTIMATION OF THE EFFECT OF INDIVIDUAL PARAMETERS ON INTENSITY OF WORK IN THE UNDERGROUND SECTOR

<i>Parameter</i>	<i>Estimate</i>	<i>Change Prob(y=0)</i>	<i>Change Prob(y=1)</i>	<i>Change Prob(y=2)</i>
<i>Constant</i>	1,5950 ** (0.3519)			
<i>Country</i> (1=Czech, 0=Slovak)	0,4380 ** (0.1299)	-0.010	-0.116	0.126
<i>Respondent age</i>	0,0122 ** (0.0041)	0.000	-0.003	0.004
<i>Female</i>	0,4463 ** (0.1042)	-0.012	-0.124	0.135
<i>Primary school education</i>	-0,7781 ** (0.2633)	0.036	0.233	-0.269
<i>Apprenticeship (2 years)</i>	-0,5733 (0.3238)	0.028	0.176	-0.203
<i>Apprenticeship (3-4 years) without diploma</i>	-0,7141 ** (0.2520)	0.026	0.207	-0.233
<i>Secondary vocational without diploma</i>	-0,4055 (0.2643)	0.014	0.120	-0.134
<i>Grammar school with general diploma</i>	-0,0876 (0.3069)	0.002	0.025	-0.027
<i>Desired income 2500 crowns less than actual</i>	-0,1758 (0.1805)	0.005	0.051	-0.057
<i>Desired income 5000 crowns less than actual</i>	0,0775 (0.1144)	-0.002	-0.022	0.024
<i>According to you, what percent of adults in your neighborhood have underground income? (variable A8 in appendix)</i>	-0,0100 ** (0.0026)	0.000	0.003	-0.003
<i>What is fine on 100,000 crowns of undeclared taxes? (variable A11 in appendix)</i>	0,0000 (0.0000)	0.000	0.000	0.000
<i>What is chance of being caught buying or selling undeclared goods or services? (variable A12 in appendix)</i>	0,0066 ** (0.0019)	0.000	-0.002	0.002
<i>Is your economic situation in 2000 worse than in 1999?</i>	-0,1702 (0.1304)	0.005	0.049	-0.054
<i>Have you ever bought goods in the underground economy? (1 – yes, 2 – no)</i>	1,0305 ** (0.1310)	-0.026	-0.265	0.291

Scotchmer (1989) explains how rich taxpayers can reduce the uncertainty of their tax liability by hiring experts. An extension of his thinking is that the rich can also research methods to evade taxes. As Slemrod and Yitzhaki (2000) explain, the Allingham-

Sandmo model of tax evasion has focused attention on risk aversion and hence on the utility function. They write "This focus has to some extent obscured other important aspects of the issue, such as the tax concealment technology."

One important aspect of the evasion technology is the opportunity people have to declare themselves as self-employed. In both countries it is common for a worker to go to a company office, work there, as would any other employee, and still declare himself to be self-employed. Such a declaration spares the company the need to pay for the worker's social security and gives the worker the opportunity to deduct from his taxes "business expenses", such as the cost of going to and from work. The daring worker who declares himself self-employed may go so far as to deduct from taxes the cost of his vacations as business trips, the cost of his car lease as a business cost, and maybe even his apartment rental. The danger to the worker is that tax authorities would investigate and find that these expenses are not related to his work. The benefit to the worker is that such expenses allow him to evade taxes. In the US, Slemrod and Yitzhaki (2000) explain that 41.4 percent of self-employed people voluntarily report their true incomes. It would be nice to compare the number of self-employed in Czech and Slovak Republics over time and relate this to the level of taxes. Such a comparison is not possible because of the three available methods for reporting self-employment - in the Czech and Slovak Republics differ in the method used. These three methods of measuring total number of self-employed are:

- 1) by the number of individuals being registered for self-employment (in the Czech Republic this is called a "Zivnostensky list").
- 2) by the number of people calling themselves self-employed (via labor market surveys).
- 3) by taking tax reports and looking at the number of the people who declared the larger part of their income as coming from sources of revenue that could be considered as independent of an employer.

The Czechs currently report the first measure in the above list whereas Slovak information is on the second measure. Even if these measures are not directly comparable, the number of Czechs declaring themselves self-employed is so much higher than the number of Slovaks declaring themselves self-employed, that it is reasonable to suspect that self-employment is greater in the Czech Republic than it is in the Slovak Republic.

Whether fewer Slovaks are self-employed because Slovak tax authorities enforce tax laws more firmly than Czechs, or because the lower income of Slovaks makes such a complicated investment in evasion technology unprofitable, is a question difficult to answer with reference to our survey. As we mentioned earlier, Slovaks and Czechs have the same beliefs about the probability of apprehension for evading taxes and the same beliefs about the penalties for tax evasion. This may mean that there is no difference in the enforcement technology, or it could mean that evaders adjust their behaviour to attain a suitable risk-level and that this risk level is the same in both countries. Inquiries into the role that available evasion technology offer taxpayers should play a larger role in future enquiries on tax evasion in transition countries.

Conclusion

This paper has suggested that the separation of the Czech and Slovak Republics was a natural experiment, which allows us to analyze whether or not differences in taxes lead to differences in tax evasion. Our tentative conclusion is that tax differences are not as important as income differences for determining the degree of tax evasion. Morality has an ambiguous effect on tax evasion and any conclusions about the effects of morality on evasion are plagued by the problem of simultaneity.

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Appendix A: Tax Structures of Czech and Slovak Republics

TABLE A1

Ratio Total Taxes/GDP

Country	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	41.20	40.50	40.00	36.20	36.40	36.00	37.10	36.80
Slovakia	36.40	38.80	42.00	41.00	38.40	37.10	35.30	34.20

Ratio Direct Taxes/GDP

Country	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	10.10	10.40	10.20	9.40	8.60	9.00	9.00	8.80
Slovakia	9.90	11.40	11.30	11.30	9.30	9.60	8.90	8.70

Ratio Indirect Taxes/GDP

Country	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	12.00	13.10	12.60	12.50	11.80	11.20	12.20	12.30
Slovakia	12.70	13.20	14.00	12.20	11.70	10.90	10.80	10.90

Source: Czech and Slovak Statistical yearbooks, 1993-2000

TABLE A2

Corporate tax rates

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	45	42	41	41	39	35	35	32	31
Slovakia	45	40	40	40	40	40	40	29	29

Source: Tax bylaws, Czech and Slovak Ministry of Finance.

TABLE A3: PERSONAL INCOME TAX RATES – CZECH AND SLOVAK REPUBLIC

<i>Personal income tax rates – Czech Republic</i>						
<i>Marginal rate (in %)</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	
up 60 000 Kc	15	15	15	15	15	
up 120 000 Kc	20	20	20	20	20	
up 180 000 Kc	25	25	25	25	25	
up 540 000 Kc	32	32	32	32	32	
up 1 080 000 Kc	40	40	40	40	40	
more than 1 080 000	47	47	47	47	43	
<i>1997</i>						
up 84 000 Kc	15					
up 144 000 Kc	20					
up 204 000 Kc	25					
up 564 000 Kc	32					
more than 564 000 Kc	40					
		<i>1998</i>	<i>1999</i>			
up 91 440 Kc	15	15				
up 183 000 Kc	20	20				
up 274 000 Kc	25	25				
up 822 600 Kc	32	32				
more than 822 600 Kc	40	40				
		<i>2000</i>	<i>2001</i>			
up 102 000 Kc	15	15				
up 204 000 Kc	20	20				
up 312 000 Kc	25	25				
up 1 104 000 Kc	32	32				
more than 1 104 000 Kc	40	40				

Source: Tax bylaws, Czech Ministry of Finance.

Note that this table splits in certain years due to a change in the income levels at which one passes to higher marginal rates.

<i>Personal income tax rates – Slovak Republic</i>								
<i>Marginal rate (in %)</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
up 60 000 Sk	15	15	15	15	15	15	15	15
up 120 000 Sk	20	20	20	20	20	20	20	20
up 180 000 Sk	25	25	25	25	25	25	25	25
up 540 000 Sk	32	32	32	32	32	32	32	32
up 1 080 000 Sk	40	40	40	40	40	40	40	40
more than 1 080 000	47	47	47	47	47	47	47	47
		<i>2000</i>	<i>2001</i>					
up to 90 000 Sk	12	12						
up to 150 000 Sk	20	20						
up to 240 000 Sk	25	25						
up to 396 000 Sk	30	30						
up to 564 000 Sk	35	35						
up to 1 128 000 Sk	40	40						
more than 1 128 000 Sk	42	42						

Source: Tax bylaws, Slovak Ministry of Finance.

Note that this table splits in certain years due to a change in the income levels at which one passes to higher marginal rates.

TABLE A4: VALUE ADDED TAX

<i>Lower rate</i>	1993	2001
Czech Republic	5	5
Slovakia	6	10

<i>Higher rate</i>	1993	1994	1995	1996	1997	1998	1999	2000	2001
Czech Republic	23	23	23	22	22	22	22	22	22
Slovakia	23	23	23	23	23	23	23	23	23

Source: EBRD, Transition Report (1996-2000)

	<i>In billions of Czech Crowns (In % of GDP)</i>						
	1994	1995	1996	1997	1998	1999	2000
<i>Tax Revenues</i>	462.5 (40.50)	536.1 (40.00)	568.9 (36.20)	607.7 (36.20)	648.0 (36.00)	682.1 (37.10)	715.3 (36.80)
<i>Direct Taxes</i>	119.0 (10.40)	135.9 (10.20)	142.4 (9.40)	143.4 (8.60)	162.5 (9.00)	165.4 (9.00)	170.3 (8.80)
<i>Corporate Income Tax</i>	64.5 (5.60)	67.3 (5.00)	61.8 (3.90)	55.6 (3.30)	67.6 (3.80)	70.1 (3.80)	70.6 (3.60)
<i>Personal Income Tax</i>	54.5 (4.80)	68.6 (5.10)	80.5 (5.30)	87.6 (5.30)	94.9 (5.30)	95.3 (5.20)	99.7 (5.10)
<i>Indirect Taxes</i>	149.6 (13.10)	168.9 (12.60)	190.2 (12.50)	196.8 (11.80)	200.8 (11.20)	223.5 (12.20)	238.7 (12.30)
<i>VAT</i>	85.5 (7.50)	94.8 (7.10)	109.1 (7.20)	117.7 (7.10)	119.4 (6.60)	138.3 (7.50)	149.9 (7.70)
<i>Social security contributions</i>	179.2 (15.70)	213.3 (15.90)	222.2 (15.90)	246.8 (14.80)	262.9 (14.60)	270.6 (14.70)	284.1 (14.60)
<i>Other taxes</i>	14.7 (1.30)	18.0 (1.30)	18.6 (1.20)	20.8 (1.20)	21.8 (1.50)	22.5 (1.50)	22.2 (1.70)

Source: Tax bylaws and State budget. Czech Ministry of Finance

	<i>In billions of Slovak Crowns (In % of GDP)</i>						
	1994	1995	1996	1997	1998	1999	2000
<i>Tax Revenues</i>	170.9 (38.70%)	217.1 (42.00%)	236.4 (41.10%)	251.3 (38.40%)	266.1 (37.10%)	275.0 (35.30%)	283.9 (34.20%)
<i>Direct Taxes</i>	50.1 (11.30%)	58.5 (11.32%)	64.9 (11.28%)	61.0 (9.32%)	68.5 (9.55%)	69.3 (8.90%)	72.4 (8.70%)
<i>Corporate Income Tax</i>	31.9 (7.20%)	35.2 (6.81%)	34.8 (6.05%)	24.4 (3.73%)	26.0 (3.62%)	23.2 (2.98%)	22.4 (2.60%)
<i>Personal Income Tax</i>	18.1 (4.10%)	23.2 (4.49%)	30.1 (5.23%)	36.6 (5.59%)	42.5 (5.93%)	46.1 (5.92%)	47.6 (5.89%)
<i>Indirect Taxes</i>	58.3 (13.20%)	72.3 (13.99%)	70.3 (12.22%)	76.8 (11.74%)	78.3 (10.92%)	84.1 (10.80%)	89.3 (10.90%)
<i>VAT</i>	37.1 (8.40%)	52.3 (10.12%)	48.7 (8.47%)	54.9 (8.39%)	55.3 (7.71%)	58.9 (7.56%)	61.4 (7.50%)
<i>Social security contributions</i>	51.4 (11.60%)	71.9 (13.91%)	85.0 (14.78%)	94.0 (14.36%)	100.5 (14.01%)	101.3 (13.00%)	107.7 (13.12%)
<i>Other taxes</i>	2.6 (0.60%)	4.2 (0.81%)	4.8 (0.83%)	4.2 (0.64%)	4.5 (0.63%)	4.4 (0.56%)	4.5 (0.54%)

Source: Tax bylaws and State budget. Slovak Ministry of Finance

Appendix B: Design of the Survey

TIME	FILL ACTUAL TIME	HOURS	
A		MINUTES	
QUESTIONS ABOUT YOU AND YOUR FAMILY.			
RAGE	HOW OLD ARE YOU?		
HNUM	HOW MANY PERSONS (INCLUDING YOU) LIVE IN YOUR HOUSEHOLDS?		
KIDNUM	HOW MANY CHILDREN YOUNGER THAN 5 YEAR OLD LIVE IN YOUR HOUSEHOLD?		
TEENUM	HOW MANY CHILDREN FROM 6 TO 18 YEARS OLD LIVE IN YOUR HOUSEHOLD?		
ADNUM	HOW MANY ADULTS LIVE IN YOUR HOUSEHOLD?		
HTYP	WHAT KIND OF HOUSEHOLD IS YOURS?	1 ADULT PERSON, LIVING ALONE	1
		2 ADULT PERSONS WITHOUT CHILDREN	2
		2 ADULT PERSONS LIVING WITHOUT CHILDREN	3
		FAMILY – PARENTS AND CHILDREN	4
		FAMILY – PARENTS, CHILDREN, GRAND PARENTS (1, OR BOTH)	5
		FAMILY – PARENTS, CHILDREN, RELATIVES (1, OR MORE), BUT WITHOUT GRANDPARENTS	6
		INCOMPLETE FAMILY – EITHER FATHER OR MOTHER WITH CHILDREN WITHOUT GRANDPARENTS	7
		INCOMPLETE FAMILY – FATHER/MOTHER WITH CHILDREN AND WITH GRANDPARENT(S)	8
		INCOMPLETE FAMILY – FATHER/MOTHER WITH CHILDREN AND WITH RELATIVES (WITHOUT GRANDPARENTS)	9
		GRAND PARENTS, CHILDREN WITHOUT PARENTS	10
		A FAMILY WITHOUT A DIRECT RELATIONSHIP: “CHILDREN– PARENTS–GRANDPARENTS”	11
		OTHER	12
RHPOS	YOUR POSITION IN YOUR HOUSEHOLD. ONLY ONE ANSWER	HUSBAND , FATHER	1
		WIFE, MOTHER	2
		PARTNER	3
		SON, DAUGHTER	4
		GRANDPARENT	5
		GRANDSON, GRANDDAUGHTER	6
		BROTHER, SISTER	7
		OTHER RELATIVE = UNCLE, AUNT, NEPHEW, NIECE	8
		WITHOUT FAMILY RELATIONSHIP	9
RSTAT	CURRENT MARRITAL STATUS:	SINGLE, WITHOUT A PARTNER	1
		SINGLE, LIVING WITH A PARTNER	2
		MARRIED	3
		DIVORCED	4
		WIDOW / WIDOWER	5

RNAT	YOUR NATIONALITY:	CZECH	1	
		SLOVAK	2	
		MORAVIAN	3	
		SILESIA	4	
		GYPSY	5	
		POLISH	6	
		GERMAN	7	
		HUNGARIAN	8	
		UKRAINE / RUTHENIAN	9	
	OTHER (WHICH):	98		
REDU	YOUR HIGHEST ACHIEVED EDUCATION LEVEL	PRIMARY	1	
		APPRENTICESHIP (2 YEARS)	2	
		APPRENTICESHIP (3-4 YEARS), WITHOUT GCE	3	
		SECONDARY VOCATIONAL WITH GCE	4	
		GRAMMAR SCHOOL WITH GCE	5	
		HIGHER	6	
		WITHOUT SCHOOL EDUCATION	7	
REPL	YOUR JOB POSITION	FULL TIME JOB	1	⇒RISCO
		PART TIME JOB	2	⇒RISCO
		OWNER OF A FIRM, DO NOT WORK IN THIS FIRM	3	⇒RISCO
		OWNER OF A FIRM, WITHOUT EMPLOYEES	4	⇒RISCO
		OWNER OF A FIRM, WITH EMPLOYEES	5	⇒RISCO
		PENSIONER, WORKING IN A FULL TIME JOB	6	⇒RISCO
		PENSIONER, WORKING IN A PART TIME JOB	7	⇒RISCO
		PENSIONER, NOT WORKING	8	⇒HEAD
		UNEMPLOYED	9	⇒HEAD
		MILITARY SERVICE	10	⇒HEAD
		CIVIL SERVICE	11	⇒HEAD
		STUDENT	12	⇒HEAD
		WIFE, WORKING IN A HOUSE ONLY	13	⇒HEAD
		OTHER:	14	⇒HEAD
RISCO	WHAT IS YOUR JOB / PROVIDE DETAILS, PLEASE	WRITE:		
RFEM	HOW MANY EMPLOYEES WORK IN THE FIRM, WHERE YOU WORK	JUST 1, ONE MAN BUSINESS	1	
		2 – 5 EMPLOYEES	2	
		6 – 25 EMPLOYEES	3	
		26 – 100 EMPLOYEES	4	
		101 – 1000 EMPLOYEES	5	
		MORE THAN 1001 EMPLOYEES	6	
HEAD	ARE YOU HEAD OF YOUR FAMILY, I.E. IS YOUR FINANCIAL CONTRIBUTION TO FAMILY BUDGET THE GREATEST?	YES	1	⇒RINC
		NO	2	⇒HHEDU
HHEDU	THE HIGHEST ACHIEVED LEVEL OF EDUCATION OF HEAD OF YOUR FAMILY I.E. OF A PERSON, WHO CONTRIBUTES THE MOST TO THE FAMILY BUDGET:	PRIMARY	1	
		APPRENTICESHIP 2 YEARS	2	
		APPRENTICESHIP (3-4 YEARS), WITHOUT GCE	3	
		SECONDARY VOCATIONAL WITH GCE	4	
		GRAMMAR SCHOOL WITH GCE	5	
		HIGHER EDUCATION	6	
WITHOUT SCHOOL EDUCATION	7			

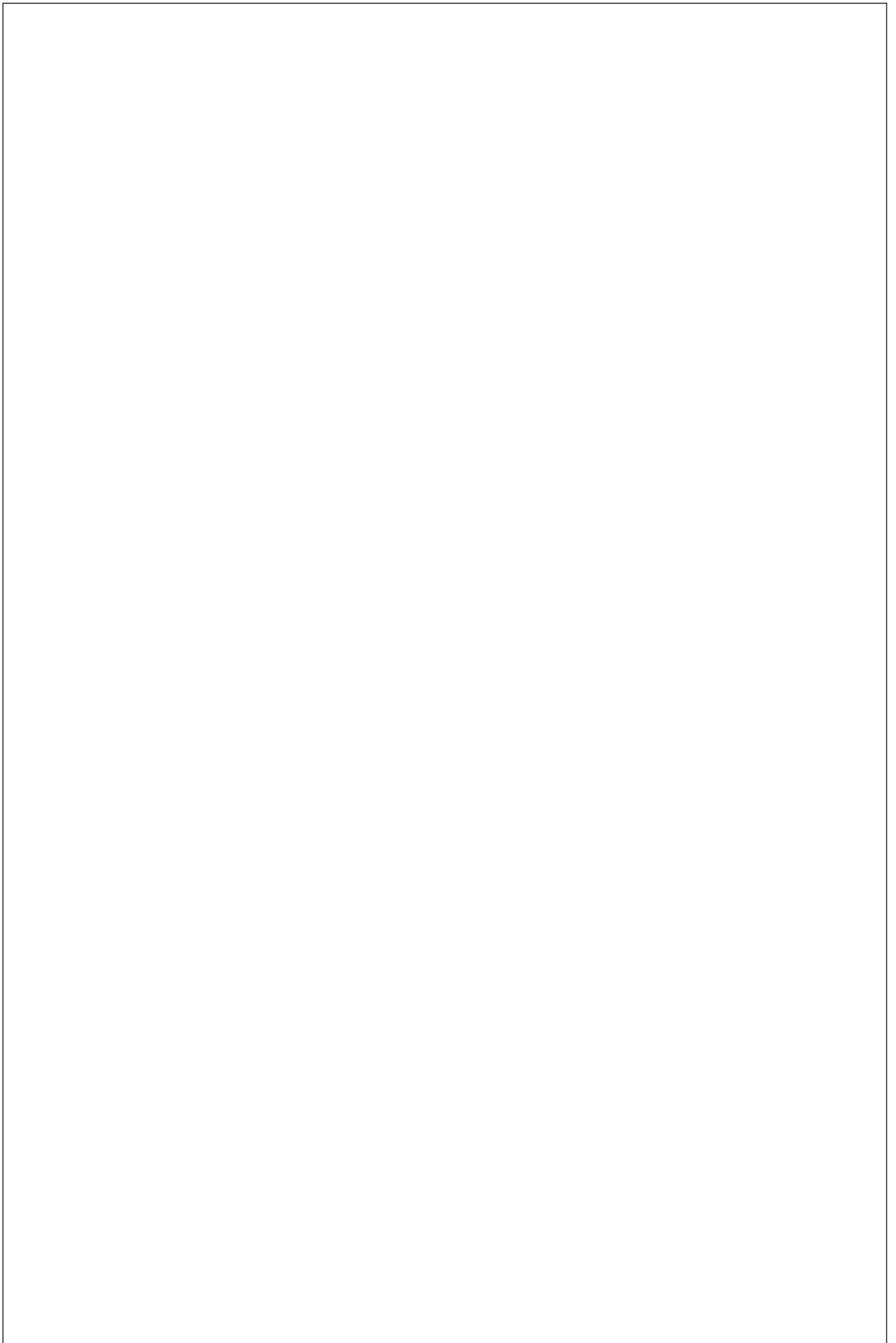
HEMPL	JOB POSITION OF THE FAMILY HEAD	FULL TIME JOB	1	⇒HISCO				
		PART TIME JOB	2	⇒HISCO				
		OWNER OF A FIRM, DO NOT WORK IN THIS FIRM	3	⇒HISCO				
		OWNER OF A FIRM, WITHOUT EMPLOYEES	4	⇒HISCO				
		OWNER OF A FIRM, WITH EMPLOYEES	5	⇒HISCO				
		PENSIONER, WORKING IN A FULL TIME JOB	6	⇒HISCO				
		PENSIONER, WORKING IN A PART TIME JOB	7	⇒HISCO				
		PENSIONER, NOT WORKING	8	⇒RINC				
		UNEMPLOYED	9	⇒RINC				
		MILITARY SERVICE	10	⇒RINC				
		CIVIL SERVICE	11	⇒RINC				
		STUDENT	12	⇒RINC				
		WIFE, WORKING IN THE HOUSE ONLY	13	⇒RINC				
		OTHER:	14	⇒RINC				
HISCO	WHAT IS THE JOB OF THE HEAD/ PROVIDE DETAILS, PLEASE	WRITE:						
HHFEM	HOW MANY EMPLOYEES WORK IN THE FIRM, WHERE THE HEAD OF YOUR FAMILY WORKS	JUST 1, ONE MAN BUSINESS	1					
		2 – 5 EMPLOYEES	2					
		6 – 25 EMPLOYEES	3					
		26 – 100 EMPLOYEES	4					
		101 – 1000 EMPLOYEES	5					
		MORE THAN 1001 EMPLOYEES	6					
RINC	CHOOSE A RANGE OF YOUR NET MONTHLY INCOME; INCLUDING SOCIAL BENEFITS	LESS THAN 10.000 KČ	1					
		10.001 – 15.000 KČ	2					
		15.001 – 20.000 KČ	3					
		20.001 – 25.000 KČ	4					
		25.001 – 30.000 KČ	5					
		30.001 – 35.000 KČ	6					
		35.001 – 40.000 KČ	7					
		MORE THAN 40.00 KČ	8					
		REJECTING A RESPONSE	9					
HINC	CHOOSE A RANGE OF YOUR HOUSEHOLD NET MONTHLY INCOME; INCLUDING SOCIAL BENEFITS	LESS THAN 10.000 KČ	1					
		10.001 – 15.000 KČ	2					
		15.001 – 20.000 KČ	3					
		20.001 – 25.000 KČ	4					
		25.001 – 30.000 KČ	5					
		30.001 – 35.000 KČ	6					
		35.001 – 40.000 KČ	7					
		MORE THAN 40.001 KČ	8					
		REJECTING A RESPONSE	9					
A01	YOU THINK THAT YOUR CURRENT HEALTH IS:	GOOD	1					
		BAD	2					
A02	ARE YOU SATISFIED WITH YOUR JOB?	VERY SATISFIED	1					
		SATISFIED	2					
		NOT SATISFIED	3					
		STRONGLY NOT SATISFIED	4					
A03	IF YOU CAN CHOOSE, WHAT WILL BE YOUR CHOICE?	MORE WORK FOR HIGHER SALARY	1					
		I AM COMPLETELY SATISFIED WITH THE CURRENT JOB	2					
		LESS WORK FOR LOWER SALARY	3					
A04	WHAT IS THE MINIMAL MONTHLY INCOME, WHICH SHOULD COVER THE NEEDS OF YOUR HOUSEHOLD IN YEAR 2000?							
A05	YOUR CURRENT FAMILY INCOME COMPARED WITH INCOME IN 1999:	IS STRONGLY HIGHER	1					
		IS A BIT HIGHER	2					
		IS APPROXIMATELY THE SAME	3					
		IS A BIT LOWER	4					
		IS STRONGLY LOWER	5					

A06	YOUR CURRENT FAMILY INCOME COMPARED WITH THE INCOME IN 1995:	IS STRONGLY HIGHER							1	
		IS A BIT HIGHER							2	
		IS APPROXIMATELY THE SAME							3	
		IS A BIT LOWER							4	
		IS STRONGLY LOWER							5	
YOU SURELY KNOW THAT THERE IS ALSO AN INFORMAL / SHADOW ECONOMY IN THE CZECH REPUBLIC.										
A07	ACCORDING TO YOU, WHAT PERCENT OF ADULTS IN THE CZECH REPUBLIC HAVE ALSO AN INCOME FROM THE SHADOW ECONOMY? I DO NOT KNOW								98	
A08	ACCORDING TO YOU, WHAT PERCENT OF ADULTS IN YOUR NEIGHBORHOOD HAVE ALSO AN INCOME FROM THE SHADOW ECONOMY? I DO NOT KNOW								98	
A09	DO YOU THINK THAT TO HAVE AN UNDECLARED INCOME (UNTAXED) IS:	STRONGLY MORAL							1	
		MORAL							2	
		NEITHER MORAL, NOR IMMORAL								3
		IMMORAL								4
		STRONGLY IMMORAL								5
	I DO NOT KNOW								98	
A10	WHAT WILL BE THE REACTION OF YOUR FAMILY AND FRIENDS IF THEY FIND OUT THAT YOU HAVE UNDECLARED (UNTAXED) INCOME?	THEY SURELY AGREE							1	
		THEY PROBABLY AGREE							2	
		I DO NOT KNOW								3
		THEY PROBABLY DO NOT AGREE								4
		THEY SURELY DO NOT AGREE								5
	I DO NOT KNOW								98	
A11	SUPPOSE YOU OWE THE STATE TAX PAYMENT IN THE AMOUNT 100.000 Kč. WHAT PENALTY WILL YOU HAVE TO PAY AFTER A YEAR?									
A12	ON A SCALE OF 0 TO A 100, SUPPOSING THAT 0 IS BEING SURE YOU WILL NOT BE CAUGHT AND 100 BEING SURE YOU WILL BE, WHAT WOULD BE THE NUMBER CORRESPONDING TO THE RISK OF YOUR BEING CAUGHT BUYING UNDECLARED GOODS AND SERVICES (OR JOBS)?									
B01	HAVE YOU EVER BOUGHT GOODS AND SERVICES COMING FROM UNDECLARED WORK?	YES	1	⇨B02						
		NO	2	⇨B03						
B02	WHY NOT 1=YES 2=NO	A. I NEVER NEED SUCH A GOOD OR SERVICES							1 2	
		B. I NEVER HAVE SUCH AN OCCASION							1 2	
		C. I THINK IT IS RISKY								1 2
		D. I THINK IT IS IMMORAL								1 2
		E. OTHER REASONS:								1 2
B03	WHAT PROPORTION (IN %) OF THESE UNDECLARED GOODS AND SERVICES (OR JOBS) HAVE YOU PAID IN	A. CASH								
		B. CREDIT CARD OR BANK TRANSFER								
		C. EXCHANGE FOR OTHER SERVICES								
		TOTAL			1	0	0			
B04	GENERALLY, HOW WOULD YOU COMPARE UNDECLARED GOODS AND SERVICES WITH DECLARED GOODS AND SERVICES (OR JOBS) CONCERNING... 1=UNDECLARED IS SUPERIOR, 2=EQUAL, 3=DECLARED IS SUPERIOR	A. QUALITY			1	2	3			
		B. WARRANTIES			1	2	3			
		C. AFTER SALE SERVICES			1	2	3			
		D. PRICE			1	2	3			

B05	WHO DO YOU BUY UNDECLARED GOOD / SERVICES FROM? 1=YES 2=NO	A. FROM FAMILY MEMBERS	1	2
		B. FROM FRIENDS	1	2
		C. FROM PERSONS IN YOUR NEIGHBORHOOD	1	2
		D. FROM COLLEAGUES FROM YOUR ACTUAL/ FORMER JOB	1	2
		E. FROM YOUR ACTUAL/ FORMER EMPLOYEES	1	2
		F. FROM YOUR ACTUAL/ FORMER BOSSES	1	2
		G. FROM OTHERS	1	2
B06	INDICATE THE REASONS THAT MADE YOU BUY THESE UNDECLARED GOODS AND SERVICES (OR JOBS): (CHECK MANY ANSWERS IF NECESSARY) 1=YES 2=NO	A. PRICES OF THESE GOODS/ SERVICES ARE LOWER	1	2
		B. LABOR COSTS ARE LOWER	1	2
		C. BECAUSE THE GOOD OR SERVICE ARE BETTER IF UNOFFICIALLY AVAILABLE	1	2
		D. TO HELP SOMEONE WHO HAS PROBLEMS	1	2
		E. TO HELP SOMEONE WHO IS UNEMPLOYED	1	2
		F. BECAUSE THE GOOD OR SERVICE IS NOT OFFICIALLY AVAILABLE	1	2
		G. OTHER REASONS:	1	2
B07	COULD YOU WRITE DOWN YOUR TOTAL EXPENSES FOR UNDECLARED GOODS AND SERVICES (OR JOB) FOR 2000.			
A.	RENOVATIONS AND REPAIRS OF BUILDING (CARPENTRY, PLUMBING, ELECTRICITY, PAINTING...)			
B.	HOUSEHOLD MAINTENANCE (CLEANING, SNOW REMOVAL, EXCAVATION WORKS, LAWN MOWING...)			
C.	RENOVATIONS AND REPAIRS OF GOOD (CAR REPAIR, BODY WORK, BICYCLE AND ELECTRIC APPLIANCE REPAIRS...)			
D.	ROOM RENTAL			
E.	BABY-SITTING, CARE SERVICES (NURSING, CARE FOR THE ELDERLY)			
F.	PERSONAL SERVICES (HAIRDRESSING TYPING, DRESSMAKING...)			
G.	PRIVATE CLASSES (DANCING, ENGLISH CONVERSATION...)			
H.	SELLING GOODS (DOOR-TO-DOOR, TELEMARKETING...)			
I.	TRANSPORTATION SERVICES (CHAUFFEUR, DELIVERYMAN, MOVER...)			
J.	SERVICES RELATED TO WEDDINGS AND RECEPTIONS (MUSICIAN, D.J., PHOTOGRAPHER, SINGER, CATERER, ...)			
K.	FOOD AND CATERING SERVICES			
L.	PURCHASE OF ALCOHOL, TOBACCO			
M.	SALE OF FARMING, HUNTING, FISHING, AND FOREST PRODUCTS			
N.	FACTORY WORK (ENGRAVING, WOOD SAWING, WELDING...)			
O.	PROFESSIONAL SERVICES (PSYCHOLOGY, MEDICINE, MATHEMATICAL, ACCOUNTING, ARCHITECTURE ...)			
P.	OTHER:			
C01	HAVE YOU EVER BEEN ENGAGED IN THE UNDECLARED SECTOR?			
		YEAR 2000	YEAR 1999	YEAR 1995
	OFTEN	1	1	1
	OCCASIONALLY	2	2	2
NEVER	3	3	3	
C02	WHY HAVE YOU NEVER BEEN ENGAGED IN THE UNDECLARED SECTOR? 1=YES 2=NO	A. I NEVER NEEDED IT	1	2
		B. I NEVER HAVE HAD AN OCCASION	1	2
		C. I THINK IT IS RISKY	1	2
		D. I THINK IT IS IMMORAL	1	2
		E. OTHER REASONS:	1	2
C03	YOUR MAIN UNDECLARED ACTIVITY	WORK (BEING EMPLOYED)	1	
		YOUR OWN BUSINESS		2

C04	HOW MANY PERSONS WERE ENGAGED IN UNDECLARED ACTIVITY WITH YOU IN 2000?			
C05	HOW MANY HOURS A DAY WERE YOU ENGAGED IN UNDECLARED ACTIVITY IN 2000?			
C06	WHO DO YOU SELL UNDECLARED GOOD SERVICES TO? 1=YES 2=NO	A. TO FAMILY MEMBERS	1	2
		B. TO FRIENDS	1	2
		C. TO PERSONS IN YOUR NEIGHBORHOOD	1	2
		D. TO COLLEAGUES FROM YOUR ACTUAL/ FORMER JOB	1	2
		E. TO YOUR ACTUAL/ FORMER EMPLOYEES	1	2
		F. TO YOUR ACTUAL/ FORMER BOSSES	1	2
	E. TO OTHERS	1	2	
C07	WHAT % OF GOODS / SERVICES, OF UNDECLARED ACTIVITY, WHICH YOU SELL IS PAID BY:	A. CASH		
		B. CREDIT CARD OR BANK TRANSFER		
		C. EXCHANGE FOR OTHER SERVICES		
		TOTAL	1	0 0
C08	INDICATE THE REASONS THAT MADE YOU SELL THESE UNDECLARED GOODS AND SERVICES 1=YES 2=NO	A. I CAN NOT FIND AN OFFICIAL JOB	1	2
		B. FAMILY BUDGET SUPPORT	1	2
		C. I WANT TO CONSUME MORE	1	2
		D. I WANT TO DO SOMETHING ALL THE TIME	1	2
		E. I WANT TO BE MY OWN BOSS	1	2
		F. TAX EVASION	1	2
		G. I ENJOY RISK	1	2
		H. NOT TO LOOSE SOCIAL BENEFITS	1	2
		I. OTHER REASONS:	1	2
C09	WHAT % OF YOUR TOTAL INCOME COMES FROM (IN 2000):			
	A. RENOVATIONS AND REPAIRS OF BUILDING (CARPENTRY, PLUMBING, ELECTRICITY, PAINTING...)			
	B. HOUSEHOLD MAINTENANCE (CLEANING, SNOW REMOVAL, EXCAVATION WORKS, LAWN MOWING...)			
	C. RENOVATIONS AND REPAIRS OF GOOD (CAR REPAIR, BODY WORK, BICYCLE AND ELECTRIC APPLIANCE REPAIRS...)			
	D. ROOM RENTAL			
	E. BABY-SITTING, CARE SERVICES (NURSING, CARE FOR THE ELDERLY)			
	F. PERSONAL SERVICES (HAIRDRESSING, TYPING, DRESSMAKING...)			
	G. PRIVATE CLASSES (DANCING, ENGLISH CONVERSATION...)			
	H. SELLING GOODS (DOOR-TO-DOOR, TELEMARKETING...)			
	I. TRANSPORTATION SERVICES (CHAUFFEUR, DELIVERYMAN, MOVER...)			
	J. SERVICES RELATED TO WEDDINGS AND RECEPTIONS (MUSICIAN, D.J., PHOTOGRAPHER, SINGER, CATERER...)			
	K. FOOD AND CATERING SERVICES			
	L. PURCHASE OF ALCOHOL, TOBACCO			
	M. SALE OF FARMING, HUNTING, FISHING, AND FOREST PRODUCTS			
	N. FACTORY WORK (ENGRAVING, WOOD SAWING, WELDING...)			
	O. PROFESSIONAL SERVICES (PSYCHOLOGY, MEDICINE, MATHEMATICAL, ACCOUNTING, ARCHITECTURE ...)			
	P. OTHER:			
C10	ARE YOU SATISFIED WITH YOUR UNDECLARED ACTIVITY	VERY SATISFIED		1
		SATISFIED		2
		NEITHER SATISFIED, NOR NOT SATISFIED		3
		NOT SATISFIED		4
		STRONGLY NOT SATISFIED		5

C11	YOUR CURRENT EVALUATION OF UNDECLARED JOB (INCOME, WORKING CONDITIONS...) IS:	SUPERIOR TO MY EXPECTATION	1
		EQUAL TO MY EXPECTATION	2
		INFERIOR TO MY EXPECTATION	3
C12	WHAT IS YOUR INCOME FROM UNDECLARED JOB	LESS THAN 10.000 KC	1
		10.001 – 15.000 KC	2
		15.001 – 20.000 KC	3
		20.001 – 25.000 KC	4
		25.001 – 30.000 KC	5
		30.001 – 35.000 KC	6
		35.001 – 40.000 KC	7
		MORE THAN 40.001 KC	8
	NOT RESPONDING	9	
TIME B	FILL ACTUAL TIME	HOURS	
		MINUTES	
RSEX	SEX OF RESPONDENT:	MALE	1
		FEMALE	2
SIZE	SIZE OF TOWN	LESS THAN 999 HABITANTS	1
		1000 - 4999 HABITANTS	2
		5000-19999 HABITANTS	3
		20000-99999 HABITANTS	4
		100000 AND MORE HABITANTS	5
REG	REGION:	PRAGUE	1
		MIDDLE BOHEMIA	2
		SOUTHERN BOHEMIA	3
		WESTERN BOHEMIA	4
		NORTHERN BOHEMIA	5
		EASTERN BOHEMIA	6
		SOUTHERN MORAVIA	7
		NORTHERN MORAVIA	8
REG	REGION OF SLOVAKIA	BRATISLAVA	1
		WESTERN SLOVAKIA	2
		MIDDLE SLOVAKIA	3
		EASTERN SLOVAKIA	4



CHAPTER 7

Informal Labor Market and Informal Economy During Economic Transition: The Polish Perspective

Maciej H. Grabowski

Informal Labor – Place in the Underground Economy, Main Characteristics of its Activities and Evolution in the Course of the Transition

The informal sector, also referred to as the underground economy, which has been drawing particular attention from experts and politicians lately, has sprung up as a topic of academic research relatively recently. In the 1960s textbooks on public finance did not mention it as a problem at all. A breakthrough in this respect happened in 1970s; extensive research on the informal sector and especially on its sociological and economic aspects was further conducted in Poland in the 1980s (Sowa, 1990, Kokoszczyński, 1988 and Wyżnikiewicz, 1987).

The nature and the mechanisms of the informal economy changed with the deregulation and liberalization when rules of competition were being set up. Before 1989 the informal sector in Poland was stimulated mainly by the excessive limitation in economic activities (including the prohibition of certain forms of activity, the necessity of obtaining licenses, etc.) and by the limited access to the means of production. Since 1989 the improvement of the competitive position (for instance, by reducing costs) was the main motivating factor for firms to remain in the underground economy.

Informal labor obviously represents only a part of the underground (or the informal) sector. Clandestine employment (or informal labor) may be defined as additional or primary job, which is performed through by-passing regulations of the

labor or tax codes. Such a definition can be applied to both illegal employment between households and companies, irrespective of whether they are registered or not, and it also covers self-employment. This definition may also apply to foreigners and to work, which is not paid for (i.e. not valued in money). Informal labor can be grouped or classified according to various criteria. It may represent the principal or the additional place of employment i.e. the source of employees' income. Clandestine employment may be permanent or temporary. The employer may be a household or a company (registered or not). As far as the economic sectors are concerned, illegal employment may be found in industry, construction, agriculture, transportation and services. Illegal employment may be provided by residents and non-residents of a country.

Main Sources of Data and Assessment of Informal Labor

Methods of Assessment of Informal Labor and Their Application in Poland

The sources of information on informal labor are not numerous. There are direct and indirect methods for assessment of informal labor. Indirect methods are based on estimation of the underground economy as a whole – this is done, for instance, using monetary methods, data from household surveys, analysis of value-added by sectors, etc.¹

Direct methods can be based on questionnaires designed for a specially selected sample or through Labor Force Survey (LFS) samples. Some of the direct methods are used to obtain data from specific societal groups. LFS have been carried out by GUS (the Central Statistics Office). These surveys are based on large representative and rotating samples of the adult population and have been conducted quarterly in Poland since 1992.

All of these methods, by definition, do not provide genuine data of number of people employed in the informal sector or the amount of labor involved (for instance, the number of hours worked). Errors of measurement are not practically possible to estimate. Different methods are used for different purposes (for instance, estimation of the number of permanently/temporary employed people in the informal sector, estimation of the number of hours worked, the types of work or industry sectors) and they have their own pros and cons.

Methods Based on Labor Force Surveys

Thanks to LFS two kinds of estimations can be done. The first method is based on the assumption that the results of LFS are accurate, and employment data provided by employers is incorrect. The number of people working according to LFSs is higher than

¹ For an excellent review of the methods, see Schneider and Enste (2000).

the number of people working according to the statistical declarations of employers; the difference is the number of people employed in the informal sector. Nevertheless, one can notice that this method may not include people, who work legally or illegally, for instance, after business hours. LFSs by definition do not include people working abroad, foreigners staying in Poland and people staying in Workers Hostels. This makes the assessment of informal labor much more complicated. The second method using LFS data is based on a comparison of the unemployed according to the Labor Administration and the LFS estimates.

The results of LFSs are provided quarterly, so we can estimate the number of permanently illegal workers every three months. Assuming that the fixed error of these surveys does not change over time, we can observe the dynamics of informal labor.

Estimates of informal labor based on LFS results indicate that the peak was reached in 1994 and since then it has been steadily diminishing (see table 2.1).

TABLE 2.1: ESTIMATES OF INFORMAL LABOR BASED ON LFS (IN THOUSANDS)

<i>Method based on:</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>
<i>LFS data and the number of people employed</i>	365	840	755
<i>LFS data and the number of people unemployed</i>	1,084	1,126	1,011

Source: Kałaska, Kostrubiec, and Witkowski (1996, pp. 6-11).

Note: Estimates only for permanently employed in the informal sector.

The data from table 2.1 suggest that there are major problems with these methods of assessment as results vary very much.

Special Large Sample Surveys

Special surveys on informal labor were conducted by GUS in 1995 (Kałaska et al., 1996) and 1998 (Kostrubiec, 1999). The sample size used was the same as for LFS - around 11,000 households (i.e. over 25,000 people were involved in each survey) during the first six months of each year.

Special surveys carried out by GUS in 1995 and 1998 allowed to understand the features of informal labor, including working hours, seasonal character, temporary illegal jobs, regional characteristics, etc. Thus, 2.199 million persons worked on black in 1995 and 1.431 million in 1998, which represents respectively 7.3 percent and 4.8 percent of the total population of age above 15 years old. This reduction of the number of illegal workers can be explained by the increase of employment from 15.48 million in 1995 to 16.27 million in 1998 and by reducing the number of unemployed from 2.23 million in 1995 to 1.83 million in 1998 (GUS 2000).

These surveys showed that informal labor is usually temporary and seasonal. In 1995 957,000 (or 43 percent of all illegal employees) worked permanently in informal sector and it was the only job for them; in 1998 this share was 46 percent (or 662,000).

This also means that 54-57 percent of the illegal workers had an additional legal job. Interestingly, well educated people often had two jobs (one legal and one illegal); 84 percent of the illegal workers among university-educated people had at the same time a legal principal job.

People with vocational training constituted the most numerous group of illegal labor. In 1995 about 11 percent of all persons in this category were informally employed, followed by the people with only elementary education (6.7 percent) and university graduates (5.5 percent). These numbers show the structure of labor demand in the informal sector.

There is a significant seasonality in the informal labor market in Poland. Summer months are much busier than winter months. The lowest demand for black labor was observed in January – 3.5 times lower than in July, which was confirmed by the surveys 1995 and 1998.

Informal labor is more common for male and less for female workers. The number of men involved is twice as large as that of women. Young and middle-aged people are the most attractive groups for illegal employment. The share of illegally employed in age group between 25 and 44 years of age was 10.4 percent in 1995 and 9.0 percent in 1998. Older people (over 60 years of age) are the least attractive for black labor market employment.

The surveys revealed that there were strong regional disparities in the informal labor sector. The Northern and Eastern parts of Poland were the regions with the strongest informal sector the central part, the South and the Mid-West had the weakest informal sector. Kostrubiec (1998) provided a correlation analysis, which showed that there was a significant correlation between regional unemployment rates and informal labor participation.

Small Sample Surveys

Other methods used in Poland assessment of informal labor were based on small representative sample surveys (over 1000 respondents). The Gdansk Institute for Market Economics (GIME) carried out such surveys in June 1994 and in May 1997 (Grabowski, 1995 and 1997). These surveys confirmed to a large extent the characteristics and the trends of informal labor observed in surveys done by GUS in 1995 and 1998, and to a lower extent - its size. According to these surveys 29.6 percent and 14.1 percent of the people were involved in unregistered work in 1994 and 1997 respectively. These differences may be explained by the timing of the surveys, which were carried out in May and June, i.e. during the months of high informal activities. The samples were derived from slightly different population groups: for the GUS survey it was the groups of people over the age of 15 while for the GIME survey it was the groups of people over the age of 18. The main results of the small sample surveys are provided in table 2.2.

TABLE 2.2: STRUCTURE OF INCOME FROM INFORMAL EMPLOYMENT IN 1994 AND 1997

sample structure for both surveys	persons with unregistered income				
	1994 (307 persons out of 1050)			1997 (142 persons out of 1008)	
1	2	3	4	5	6
	%	%	average amount of unregistered income (PLN)	%	average amount of unregistered income (PLN)
Total	100	29.6	160	14.1	267
Male	50	64	180	65	246
Female	50	36	110	35	278
<i>Place of living (in '000):</i>					
city +200	24	28	170	22	172
50-200	16	14	130	20	290
up to 50		22	26	180	27
228					
village	37	31	160	31	354
<i>age:</i>					
18-24	15	20	160	22	185
25-39	30	36	170	40	250
40-59	36	37	150	32	352
+60	19	7	180	5	229
<i>labor relations:</i>					
employees	48	56	160	58	289
farmers	6	4	240	2	225
pensioners	25	11	160	8	223
students	7	9	140	11	126
unemployed	10	16	190	14	305
not working	3	3	130	6	301
<i>Education:</i>					
Elementary	26	13	100	29	221
Vocational	25	35	180	31	265
High	36	37	170	29	353
University	12	15	150	11	167

Source: Grabowski (1995 and 1997).

Notes:

- (i) Surveys were carried out in June 1994 and May 1997 by Pracownia Badań Społecznych in Sopot.
- (ii) Columns 2, 3 and 5 may not sum up to 100 due to rounding error.
- (iii) Non-response was not taken into account for calculations.

The data in table 2.2 suggest that informal labor diminished between 1994 and 1997, but its main characteristics remained the same. There is, however, one exception: in 1993 the least educated and skilled people did not work illegally as much as they did in 1997. Informal labor diminished between 1994 and 1997, but the average nominal income from informal work increased roughly at the rate of inflation - it was respectively 67 percent and 75 percent in June 1994 and in May 1997.

There is one more important feature of informal labor – the difference among employers. The results of the empirical surveys indicated that informal employment in firms is much less popular than employment in households. This means that 14 percent (or between 14 and 17 percent) of all illegal workers are employed by firms (mostly

small, private firms); the rest, i.e. 86 percent, worked for households. Still, firms' black workers are much often permanently employed and their jobs are the principal, not the additional, ones. Grabowski (1995) provided a detailed analysis of the data, which showed that there is a link between the official labor market and the informal labor market - for instance, there is a strong correlation between the rates for work and the hours worked in both markets. This suggests that labor supply (hours worked) is strongly related to the rates in both markets. Thus, if the difference between the rates for work in both markets is small, the supply of informal labor is small as well, *ceteris paribus*.² There is also a relatively strong correlation (but not as strong as the correlation between the rates and the hours worked) between the rates for work in both markets. It means that those who make a good living in the formal market usually make a good living in informal market too, and vice versa.

Official Assessment of the Hidden Economy and Unregistered Labor

GUS provides estimates of the hidden economy according to the rules of European System of Accounts 1995 (ESA 1995). GUS does not, however, provide estimates of the illegal activities, but of the hidden economy. It is defined as economic activities not prohibited by law, but partly or wholly hidden vis-a-vis the public administration (fiscal, statistical, custom, etc.). The hidden economy is divided into:

- non-registered economic activities;
- under-declared economic activities.

Estimates of the hidden economy (the under-declared activities) are done by GUS for registered private firms of the following sizes:

- (i) 0-5 employees for all sectors;
- (ii) 6-50 employees for the sectors of manufacturing and mining;
- (iii) 6-20 employees for all other sectors.

Non-registered economic activities are estimated for individuals on the basis of the assumption that they work mostly in service sector. Three methods are used:

- (i) direct method;
- (ii) labour force survey (LFS) and module-survey of non-registered labour;
- (iii) survey of consumers.

A direct method is used for the estimation of under-declared economic activities of firms. It is based on the assumption that the average productivity of labor and the wage levels are similar in the informal and the formal economy. This estimation is done by sector of the economy, localization (rural and urban), and the size of firm (according to the number of employees).

² Lemieux, Fortin, and Frechette (1994) drew similar conclusions about the Canadian labor markets.

- Labor surveys are used to estimate non-registered labour. Three sets of data are used:
- (i) official statistical data on wages, number of employees and registered unemployed persons;
 - (ii) LFS;
 - (iii) module-survey of non-registered labour.

On the basis of these methods the number of individuals working in the informal sector and their income can be estimated. Consumer surveys are used to estimate the expenditures of households on services (such as childcare, rent, car repair, cleaning and home repair) and construction. It is compared with the available statistical data on such activities. The assessment of the hidden economy is provided in table 2.3. Table 2.4 provides data on employment, the hidden economy and unregistered labor in 1995-1999.

TABLE 2.3: ASSESSMENT OF THE HIDDEN ECONOMY IN THE CREATION OF GDP IN 1995-1999
(IN CURRENT PRICES)

	1995	1996	1997	1998	1999
	<i>In %</i>				
<i>GDP (hidden economy not included)</i>	100	1000	100	100	100
<i>GDP (hidden economy included)</i>	116.6	115.9	115.2	115.3	114.5
<i>Disaggregation of hidden economy</i>	16.6	15.9	15.2	15.3	14.5
<i>(i) in registered firms</i>	11.9	11.3	11.0	11.0	10.4
<i>(ii) non-registered labour</i>	4.7	4.6	4.2	4.3	4.1
<i>A. Manufacturing</i>	1.9	1.6	1.5	1.6	1.4
<i>B. Construction</i>	3.1	2.9	2.5	2.5	2.5
<i>C. Trade and Repair</i>	8.6	7.8	7.2	6.9	6.5
<i>D. Transport</i>	1.0	1.0	0.9	0.9	0.8
<i>E. Firms services</i>	0.6	1.0	1.6	1.9	1.9
<i>F. Other sections</i>	1.4	1.6	1.5	1.5	1.4

Source: Rachunki narodowe według sektorów i podsektorów instytucjonalnych 1995-1999 (2001, p. 472).

The data from tables 2.3 and 2.4 suggest that there is relatively weak correlation between unregistered labor and the labor market. In 1995-1999 the numbers on unregistered labor are almost flat while unemployment as well as employment varied strongly. This finding is contrary to intuition and the conclusions of earlier research. The trend of decline of the informal sector during 1995-1999, however, may be explained by the strong economic growth during that period.

TABLE 2.4: EMPLOYMENT, UNEMPLOYMENT, HIDDEN ECONOMY AND UNREGISTERED LABOR
IN 1995-1999

	1995	1996	1997	1998	1999
<i>Employed (December, thousands),</i>	15,486	15,842	16,294	16,267	16,009
<i>Including self-employed</i>	5,261	5,398	5,599	5,648	5,578
<i>Unemployed (December, thousands)</i>	2,629	2,359	1,826	1,831	2,349
<i>Unemployment rate (%)</i>	14.9	13.2	10.5	10.4	13.1
<i>Unemployed (according to LFS; November, thousands)</i>	2,233	1,961	1,737	1,827	2,641
<i>Unemployment rate (%)</i>	13.1	11.5	10.2	10.4	15.3
<i>Employed in the hidden economy (thousands)</i>	805	850	870	830	820
<i>Hidden economy (% GDP)</i>	16.6	15.9	15.2	15.3	14.5
<i>Unregistered labor in GDP (% GDP)</i>	4.7	4.6	4.2	4.3	4.1
<i>GDP growth (%)</i>	7.0	6.6	6.8	4.8	4.1

Source:

1. Rocznik Statystyczny Pracy (2000, pp. 27, 82, 95).

2. Rocznik Statystyczny (2001, p. 131).

3. Rachunki narodowe według sektorów i podsektorów instytucjonalnych 1995-1999 (2001, p. 472).

Economic, Institutional and Social Causes of the Informal Labor Market

The main causes of informal labor may be divided in three main groups: economic, institutional and social. This classification can be instrumental for the adoption of policy measures addressing the issue of informal labor.

The main economic reasons of informal labor are the following:

- lack of legal jobs;
- lack or insufficient level of legal income;
- higher remuneration if the job is done without registration;
- strong and unfair competition, which may prompt firms to look for cost reduction, including through informal labor.

Economic transition has brought new phenomena such as unemployment, poverty and large income disparities. This has been instrumental for many people to accept jobs in the informal sector. Fast changes in income distribution may create incentives for “the losers” to accept additional informal jobs. Strong competition from firms, which benefit from the informal economy, including from black labor, may create pressure for other firms to do the same (a mimic effect).

The institutional environment, in which firms, workers and households operate, is usually considered as a major cause of informal labor. This environment includes:

- high taxation on labor;

- high unemployment benefits;
- complicated procedures for getting unemployment benefits (how easy it is to get benefits, their time-span, methods of skill assessment, rules of registration of temporary job contracts by retired and unemployed people, etc.);
- other specific labor markets regulations, such as rules of hiring and firing employees, including temporary and seasonal workers;
- size and capacity of the tax administration.

High income taxes create large disparities between legal and informal wages and incentives to go informal. Empirical studies suggest that labor supply (the number of hours worked) is strongly correlated with the pay rates in both legal and informal labor markets. This means that a reduction of the divergence between the pay rates for legal and illegal work will lead to a decline of the volume of informal work. Low unemployment benefits create incentives for taking informal jobs. In addition, relatively high unemployment benefits do not motivate towards searching for jobs (this is the poverty trap). Barriers to registration of temporary labor contracts by employers may lead to increase of informal labor. Inflexible labor regulations also provide incentives to go informal. High firing costs, such as obligatory severance pay, do not encourage employers to hire workers legally. This is certainly obvious for small firms. Transformation has also brought new challenges for the administration in general, but both fiscal and labor administration can be instrumental for controlling the size of informal sector, although it takes a long time to build their capabilities.

The third group of causes of informal activities consists of psychological and cultural motivations to go informal:

- social tax morality (i.e. the acceptance of black labor and tax evasion by society);
- risk-adverse or risk-taking attitudes in society;
- willingness to work on a permanent labor contract.

Lack of identification with the state and traditions of cheating the state creates a suitable ground for informal labor relations. Strong family links and weak regional and national identification will probably lead to strong informal labor sector. Attitudes towards taking risk are also instrumental for clandestine employment.

This weak tax morality and identification with the state is indirectly confirmed by the corruption index. Table 3.1 provides data on corruption perception for 1996-1999.

Empirical surveys of informal labor have focused on the first type of causes, which suggest that informal labor has mostly economic motivation. Both surveys mentioned above are similar in this respect. Researchers also indicate that there are direct mutual benefits for both employers and employees in clandestine employment in detriment to the state. There are also numerous labor market regulations, which stimulate informal labor-market growth. Moreover, tax morality is very low and there is a significant social acceptance of black jobs.

TABLE 3.1: CORRUPTION PERCEPTION INDEX FOR POLAND IN 1996-2001

<i>Indicator</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
CPI (corruption perception index)	5.57	5.08	4.6	4.2	4.1	4.1

Source of data and notes:

Transparency International (various issues from www.transparency.org). CPI is between 0 and 10, the higher the better (less corruption).

There are two kinds of institutional causes for the informal labor market in Poland. First, new labor regulations and policy measures were introduced to limit the social costs of the reforms. Their main goal was to provide social safety nets for workers and obligations set on labor were too easy to comply with - for instance, it was relatively easy to get unemployment benefits for any person without a job. Additionally, new administration, which was created to deal with labor issues, needed time to acquire skills and build capabilities. Second, labor regulations, which were enacted before 1989, to a large extent carried a disregard for the problems of small firms. As a result, regardless of their size firms faced the same administrative burdens. The surveys suggested that firm size is an important factor for informality.

Generally, the institutional order encourages informal labor; many features of the Polish institutional order support the growth of informality. They include, but are not limited to: high taxes (marginal rate of income tax) and social security fees, high costs of firing, and high costs and administrative burdens for hiring new employees. Since 1990 the tax and labor administration has improved and enlarged its staff and increased its capabilities, which should help control the size of informal labor in the future.

Conclusions and Final Remarks

1. The results of the surveys during the period 1995-1999 indicate that informal labor has shrunk in size and role in economy. This conclusion has been confirmed by all other surveys. Nevertheless, the estimates of the informal market size have varied significantly. The table below provides a summary of the main sources of data on the informal labor market – the numbers indicate the share of informal labor force in the total adult population.

<i>Source of data</i>	<i>1994</i>	<i>1995</i>	<i>1997</i>	<i>1998</i>
<i>GIME</i>	29.6		14.1	
<i>LFS (*)</i>	2.8-3.7	2.5-3.4		
<i>GUS</i>		7.3		4.8

(*) only permanently employed

Generally, these numbers are relatively low. Schneider provides similar data for some OECD countries. The participants in the shadow economy, taken as a part of the

labor force, are more numerous. For instance the numbers for Denmark are respectively 15.4 percent (1994) and 22.5 percent (1998); for Spain - 11.5-32.5 percent (1997-1998). Estimations for the OECD countries suggest that during the 1990s the size of informal labor increased in all OECD countries.

2. 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. Thus, between 1994 and 1998 unemployment dropped by about 1 million people.

3. Assessments of the Polish informal labor market do not cover all participants of this market. There is anecdotal evidence, for instance, about the large number of foreigners working on black in Poland. The number of foreigners, who worked illegally and were caught by the Polish labor administration, increased over the recent years. This part of informal labor market is not taken into account by any assessment.

4. Informal and regular labor markets are inter-related. The nature of this relationship should be taken into account by policy makers in the design and implementation of policies aimed at limiting the informal labor market.

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CHAPTER 8

Behind the Informal Economy: Estimating, Explaining, Counteracting

Guoda Steponaviciene

The essence of an informal economy is to escape from being measured and captured; therefore both definition and methodologies shall be treated only as a way of approximation more than elsewhere in the economy in general. The informal economy is particularly flexible in reacting to changes in the regulatory framework - every new prohibition or regulation widens its scope and size. What was formal and legitimate yesterday can become informal today, for instance, the business of individual tours by boats before and after introducing new standards for passenger boats, or kiosk owners business before and after introducing the requirements to use cash registers.

It is universally recognized that official statistics fails to reflect all the activities in the national economy. The informal economy exists in all countries, although those, which are in a process on transition, provide additional space for its existence.

In this paper the term “informal economy” refers to economic activities which are either illegal or, if legal, go unreported (or partly unreported) in order to avoid taxes or state regulation. The illegal economy includes any activity prohibited by law. Household economy, including activities such as babysitting, construction and repair services or garden work grounded in personal relationships or recommendations, is excluded from the concept of the informal economy.

The Lithuanian Department of Statistics (LDS) normally adjusts GDP in an upward direction to include the informal economy. Its size, however, was measured

only once - in 1995 when it was estimated to be 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 (although the underlying activities can hardly be considered as informal from our standpoint). 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, state social insurance fund employees as well as interviews with randomly picked individuals. Salaries and wages were adjusted on the assumption that they could not be lower in private enterprises than in state-owned entities, an assumption which is highly questionable.

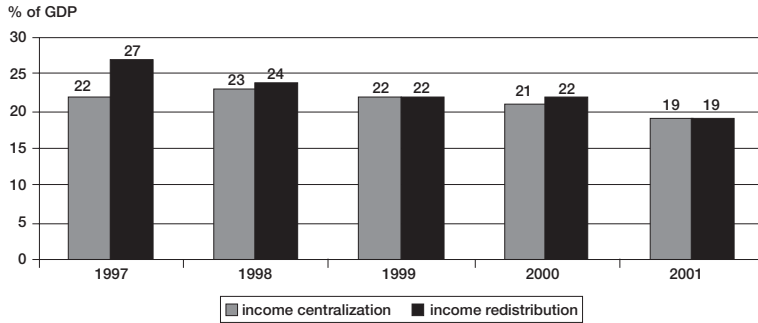
The Lithuanian Free Market Institute has conducted regular, semi-annual surveys of market participants' expectations since 1997. The informal economy is one of the issues under analysis. The survey is based on the expert consensus paradigm originating from the theory of rational expectations. In theory, market participants use all available information to make estimates and forecasts. It is the expectations of market participants that determine their actions and the trends in economic development. LFMI's survey participants include managers, financial analysts and other employees of successful business enterprises. They are asked to provide estimates and forecasts of Lithuania's economic variables based on all available information. The rationale for our survey is the obvious mismatch between the official statistics and reality (the number of cars in the streets, housing purchases, cafes' turnover, etc.) which most investors find rather confusing.

LFMI Survey Results

The results of the LFMI's surveys show that the informal economy in Lithuania has been steadily shrinking. This seems to indicate a positive trend at first glance, but without knowing the cause of the informal economy and its decline interpretation of the figures can be superficial. People who for various reasons cannot find their place in the formal economy can either go informal or turn to the labour exchange or their municipality for social support. A comparably low level of the informal economy can be indicative of a lack of entrepreneurship in society and this is very likely to be the case for Lithuania.

In exploring the phenomenon of the informal economy, it is not the numbers but the causes behind them that matter the most. The roots of a shadow economy lie in the burden of taxes and other government regulations; other factors include the quality of state administration and services, the volume of cash transactions, price differences in neighbouring countries and the general economic situation. The reasons for an individual to go informal are manifold, but one thing is clear: if business conditions are favourable the risk of going informal does not pay off.

INFORMAL ECONOMY

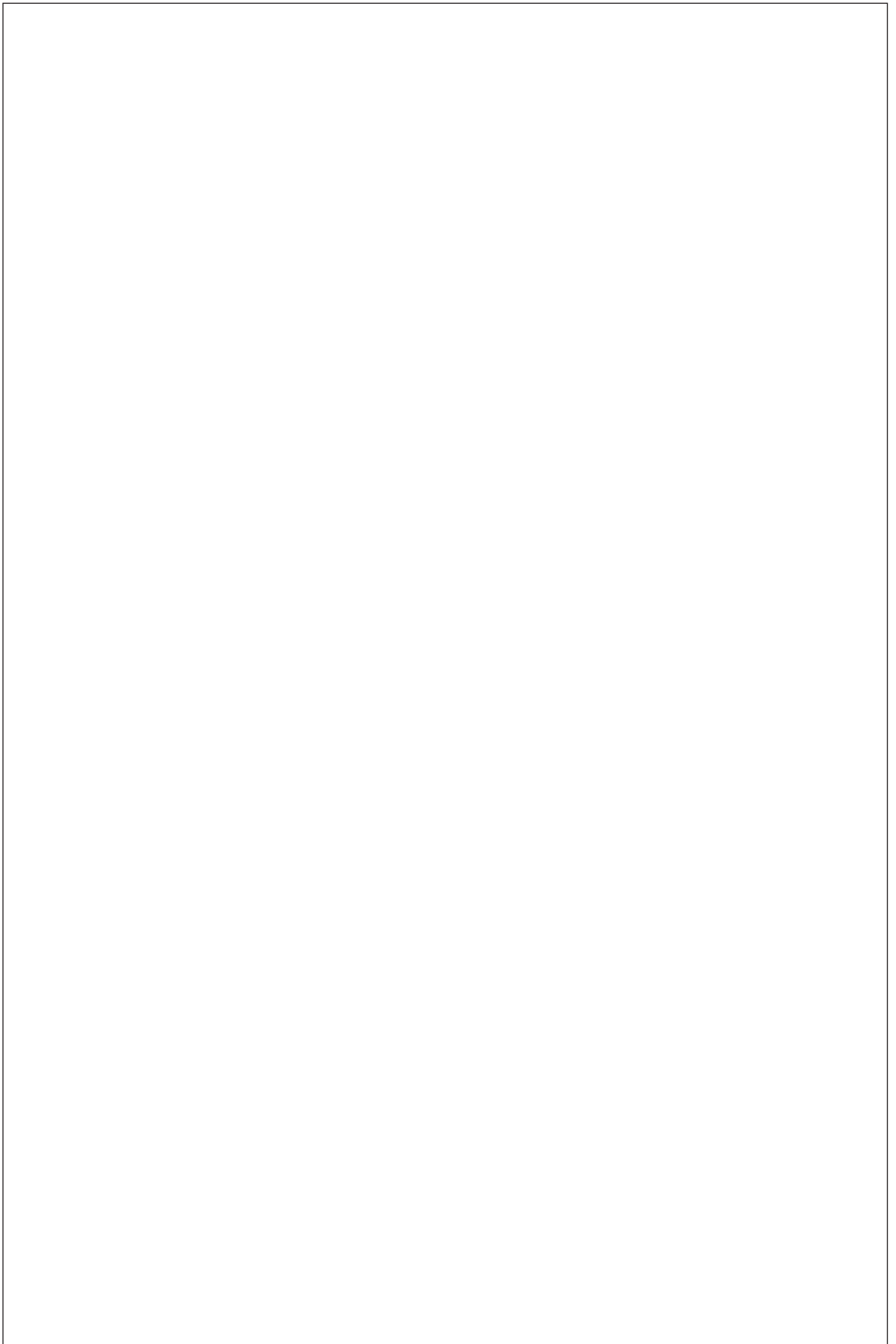


Source: LFMI surveys

From the perspectives of policy decision-making finding measures that would make informal business activity less attractive is crucial. For the shadow sector to contract and, more importantly, for the formal economy to expand, it is essential to have:

- minimum taxes and regulations, including legal provisions on starting a business, employment regulations, licensing rules, etc.;
- simple and efficient administration;
- equal and transparent rules (e.g., no tax exemptions, minimal discretionary powers of public officials to interpret and apply legal provisions) and small bureaucracy;
- clear procedures for settling tax and other business disputes;
- reasonable fines;
- property and business security (e.g., law enforcement);
- stability of the legal system;
- corporate development (more companies investing in brand name, publicity, etc.);
- adequate general level of income.

The Lithuanian Free Market Institute's motto provides a suitable summary of what has been said: if you don't create a free market, a black market will emerge.



CHAPTER 9

Barriers to Participation: The Informal Sector in Emerging Democracies. The Case of Hungary

Laszlo Kallay

In the late eighties Hungary started a transition process from central planning and a soft communist dictatorship towards a free market economy and political democracy. On the ruins of the old economic regime hundreds of thousands of new businesses emerged in a country of 10 million people. With the legacy of an informal sector in the planned economy, one of the major concerns of economists and social scientists was that a large informal sector would develop.

New Institutions, New Entrepreneurs

In the early phase of transition, entry barriers (costs of registering a business) were low, registered businesses could deduct expenses from their taxable income, and sometimes enjoyed tax benefits as well. As early as in 1989 the Hungarian government started a deregulation campaign abandoning several pieces of regulation.¹ The economy was liberalized relatively fast; certain restrictions and state controls over foreign trade, currency issues, licensing, investment and employment were eased. Enforcement efforts of the government were not particularly intense. The majority of SMEs could follow a minimum taxation strategy, meaning they did not pay profit or income taxes and kept social insurance contribution payments at the lowest possible level. There was a gap between taxes to be paid by law and the amount actually paid. The major form of informality was tax evasion of registered businesses. At the beginning of the transition process the benefits of having a registered business were higher than the costs of registering and operating a business.

¹ Authorities had to survey all regulations they had issued before and find good arguments if they wanted to keep any of them.

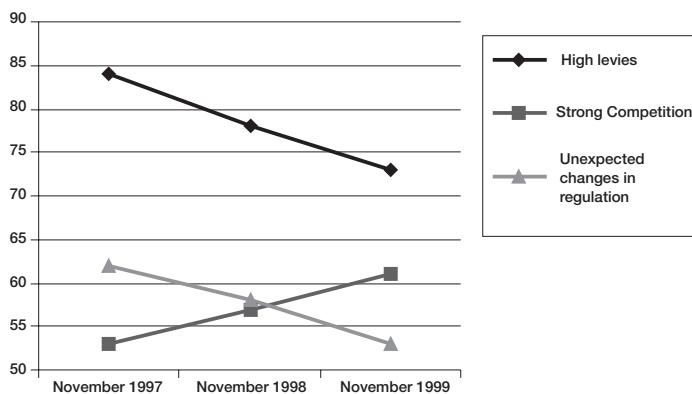
What happened next is a kind of challenge to the simple interpretation of the role of transaction costs. The costs of registering and operating a business (including money, time and effort) slowly, but steadily started to grow for two reasons: a) regulation on licensing became more and more extensive; b) enforcement on declaring a larger portion of income became stricter. This means that although, generally speaking, tax rates became somewhat lower, taxes and contributions were paid on a larger part of the income. At the same time, most of the estimates show that the share of the informal sector in the Hungarian economy has decreased in this period, with other signs like the number and quality of tax returns, and to a lower extent the cases of non-payment problems also supporting this statement. At the first sight, this seems to be illogical – is it possible to have higher transaction costs and lower share of the informal sector?

One potential way to address this contradiction is if we think about transaction costs in relative terms, and not as amounts of time and money required in order to follow the rules. The key notion here is the learning process. If entrepreneurs learn to comply with the existing rules the actual level of effort may be lower even if the prescribed obligations are more complicated. Chart 1 shows that SMEs in Hungary felt somewhat less uncomfortable about high levies and unexpected changes in regulation as an obstacle of doing business in November 1999 than two years before. In the same period competition became a more important problem for them - they had to spend more effort to struggle for their markets and less effort to struggle against tax collectors. Paying taxes and social contributions at high rates is one of the major items of the costs of doing business for the ventures in the formal sector. Thus, one of the key elements of making formality more attractive is to reduce the role of income redistribution systems. This has been happening in Hungary since the mid-1990s (see Chart 2). The explanation for this is not only the lower level of income centralization and a more stable legal and regulatory environment, but more importantly the improved capacity of SMEs to comply with the rules.

Taxation is always one of the most problematic issues for SMEs. More than 70 percent of the businesses in Hungary (including one person units) contract out accounting. This means that there is a supply of these services at affordable prices in large volume and very probably of acceptable quality. For the majority of businesses complying with the rules of taxation and paying social contributions means consulting with their accounting firm not only on keeping the cost of compliance low but also on reducing the risk of additional expenses coming from being fined for errors and mistakes in the tax returns.

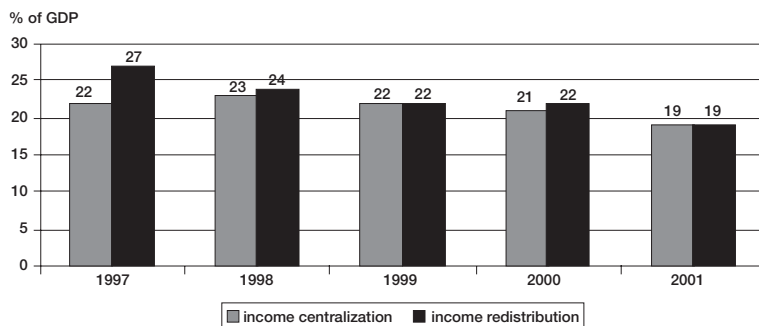
This issue is important because in an emerging market economy there is a natural trend of more and more sophisticated regulation. For example, the Central and East European countries have to adopt a huge amount of EU regulations in the course of their accession process, but improving capacity to comply with the rules may result in lower actual transaction costs.

CHART 1: INTENSITY OF OBSTACLES TO DOING BUSINESS IN HUNGARY



Source: Business survey data by the Institute for Small Business Development

CHART 2: LEVEL OF INCOME CENTRALIZATION AND REDISTRIBUTION IN HUNGARY, 1990-2001



Source: Official budget statistics.

Income centralization = all revenues collected by the central budget, local governments and the state social security system/GDP

Income redistribution = all spending by the central budget, local governments and the state social security system/GDP

The Role of Government Policy: An Unintentional Strategy?

Although the Hungarian government has declared only intentions, but never a comprehensive strategy, to push back the informal sector and attract more and more activity to the formal one, this seems to be happening judging by the actions of the government and the Parliament which, in fact, contributed to turn back the increase of the informal sector. The key points are minimizing registration costs at the beginning of the transition process, providing the opportunity to deduct costs from the tax base, compensating high tax rates, in a sense, by following a not very consistent and rigorous tax collection practice. Later on, when the early transition crisis was over, economic growth started and the number of registered businesses stabilized, the government began to send signals to the small businesses indicating the expected level of (declared) income in different trades and professions. Most of the entrepreneurs got the message and stated income just above the expected level. The result was a gradual increase of the portion of formally declared income. Another element of this strategy has been raising every year the level of minimal payments, mainly for social security contributions.

How can governments be motivated to try to push down income centralization and what should be the key element of any transaction cost reducing strategy? Hungary has had three different governing coalitions since the first democratic elections in 1990. All of them felt a pressure from different societal groups to reduce levies, and leave more income at the entities where it was originally produced.² This resulted in a political bidding process by political parties on reducing income centralization, quite intensive during election campaigns, which indicates that reducing government involvement in the economy is easier if it is a widely shared value in the society.

Comparison of the Two Stages

The history of the transition process in Hungary from the point of view of informal economic activity can be divided into two stages. The behaviour of entrepreneurs and the government as well as the state of the entire economy was different at these two stages. The following table is a summary of the most important aspects and changes.

Lessons

1. Making distinction between the following types of activity is important:
 - business aspects of criminal activity (e.g. trade of drugs, illegal weapons);
 - business activity where the only income is from evading taxes (illegal oil trade, reimbursing VAT with forged invoices); and

² This message was sometimes weakened by requests for more funds from the budget by the same interest groups.

<i>Aspect</i>	<i>Stage one 1990-1997</i>	<i>Stage two 1998-?</i>
<i>Legacy of the planned (state controlled) economy</i>	Strong	Weakening
<i>Entry (registration) cost</i>	Low	Slightly higher
<i>Licensing obligations</i>	Low	Higher
<i>Level of tax evasion</i>	High	Somewhat lower
<i>Level of tax avoidance</i>	High	High, but more difficult
<i>Number of formally registered businesses</i>	Large and quickly increasing	Large and slowly increasing
<i>Level of centralization (tax and social contributions)</i>	High	Slowly decreasing
<i>Intensity of enforcement</i>	Low	Gradually increasing
<i>Economic growth</i>	Negative	High
<i>Capacity of entrepreneurs to comply</i>	Very low	Increasing
<i>Difference between the turnover of large and small businesses (in favour of large firms)</i>	Increasing	Stagnating
<i>Difference between the capital accumulation of large and small businesses (in favour of large firms)</i>	Large	Large
<i>Difference between employment by large and small businesses (in favour of small firms)</i>	Increasing	Stagnating

- informality (not registering a business or tax evasion of otherwise normal business activity).

With regard to criminal activities, the whole range of enforcement measures should be used, including adequate legislation, efficient organisation and low tolerance. Almost the same should be done with regard to activities where the only source of income is evading taxes, although the reason of these activities is very often the weakness of the legislation.

Unregistered business activity or underpaying taxes should be treated in a different way. People who are in the informal sector cannot switch to the formal one overnight. Institutions can not be reformed in a day; democratic consolidation needs time; understanding and applying the new rules is a learning process. Thus, governments may consider to be tolerant, provided there is a clear and continuous progress towards the strategic goal of an efficiently working formal economy.

2. Timing and sequencing of policy measures is important

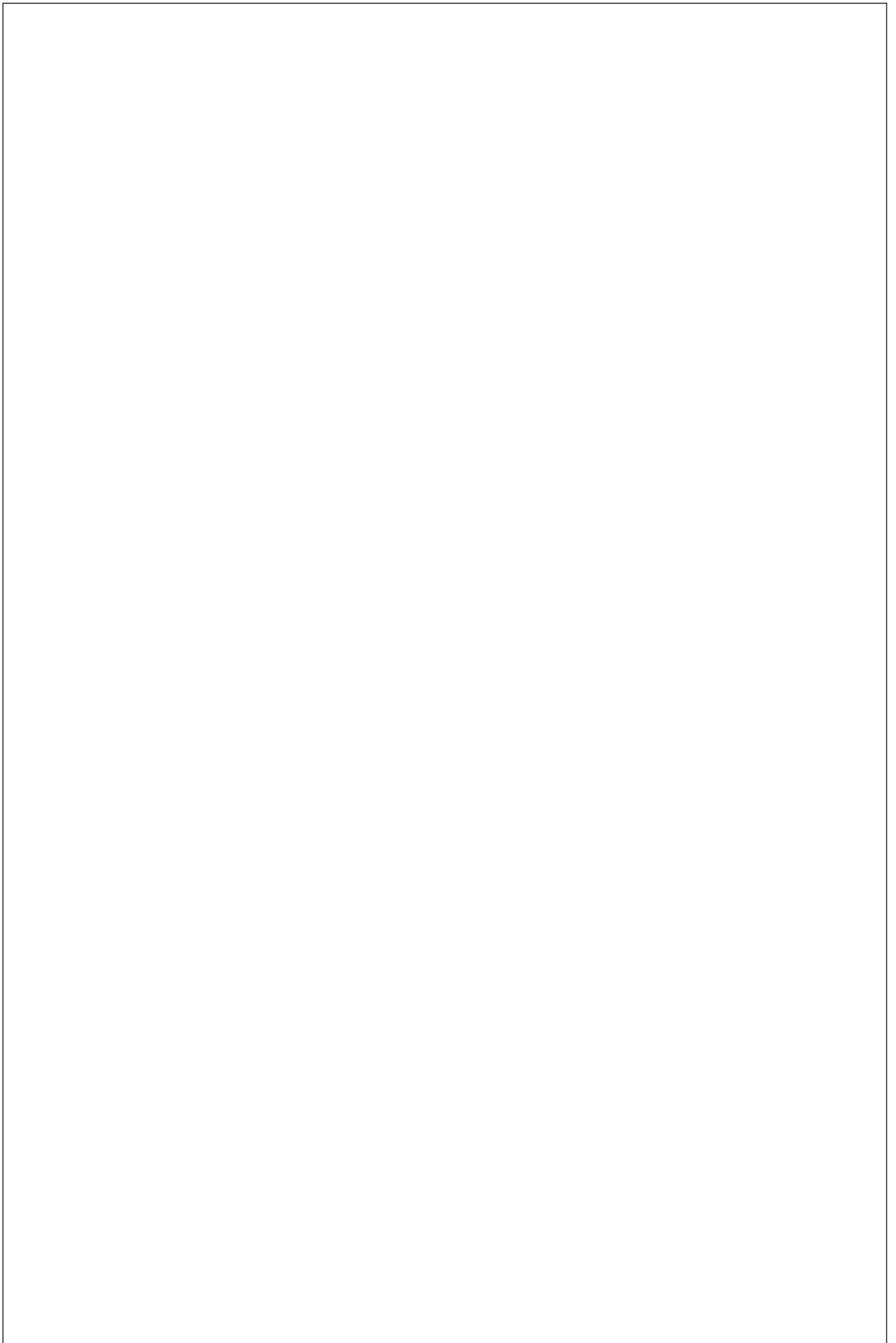
The first strategic goal can be getting businesses to register and see the benefits of

doing so, first of all, by making the process cheap, simple and fast. It is easier to communicate with formally registered businesses and provide further benefits to them for being formal. High tax rates and rigorous enforcement practices in this phase may neutralize low entry cost. Complying with an increasing amount of rules may be a result of a gradual process taking several years.

3. Parallel existence of formal and informal economy causes structural problems

This is especially important if large foreign investments are made in a country and standards in the foreign and locally owned part of the economy are different. Informality as a hidden support (a kind of tax exemption) for the local business does not work in the long run as it distorts allocation decisions and contributes to the disintegration of the economy.

The Informal Economy in Southeast Europe



CHAPTER 10

Use of Households Survey Data to Estimate the Size of the Informal Economy in Romania

Lucian-Liviu Albu and Mariana Nicolae

Introduction

Generally, there are three methods frequently used to estimate the size of the informal economy: time-series analysis based on cash demand; method of discrepancy between total incomes and total expenditures at the aggregate level; and discrepancies between income and expenditure at the microeconomic level. The lack of some reliable historical data before transition and the existence of a structural break between pre- and post-transition suggest that the time-series method is not feasible. So, a remaining alternative is to analyze individual household data. Moreover, the results from the analysis on the basis of micro-data might provide more significant information for policy-making because they, unlike those using aggregate data, can highlight the main participants in the informal sector and the effects on welfare/behaviour of households.

The study focuses on data and methodological problems trying in the same time to outline few behavioural aspects by using only simple simulation models. In the last section of this paper, we introduce certain more sophisticated dynamic models, which could simulate very complicated types of households' behaviour relating to participation in secondary activities and in informal economy.

Data and Methodological Aspects

The so called Integrated Household Survey (IHS), comprising a sample of approximately 36,000 observation units from about 500 urban and rural research areas, provides the main source of information in order to study households' behaviour. In September 1996 a Supplementary Survey on Household Informal Economy Activities was conducted in Romania (Duchene et al., 1998). The Supplementary Survey, which used a sample size of around 2,600 households, focused on informal economy activities carried out by households. The survey was divided into 21 sub-sections containing indirectly formulated, but detailed, questions on the informal economy. It was essential for our work to correlate the two sources of data. The survey asked about the ratio between income from main activity and that from secondary activity. Using the information, we obtained an absolute measure of households' income from secondary activity.

Based on answers provided by the question in which all members of household compared their two incomes (from main activity and from declared secondary activity), we computed a composite coefficient (k_s) for every household in the sample, in order to characterize the share of the two types of activity.

$$V_s = k_s \cdot V \quad (1)$$

where V_s is income from second activity, k_s – the share of income from declared secondary activities in total declared income, and V – total declared income.

Also, the income corresponding to the main activity (V_b) was obtained as following:

$$V_b = V - V_s \quad (2)$$

Using (1) and (2), we rewrote the shares of the two components in total declared income of a household:

$$k_s = V_s / (V_s + V_b) \quad (3)$$

and respectively

$$k_b = V_b / (V_s + V_b) \quad (3')$$

where k_b is the share of income from the main job in total declared income.

One important result was also obtained by comparing the so-called decent (or desired) income with the actual size of income. So, in order to capture the size of informal

(or hidden) economy we computed the difference between the two types of income:

$$V_a = H - V \quad (4)$$

where V_a is hidden (informal) income, H is decent income (or the maximum level of desired income) and V is actual total declared income ($V = V_s + V_b$).

The computing outputs obtained by grouping data conforming to the last criterion are presented synthetically in Table 1, where the desired level of income, H , was replaced by H^* , which means that data were adjusted in order to solve some logical incoherence existing in initial answering data (for instance, in case when a qualitative answer relating to the report between actual income and desired income was $V < H$, but from other answers on the precise levels of actual income and respectively desired income resulted an opposite situation, $V > H$, the respective household was moved into this last group, denoting the new obtained classification by H^*). As we can see from computed data, indeed in case of the richest group ($V > H^*$), where the average of declared actual income is 311.8 thousands Lei/person, there is no informal activity. A different situation is registered in the case of the poorest group of households ($V < H^*$), where the difference between the considered decent income and actual declared income is huge. We could interpret this difference as a measure of “potential supply of informal activity” (it may be interpreted as the desired level of informal activity supplied by people). However, this “supply” is more than likely covered in a smaller proportion by a corresponding demand coming from the real economy. To capture the real size of this proportion in case of the poorest group ($V < H$) continues to be a challenge for economists and statisticians from everywhere.

TABLE 1: HOUSEHOLD INCOME GROUPED BY RATIO BETWEEN V AND H , IN 1996
Thousand Lei/person

	Number of households	Declared income		Desired income H^*	Potential informal activity $H^* - (V_b + V_s)$
		Main activity V_b	Second activity V_s		
$V < H^*$	2181	127.0	9.8	368.2	231.5
$V = H^*$	288	263.6	20.1	384.3	100.6
$V > H^*$	92	258.0	53.8	311.8	0.0
Total sample	2561	146.6	12.6	367.7	208.5

Estimation of the Hidden Economy in the Case of the 288-Sample

In order to capture the size of hidden income, we computed the differences between the two levels of income in the case of households declaring that they are the same, so the

group V=H (the 288-sample). However, a problem, which was also solved when we computed the adjusted data, was in the case when the desired (decent) income in the Supplementary Survey declared by a household was smaller than the same indicator reported in IHS. So, in Table 2 there are presented data in case of both corresponding situations: initial data and respectively adjusted data (when the difference between declared decent income and actual income was negative, it was replaced by zero, considering that in case of the 288-sample the decent income must be at least equal to actual declared income in IHS).

Corresponding to the two considered hypotheses (initial data and respectively adjusted data), as it is shown in Table 2, at the level of whole 288-sample, the share of probable informal (hidden) activity, V_a/H , was around 20.4 percent and respectively 26.2 percent, on average. In other words, the composition of total income, H , by sources was, in 1996, in case of initial data: 74.0 percent main activity, 5.6 percent second declared activity, and 20.4 percent informal activity. In case of adjusted data, the structure of total households income, H^* , was: 68.6 percent main activity, 5.2 percent second activity, and 26.2 percent informal activity. More analytic conclusions were provided by a deeper analysis in which the two conventional sectors, SI (households operating only in one activity, main or basic activity), and SII (households operating in more than one activity, main activity and secondary activities), were compared.

TABLE 2: ESTIMATED SHARES OF HIDDEN INCOME BASED ON THE 288-SAMPLE

	<i>Initial data</i>			<i>Adjusted data</i>				
	<i>Declared Income</i>	<i>Hidden Income</i>	<i>Total</i>	<i>Declared Income</i>	<i>Hidden Income</i>	<i>Total</i>		
	<i>Main activity V_b</i>	<i>Second activity V_s</i>	<i>V_a</i>	<i>H</i>	<i>Main activity V_b</i>	<i>Second activity V_s</i>	<i>V_a</i>	<i>H*</i>
SI	162.9	-	35.9	198.8	162.9	-	52.6	215.5
Average	340.1	-	74.9	415.0	340.1	-	109.8	449.9
SII	44.3	15.8	21.1	81.2	44.3	15.8	26.5	86.6
Average	144.3	51.5	68.8	264.6	144.3	51.5	86.2	282.0
Total (SI+SII)	207.2	15.8	57.0	280.0	207.2	15.8	79.1	302.1
Average	263.6	20.1	72.5	356.2	263.6	20.1	100.6	384.3

SI – households operating only in one activity (main or basic activity, conforming to the definitions included in the Supplementary Survey questionnaire)

SII - households operating in more than one activity (main activity and secondary activities, conforming to the same definitions comprised in Supplementary Survey)

The first and second rows in each category refer to total households' income of the sample (in million Lei) and respectively to the average level of income per person (in thousand Lei).

So, the last estimated level of informal activity, 26.2 percent of total income, H^* , may be used as a first estimation in order to obtain parameters in a more general regression equation and to capture the behaviour of the household under consideration.

A very severe restriction, which occurs when we wish to extrapolate some conclusions in order to capture the general households' behaviour, is coming from the asymmetry between the 288-sample and the whole sample including more than 2500 households. The best general fitting function to estimate the household's behaviour seems to be one expressing a complex inverse relation between the average level of income provided by main activity and participation rate in informal activity.

However, the 288-sample may confirm that, at an average level of income provided by the main activity of 263,600 lei/person, some people are forced to work in a secondary job and also in the informal sector in order to obtain supplementary income for their family (20,100 lei/person from secondary job and respectively 72,500 lei/person from informal activity). Moreover, at an average monthly income of only 144,300 lei/person, people are forced to be relatively more involved both in secondary activities and in informal activities (in order to add supplementary incomes of 51,500 lei/person and 68,800 lei/person respectively). In the last case, the structure of the final income is: 51.2 percent main activity, 18.3 percent secondary declared activities and 30.6 percent informal activities. However, the situation is quite different when the basic income rises. For instance, at an income obtained from the main activity of 340,100 lei/person (average level for SI in Table 2), there were supplementary opportunities for people to work in the informal sector in a smaller proportion, 24.4 percent, of their total income.

Indeed, aside the level of income provided by their main activity, the households' informal activities are probably affected by occupation, region, age, education and many other factors. However, at this stage of our investigation, a few conclusions could be outlined:

- Taxation is perceived by people as the main cause of underground activity.
- Separating the main motivations of operating in the informal sector in two groups – “subsistence” one and “enterprise” one – the Supplementary Survey suggests that, at least for 1996, the subsistence represented a relevant reason for the households' decision to operate in informal economy, including its underground segment.
- Informal activities supplied a “safety valve” within the surviving strategies adopted by the poorest households.
- Participation in the informal economy seems to not be simply correlated with poverty: in the informal economy are involved poor people (having probably a small level of instruction) as well as relatively reach persons. But their motivations are quite different. The former are practically “forced” to operate in the informal economy (“subsistence” criterion), but the latter are “invited” to participate in it (“enterprise” criterion). In both cases, at least during the last stages of transition, the environment was propitious due to legislative incoherence, feeble penalty system in cases of fraudulent activities, and the existence of some accompanying elements of informal activity proper, such as

corruption, bureaucracy, etc. Nevertheless, the behaviour relating to the informal economy is sometimes fundamentally different for the two groups of population. This is why we consider that deeper investigations focused on the behavioural aspects of different groups of population will continue to be needed in the future.

Empirical Analysis

In order to study systematically the households' behaviour, as a first stage of research, we consider some simple empirical analyses. So, to identify the type of diverse relationships between components of total income, it may be useful to see the simple graphical representations of such relations based on brute registered data.

First, considering only the average levels, we identified the general types of demand-curves and supply-curves in cases of secondary activities and informal activities respectively, as they are shown in Figures 1 and 2 (on the abscise axis the levels are in thousand Lei/person and on the ordinate axis they are in thousand Lei but using a logarithmic scale). The samples that we used were obtained from the entire SII-sample (within the total sample of 2,561 households there are 931 households operating in SII) sub-grouped by criterion of ratio between V and H^* . In figures, the notations represent: CY and CZD – total demand for V_s and total desired demand for V_a respectively (it is the already mentioned “potential informal activity”, in Table 1); $Y=V_s$, $X=V_b$, and $Z=V_a$; OY and OZ - supply for V_s and V_a respectively. Also, we mention that on abscise, X may be interpreted as a level of qualification, function of which the demand of real economy is established. So, it must be noted that in case of informal activity the demand is only that desired by people but not the demand coming from the real economy. On the graphs of Figures 1b and 2b, the solid lines are the demand curves, the dotted lines – the real supply curves, and their corresponding intersection points – the registered (empirical) data. Also, on the graphs the average levels per person in case of the 931-sample (V_m and ZD_m) and the total effectively registered demand for the entire 931 households (CY_t and CZD_t) respectively are marked.

The empirical distribution-maps for the shares of income components ($x=V_b/H^*$, $y=V_s/H^*$, and $z=V_a/H^*$) against the level of income supplied by main activity ($X=V_b$) in case of the 288-sample suggest the existence of certain inverse correlations $y-X$ and $z-X$ and of a direct correlation $x-X$. In Figure 3 an equivalent graph of such correlations in 3-D space is shown. In the next section of the study, we shall analyze in greater detail the relationships between y and X , and between z and X respectively by using certain linear and hyperbolic descriptive functions.

FIGURE 1a

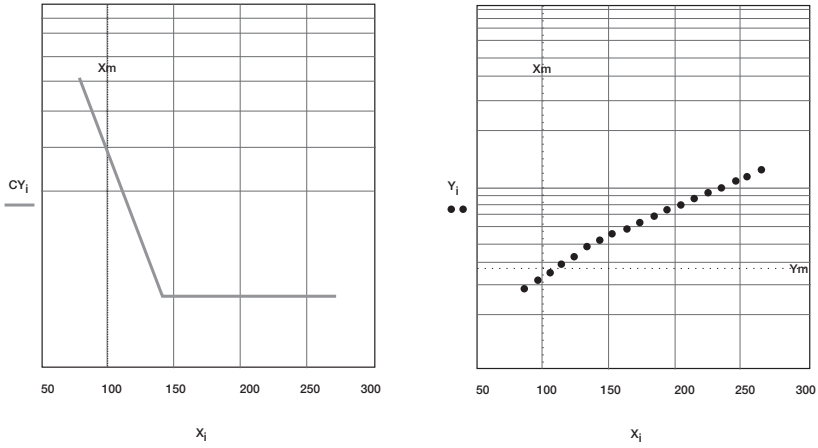


FIGURE 1b

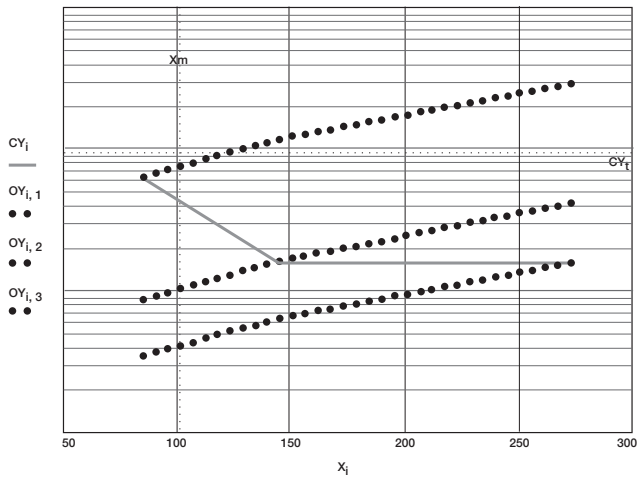


FIGURE 2a

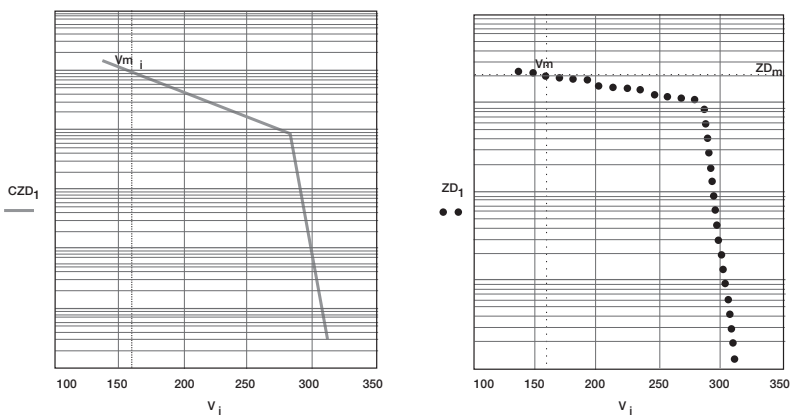


FIGURE 2b

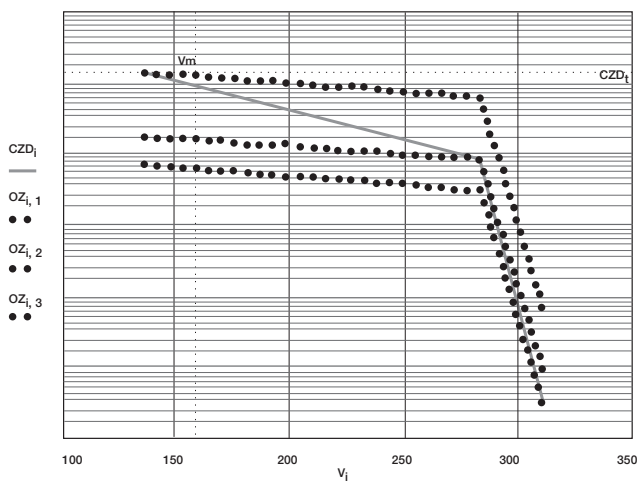
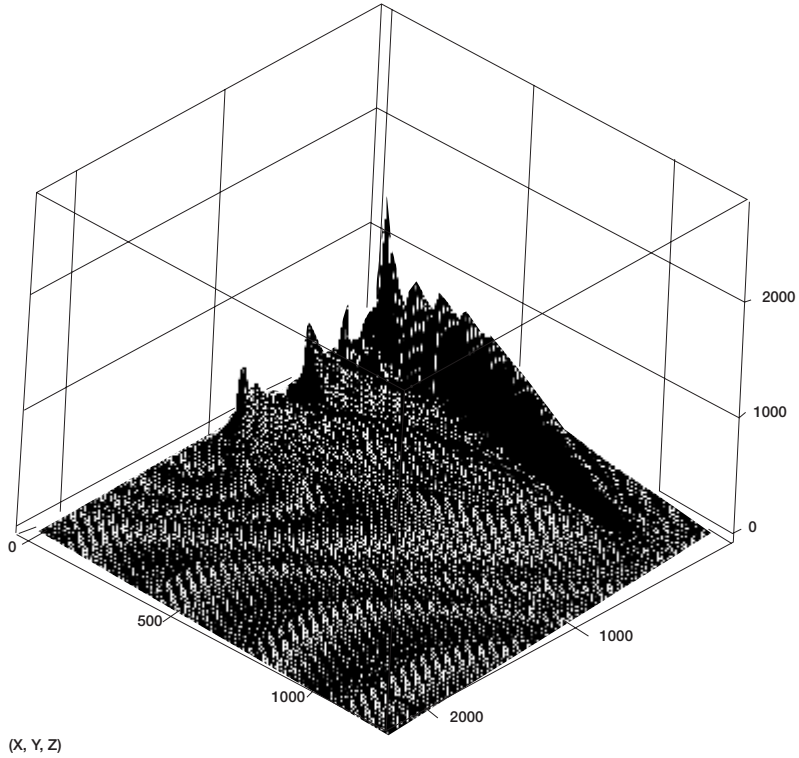


FIGURE 3



Behavioural Regimes

In order to capture the households' behaviour, we used data from the 288-sample. Conforming to empirical data for 1996, the parameters of the following estimation functions were calculated:

$$Y(X) = a / (X+b), \quad Y(0) = a/b = 48.7 \cdot 10^3 \text{ Lei} \quad (5)$$

$$Z(X) = c / [X + Y(X) + d], \quad Z(0) = bc / (a+bd) = 140.7 \cdot 10^3 \text{ Lei} \quad (6)$$

Then

$$H(X) = X + Y(X) + Z(X) \quad (7)$$

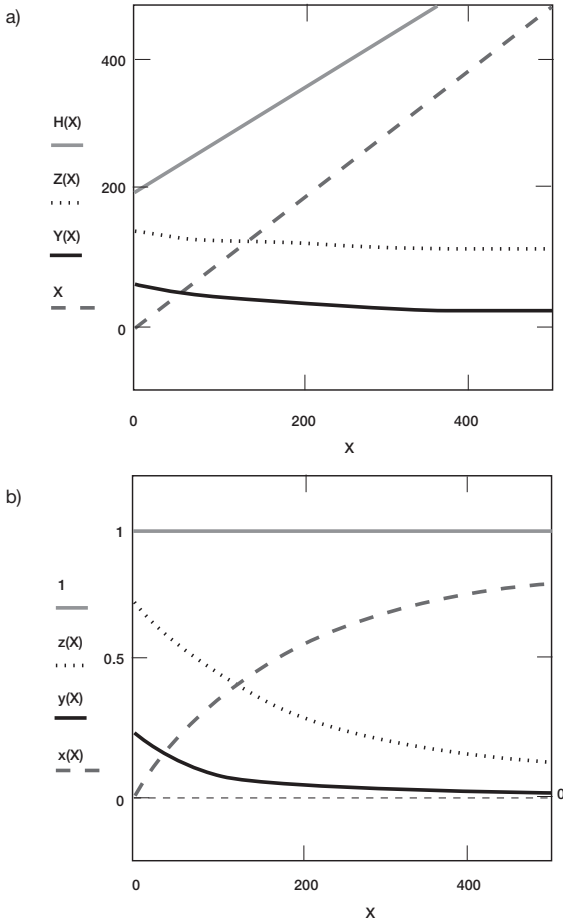
was used as a constraining relation and

$$x(X) = X/H(X), \quad y(X) = Y(X)/H(X), \text{ and } z(X) = Z(X)/H(X) \tag{8}$$

as resulting formulas, where X, Y, and Z are Vb, Vs, and Va respectively (as they were defined in the previous section).

Figures 4a and 4b show the general dynamics in absolute and relative terms respectively.

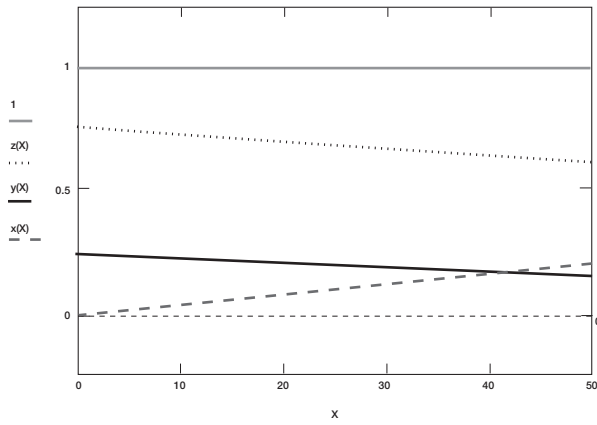
FIGURE 4



The following three behavioural regimes, defined by the hierarchy of components, in relative terms represent the output of the simulation:

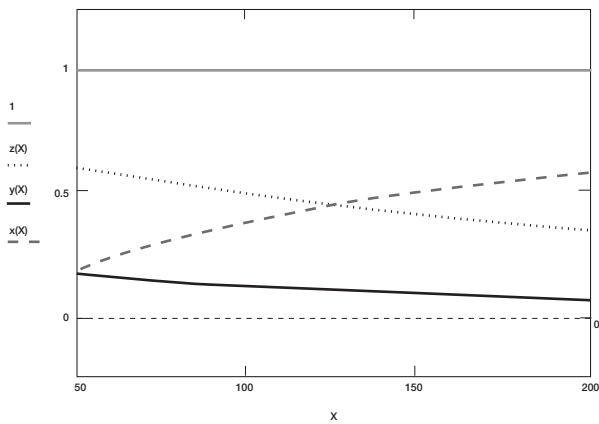
1) Transitional regime from $z-y-x$ to $z-x-y$ (Figure 5)

FIGURE 5



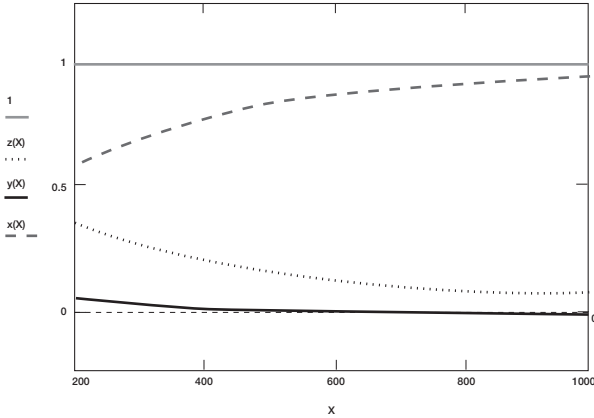
2) Transitional regime from $z-x-y$ to $x-z-y$ (Figure 6)

FIGURE 6



3) Stability regime $x-z-y$, with z and y drawing near zero (Figure 7)

FIGURE 7



Conclusions

Among the most significant results of the study based on household survey, the following could be mentioned:

- informal activities are responsible for 20.4 – 26.2 percent in the structure of total households' income, representing a "safety valve" within the surviving strategies adopted especially by the poorest households;
- in informal economy are involved poor people as well as reach persons;
- the reasons for which people work in the informal sector are quite different, function of their basic income. The poor are "forced" to operate in informal economy ("subsistence" criterion), but the rich are "invited" to participate in it ("enterprise" criterion);
- during the last stages of transition, the environment stimulated people to enter the informal sector due to persistent crisis in the formal sector, legislative incoherence, feeble penalty system, corruption, over-bureaucratization, etc.;
- varying with their monthly average basic income per person, the households' behaviour changes between "regimes", from the predominance of informal and secondary activities to that of main official activity ("stability regime").

In the case of Romania, the most general way to escape from "transitional regimes" and enter "stability regime" for an increasing number of households is, at macroeconomic level, to achieve a high growth rate and a durable development process

by a mix of policy measures, such as: improving reforms, legislation, and institutional reconstruction; extending the privatization process; stimulating domestic saving and attracting foreign investments; increasing volume of export and its efficiency; implementing new measures in the field of social security, pension system, poverty alleviation, etc.

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CHAPTER 11

Transactions versus Work: The Informal Economy in Bulgaria in the 1990s

Tanya Chavdarova

The informal economy was an integral part of the former communist economies and is now also an important part of the transition economies in Central and Eastern Europe. During the 1990s it grew at a higher rate than in the rest of the world. Rather than being a universal phenomenon, the informal economy is economically and socially embedded: it can take various shapes and its importance differs depending on the contexts. The main questions addressed in this paper, therefore, are what kind of informal economic activities are important in the Bulgarian post-communist context and how they are embedded. In order to answer these questions, the following three issues are considered from a sociological perspective: (1) the variety of the informal economic activities and their conceptualization; (2) their dynamics during the 1990s; and (3) the short- and long-term consequences of the spread of informal economic activities.

The concept of the informal economy

In the analysis of the concept of the informal economy the definition of an institution by Mary Douglas (1986) is taken as a starting point. She distinguishes between two levels constituting an institution. The first one embraces the conventions or rules which establish the structure of order. People are not deeply bound to them, which demands considerable control over their observance. Norms and value attitudes regarding the right course of action and behavior, which are deeply rooted in the national cosmology, constitute the second level. They attach a feeling of mutuality and weight to action; they are followed by tradition and passed down to new members of a community (Douglas 1986).

The definition of formal and informal institutions is derived from this distinction. Conventions and rules embody not just the formal level of each institution, but more abstractly they could be defined as the formal institution itself. Respectively, the norms and values that govern action represent the essence of informal institutions. As related to economic life, the formal economy embraces all economic activities governed by legislative rules and economic policy arrangements. Consequently, they are recorded by the formal measurement and accounting system in society. The informal economy consists of those economic activities which are governed by the shared norms and values in a given group or community and do not stick to the official economic conventions in society. Hence, the informal economy is one, which is not registered. Equally unregistered are criminal economic activities, but, in contrast to the informal ones, they are performed *explicitly against* the accepted rules and conventions and their final product is forbidden (Castells and Portes, 1989, p.14).

Thus, alongside the official (regular) economy and the officially recognized illegal (criminal) economy, the informal economy is a third element of the economic space. In describing the enormous heterogeneity of informal economic activities, I adapt the typology proposed by Henry (1981, p.7) to the current Bulgarian situation (see Table 1). Henry distinguishes between informal economies¹ according to the degree to which they are an *integral* part or an *alternative* to the official institutions and according to their *legal vs. illegal* status (ibid., p. 6ff).

There are two kinds of **legal** informal economies. The alternative informal economy, also called *social economy*, consists of domestic production (food, clothing, etc.). It includes social exchange of products and labor in personal networks. The integrated *non-official economy* encompasses all those activities which occur within official institutional settings, but are not officially recognized as part of these institutions. Volunteer labor is one such instance. In the course of the transformation in Bulgaria it included primarily the unpaid family workers who worked without social insurance.² Unofficial activities and practices that are **illegal** and integrated constitute a separate economy called the *hidden economy*. It is composed mainly of transactions and not of work activities. For the hidden economy in Bulgaria, the most widespread of these activities are hidden privatization, corruption and tax evasion (Chavdarova, 2001a).

A problem with distinguishing between the hidden and *the black economy* appears in the Bulgarian case and probably in all transformation countries. There are plenty of cases in which the terms of the written labor contract do not correspond to the real

¹ According to the literature in the field, the term “informal economies” does not mean that each economy is completely separate from one another, but rather that they function according to a different economic logic, although all could be classified within one overarching economic system.

² The National Statistical Institute categorizes unpaid family workers as “persons who work without pay in an enterprise or farm owned and operated by a related person living in the same household” (NSI, 2000, p. 15). There is no legislative requirement for the unpaid family workers to be socially insured. Because this category is very small (1.2 percent of the active population in 1999-2000) and as volunteer labour is almost non-existent in Bulgaria (Chavdarova, 2001b, p. 176), the non-official economy will not be considered in this paper.

TABLE 1: LEGAL AND ILLEGAL INFORMAL ACTIVITIES

Legal

<i>Official</i>	<i>Integrated</i>	<i>Alternative</i>	
REGULAR	NON-OFFICIAL	SOCIAL	
(Formal) Regular, official employment	Unpaid family workers; volunteer labor	DOMESTIC Domestic production for own consumption	COMMUNAL Social exchange of products and labor

Illegal

<i>Official</i>	<i>Integrated</i>	<i>Alternative</i>	
CRIMINAL	HIDDEN	NON-REGULATED	BLACK (Underground)
Mafia and racketeering; criminalization of the economy	Hidden privatization; corruption; tax evasion	Employment on a non-labor or fake labor contract	Employment and self- employment without any contract

working conditions, particularly with regard to payment and hours worked. Companies might declare official wages to be lower than the real ones. In this way a part of the value-added is not officially declared. A similar practice is hiring people for a limited time to perform a particular job on a civil contract. Their work is at least partly non-regulated, which is different from work on the black labor market. Both black and non-regulated jobs are fully or in part socially unprotected as they are not subject to social security regulations. Non-regulated work differs from hidden transactions as it is productive; non-regulated work differs from work on the black labor market by being integrated in the official institutional framework. Black jobs, in contrast, constitute an alternative activity.

A detailed review of the types of production and exchange, which characterize the different informal economies shows other essential distinctions too (Table 2). In terms of production, informal economies are very heterogeneous. They vary from in-kind-based economies to market-based. In terms of exchange, more features are held in common. Although to a different degree, they all rely on networks where respect, loyalty and social position are exchanged or even traded. Despite the different types of production, reciprocity dominates as an exchange mode in all kinds of informal economies. This has to do with the fact that all informal institutions are governed by norms and values shared within a certain community.

TABLE 2: INFORMAL ECONOMIES ACCORDING TO THE TYPE OF PRODUCTION AND EXCHANGE

<i>Economies</i>	<i>Production</i>	<i>Exchange</i>		
		<i>Exchange mode</i>	<i>Means</i>	<i>Network type</i>
<i>Non-official</i>	Social	Reciprocal, social	Respect, authority	Loose network, common ideas
<i>Social</i>	In kind	Reciprocal, social	Respect, loyalty, barter	Family, relatives, friends, neighbors
<i>Hidden</i>	Market integrated but not productive	Redistributional reciprocal	Social position, trust, money, commercialized barter	Chain of personal connections
<i>Non-regulated Black</i>	Market	Market, reciprocal	Money, barter, trust	Personal connections; family, relatives, friends

Reciprocity turns out to be the most essential feature of informal economic institutions. I have tried to show elsewhere that reciprocity as a mode of economic integration has deep roots in Bulgarian history, with the consequence that a contradiction between formal and informal institutions has been continuously reproduced (Chavdarova, 2000). Hence, the informal economic institutions have played a decisive role in shaping the long-run path of Bulgarian socio-economic development. It is through a reference to path-dependence in the process of institutional change³ that the sustained preferences for informal forms of associations and cooperation in the Bulgarian society can be explained.

The Informal Economy in the Focus of the Economic and Social Dynamics in Bulgaria

The political change in 1989 was not a result of any natural processes of ripening of the Bulgarian society; it was rather caused by external factors. The *lack of incremental institutional change* (North, 1990) is expected to cause *incremental structural deformations*. This is obvious in the combination of large reciprocity and redistribution processes, which do not contribute to economic integration but, on the contrary, to *disintegration*.

Reciprocity preserved its cohesive strength at a micro-level within the framework of particular groups. The personal bonds and loyalties which had been passed on for generations led to a situation in which economic “wars” began between some clan-like groups for the opportunity to plunder specific economic institutions. The former political

³ The model of path-dependence is formulated by Douglas North as follows: “Path-dependence means that history matters. We cannot understand today’s choices without tracing the incremental evolution of institutions. If, however, the foregoing story sounds like an inevitable foreordained account, it should not. At every step along the way there were choices – political and economic – that provided real alternatives” (North, 1990, p. 98).

and economic *nomenklatura* and its offspring, the secret service networks, those of “the newcomers” in the power elite and some criminal structures (the so-called “wrestlers”) could be deemed as the most vital reciprocal groups. Besides, for the new anti-communist political elite, which was initially as poor as everybody else, political power became the only source of individual enrichment. Thus, it is in the interests of not only the old, but also the new political elite, that the state should function as a “political capitalist”.

As it was in the initial period of capitalism in Bulgaria (1878-1944), the insufficiency of private capital and the lack of available credit for small businesses turned state plunder into the major path of private capital accumulation. Patron-client relations have reappeared and influenced private business behavior from the very beginning. In politics this has led to the creation of a new oligarchy; in the sphere of the economy this has stimulated a process of hidden privatization - illegal transfer of income and capital from state-owned enterprises to the private sector.⁴ This functions as a vicious circle: the private sector is strengthened at the expense of the state, the state transfers its losses to the population and the population at large does its best to minimize them. One small group gets richer at the expense of the majority of the people who get poorer⁵, provided the level of wealth in society remains more or less the same.

Mainstream economists argue that during the transformation in Eastern Europe there is an institutional vacuum. Indeed, a working institutional framework, which could enforce market mechanisms in Bulgaria, is still missing. For this reason informal institutions are filling up the formal institutional gap. The informal economy has turned out to be a central element of economic and social dynamics; it has penetrated very deeply in the Bulgarian society today – a situation, which is typical for less-developed countries (Portes, Castells, and Benton 1989).

While the official GDP has gradually decreased by 33.5 percent for the period 1989-1996, the shadow economy in Bulgaria has grown significantly for this period. There are serious discrepancies between different estimates of the share of the shadow economy in GDP, but all of them show peaks in the early nineties and in the mid-nineties, especially in 1996⁶. The following results were presented by Kyle et al. (2000),

⁴ There are many channels of this “privatisation of profits and nationalisation of losses” (Stark, 1990). One of the most important of them has been the setting up of parallel private firms to operate at the “entrance” and/or the “exit” of state-owned enterprises. As a rule, they are managed by people who belong to the informal circles of the state managers. The state has allowed the managers to transfer information and the established contacts with suppliers and other agents to private hands. For example, they take orders that have been made to the state firm and by subcontracting execute them in the private one. They can sell ‘reassessed’ enterprise shares too, i.e. lower the stock value, so that in the long run the sellers indirectly become buyers. For more details, see Chavdarova (2001a).

⁵ The drastic impoverishment of the Bulgarian population is also related to the high unemployment (the rate was 18.8 percent of the active population in 2001 according to official data). Trade unions estimate the unemployment rate at 25 percent.

⁶ According to estimates of the share of the shadow economy in GDP resulting from the application of different measures, the shadow economy amounted from 24 percent (Johnson et al., 1997) to 33 percent (Lackó, 1999; Kyle et al., 2000) in the early 1990s. It increased by 32.7 percent from 1989-90 to 1991-92 according to Lackó (electricity consumption method); it had decreased to 10.8 – 21.3 percent according to Kyle (using the same method). It was between 17.3 – 21.6 percent (Kyle et al.) and 40 percent (National Statistical Institute) in the mid-1990s, 15.2 percent (Nenovsky and Hristov, 2000, following a monetary approach), respectively from 18 percent (National Statistical Institute) to 28.2 – 34.4 percent (Kyle et al.) in 1996-97, and between 21 percent and 23 percent in 1998 and 1999 (National Statistical Institute; Kyle et al.)

who studied the entire period; the absolute peaks were in 1990 with 32.2 percent and 1996 with 34.4 percent. After the introduction of the currency board on July 1, 1997, a macroeconomic stabilization as well as price and trade liberalization took place; consequently, the shadow economy has shrunk since 1997-1998. According to Kyle et al., the shadow economy decreased by one-third to 21.9 percent in 1998. Thus, the increase of the shadow economy and that of the GDP are negatively correlated.

The informal economy, however, does not shrink to an equal degree in all of its parts. The *hidden economy*, composed in the Bulgarian case of corruption, hidden privatization and tax evasion, seems to have shrunk since 1997. Corruption is the main technique for avoiding taxation. Due to high taxes and duties, entrepreneurs often apply double standards.⁷ The introduction of a currency board brought a steady rise in tax revenues for the GDP; as a result, Bulgaria climbed up in the *Corruption Perceptions Index (CPI)*: from 66th to 47th place for the period 1998-2001⁸. (Transparency International, 2001) Yet, it seems that in the case of Bulgaria, the CPI reflects not as much the real fall in corrupt practices but the process of macro-economic stabilization, which improved the socio-economic situation in general.

There is a similar tendency with regard to the evolution of the *social economy* too. The domestic⁹ and communal economies have always been widespread in Bulgaria. During the transformation period the domestic production of food increased very rapidly. Representative survey data from 1999 shows that about 36 percent of the population does not go to the market for basic consumer goods. (Rajchev et al., 1999) One-third of the population produces at least half of the food that it consumes.¹⁰ In the period 1990-1996, the share of this kind of production in the total household income gradually increased from 14.4 percent to 27.6 percent; since then the respective share has declined to 17.7 percent in 1999 (NSI, 2000).

The pattern of development of the *non-regulated activities and those on the black labor market* is difficult to assess. The World Bank (1995) estimates show that 8.5 percent of the active population was employed in the black economy in 1995. According to a 1996 national survey, 6.8 percent of the respondents openly admitted that they worked without any contract and social insurance (Hristoskov et al., 1996, p.13). In 2001, according to the NSI, these responses still made up 6.1 percent. (Chavdarova, 2001b) According to another non-representative survey of small and medium-size businesses in Bulgaria, the number of people employed without labor

⁷ The common practice is to cut enough for it to be lucrative, but not enough that the controlling inspectors would pay attention. That means paying 50-70 percent of what is due plus a bribe of about 10 percent. Remarkably, tax inspectors receive some of the lowest salaries in the state administration (TI, Bulgarian Branch, 2001).

⁸ CPI is build each year by Transparency International. Bulgaria and Croatia are the only two states among the selected Central and Eastern European countries which have a clear improvement of CPI in this period. (For details, see Chavdarova, 2001d)

⁹ In 1991, 94 percent of the households were domestic producers of various scale. (Rose and Haerpfer, 1992, p.13).

¹⁰ The share of the population producing selected food for themselves is as follows: fresh fruits and vegetables (39.2 percent), potatoes (38.5 percent), beans (35.9 percent), eggs (35.2 percent), meat (31.7 percent), chicken (28.7 percent) and cheese (15.9 percent). Author's estimates based on data in Rajchev et al. (1999, pp. 8-9).

contract made up only 2.2 percent in 1998, but it grew by one-fifth by 1999. (Kyle et al., 2000, p. 44) Work on a fake labor contract is a much more common and significant way to participate in the informal sector of the economy. Its share is relatively high – 22 percent of all contracts according to the 1996 national survey. In a 1999 survey nearly two-thirds of the participating managers replied that this practice was common for most firms.¹¹ Black jobs can be most often found in agriculture and trade, in villages and small towns, but only in cooperatives and private firms and not in state-owned firms. Working on a fake labor contract is most typical for construction and trade, in private firms in regional centers (ibid., pp. 45-50).

The Social and Economic Implications

The processes of macro-economic stabilization has succeeded only partially in offsetting the informal economies as the administrative and tax burden, the regulatory inconsistencies and the excessive licensing regimes have continued to serve as incentives for informal activities. The drastic impoverishment and high unemployment still encourage people to get involved in the informal sector. Although the firms and individuals benefit in the short run from informal operations, the total economic effect of the informal economy in Bulgaria is generally negative. At a macro level, it lowers the competitiveness of the national economy, slows down economic growth, prevents the implementation of state policies and labor regulations, and thus, distorts the proper functioning of the market. In sum, the economic and social disintegration which was obvious before 1997 has not yet been overcome.

With regard to the social stratification, the informal economy, due to its heterogeneity, can have an ambivalent impact in shaping the new social inequality and the new institutional order. In fact, the illegal hidden economy is opposed to the black and social economies. At a micro level, participation in the *hidden* economy consisting of *illegal transactions* turned out to be the most successful profit- and rent-seeking strategy; respectively, those involved in it – mainly entrepreneurs, politicians and bureaucrats – were able to rapidly change their income levels¹² and in some cases their socio-economic status. 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.

The roles of the *social, non-regulated and black economies* appear to differ greatly from that of the hidden economy. They all represent a sort of individual survival strategy through *more and more work*, or a kind of self-exploitation. For those who rely

¹¹ One indirect piece of evidence in this respect is the fact that, although the share of the private sector in the total number of employees for 1999 was 63.3 percent, the contributions to the National Social Insurance Institute accounted for much less than 50 percent (Kyle et al., 2000, p. 8).

¹² Unfortunately, in Bulgaria there is no reliable data for studying the income and economic power of socio-economic groups participating in the hidden economy.

exclusively on household production of food, or the non-cash economy, for their existence, the market economy is an imaginary concept. The *domestic economy* Latin American style has turned out to be a source of *disguised wage labor*, which comes as a spontaneous solution to the unemployment and poverty problems. Still, the domestic economy cannot bring any dynamics into the national economy as a whole. On the contrary, it mirrors the reality of the enormous tightening of the market and the shift towards an in-kind economy, regardless of the claims that a transition to a market economy is taking place. The participants in *non-regulated and black economies* form another marginal group. First, workers with black or non-regular jobs, who have only *one job*, are as a rule underpaid and work without social protection; they form the labor market periphery. Moonlighters, who have a second job, typically non-regulated, and those, who are informally self-employed, receive as a rule higher income compared to the people who do not have regular jobs; their participation in the non-regulated economy is not a matter of survival but of accumulation. Moonlighters are in the best possible position, being socially insured at their first place of work, whereas the informally self-employed are very vulnerable in this respect.

Thus, the informal economy largely contributes to the deepening of social inequalities. *The social differentiation goes through the dichotomy: transactions vs. work*. It is usually possible to increase well being at a micro level through illegal transactions, but the general effect of informal work is to cope with poverty by means of exploitation and self-exploitation.

With regard to the social dynamics, there is a tendency of inclusion of new social groups into the informal sector, for instance, *children and students*. A recent national survey by Todorova et al. (2001) shows that of all children 5 to 17 years of age 6.4 percent are economically active; 32.2 percent work in the subsistence economy as agricultural producers; 41.8 percent perform domestic work. Fully non-engaged in any kind of work are only 14 percent of all children. The economically active children are employed, as a rule, in the private sector without labor contracts and against the law. They are concentrated mainly in the services and trade sectors – 56.2 percent, in agriculture – 16.9 percent, and 7 percent in transportation and communications. Their labor is not compulsory. Economic activity is higher among boys than among girls (55.8 percent and 44.2 percent respectively). By age, the economically active children are distributed as follows: 5-9 years – 11.8 percent, 10-14 years – 32.9 percent, 15-17 – 55.3 percent. The smallest number of working children is found in the capital – 16 percent of all; the smaller the location, the larger the percentage of children employed - 27.6 percent in big cities, 27.5 percent in small towns, 28.9 percent in villages.

The income of the working children is low – 43.3 percent of them get between 10 and 30 leva per month; 56.7 percent – more than 30 leva.¹³ Exploitation is obvious. 34 percent of the children contribute a part of their income to the family budget; 64 percent

¹³ The exchange rate in April 2002 was roughly US\$1 = 2.2 Bulgarian Leva.

save a part of the income earned. 41.6 percent of all children work up to 9 hours a week; 28.7 percent – 9-24 hours, 26.4 percent – 24-41 hours, and 3.3 percent - more than 41 hours. *About one sixth of them work more than what the law permits –30 hours a week* (Todorova et al., 2001).

In the short run, non-regulated employment can absorb part of the large unemployed mass, soften poverty and thus decrease social tension. In the long run, however, it undermines labor legislation and social policy measures and creates labor relations usually associated with the darkest side of early capitalism – in other words, the informal economy increasingly creates its own social order.

In conclusion

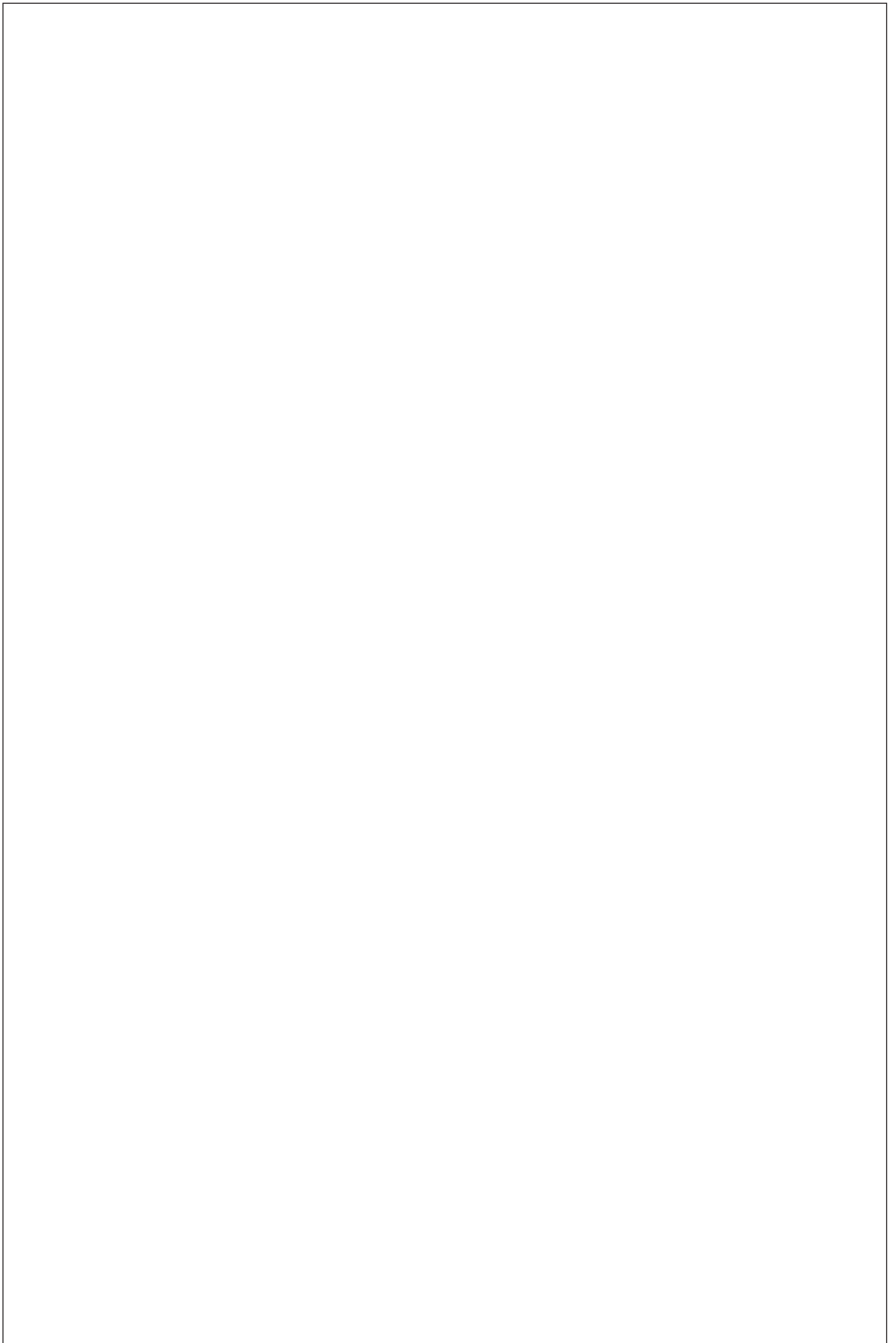
The informal economy in Bulgaria flourished during the 1990s. Such a finding cannot be surprising given the background of the entire process of transformation. The former socialist countries were challenged to create as quickly as possible a new system, based on market forces and the reign of economic and social equilibrium, to replace the old one. In the beginning of the transformation, the speed of destruction of the old system was higher than the speed of building up the new institutions of the market economy - this is probably where one should look for an explanation of the strength of the informal economy in these societies.

Bulgaria is not an exception – it is rather an extreme case, in which the newly introduced institutional framework of the market economy is still not functioning properly. One of the most serious problems for the country is its disembeddedness from formal normative regulation. Historically, formal legislation never had a chance to develop from indigenous customary law; the legal system has always been either borrowed or imposed. From this perspective, the informal economy indicates an incompatibility of rules and everyday practices. This economy has produced during the last ten years social or institutional deformations which cannot be cured simply by direct social and economic policy measures. Reducing informality seems to be a long-lasting process, the core of which should be the improvement of institutional performance. The establishment of fair and realistic rules of institutional behavior is a responsibility of both state and civil society in Bulgaria.

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CHAPTER 12

Tax Avoidance in Bulgaria: The Human Capital Approach

Andrey Zahariev

Introduction

Every taxpayer faces a serious dilemma when he/she has to answer the question what part of his/her income should be declared in his/her tax return. According to the answers given to this question, we distinguish three major types of taxpayers:

- completely fair taxpayers who meticulously declare the full extent of their yearly income;
- not completely fair taxpayers who use various instruments for legal tax avoidance plus some ways of tax evasion, thus reducing their overall personal tax base;
- entirely unfair taxpayers who either do not declare any income or declare income below the non-taxable level.

The present study aims to explore the processes of tax avoidance from a different point of view - the concept of tax avoidance as a form of protection of investment incomes by rational investors in human capital. I would argue that the state can have legitimate claims on an individual's income but only to the extent of the percentage of utilized public investment for the creation of human capital through the public education system. In case of an equilibrium, we may assume that expenses on public education as a form of human capital formation should be equally shared between the individuals and the society. Thus we should distinguish the following two theoretical models:

- 1) If the financial benefits from the education of a certain individual, measured by the difference between income from positions requiring higher educational degree and that from positions which do not require such a degree, are shared equally between the individual and the society, then the payback period for both of them will also be equal;

2) If the financial benefits from the education of a certain individual measured through the difference between the income from positions requiring higher educational degree and that from positions which do not require such a degree, are not shared equally between the individual and the society then the payback period will be shorter for the individual proportionally to the excess revenue which remains for that individual, and vice versa.

As a result we can have a matrix of combinations,

where

- a) EFC_i is the individual's educational financial costs;
- b) EFC_s is the society's educational financial costs;
- c) EFB_i is the individual's financial benefits;
- d) EFB_s is the society's financial benefits.

TABLE 1: DISTRIBUTION OF THE FINANCIAL COSTS AND BENEFITS FROM HUMAN CAPITAL FORMATION

Distribution of costs	Distribution of benefits		
	$EBi > Ebs$	$EBi = Ebs$	$EBi < Ebs$
$EC_i > EC_s$	1 equilibrium	2 non-equilibrium for the benefit of the society	3 non-equilibrium for the benefit of the society
$EC_i = EC_s$	4 non-equilibrium for the benefit of the individual	5 equilibrium	6 non-equilibrium for the benefit of the society
$EC_i < EC_s$	7 non-equilibrium for the benefit of the individual	8 non-equilibrium for the benefit of the individual	9 equilibrium

As we can see from the above table the diagonal combinations (those in the 1st, 5th and 9th quadrants) express the equilibrium states. The other combinations express imbalance, which goes to extremes in the 3rd quadrant (extreme imbalance beneficial to the society) and in the 7th quadrant (extreme imbalance beneficial to the individual). We may also point out that:

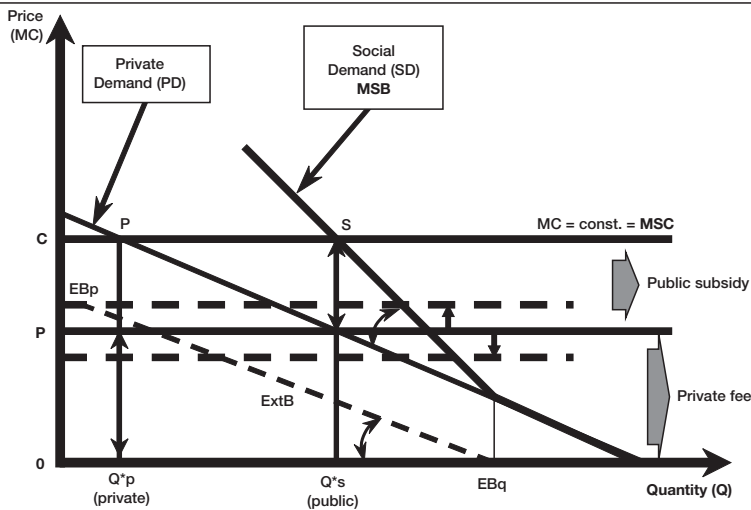
First, the non-equilibrium combinations in the 2nd, 3rd and 6th quadrants are most typical when the state is in a superior position vis-à-vis that of the citizens. Under these circumstances a rational individual is motivated to avoid taxes by the excessive claims of the society on the income generated by the individually owned human capital.

Second, the non-equilibrium combinations in the 4th, 7th and 8th quadrants are most typical when the state is in a weak position vis-à-vis that of the citizens. Usually under those circumstances the tax rate is below the level, which can motivate tax avoidance.

According to the public finance theory, education is a mixed good with non-competitive characteristics. A certain number of citizens may decide not to take advantage of this good. The reason for such a decision may be the mismatch between the real investor in education and the real benefit-taker. The benefits from education could be obtained by individuals different from the individuals in whom has been invested through education. In other words, as the owner of education as a good is the private person, the education could be considered more precisely as a private good with externalities.

Certain private goods with externalities can be produced according to optimality criteria. The main purpose of this model is to offer optimal distribution of all human capital formation costs among all benefit-takers. Such a model will decide where the exact location of the point of competitive equilibrium between education demand and supply will be, in other words, where is the point of Pareto optimality, i.e. with marginal public benefits equal of marginal public costs. But because the marginal public benefits represent a cumulative expression of all benefits generated as a result of the human capital formation through education, we should find out how to optimally distribute all related costs for investment in human capital formation (see Fig. 1).

FIGURE 1: NON EQUALITIES IN THE MODEL OF DISTRIBUTION OF THE COSTS FOR HUMAN CAPITAL FORMATION



If we suppose that society provides 35 percent of all funds needed for producing one unit of human capital (the line PC on the Y axis), later with the help of the income

tax the society should extract only an amount equal to those 35 percent initially invested in human capital formation through education.

If political or other considerations lead to a situation, in which the state tries to use the fiscal system in order to extract more than this level, the ordinary taxpayer will have the right to undertake all necessary steps to avoid paying taxes.

In other words, when the introduction of tax extends the payback period on human capital investments, a rationally acting individual will take all necessary measures to reestablish the initial payback period (under the conditions of a perfect market).

Hypotheses, Data and Methodology

Testable Hypotheses: The Human Capital Approach on Tax Avoidance

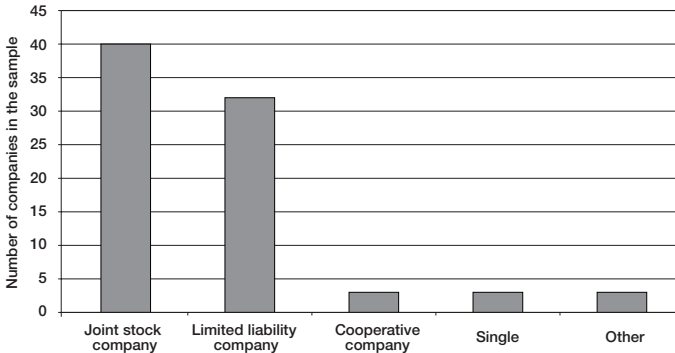
Under the conditions of high unemployment and high business risk, firms and their employees undertake common, low-conflict actions for the reduction of fiscal and insurance payments related to labor contracts. The threshold level for this process to start decreases with the increase of the size of the firm as a taxpayer, measured by the number of its employees. The influence or lack of local labor unions, policy of fixed-term labor contracting, etc. can serve as additional factors for these outcomes.

Data Description

The research carried out in the summer of 2001 on Bulgarian private companies clearly showed the importance of HR as a factor for business success. We received 82 replies to a questionnaire distributed among more than 400 benchmark firms.¹

The full distribution of answers is shown below:

FIGURE 2A: LEGAL FORM



¹ Research was carried out in the framework of the program INTERREG M 6.3.

FIGURE 2B: PERIOD OF ESTABLISHMENT

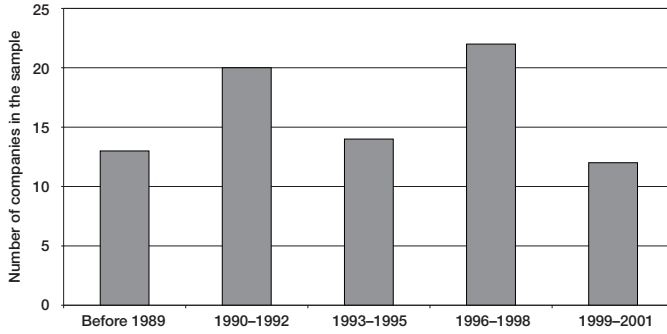


FIGURE 2C: INDUSTRIAL SECTOR

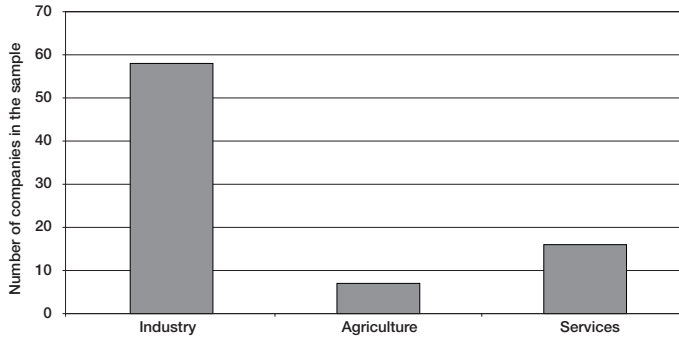


FIGURE 2D: TYPE OF OWNERSHIP

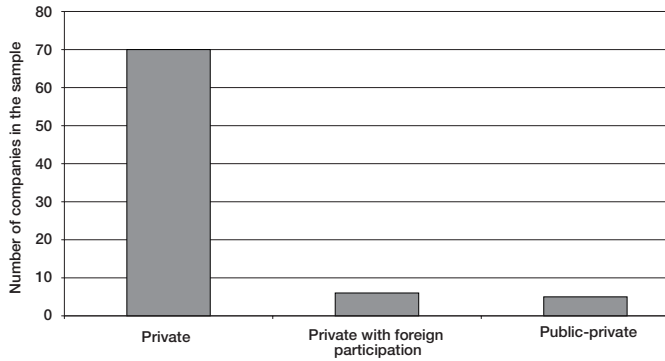


FIGURE 2E: NUMBER OF EMPLOYEES

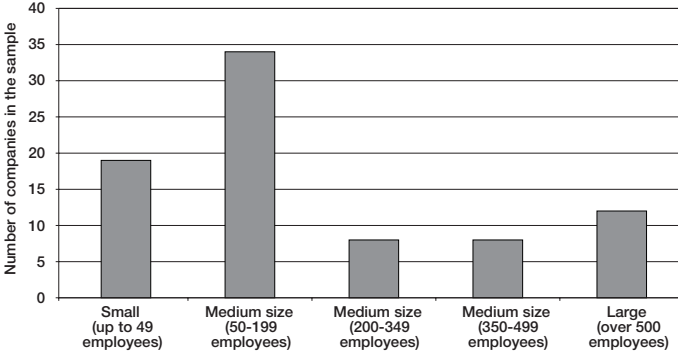


FIGURE 2F: LABOR UNION

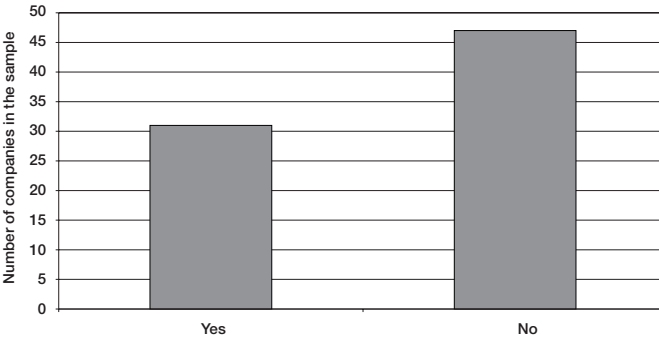


FIGURE 2G: INTRODUCED QUALITY STANDARDS

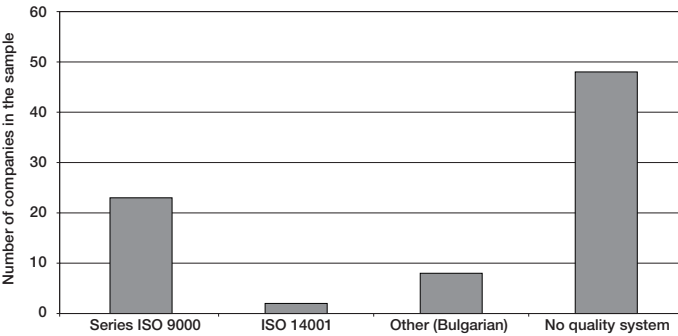


FIGURE 2H: TO WHAT DEGREE DO YOU BELLEVE THAT HUMAN RESOURCE MANAGEMENT CONTRIBUTES TO THE SUCCESS OF YOUR BUSINESS?

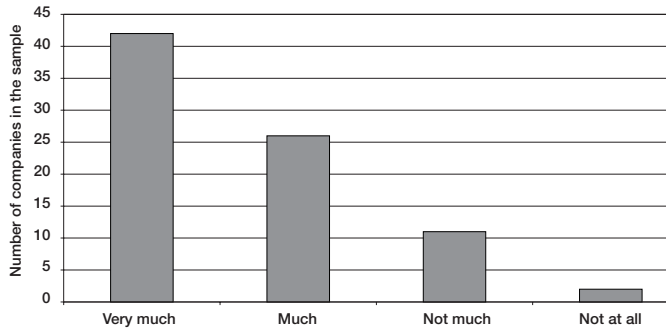


FIGURE 2I: DOES YOUR COMPANY OPERATE A HUMAN RESOURCE DEPARTAMENT?

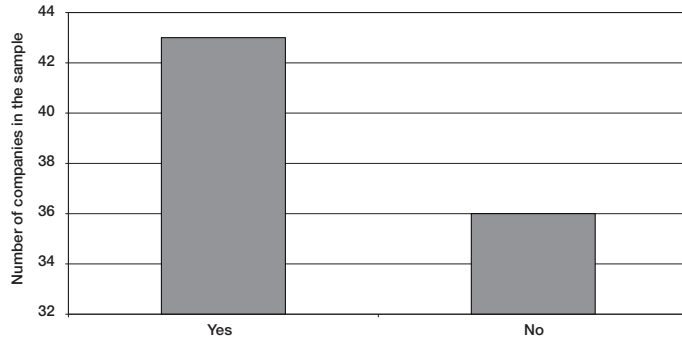


FIGURE 2J: WHO IS RESPONSIBLE FOR HUMAN RESOURCE MANAGMENT?

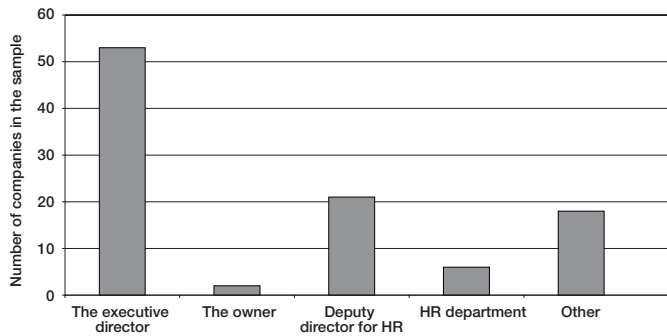
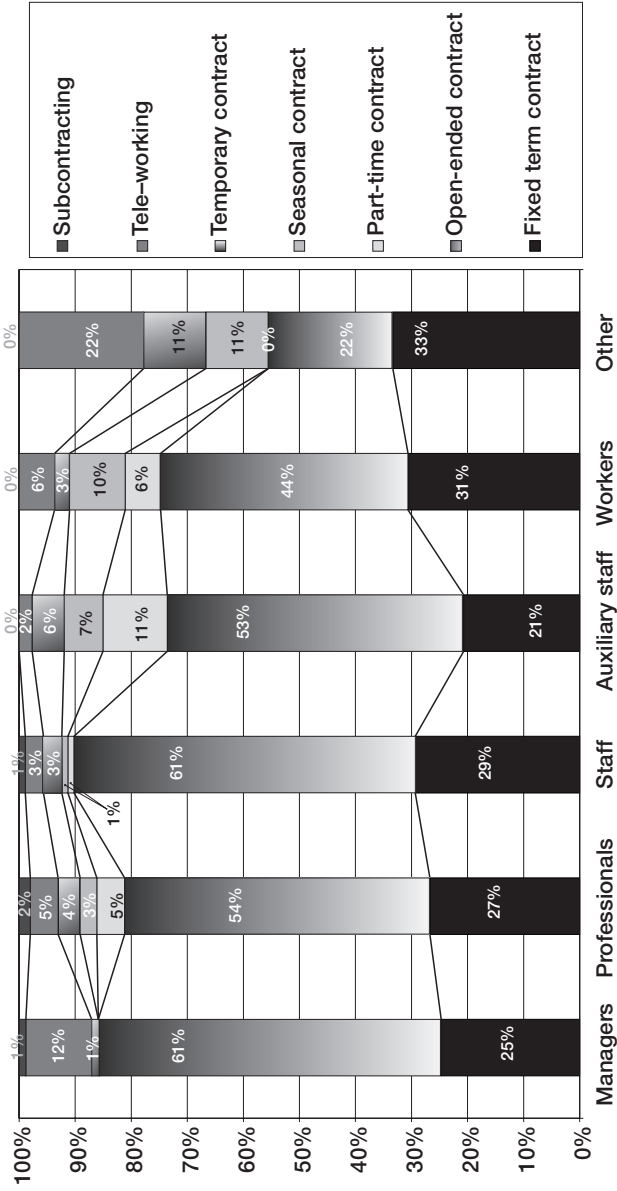


FIGURE 3: TYPE OF CONTRACTING ACCORDING TO THE DIFFERENT OCCUPATIONAL CATEGORIES OF THE EMPLOYEES



Mode characteristics of the firms in the sample are as follows::

- registered as Joint Stock Company (near fifty percent);
- established in the period 1996-1998 (over 27 percent);
- operating in industrial sectors (manufacturing, engineering, etc.) - over 72 percent;
- with 100 percent private ownership (86 percent from the sample);
- medium-size with personnel between 50 and 199 persons (42 percent);
- without labor union (58 percent);
- without existing system of quality control (59 percent);
- with high confidence (over 50 percent of responses) in the contribution of the HR management for the success of the business;
- with existing HR department (53 percent);
- with executive directors who are in charge for HR management (53 percent);
- with open-ended contracts for employment of managers (61 percent), specialists (54 percent), employees (61 percent), support staff (53 percent) and workers (44 percent), and with fixed-term contracts for personnel with other types of responsibilities (33 percent).

Methodology

The study tries to establish a relationship between:

- a) The distribution of fixed term contracts according to the hierarchy status of the employee in some small, medium-size and large companies in Bulgaria:

$$(1) Y_{FTC} = a + bX_{HIERARCHY},$$

where: Y = distribution of fixed term contracts (FTC);

X = hierarchy status;

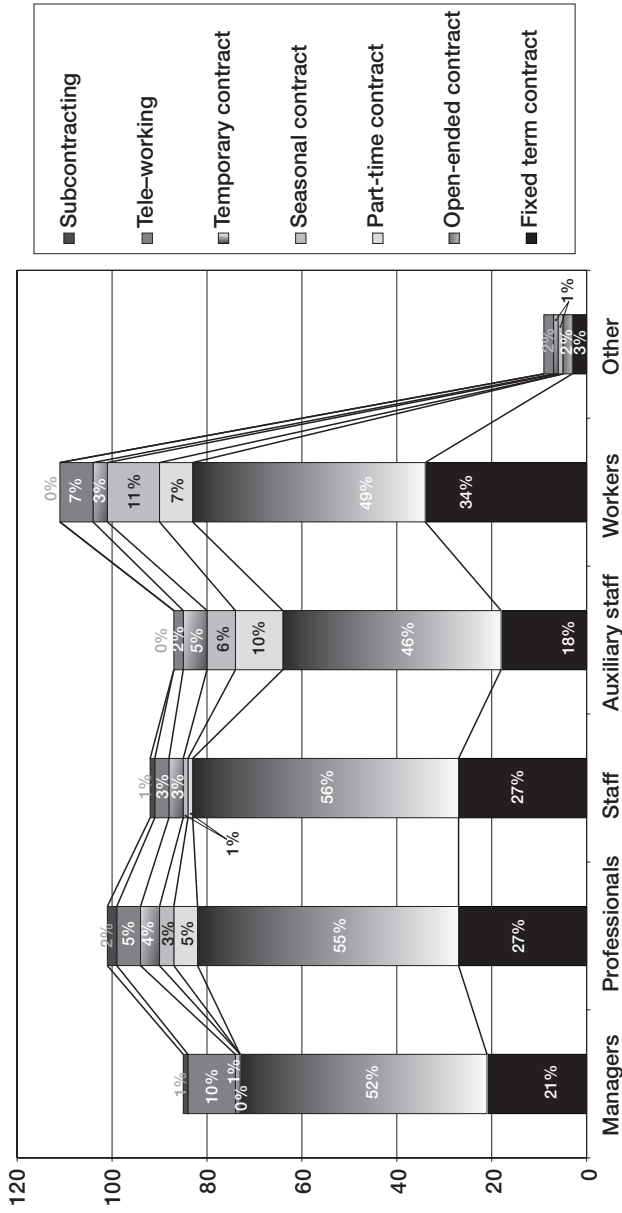
- b) The distribution of fixed term contracts according to the existence of local labor union:

$$(2) Y_{FTC} = a + bX_{UNION},$$

where: Y = distribution of fixed term contracts (FTC);

X = the percentage of unionized firms in the sample;

FIGURE 4: CONTRACTING ACCORDING TO OCCUPATIONAL CATEGORIES (NUMBER OF CASES)



- c) The size of the company according to the number of employees, and the official taxable income according to the corporate policy on labor contracting and social insurance:

$$(3) Y_{\text{INCOME}} = a + bX_{\text{SIZE}},$$

where: Y = official taxable income established on insurance basis;

X = size of the company according to the number of employees;

In order to test the above hypothesis for our sample of Bulgarian firms we apply correlation and regression analysis. Initially, the firms from the sample are distributed in five groups according to the number of employees:

I	small firms (up to 49 employees)
II	medium-size firms - category 1 (50-199 employees)
III	medium-size firms - category 2 (200-349 employees)
IV	medium-size firms - category 3 (350-499 employees)
V	Large firms (over 500 employees)

Analysis of Key Results

The key results of the survey are related to the three main relationships indirectly expressing the size and the causes of tax avoidance in Bulgaria. Figures 5 and 6 show that the distribution of fixed-term contracts is a function of the size of the company and the hierarchy status of the employees.

According to the size of the company, for the categories specialists and workers the regression line has a negative beta ($\beta = -0,016$ for professionals and $\beta = -0,046$ for workers). Otherwise, for the category managers the regression line has a positive slope. The reason for this is the increased number of JSC as a legal form of registered firms relative to the size of the company. All governing bodies are usually contracted under fixed terms.

The existence of a labor union is also an important factor for introducing a policy for fixed term contracting as a tax-avoidance factor. The larger the company, the better represented the labor unions are, and vice versa (the trend line confirms our hypothesis with $R^2 = 70$ percent).

The final and most representative figure for the purposes of the study is Figure 8. The answer to the question "Does your company offer retirement benefits (public and private) to its employees on a taxable income basis?" allowed us to confirm the

FIGURE 5: DISTRIBUTION OF FIXED TERM CONTRACTS AT BULGARIAN SMALL, MEDIUM SIZE AND LARGE COMPANIES

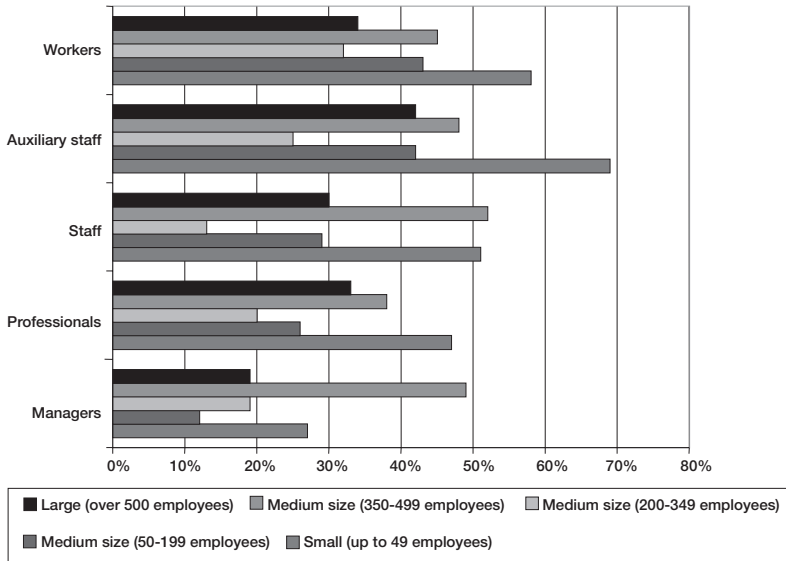
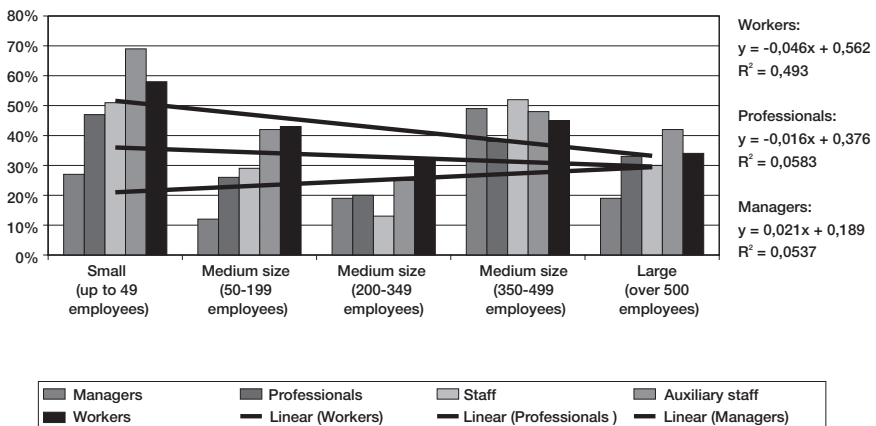


FIGURE 6: DISTRIBUTION OF FIXED TERM CONTRACTS FOR MANAGERS, PROFESSIONALS AND WORKERS AT THE BULGARIAN SMALL, MEDIUM SIZE AND LARGE COMPANIES



relationship between the size of the company and the retirement benefits for the company employees on a non-taxable basis. The intensity of such policies of tax avoidance declines with 13 percent for every subsequent category of firms according to the “number of employees” criterion. Ninety-eight percent of the variation of the observed trend can be explained by the change in company size.

FIGURE 7: DISTRIBUTION OF FIXED TERM CONTRACTS POLICY ACCORDING THE EXISTENCE OF LABOR UNIONS AT THE FIRM

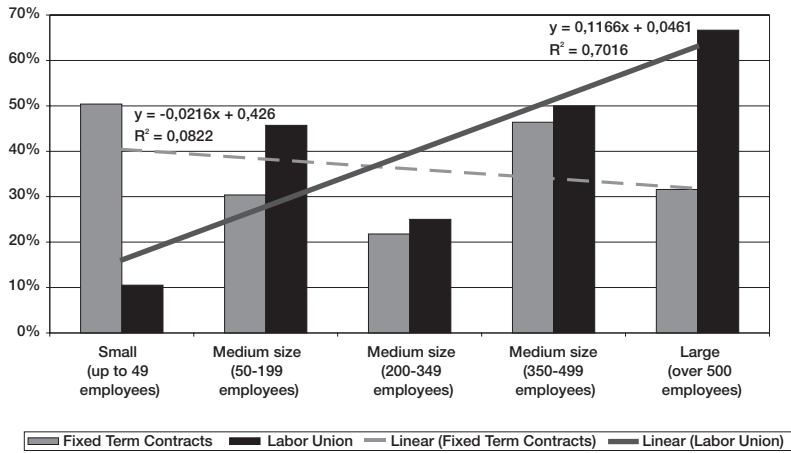
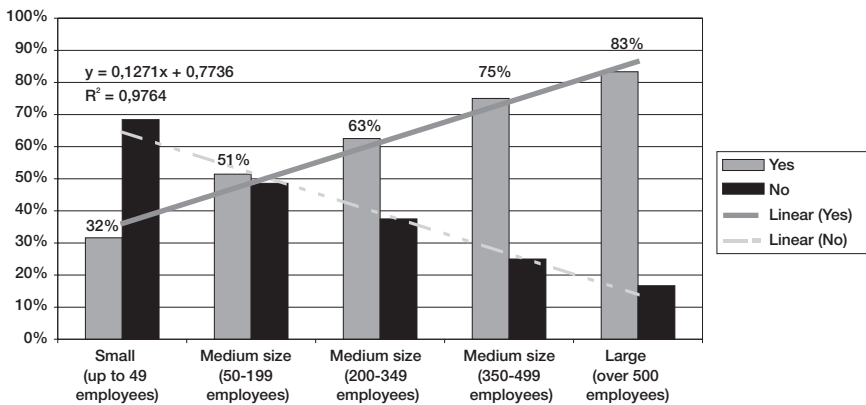


FIGURE 8: DOES YOUR COMPANY OFFER RETIREMENT BENEFITS (PUBLIC & PRIVATE) TO ITS EMPLOYEES ON TAXABLE INCOME BASIS?



Summary and Conclusions

Our study confirms that Bulgarian companies, especially SMEs, largely avoid paying taxes and benefits. Some of the major causes for this can be explained as follows:

- the employees agree with the corporate policies of tax and benefit payment avoidance because of the unemployment risk. Such a risk directly reduces the return from the investment in human capital through education;
- the lack of labor unions allows the management to increase the extent of tax avoidance with or without the agreement of the employees;
- the reduced payments towards the state and social insurance funds free resources for new corporate investments and for certain increase in the disposable income of the personnel, *ceteris paribus*;
- due to the small size of the companies, the local tax offices perform tax audits quite rarely, thus reducing the probability of getting caught for tax-avoidance to a risk level acceptable for the corporate management. The larger taxpayers (firms with over 350 employees) are, however, very often audited by the tax authorities. As a result, large companies prefer to pay a fair level of salaries, income taxes and social insurance rather than pay penalties;
- tax and insurance evasion in Bulgarian private firms varies from 17 to 68 percent of the cases.

CHAPTER 13

Characteristics of Informal Sector Development in Albania

Genc Ruli

In all transition economies one can observe a parallel existence of two separate sectors - formal and informal. The informal sector is present all over the world today and particularly in the developing countries. There are two main features of this phenomenon in transition countries. First, we have an upsurge of the informal sector within a very short span of time. In most of these countries, with Albania as a typical example, until less than ten years ago this phenomenon was non-existent in the economy. And second, the growth of the informal sector has occurred in parallel with the process of political and social transformations towards a free market economy, heavily marked by intensive creation and transformation of institutions and their natural immaturity.

The analysis of the characteristics and the impact of the informal sector of economy in the transition countries of SEE is of particular importance today for a number of reasons, namely:

- the serious presence of the informal sector in these countries shows that these countries to a great extent feel a need for development policies per se in addition to the standard policies of post-communist transition. Facing the informal sector problems is essentially an issue of development policy.
- there is a need for a better definition of the state and the institutions' role in the transition period. This requires both a critical evaluation of the liberal theories of the decreasing role of the state right from the beginning of the transition as well as a consideration of a typical phenomenon for the Balkans today - the presence of "weak states". The states in our region are demonstrating a worrying incapacity to duly regulate the economic and social space under their own jurisdiction.

- the perspective of European integration of countries of the region. Despite the distance in time to the achievement of this objective it requires indispensably an immediate reaction towards problems of the widespread informal sector, because the policies in this respect which could be undertaken today will have an impact only in the long run.

* * *

Researchers agree that the informal sector is a complex phenomenon in the economic, social and political life of transition countries. The legal status of informal activities, their relationship to the state and the role of public institutions are of major importance. Nevertheless, it is not easy to define what is informal and what is legal, as this depends, to a significant extent, on the local realities themselves. What is the level of alleged illegality of the various forms of informality? What are the principal causes of informality - institutional, structural or cultural? In addition to collecting a lot of statistical information to enable the evaluation of the extent to which fiscal rules, administrative and labour legislation are respected, the answers to these questions require as well an evaluation of the impacts that strict compliance with these rules will have on income distribution and the level of employment or investment in the informal sector enterprises. This would necessitate precise analysis of the size, the type of activity, and the level of operating within the law of informal sector units themselves. It is difficult to say that reliable analysis of this kind has been done so far in the different countries of region. Further to that, there is no evidence that the governments of these countries have undertaken clear policies towards legalization of informal sector activities; very little effort has been made to promote small enterprises, which tend to be most often informal.

A serious analysis of the informal sector in transition countries, its typology and real impact has been ignored for a long time. This problem has become part of the research agenda and the debates only for the last two or three years. In the entire region government attitudes towards the growing informal sector oscillate between two extremes. The first one is the consideration of the informal sector as valuable for economic growth because it provides opportunities for massive self-employment and gives support to large groups of people. This means that the state itself tolerates the increased presence of the informal sector, which, in fact, makes it legitimate by a tacit acceptance of its existence. The other extreme is simply an administrative, or even repressive, reaction to the informal sector, which generally does not bring any positive results. The first tendency is somewhat justified at the beginning of the transition, when macro stabilization and structural reforms *per se* bring, on one hand, an obvious decrease in the income of large social groups as well as explosive unemployment; on the other hand, the state itself has a fairly limited degree of freedom to design and implement the proper motivating policies towards the re-emerging private sector.

In the meantime, for our governments it is quite imperative to curb down the growth of the informal sector and bring business within the legal zone. The approaches they adopt to achieve this goal and the relationship they create between small-scale business and various state institutions will determine to a great extent the future of this business as small business is, and will continue to be the most active and dominating economic actor in the majority of the transition economies. It is imperative to undertake a broad analysis and define the basic aspects of this relationship between the state institutions and the informal small business.

First, small business is hardly able to be legal due to structural constraints. The low degree of registration and compliance with tax and labour legislation can be attributed to the unfavourable environment for small business: tight markets, unstable or inadequate demand, strong competition, lack of financing and difficult access to institutional credit (the informal sector as a “pathology” of the economy).

Second, there is an inadequate institutional framework. In most of our countries, the tax and commercial laws, the labour legislation, investment rules, etc. have been quickly brought to western standards, which in most cases poorly fit the local realities.

Third, the state has low capacity to pursue business promotion policies. This is a result of budgetary constraints and financial imbalances faced in the course of the transition. Fiscal priorities impose the necessity of a broad taxation on small business. State institution incapability is linked also to their own non-compliance with the law, the inadequate implementation of rules, the arbitrary use of power, corruption of the public administration, etc. (the informal sector as a “pathology” of the State).

* * *

The emergence of the informal sector in Albania coincided with the start of the reforms towards liberalization and deregulation undertaken in early 1990s. Unlike some other communist countries, which undertook a number of partial liberalization measures in their economies during the 1980s, in Albania up to 1990 any form of private economic activity was banned by law. It is not surprising that in the first years of political change for many individuals the involvement in private business was considered as “ideological” - an expression of their anti-communist beliefs, which in the end was cultivating the grounds of an anarchic mentality. Everything that was not private, every activity or asset of the state should be closed, privatized or appropriated by someone. The fetish of “the private” started to confront not only the fetish of “the state” (communist), but also the phenomenon of the state itself.

The privatization process in Albania was carried out very rapidly - during the period 1991-1994 70 percent of the economy turned private; sectors, such as trade, services and agriculture, were totally privatized. Yet, this rapid process was at the same time a manifestation of a dilettante liberalization, of the incapacity to guide an effective process of liberalization. The pursuit of the legitimate goal to reduce the role of the state

as an owner or economic entity brought as a side effect the destruction of the regulatory and monitoring capability of the state over economic activities. Thus, since its genesis, the new private sector emerged mainly as an informal sector with an anti-state mentality and disregard for laws and rules in general.

In the course of the post-communist transition, the informal sector of economy was undergoing a transition itself - it was evolving too; its size, nature, spheres and patterns of activity changed.

Empirical studies conducted in the recent years in Albania show that the informal sector in the country is neither entirely legal nor completely illegal; it operates extensively in a grey area ranging from fully within the law to entirely outside it. A number of assessments carried out through direct surveys or indirect methods show a level of informal sector presence in the economy oscillating from 30 to 40 or 45 percent of the GDP. Thus, we have a rather large informal sector, but the depth of informality is quite different in various economic activities.

The informal sector in Albania appears in some typical forms:

- the activity of rural families;
- individual or familiar micro business, mainly temporary and almost entirely not registered;
- registered businesses, small, medium or large in size, which operate at different levels and forms of informality;
- illegal and criminal activities, such as money laundering, smuggling, for instance, which in certain cases can be disguised as legal businesses.

Elements of informal operations are also observed in enterprises with foreign capital, no matter if they are small, medium or large. Thus, it is obvious that the informal sector has a dual nature: on one hand, it includes low-income activities, while on the other hand, it involves high-return business. Further evolution of the informal sector, following a pattern already observed in many developing countries, is likely to occur as legislative and institutional reforms are advancing. In the course of this evolution, lower income segments can gradually eclipse the higher return area, which will soon become formal and legalized.

* * *

Agricultural activities accounting for 50 percent of GDP are exercised by approximately 400,000 rural households, which occupy plots of land ranging from 1 to 2.5 ha per unit and generally produce a little more than what is necessary for subsistence. In the last 10 years rural families have not contributed to the social insurance system and are almost entirely not covered by it, while no tax is levied on agricultural production or land. Thus, the informality of the agriculture sector as it remains rather relative since the state itself has tolerated and recognized its status out of the regulated and taxed zone of economy. In-kind consumption based on production

from private plots has constituted a sort of “safety net” for almost 50 percent of the Albanian population – an important factor in satisfying the consumption needs of the rural households.

The sectors, in which the informal economy is really strong, are trade (retail in particular), transportation of goods and passengers, services (bars, restaurants), construction and some production activities.

The significant presence of informal activities in Albania is also conditioned by the structural characteristics of the Albanian economy. Almost all enterprises in Albania can be defined as micro or small, with 76 percent of all enterprises having just one employee. More than 80 percent of all enterprises operate in the trade and services sector while only 10 percent in the industry. Services are likely to remain a growing sector of economy in the country, presenting more opportunities for informal activities.

The banking sector continues to remain underdeveloped and has limited influence on the economic development of the country, while capital market is almost entirely inexistent. The Albanian economy may be characterized as a “cash economy” – the cash held outside the banking system in 2001 accounted for 77 percent of the monetary base (or 30 percent of M3), while only one third of the monetary transactions are channelled through the banking system. Road dealers, the majority of whom is not even registered or licensed, make more than 60 percent of foreign currency exchanges. The financial sector became a prey of intensive informal activities during the period 1995-1996 after the creation of large pyramid schemes, in which more than 70 percent of the country’s population deposited their savings, estimated to be around 1-1.2 billion USD. The banking sector today appears to be more stable and functional after the Bank of Albania strengthened its supervisory and regulatory role, and some foreign private banks opened their branches in the country. Nevertheless, other elements of the financial services sector, such as insurance, are poorly regulated and monitored, and the appearance of irregularities and informalities is recurrent.

The banking sector credit to economy remains too low - in 2001 it accounted for 10 percent of the primary deposits of the banking sector. Commercial banks are disinterested in lending to SMEs. The reluctance of commercial banks to lend is linked to the poor legal and regulatory framework, especially with regard to contract enforcement, collection of collateral and dispute resolution. Legacy of bad loans from state-owned companies also discourages banks from lending.

The micro-finance sector is more active but there is still excess demand for small loans and access to savings. Regulatory issues related to micro-financing institutions (MFIs), inappropriate provisioning and risk-based supervision based on standards set for commercial banks, makes MFIs less competitive vis-à-vis commercial banks. The newly established Loan Guarantee Fund seems to be insufficient and inappropriate to stimulate lending in the micro/small enterprise sector.

The scarce resources for institutional lending constitute one of the factors for informality forcing businesses to seek financing from informal sources. Among these

sources remittances are the most important, estimated at a level 500 – 600 million USD annually; undeclared profits and revenues come second. Earnings from criminal activities are also a source for financing economic activities. It is difficult to get a general idea of the profits generated through criminal activities, although the numbers are believed to be very high. The flux of illegal profits is observed to be larger in services enterprises, such as bars, restaurants, discos, gambling facilities, etc.

In order to cope with the insufficiency of formal bank credit, non-bank borrowing schemes are used by many businesses, especially in the housing\construction sector.

A specific factor accounting for the large spread of the informal sector has been the intensive migration of the Albanian population over the last decade. Almost 20 percent of the population has already emigrated, preferring mainly Greece and Italy. Albanian economic migration is the source of a high level of remittances, without the typical trend of their gradual reduction in a medium-term perspective observed in other countries. These remittances have played, on the one hand, an important role for financing domestic business, helping to increase imports and even alleviate the poverty of certain social segments. On the other hand, they have constituted a substantial source fuelling informality either because they are not declared given that their transfer for the most part is done outside banking channels, or because income from remittances has served as a cover up for using illegal capital or capital with unclear origin.

Most part of Albanian emigrants (almost 60 percent) do not enjoy a legal emigrant status - they have no residency permits; they are illegally employed and pay no taxes either in their country of residence or in Albania. Such a situation is most often encountered amongst the emigrants in Greece and Italy. This type of clandestine emigration produces an additional stimulus to the informal activities within the country.

Another fact to be considered is that the major trade and investment partners of Albania are Greece and Italy, whose economies also have substantial informal sectors – probably the largest among in the EU. In imports from Italy and Greece, partially subsidised by the EU, fake documentation and customs declarations are a common practice, which leads to a significant evasion of duties on both sides.

Massive internal migration also happened in Albania. Almost one third of the country's population has moved in the last dozen of years, mainly from rural to urban areas, which led to a double or three-fold increase of the population of a few major cities. Wild swings of a huge labour force fuelled the informal activities as due to poverty, low cultural level and poor qualifications these people could not be employed in the formal sector.

Tax evasion and, more generally, non-compliance with the tax legislation is the most recurrent form of informality. Fiscal informality appears first in those business activities, which do not register with the tax authorities, thus completely avoiding payment of any taxes and duties. According to official estimates unregistered businesses nation-wide represent 15 percent of the total number of registered small businesses and are located mainly in rural and remote areas. Although the real percentage is almost

twice as much as officially reported, i.e. one third of the businesses are not registered with the tax offices, it is not this segment, which accounts for the major part of tax evasion. The most worrying recurrence of informality in the fiscal area lies in the zone of small medium, or large businesses which are duly registered, but hide their turnover, profits, number of employees and real wages. It is precisely this kind of businesses, which account for the largest part of the country's economic activities.

A survey done by the Albanian Centre for Economic Research in 1999 demonstrates that the taxpaying ethics standards among Albanian companies are very low. About 75 percent of the companies state that fiscal evasion is "very frequent", 73 percent of the interviewed businesses state that they hide their real profits (20 percent on average of the profits before taxes), while in some sectors such as construction this number reaches up to 50 percent. Despite the progress achieved in the last two years, complete or partial evasion of paying custom duties as a result of smuggling still remains rampant.

94 percent of the businesses admit that this evasion is caused by the existing tax system and the fiscal policies pursued by the government. Nevertheless, it is a fact that the fiscal legislation has been subject to very frequent changes, and its enforcement has been insufficient and inconsistent. Tight fiscal policies have also led to setting relatively high tax levels and moreover - high customs duties. Albania applies a relatively high VAT tax (20 percent), higher than Macedonia (19 percent) or Bulgaria (18 percent). Besides the high level of corruption, the Tax Administration is still ill-equipped and poorly trained; it often becomes prey to the frequent personnel changes on political grounds.

Informality is even more widely spread in the implementation of the labour legislation and that of the social insurance. This is obvious from the low number of registered businesses (quite lower than the ones registered with the tax authorities), the low level of enrolment of employees in the social security scheme, the low level of individual or collective labour contracts signed as well as the low standards of labour safety.

More than one third of the businesses are not registered in the social insurance offices, which means they practice illegal employment. In the meantime, it is estimated that about half of the people employed in the country are working without labour contracts. Only 75 thousand employees pay social security contributions out of about 200 thousand employees in the private sector. The situation is not much better even at the foreign-owned companies: only 10 percent of them have collective labour contracts; only 30-35 percent of their employees have labour contracts.

The implementation of the labour legislation at such a low level is a consequence of a number of factors: (i) inefficiency of relevant state institutions; (ii) extreme weakness of organized labour; (iii) low number of people involved in business; (iv) high unemployment; (v) poor culture of the employees themselves.

There is also a clear contradiction between the far-advanced level of labour legislation existing in Albania and the underdeveloped and unprepared social

environment for its implementation. Maybe this can justify a claim that in countries, in which the informal sector is widespread, lower labour standards or their gradual application would be the most reasonable policy to follow.

The existence of organized crime complicates the picture of the informal economy. The latter is not criminal *per se*, but it becomes a fertile ground for criminal activities. Crime, and especially organized crime, thrives even when the informal sector's presence is rather low or totally absent. Nonetheless, in our countries we observe an alarming intertwining between criminal and informal activities. It is not difficult to identify the various forms of their interaction:

- Clandestine human trafficking;
- Prostitution;
- Smuggling;
- Stolen cars networks;
- Illegal weapons trade;
- Currency forgery, etc.

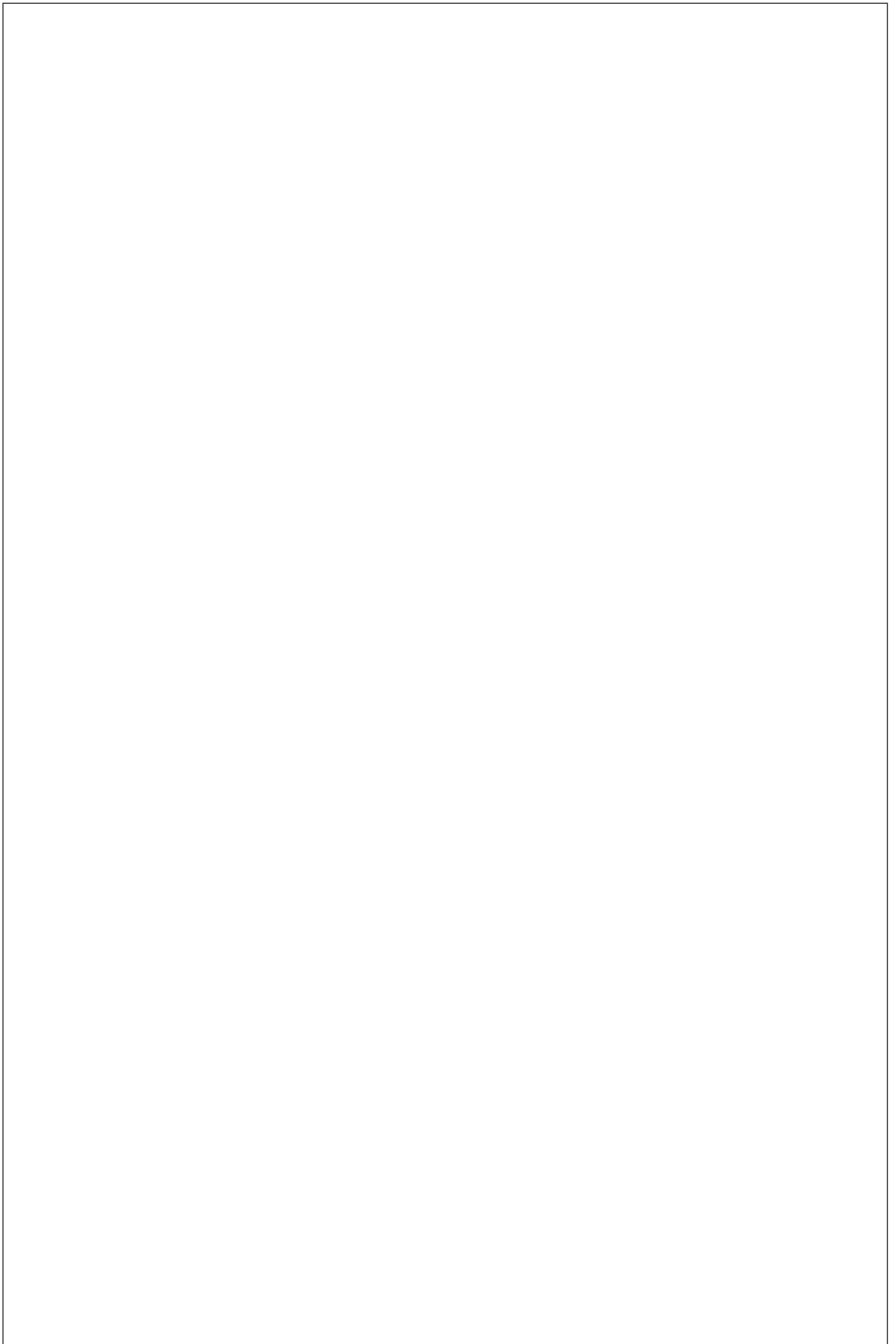
The fight against organized economic crime is imperative on its own for our governments, but their specific policies and actions towards bringing down the size of the informal sector should obviously have a significant impact on reducing the dimensions of the organized crime itself.

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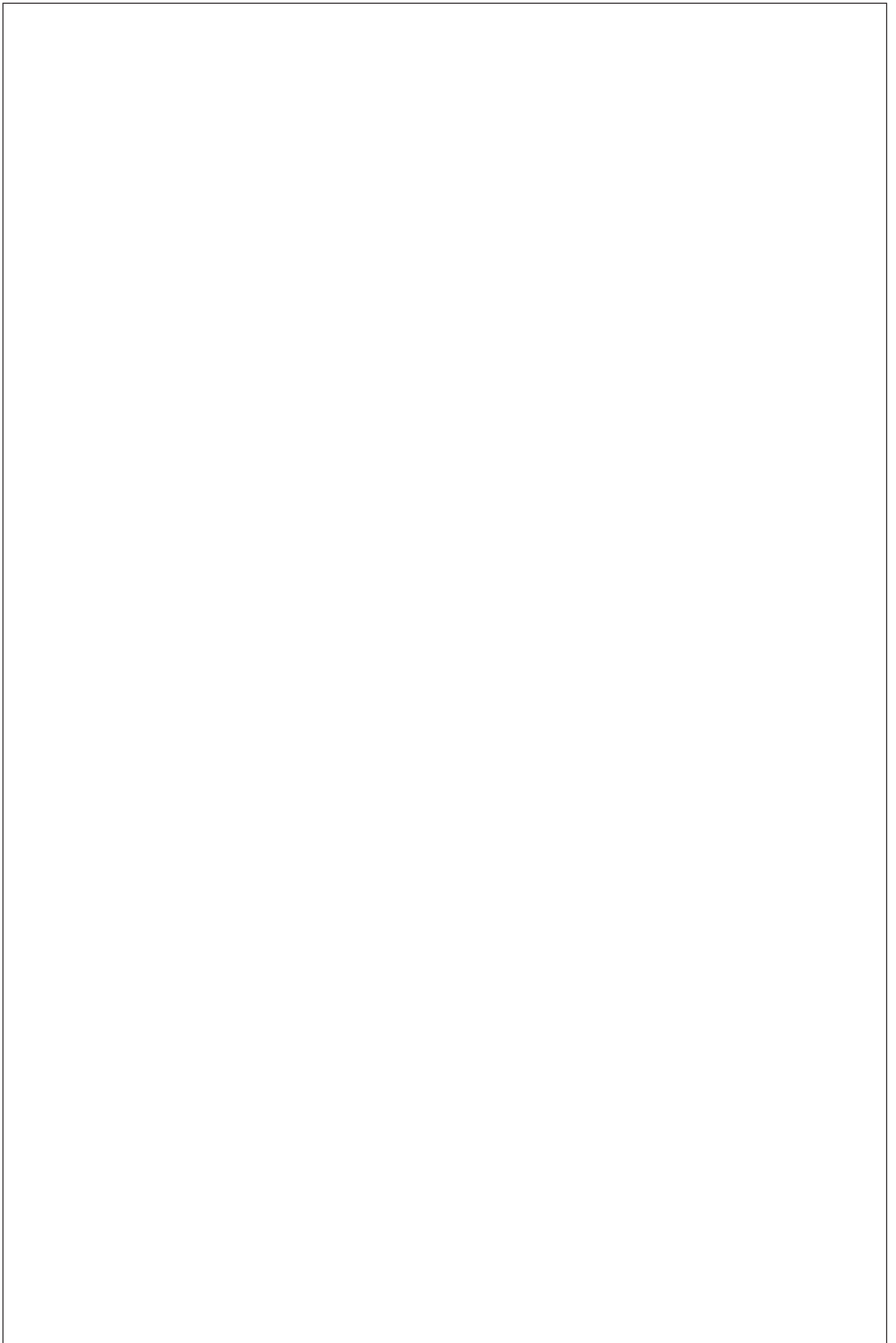
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**Early Warning and
Risk Reporting for
Good Governance and
Against Corruption**



CHAPTER 14

The Risks of Corruption and Anti-Corruption Strategies

Wim van Meurs

Risk Reporting and Early Warning¹

Whereas in recent years UNDP has gradually expanded its “Early Warning” projects to most countries of Southeastern Europe (<http://earlywarning.undp.sk/Reports>), the Bertelsmann Foundation and the Center for Applied Policy Research are in the third round of their “Risk Reporting” series (<http://www.cap.uni-muenchen.de/bertelsmann/soe.htm>). The catchwords “Early Warning” and “Risk Reporting” seem to indicate diverging approaches. What the two projects have in common, however, is a fundamental concern with external interference and guidance at the detriment of regional ownership. National teams of experts are in charge of UNDP’s early warning reports and next to all authors in the Risk Reports are academics or NGO representatives from the states involved. Nevertheless, the term “early warning” - with its Cold War connotation of readiness requirements posed by nuclear deterrence policy (Schmid, 2000, pp. 37-39) and its broader definition as “the period before a situation in which tensions develop into a conflict” – implies a focus on the identification and analysis of national “risks” rather than a policy advice approach. Risk Reporting, despite its name, focuses on strategic answers to structural (regional) problems related to European integration rather than the in-depth analysis of specific risks and developments.

¹ This paper is based on research done in the framework of a joint project “Issues and Consequences of EU Enlargement” by the Bertelsmann Foundation and the Center for Applied Policy Research (CAP). I would like to thank Martin Brusis, Iris Kempe (CAP) and David Chandler (Leeds Metropolitan University) for suggesting some of the arguments in this paper.

Risk Reporting combines the future Eastern and Southeastern neighbourhoods of an enlarged, post-2004 European Union. The Stability Pact, more explicitly, the Presidency Conclusions of the Feira European Council have given even the countries of the Western Balkans a (long-term) perspective of EU accession, whereas Russia, Ukraine, Belarus and Moldova have been refused such a perspective (Kempe and Van Meurs, 2002). Nevertheless, for the time being some challenges and risks related to the EU enlargement process are common to both future neighbouring regions. Thus, on the basis of a general philosophy of tackling issues that will reach the top of the European agenda in a few years only, the first one, the 1999 Risk Report focussed on the accession states' relations to their Eastern neighbours rather than to their future European partners in the West (Kempe, Van Meurs and Von Ow, 1999). The second, two-volume Risk Report was published in 2001 under the title *Beyond EU Enlargement*, identifying risks both for the accession countries, for the current members and for the neighbouring states that are *beyond* enlargement, in a temporal, qualitative and geographic sense (Kempe and Van Meurs, 2001). For Southeastern Europe this year's Risk Reporting is focussed on the intended and unintended consequences of the massive international assistance, conditionality and robust mediation in an unstable European region, characterized by developmental and transition deficits as well as by weak states (Van Meurs, 2003).

The 2002 round of Risk Reporting for Southeastern Europe combines a number of perspectives usually treated separately: regional stabilization, diplomatic conflict-management, military crisis prevention and external assistance for the reform processes. The European Union is increasingly becoming a regional power and a guarantor of security and stability in the Balkans with a unique set of policy instruments, ranging from diplomatic and military crisis management (CFSP/ESDP) to regional stabilization (Stability Pact) and reform assistance with a long-term perspective of integration (Stabilization and Association Process, CARDS). The basic dilemma of the region, however, is the structural tension between the necessity for massive, multifaceted external "interference"² caused by the stability risks and backlog of reform in the region, on the hand, and the economic and political dependencies as well as deficits in democratization and regional ownership generated by this very external interference, on the other hand.

Currently, the European Union is increasingly accepting a leading role in the process of stabilization and reform for the Western Balkans. An insular region of instability would contradict the EU's self-identification as regional power and guarantor of security and prosperity in a Wider Europe. The perspective of long-term EU integration with the Stabilization and Association Process and, to a lesser extent, the Stability Pact as a credible road map leading to accession has become the key incentive

² The physics term "interference" – as an alternative to "assistance", "dominance" or "intervention" – denotes the complex interplay between external input and indigenous processes, with unintended side effects and with neither party in control of the entire process.

for reform and stability in the region. In the aftermath of September 11th, while shouldering the main burden for the region's future, Europe is also bound to prefer a self-sustaining model for regional stability (CEPS Europe, 2001).

Developmental or reform assistance is increasingly identified as a potential destabilising factor in weak or failing states. Therefore, the focus is shifted from *more* assistance and *more* policy prescription to self-sustaining development and regional ownership. In view of the complex architecture of international interference in the region and acknowledging that multitude does not equal pluralism, a review of the horizontal and vertical division of spheres of competence among organizations and sub-state, national, regional and international levels might reduce counterproductive duplication and competition among institutions as well as conflicting strategic principles and policy instruments. The diverging dimensions of interference - ranging from conflict management and regional stabilization to reform assistance and roadmaps of integration - highlight the need for screening criteria, risk identification and mechanisms of conditionality, which cover both acute crises and incremental reform policies. In sum, this round of risk reporting critically surveys the institutional architecture, policy principles and screening procedures of external interference in the Balkans.

In the past decade the region of the Western Balkans has been largely unable - due to adverse initial circumstances and structural deficits - to generate a process of reforms and development similar to that in East Central Europe and the Baltic states. Even in the current post-Milosevic window of opportunity with democratic governments dedicated to political and economic reform, regional cooperation, negotiated arrangements and Euro-Atlantic integration, which are in office in all states and state-like entities of the region, international resources, incentives and engagement are deemed essential for a regional catch-up process. The perspective of EU membership in a future Southeast enlargement (in a tentative 10-15 year timeframe) forces the individual countries and the region as a whole to leap to maturity and shake off the structural deficits, dependencies and the legacies of the past. As an insular region with a potential and a track record of instability within the Wider Europe, the Western Balkans are increasingly subjected to massive international and European interference on political, economic and security issues.

Structural deficits in institution-building and good governance are detrimental to the efficacy in the use of international assistance, whereas deficits in aid-absorption capability, aid dependency and misappropriation of resources weaken state's political authority and economic control. The need for legislative power and veto rights of the High Representatives in Bosnia and Kosovo contradict some basic requirements of democratization, civil-society consolidation and ownership in policy-making processes, but - then again - so would a democratic *carte blanche* for obstructionist political forces risking ethnic conflict and legislative inertia. The current window of opportunity for self-sustaining, legitimate processes in regional/national ownership underlines,

rather than negates, the pivotal role of the international community as the structural indigenous *weaknesses* and blockades in the reform processes persist.

Nevertheless, irrespective of the dire consequences an international disengagement would have, the international interference in national and regional processes has its own inherent *inadequacies* rooted in the externality of the assistance, guidance and control. External interference *eo ipso* contrasts to the imperative for indigenous capacity building and regional ownership of the process. Moreover, the intricacies of international interference and government deals are, by and large, exempted from democratic control and domestic transparency in policy-making. By inducing regional authorities to implement an agenda of reform priorities, external dependencies increase at the cost of domestic responsiveness, legitimization and accountability.

In view of the above catch-22 of indigenous weaknesses and international inadequacies, the “regional approach” and “regional ownership” have recently advanced to a cult status. The pooling of regional resources and the synergies of regional cooperation are identified as an alternative to both international interference with its potential negative side effects and to structural indigenous reform blockades. On a closer scrutiny, however, it becomes apparent that the regional level may be a pragmatic alternative for some policy issues rather than a panacea, as many structural problems have to be tackled on a national and/or international level.

Despite the experience in East Central Europe, and despite the far larger impact and potential side effects of external interference, the massiveness of international engagement and assistance for a relatively small region and even the formation of quasi-protectorates are often considered as causes for optimism on the national and regional reform process. Similarly, the stabilization of the countries of the region is often seen as a binary, irreversible process: once instability has been conquered, reform-oriented elites are expected to lead the way to stability, prosperity and Euro-Atlantic integration. In recent months, however, the Tetovo crisis in Macedonia forcefully demonstrated the fragility of stability: although it was the first country to meet the conditions for a Stabilization and Association Agreement at the Zagreb Conference in November 2000, a small number of rebels soon thereafter exposed the vulnerability and deficits of the Macedonian political and societal arrangements. Apparently, it is a fallacy to assume that the Balkans are currently at the crossroads between progressive stabilization and spiralling destabilization, or even that the region's vicious circle has at long last been replaced by a virtuous circle. Rather, both trends are intimately and causally linked. Paradoxically, the trend towards stabilization thus entails new, heightened risks of destabilization. Last but not least, the international community is not an external actor, as appealing to the interests and provoking specific reactions from the international community has become an integral part of regional politicking.

Disparities in stability and prosperity are bound to increase along the future outer borders of the European Union - abortive reform processes in some of these

neighbouring states with their long history of inter-state, inter-ethnic and inner-state conflict create a stale-mate situation with substantial risks for Europe as a whole. Failing or weak states and state-like entities in the periphery are potential victims of “conflict economics” and its double disruptive effects: the proximity of the prosperous enlarged EU and the availability of EU assistance creates the preconditions for “aid-dependency”, a creeping criminalization of the economy in these states and state-like entities. Coterries of political and business elites create vested interests in simulated reforms and reduced state authority. A destabilizing potential may become its only asset in order to access international assistance. Nationalist mobilization becomes a key instrument in the discrediting of reform strategies and the consolidation of a high level of instability and conflict with maximum scope for profiteering. At the same time, state weakness and abortive reforms result in a progressive pauperization of the population, a precondition for nationalist mobilization. In a number of cases unresolved issues of status and sovereignty add to the weakness of small states and state-like entities, elite coterries and simulated reforms.

The argument above runs counter to many a perspective for the transition process - thus, national movements may originate from elite considerations of economic and political profiteering rather than “righteous” motives of national self-determination for the populace. Identifying specific groups (usually the “conservative” communist nomenclature) or persons as the key culprits of non-reform or simulated reform ignores the structural causes of the problems. In contrast to optimistic views of post-communist transition, the downward spiral does not make failing or weak states short-lived by default. Quite on the contrary, the societal and economic basis for profiteering consolidates, the basis for a belated reform effort dwindles as the relative reform gap and the social costs increase. More often than not, international assistance purposively prevents a collapse because of the ensuing stability risks. In a way, structural disadvantages - an economically or geo-strategically unfavourable position and burdening legacies obstructing post-communist transition - are aggravated by external interference and assistance. Faced with strictly limited resources and capabilities, indigenous elites are forced to capitalize on the ambiguous position vis-à-vis the European Union and the international community. The elites may be tempted to appeal to the international community’s interest in regional stability and highlight the assumed destabilizing effects of reduced assistance that would be the consequence of their failure to meet criteria of democratic or economic reform. In a parallel process, a thorough criminalization of the economy and the administration promotes a recurrence of political instability, ethnic conflicts and socio-economic crises. Following the failure to meet EU criteria, the potential to generate regional instability remains the only fallback position for weak or failing states.

Thus, there is tension between the different sets of policies and strategic principles, sometimes within one field (crisis management, regional stabilization, reform assistance and integration perspectives) of international interference, sometimes

between them. Official policy documents, more often than not, fail to address these concerns by prioritizing or harmonizing conflicting principles. These conflicts may be summarized in five dilemmas:

The dilemma of regionality and conditionality concerns the dichotomy between the general European principle of conditionality, which requires each individual country to meet a set of criteria on a bilateral basis, and the principle of regionality, which requires the countries of the region to create synergies in regional cooperation, making progress towards EU association and eventually accession a collective undertaking. Conditionality implies individual privileges based on merit and thus contradicts the altruistic concept of regionality. This dilemma is exemplified by the Stability Pact - based on regional cooperation once some basic conditions have been met - and the Stabilization and Association Process - based on individual progress in meeting fixed criteria, with readiness to engagement in regional cooperation ranking low as a non-enforceable condition.

The dilemma of aid and peace building concerns the distribution of assistance: at least in the perception of the conflicting parties and social/ethnic groups in a divided society, international assistance is bound to be seen as favouring one party/group or the other. Whereas humanitarian and reform assistance may exacerbate regional and/or ethnic disparities or promote aid dependency rather than regional ownership, external crisis management may undermine the domestic legitimacy and authority in weak states. Thus, international aid may invigorate rather than alleviate conflicts and tensions by providing resources as an additional incentive. The conditional input of resources links this dilemma to the next, where remuneration criteria and priorities are key.

In a heterogeneous region, the dilemma of stabilization and conditionality concerns the growing disparities between countries with the better preconditions and consequently a more reform-oriented elite, on the one hand, and countries in adverse circumstances. But for the overriding motive of stabilization, the conditionality of Eastern (and Southeastern) enlargement requires a preferential treatment in terms of assistance and privileges for the more successful states in the region at the cost of exacerbating the deficits and backlogs of those posing key stability risks for the region as a whole.

The dilemma of participation and control refers to the conflict requirements for the ultimate decision-making (or vetoing) authority in political and economic transformation processes and indigenous capacity-building: on the one hand, the international community needs the handles to interfere in escalating political conflicts and to curb nationalist tendencies, while, on the other hand, nationalist and conflict-oriented strategies may represent a democratic majority.

The dilemma of speed and sustainability refers to the predominantly economic problem of balancing the speed of the reform process with the much needed for the elites engaging in reform policies social and democratic sustainability. Again, consideration of stability or integration may accelerate the process beyond the limits of popular consent.

The multifaceted international (and most of all, European) interference in the

Balkans, ranging from crisis management and regional stabilization to reform assistance and integration perspectives, implies specific challenges in terms of screening and evaluation – both for the efficacy and goal-orientation of external interference and for the implementation *in situ*. The general evaluation problem concerns the combined tendency of uncritical laudatory evaluations created by the institutional dynamics of the assistance process. International organizations, agencies and NGOs tend to give their own efficiency and reform impact an (overly) positive evaluation as they too are in competition for resources and political influence. Recipients in the region for similar reasons evidently echo these tendencies. Thus far the search for an evaluation mechanism, which is both unobtrusive and critical, has proven elusive: simulated reform, misappropriation of funds and corruption accompany international assistance.

The evaluation problem has another dimension in the case of the long-term EU accession perspective. So far, the screening mechanism accompanying the Stabilization and Association Agreements has not been specified and implemented yet. Along the lines of the Eastern enlargement, a Stabilization and Association Council and Committee have been announced along with the more general progress report for the process as a whole. The cumbersome controlling procedures of the Stability Pact funding, apart from being criticised for delaying necessary reform measures, point to the same unresolved strategic question. The screening criteria for the Balkan region will have to be in sync with the Copenhagen Criteria, but whereas a detailed screening based on the *acquis communautaire* would be premature, diverging sets of criteria would lead to duplication on the roadmap to EU accession. It seems doubtful whether screening mechanisms designed for regulated assistance and reform support can be adequate for the detection of fundamental conflict potentials and stability risks. At this point, the seamless European strategy combining crisis management and reform assistance is obviously still on the horizon.

From a broader perspective, the inevitability and normality of international interference in transformation processes should be underlined. Even though the interference is inescapable and without alternative for the Balkan region, the optimization of its beneficiality and efficacy, as well as the minimization of pernicious side effects, remains a key challenge.

Corruption in the Transition and Accession Countries

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 above dilemma of weak states and strong international support. Although corruption is as old as humanity, much has been said and done about this phenomenon in the East and Southeast European countries recently. In 1993, the Berlin-based NGO Transparency International was the first to highlight corruption as a key factor in economic and societal transition

(http://www.transparency.org/about_ti/history.html). By now, anti-corruption and good governance have become two recurring key issues in each accession country's annual EU Progress Report. Here is a quote from the 2002 Progress Report on Latvia (*Commission of the European Communities, 2001, p.19*):

The last Regular Report stated that corruption continued to pose a serious obstacle to the proper and efficient functioning of the public administration in Latvia. Since then, the government has remained committed to the fight against corruption. Some positive steps could again be noted, including at the conceptual level, in clarifying the institutional set-up and in implementing practical measures to counter corruption. After the adoption in 2000 of an anti-corruption programme and a conceptual document foreseeing legal and institutional changes, three working groups were established at the end of 2000 to draft legislation on political party financing and a new Anti-Corruption Law, as well as on the creation of a new anti-corruption institution. While the government decided in September 2001 to set up the Corruption Prevention and Combating Bureau, the respective Law still needs to be adopted by Parliament. The institutional set-up for the fight against corruption had already been enhanced with the creation of a Secretariat for the Corruption-Prevention Council in December 1999; however, many different institutions maintained responsibilities in the area of anti-corruption. In May 2001, the government adopted a revised Corruption Prevention Programme, which includes measures such as protection of whistleblowers, improvement of criminal procedures, internal audit and the system of financing of political parties.

Thus, 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. This long quote also illustrates the detailed prescriptions made for the national legislative and institutional framework for the fight against corruption and organized crime. Recently, with the main legal and institutional frameworks in place in East Central Europe and the Baltic states, a certain discomfort with the downright external imposition of these frameworks has induced a new approach. The terms "regional ownership," "sustainability," "public awareness," "codes of conduct" and "anti-corruption networks" have thus become fashionable.

In the states and regions of post-communist transition in Europe, links between corruption and organized crime are of great concern as they undermine democratic, social and economic reform, all the more so as state socialism implied the absence of public transparency and well-entrenched informal networks. No other world-region can match the conditionality and intensity of anti-corruption programs by international organizations and financial institutions. In the ten EU accession states, the current level of corruption does not pose a vital threat to the functioning of democracy, state

administration or the market economy. Indeed, after a decade of massive international input in the field of anti-corruption, implementing preventive and punitive strategies is now on the top of the agenda. The policy focus is on tightening control and regulations in corruption-prone “grey zones”, such as party financing, border and customs services and public procurement (Brusis, Kempe and Van Meurs, 2002, pp. 177-189).

Recently, the Council of Europe and the Organization of Economic Cooperation and Development (OECD) have provided more detailed normative templates as well as institution-building and policy implementation assistance. The Council of Europe, introducing a broad concept of corruption, has adopted Criminal and Civil Law Conventions on Corruption, a Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, as well as recommendations for the elaboration of codes of conduct for public officials. The Council of Europe’s Greco program establishes a framework for the implementation and monitoring of these conventions. The Octopus program provides advice to strengthen national institutional and legislative frameworks against corruption. Unlike the EU Progress Reports, Octopus country reports and recommendations are written by representatives of the same country. Octopus complements other activities of the Council of Europe in the field of standard setting (conventions and recommendations on corruption, money laundering, organized crime and cooperation in criminal matters), monitoring and evaluation. Well-founded critique and policy recommendations in Octopus or Greco country reports or in the framework of accession procedures for EU (and NATO) have often galvanized national authorities into action.

The fight against corruption begins with the creation of an adequate institutional framework, but it appears that informal institutions (e.g. business culture and its corruption-resistance as well as legacies of the past and the specifics of the transition period) have a significant impact on the success of anti-corruption measures. Despite (or due to) its aversion to market forces, the state-socialist economic system structurally entailed backroom deals and fraud – a legacy of the recent past, more present in some countries than in others. Administrative corruption has a strong tradition under state socialism, especially in specific sectors. These legacies of the past are inflated by the post-communist transition and certain consequences of the EU enlargement process. Under socialism the use of personal networks, bribery and corruption were a structural characteristic of economic and administrative dealings – “enticements” for administrative services were common practice, especially in monopoly positions with low-payment. Quite naturally, this legacy of the past has a high impact on corruption awareness and tolerance among civil servants as well as the public. Even if countries have similar formal institutions, corruption may differ because of differences in the informal sphere. Typically, the level of political corruption in East Central Europe and the Baltic states exceeds that in most of Western Europe, but the state functions reasonably well. In the period under review, cases of large-scale political corruption discrediting the legitimacy of key state institutions and democratic procedures or even

“state capture”³ have been rare. Despite this possible indication of a consolidation of democratic procedures and the effectiveness of public awareness, the region has witnessed some dramatic incidents of political corruption, involving conflicts of interest and corporate influencing. In the middle of the political transition, new institutions have to be created and rules of the game established – in the case of anti-corruption, without recourse to examples or experiences from the preceding era. A sustainable anti-corruption framework requires, furthermore, a broad political consensus of government and opposition. Typically, with the increasing sensitivity of the public on corruption issues, accusations of political corruption tend to become part of politicking, definitely so during electoral campaigns. The fact that election fraud remained below the visibility threshold in the recent polls, although party financing has occasionally aroused suspicions of political corruption and corporate favouritism, may be considered as an indicator of democratic consolidation.

The Risks of Corruption and Anti-Corruption Strategies

At first sight, the 1990s seem to have been a decade marked by a boom in corruption, embezzlement, cronyism and conflicts of interest – particularly in the states of post-communist transition. Conversely, some convincing arguments may be found to identify a boom in anti-corruption strategies and rhetoric rather than corruption as such (Kraštev, 2000 and Cisar, 2001). International organizations, such as the Council of Europe, OSCE and the IFIs, on the one hand, and surveys revealing high levels of public dissatisfaction with government corruptibility, on the other hand, have “domesticated” the fight against corruption, brought anti-corruption to the top of any policy agenda. Even utterly corrupt and reform-resistant politicians by now are forced to phrase their policies in the jargon of anti-corruption as an unquestionable norm and imperative.

Thus, in a classical pincher movement, each government of a transition state is compelled both by international organizations and the domestic civil society to adopt anti-corruption as a policy priority. Domestic civil society is mainly represented by NGOs with strong international ties and the relevant surveys are mainly conducted by international organizations and local affiliates. Whereas the European Union and other European organizations may favour an anti-corruption strategy based on institution building and checks-and-balances within the political and administrative system, US-based organizations tend to highlight the role of civil society and public transparency in controlling corruption and conflicts of interest in the administration and politics. Yet, while Americans demand “freedom of information” and Europeans “access to information”, the united front of anti-corruption is an undeniable political fact.⁴

³ “The efforts of firms to shape and influence the underlying rules of the game (i.e. legislation, laws, rules, and decrees) through private payments to public officials.” See Hellman et al. (2000, p. 14).

⁴ Observation at a workshop on democratization at New Europe College, organized by the Romanian Academic Society in Bucharest on May 6, 2002.

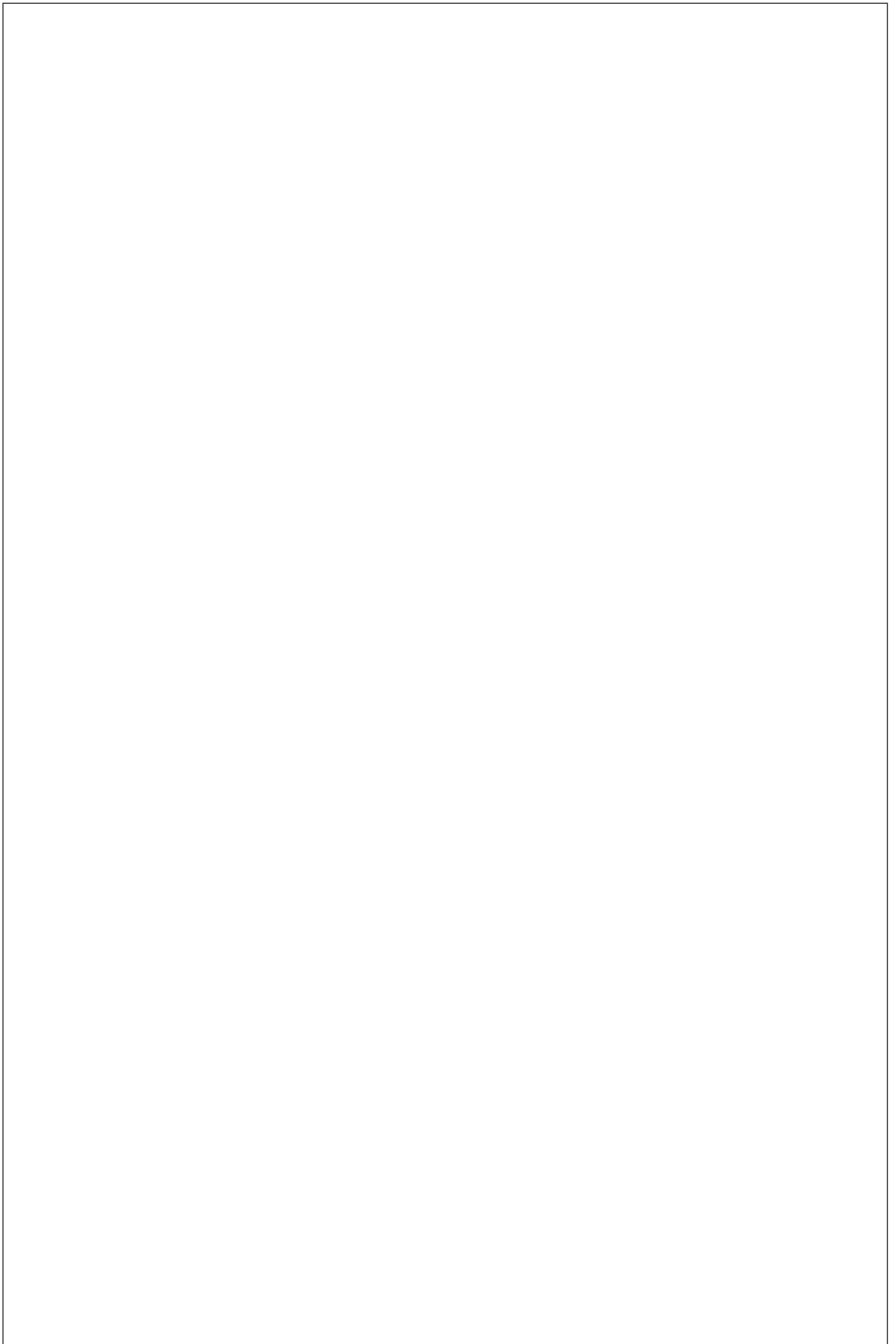
From the perspective of international strategies of political and economic transformation, the anti-corruption drive – i.e., the imposition of a universal norm as a short-cut solution to post-communist dilemmas - seems to be to some extent a corollary of transitology. As an independent variable with a high moral impetus, corruption came to represent an evil aberration hampering a successful completion of the transition or even – in the case of some countries – derailing the entire process. Thus, corruption – be it political or administrative, petty or grand – tends to become isolated from the broader picture with its complex intertwining of communist legacies, hardships of transition, weak states and disenfranchised citizens. Prior to the emergence of the economists' moral view of corruption in the 1990s, the informal economy had been given some credit for smoothening modernization and market mechanisms in post-colonial contexts (Krašteš, 1998). Currently, there is a drive for ever-more anti-corruption strategies and agencies, despite all reservations on effectiveness and unintended side effects (Lízal and Kocenda, 2000, and Hellman, Jones and Kaufmann, 2000).

The high proportion of citizens considering the national government, political parties and administration thoroughly corrupt in surveys legitimises the anti-corruption drive of international organizations and domestic NGOs (Global Corruption Report, 2001). More likely, the high rating of anti-corruption in surveys is a basic indicator for a whole range of democratic deficits, ranging from political cynicism and apathy to egalitarian leanings and frustrated expectations in transition. Whereas an iron rule seems to exist in Eastern Europe that reform governments are never re-elected, some unlikely politicians of dubious repute have played the anti-corruption card with much success in their electoral campaigns. Thus, studies investigating administrative corruption by recording citizens' personal experiences and confronting public officials in corruption-prone offices with the results to concretise motives and structural causes of corruption are more convincing than mere perception rankings and political declarations of intent. More often than not, corruption is in the end a flexible mechanism to cope with the failings of a weak state no longer (or not yet) willing or able to deliver.

In sum, what is perceived as corruption (for the lack of a better term) in the economies and government institutions of the states in transition is an integral part of the process, 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. Ill-designed and uncritical anti-corruption drives may be characterized by detrimental unintended consequences rather than (seemingly) quantifiable results in fighting corruption. National anti-corruption strategies and institutions constitute only one specific aspect of the corruption “quagmire.”

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CHAPTER 15

Corruption or State Failure?

Alina Mungiu-Pippidi

Fighting corruption in Eastern Europe should be part of a comprehensive accountability-building strategy in order to succeed.

‘Culture of Corruption’ versus Unfinished Modernization

The post-1989 reforms produced uneven results in Eastern Europe. Explanations of success and failure vary from author to author and school to school, but both those who blame structural legacies and those who allow a greater role for transformation management acknowledge that corruption remains an important part of the picture, in successful as well as less successful transitions. The regional survey New Europe Barometer 2001 shows, for instance, that countries invited to join the European Union in the first wave, such as Lithuania or Slovakia, perceive in similar numbers their administrations to be corrupt with countries lagging behind, such as Romania and Bulgaria (Rose, 2002). From ‘plan to clan’ or from ‘nomenklatura to kleptokratura’ there was no shortage of catchy phrases depicting various features of this phenomenon, commonly referred to as ‘corruption’. But is ‘corruption’ the right word to capture societies that seem to operate alongside formal rules altogether? We call ‘corruption’ the use of a public position to seek personal gain, but when generalized at the level of ‘state capture’, and those corrupted are elected and reelected in free elections, is this still a meaningful word? Quite a few authors have tried recently to cast a more anthropological look at these societies in order to understand the prevalence of informal institutions over formal ones, by resorting to various concepts such as social capital (Rose, 2000; Rose-Ackerman, 2001), unwritten rules (Ledeneva, 1998) and even ‘a culture of corruption’ (Miller, Grodeland and Koshechkina, 2001). Pioneering work into the nature of communist patrimonialism was undertaken by Ken Jowitt (1992,1993),

and his followers developed further the model of 'neo-traditionalism' of communist societies (Waldron, 1996).

This paper follows these authors, arguing on the basis of survey evidence from three Eastern European countries (Romania, Bulgaria and Slovakia) that a different paradigm, broader than 'corruption culture', is needed to explain, not just describe, the 'informal' essence of post-communist societies and conceive a policy against it. The data comes from a Freedom House-Romanian Academic Society survey on corruption and government accountability, but its relevance goes beyond these phenomena, shedding some light on the nature of the relation between state and society in post-communist Eastern Europe. More specifically, the widespread practice of bribing in dealings with the public administration in this part of the world needs to be understood as part of a more complex design. Rural post-communist societies have never achieved the stage of fully modernized societies, and their administrations have never reached the impartiality, impersonality and fairness supposed to characterize modern bureaucracies. Therefore, corruption manifests itself often not just by use of a public position to seek personal gain, but more broadly as widespread infringement of the norm of impersonality and fairness which should characterize modern public service. Providing discriminative public service as a general rule may not be prompted by financial gain only, but be the norm in societies dominated by groups of uneven power status. A favor may be granted to acknowledge superior status or establish one's own without money being even involved. The superimposition of communism on traditional rural societies led to a sort of neo-traditionalist or *status societies* governed by unwritten rules more than formal laws (Jowitt, 1992). The explicit modernizing design of Communism was doomed from the start by the essential contradiction embedded in the communist power structure, the legitimating of status groups such as nomenklatura enjoying political and economical monopolies, and by the enforcement of this inequality against the ideology. The three countries I look at in this chapter – Romania, Bulgaria and Slovakia – exchanged a peasant variant of status society (their share of peasants from total population was higher compared to the rest of Central European states even before the advent of communism) with a communist variant. This reconstitution of the basic features of a status society hinders importantly the development of an open society and a free market. Such societies are characterized by *unpredictable patterns of distributing social and legal rights from a rational standpoint, but fairly predictable for whoever is acquainted with the patterns of authority generating unwritten rules of the game.*

Max Weber (1978, pp. 177-180) originally defined status societies as societies dominated by status groups and ruled *by convention rather than law*. "The firm appropriation of opportunities, especially of opportunities for domination always tends to result in the formation of status groups. The formation of status groups in turn always tends to result in monopolistic appropriation of powers of domination and sources of income...Hence, a status society always creates ... [the] elimination of individual's free choice ... [and] hinders the formation of a free market". Considerable evidence gathered

from studies looking at the black market during communism, or the underground economy in post-communist societies enforce the idea that uneven distribution of power according to status (as an apparatchik, a “director”, a party member, a civil servant or state salesman in charge of distributing resources always in short supply, a member of an official group, from the Union of Writers and Journalists to a sports club) was rather the norm than the exception. As other resources or forms of social stratification had been *de facto* annihilated by the Communism regime, *status* (conceptualized here as the distance of an individual from the groups or networks holding power) became the main provider of social hierarchy.

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. Post-communist societies are complex societies: the legacy of communism often comes as this entangled mix of complicities in which victim and perpetrator have become difficult to tell apart. Unwritten rules prevail over written ones not only due to habit, but also to a less understood bounded rationality of their own. Widespread corruption is easier to understand if we see it as part of the more complex environment of an ‘informal society’, that is, a society in which informal institutions of power and power relationships are stronger and produce different outcomes than what one would expect by observing formal ones.

Method and Data

In line with this theoretical argument, this paper draws on surveys executed in three East European countries (Romania, Bulgaria and Slovakia) to, first, argue that we are dealing, although to different extents, with state failure, of which corruption is only a symptom; second, that business-related corruption is only a particular case of administrative corruption in general; third, that the public itself is part of the problem, being resigned to permanent administrative abuse and mistreatment; fourth, that despite this fact, institutional social capital lingers at a worrying level for the legitimacy of these political regimes, due precisely to the state failure to provide fair and satisfactory public services. Drawing on these findings, I will then advocate a set of recommendations to overcome this state of affairs, addressed to governments as well as international donors and civil society.

This policy paper draws upon a model of corruption in Southeast Europe based on empirical data. The source of most public opinion data used here is a survey of the Romanian Academic Society, sponsored by the Freedom House and World Bank Institute in Romania, Bulgaria and Slovakia, and measured in the spring of 2000 by national polling institutes in each country. The questionnaire was unique and the sampling technique identical. The sampling model was a two-stage random cluster sample. The sampling universe was the population of Romania, Bulgaria and Slovakia

aged 18 and over. The final sample included 1,237 respondents for Romania, 1,161 for Bulgaria and 1,011 for Slovakia.

I use two common measures of corruption in this paper. On the one hand, I asked people for their own assessment of corruption in society, which I call *subjective corruption*. On the other hand, I asked them to report their personal experience with corruption, which I call *corruption experience*. Both measurements are subjective, relying on one's ability to perceive, assess and report correctly situations that are not always clear-cut.

The first question (how wide-spread do you think corruption is in the public sector?) actually asks for a generalization from every respondent, regardless of his or her personal experience. From the point of view of survey theory, such a question is quite misleading, since it asks people to answer a query that they have little or no means to solve. Consequently, subjective corruption surfaces in models as associated beyond one's experience with social paranoia and should be regarded rather as a measure of institutional social capital. The second category of questions is not without problems either, since respondents are asked to report illegal behavior and there is practically no way to check their stories or to differentiate between an active party and a passive party (since corruption involves at least two actors). Two risks are obvious here, namely, that respondents would be tempted to underreport socially undesirable behavior, and that, while reporting it, they would attribute it to other sources than their own behavior, in order to avoid personal guilt.

Nevertheless, on the basis of a large number of regional and national surveys, it has been noted that the above-mentioned risks are smaller than one would believe. People seem to report corruption with no fear of consequences, probably as it is such a widespread phenomenon that prosecution becomes unlikely. Having said this, such risks are still present when addressing specific target groups, such as investors, since businessmen tend to be discrete on their own initiative and collaboration in acts of corruption. Furthermore, they often obscure the fact that the original motivation for bribing officials is not to defend some legal right of theirs, as with the ordinary citizens, but to obtain "favours", such as short cutting existing laws and regulations.

Corruption as the Grease of Public Service

The results display a picture of large-scale participation in bribe giving (see Table 1) as well as considerable lack of satisfaction with the administration and judiciary (Table 2).

While corruption experience varies considerably in the three countries, with Bulgaria doing better than the other two, subjective corruption, negative experience with civil servants and their low score of public trust, together with judges and MPs, are quite similar. Most of the respondents in the three countries report having been mistreated by a civil servant after the fall of communism; those who give a favourable assessment of civil servants, judges and politicians are well below a third of the total.

Recruitment of these groups in the three countries is done in a more or less similar way. Representatives are elected on party lists, not directly, as in majority systems, judges are appointed by a national authority and civil servants represent a mixture from the communist bureaucracy and new recruits. Public advertising of job openings in these sectors is exceptional: as a general rule, one gets a job as a civil servant by informal connections; open contests for jobs are organized only in order to create an appearance of competition (results are manipulated either by restricting information, inventing peculiar contest rules or at the stage of evaluation). Politicization of the administration runs deep, less from political interest in these low-key jobs, but because political parties are super-status groups, managing various influence monopolies and supporting a wide range of cronies.

TABLE 1: COMPARISON ACROSS SELECTED CEE COUNTRIES

	Romania	Bulgaria	Slovakia
Subjective corruption	69.5%	62.0%	64.3%
Experience with (frequency of bribe giving)	67.1%	29.1%	55.9%
Accountability index	1.75	2.64	1.51

Scale ranges from 0 – no response, to 5 - full satisfactory response (in terms of timeliness and content) at the request to provide the last year's activity report or an equivalent document addressed to all central government agencies. The country index is a simple average of the scores granted per national agencies queried. The index was built by SAR in 2000 in the framework of the same survey on accountability quoted.

TABLE 2: OPINIONS ON CIVIL SERVICE AND GOVERNMENT

	Romania	Bulgaria	Slovakia
Experience and trust in the civil service			
Mistreated by a civil servants after 1989	59.2	34.4	61.3
Members of Parliament work in the public interest	11.0	9.0	15.5
Judges work in the public interest	27.5	13.4	37.5
Civil Servants/Central Govt work in the public interest	16.5	15.1	25.9
Civil Servants/Local Govt work in the public interest	33.8	18.4	34.2

There is also a strong correlation between reported bribe and reported abuse by administration, which shows that bribe is often a consequence of mistreatment (see Table 4). People bribe because otherwise they would hardly get anything they need - in post-communist countries the dependence on the administration for an array of permits is considerably more extensive than in the West. Mistreatment is generally interpreted

as a signal to deliver a payment to the civil servant or public official. This works regardless of social status differences - the only variable which makes a difference is to belong to a minority status group or a network, which will connect you to the administration and turn the impersonal relationship into a personal one, which, on this particular item, includes 23 percent of the respondents (see Tables 3A and 3B). The likelihood that in this case one will get the service one needs done in a satisfactory manner is considerably higher.

TABLE 3A: SATISFACTION WITH SERVICE RECEIVED BY PERSONAL CONNECTION.

	Has a personal connection	Has no personal connection
Satisfied	77	62
Not satisfied	23	38
Total	100	100

TABLE 3B:

	Has a personal connection	Has no personal connection	Total
Satisfied	35	65	100
Not satisfied	19.6	80.4	100

Chi-square association test significant.

Source: Barometer of Opinion Romania 2001, Metromedia.

TABLE 4: ASSOCIATION BETWEEN ADMINISTRATIVE ABUSE AND BRIBE GIVING

Predictors	Non-standardized coefficient (Standard error)	
How often did you have to bribe?	.6410	(.2200) ***
Wealth	.4310	(.0300)
Age	2.504E-02	(.0340)
Size town	2.214E-02	(.0270)
Education	-3.605E-02	(.0440)

*Noted significance levels: * = $p < .05$, ** = $p < .01$, *** = $p < .001$*

Linear regression with dependent variable 'Have been mistreated by an official after 1989?'

The reason to exist of the public administration is to provide services to every taxpayer, but it fails to do so on a large scale in many East European countries. Corruption is the means by which the best networked and the well off (usually one and the same), manage to obtain what is more often than not *normal* treatment. The public sector should, of course, provide such treatment on a general scale to every tax-paying citizen, but it fails to do so, either from objective lack of resources (the case of health care), or from lack of effectiveness (police), accountability, or both. *Bribe is therefore a*

supplementary tax paid to obtain normal public service, and as such, it is an indicator of lack of institutional performance.

Moreover, when correlating bribe giving with consequent satisfaction with the service received the survey finds a *negative* association, meaning that people on one hand dislike bribing, and on the other that even bribing fails to make the administration more efficient, being inferior to having a personal relationship or belonging to the right network of people to make dealing with the administration easier (see Table 5).

TABLE 5: ASSOCIATION BETWEEN BRIBE GIVING AND SATISFACTION WITH SERVICE DELIVERED

Predictors	Non-standardized coefficient (Standard error)
Bribe giving	2.31 (0.35)***

Dependent variable: Satisfaction with service after bribing.

*Legend: * predictor significant at $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$*

Corruption is commonly defined as the grease of commerce. Evidence coming out of these surveys is that of *the grease of public service, not business*. In none of the three samples could I find any correlation between being engaged in business and bribing. It is not the reinvention of business, which prompted corruption in post-communist Europe; it is the survival of the communist times' organization and culture of administration. Business-related corruption may be the one involving the largest amount of money, but corruption related to everyday life and the public service, which the administration is supposed to deliver, is the one burdening people.

TABLE 6: CROSS-TABULATION OF 'ENGAGED IN BUSINESS' WITH 'HOW OFTEN DO YOU HAVE TO BRIBE?'

	BUSINESS		Total
	yes	no	
Always	13.5%	13.8%	13.7%
Varies	57.1%	52.9%	53.4%
Never	27.1%	28.2%	28.2%

* Romanian sample only.

Another poll of the World Bank in Romania reported encounters with corruption of 38 percent among civil servants (self-reports of being offered bribe), 42 percent of the public, and only 28 percent of businesses. Even if the businessmen in the sample played down encounters with corruption, thus playing down their own involvement, a clear sign of weakness of the instrument, it is clear that business-related corruption does not carry the bulk of the phenomenon.

The Abused as Part of the Problem

In this picture of generalized bribe in ordinary dealings with the administration it is obvious the public plays a large part. Despite having only a minority agree that you must always bribe to get what you need (Table 7), it is obvious that the public at large is not revolted by the system and fighting it, but rather resigned with its arbitrariness. Abusive treatment one by the administration is not general (Table 8), but simply arbitrary and unpredictable, as synthesized by the answer: "Depends on the civil servant you encounter". One never knows the treatment one will get from the administration, usually it turns bad if you do not have a personal "connection", so you have to bribe, it may not work even after that, but then it may work even without bribing if you are lucky. It is like the weather or God's will: one never knows where one stands. And arbitrariness confers power of the civil servant over the citizen, even more than in communist times. Most rules and practices in the administration, despite frequent changes of legislation, still originate in communist times, because legislation reform did not reach into micro-management of state agencies. And arbitrariness confers power to the civil servant over the citizen, even more than in communist times. Despite frequent changes of legislation most rules and practices in the administration still originate in communist times, because changes of legislation did not include all regulations for the state agencies. Even the philosophy stayed the same: in the new oath Romanian civil servants take according to the 188/1999 Law of the Civil Service, prompted and supported by the European Commission, there is no word of the public as being the consumer. Quite on the contrary, the civil servant swears allegiance to the country and to his superiors. No wonder, the combination of tight and uneven access to public services with the decrease of accountability, which followed the fall of the dictatorships, led to an increase of petty corruption. There was no other tool available to the ordinary citizen to make the administration work and be reliable.

TABLE 7: HOW OFTEN DO YOU HAVE TO BRIBE?

	Romania	Bulgaria	Slovakia
	%	%	%
Always, if you want things done	13.7	1.3	8.2
Sometimes	53.4	28.3	47.7
Never	28.2	66.2	39.8
No answer	4.7	4.1	4.4
Total	100	100	100

Nevertheless, only a minority is part of informal networks, connected to those, who can award public services as favors; in addition, not everybody has the resources to bribe. Where does this leave the rest of people? How do they react when they need something? Answers in Table 9 show that the majority simply accepts being abused by a civil servant

just like they would have acted under communism out of fear of political repression. Slovaks are the most self-assertive in asking for their rights, followed by Bulgarians. Romanians prefer to try to bribe more than to fight back, but the majority of people in all three countries is simply “letting it rest” when it happens as still the safest solution.

TABLE 8: WOULD YOU AGREE THAT THERE IS NO FAIR TREATMENT WITHOUT HAVING TO BRIBE SOMEONE?

	Romania %	Bulgaria %	Slovakia %
Definitely yes	14.1	10.8	7.7
Depends on the civil servant you encounter	53.4	34.2	57.2
Rather not	22.3	32.6	18.0
Certainly not	10.3	6.9	11.5
No answer	0.0	15.6	5.6
Total	100	100	100

TABLE 9: IF MISTREATED BY A CIVIL SERVANT, WHAT IS YOUR REACTION MOST LIKELY GOING TO BE?

	Romania %	Bulgaria %	Slovakia %
Complain to the proper authorities	12.5	25.4	35.2
Offer him something to get a fairer treatment	23.0	4.6	9.3
Let it rest	39.3	40.4	41.7
Other	5.4	3.3	
Does not apply	19.8	10.4	
No answer	0.0	15.9	13.7
Total	100	100	100

TABLE 10: DO YOU KNOW WHERE TO FILE IN A COMPLAINT IF MISTREATED BY THE FOLLOWING CATEGORIES OF PEOPLE ? (PERCENTAGE REPRESENTS THOSE WHO DO KNOW)

	Romania %	Bulgaria %	Slovakia %
Civil servants at the local government	60.6	49.1	63.6
Tax officers	44.1	39.5	50.0
Telephone company	57.0	28.5	73.7
Court	45.7	24.4	50.5
Mayor	37.6	36.0	55.6
Doctor/medical staff	54.9	51.6	73.7
Member of Parliament	18.8	17.5	28.8
Central government agency/institution	19.6	19.2	30.5

The reason people do not complain or fight back administrative abuse is that, on the one hand, channels of accountability are simply not there for the people to use, or they are inaccessible to the poor and least educated people. Most people know where to go to complain of local governments, but do not know of any channel for complaints against national government agencies, courts and the almost universally disliked members of Parliament, who enjoy the lowest trust of every professional category.

A competent and demanding public is needed, however, to take advantage of the channels of accountability when available, or ask for them when they are not. Abuse of the governed by governments persists due to the low civic competence and participation of the governed. By civic competence I mean a citizen's awareness of his or her own rights and the corresponding active attitude in making these rights respected. I created a correspondence analysis index of 'civic competence' made of:

- behavior when mistreated by a civil servant;
- attitude when witnessing bribe given or taken;
- awareness of accountability mechanisms the public can resort to if abused by the local government, local tax office, phone company, the courts, the mayor, hospital, Parliament and Government.

Two classes of individuals surfaced after correspondence analysis: individuals, who complain when mistreated, know where to complain in the case of most public institutions; they report corruption when encountered, try to talk out or avoid the persons involved (competent, 28, 4 percent), and individuals, who are unaware of accountability mechanisms and let the matter rest, when they encounter abuse or corruption (incompetent).

What determines civic competence? Individuals, who are generally young, educated, relatively well off, residing in urban areas and more competent politically (factor score made of self-assessed interest in politics, reading or watching political reports in the media, and discussing politics with friends and family) tend to be more competent. Considering the practice of giving gifts acceptable only as a token of gratitude completes the picture. For the rest, the three countries we surveyed differed. Romanians and Slovaks tend to attribute corruption to the low moral standards of the people, while Bulgarians are more likely to blame the institutions.

The final picture is clearly that of a population used to being abused by government, with less than a third exploring channels for defending their rights and dignity. The situation is enforced by state dependency, as the majority, which is not civically competent, is made of people living on state pensions or other entitlements, dependant on the postman who delivers the monthly paycheck, the local government official who would grant the approval to install gas in one's kitchen or distribute vouchers for domestic or agricultural work. This picture is confirmed when explaining subjective corruption.

A glance at a basic model of subjective corruption shows that the perception of widespread or general abuse is mostly encountered in less developed regions and more

in urban than rural areas (Table 11). There is also a strong correlation between subjective corruption and trust in the public sector (Mungiu-Pippidi, 2000). More than a measurement of corruption, it can be seen rather as an indicator of institutional social capital. High subjective corruption indicates low social capital. Institutional social capital is lower in cities than in villages and in poorer areas than in developed ones.

TABLE 11: DETERMINANTS OF SUBJECTIVE CORRUPTION

Predictors	<i>Non-standardized coefficient (Standard error)</i>	
<i>Village and small town</i>	-0.058	(.020)***
<i>Age</i>	-0.054	(026)**
<i>Education</i>	0.029	(010)**
<i>Regional development index</i>	-0.003	(.002)*
<i>Income</i>	-0.000	(.000)*

*Noted significance levels: * = $p \leq .05$, ** = $p \leq .01$, *** = $p \leq .001$*

Undermining Institutional Social Capital

Institutional social capital is conceptualized in this paper as simply the aggregated public trust in public sector and state institutions (Knack, 1999, Newton and Noris, 2000). This narrow definition does not include, therefore, any unwritten rules and the practices of citizens in their dealings with the administration. By making a distinction among the two, I try to stay clear of the usual causality problem of social capital theory and distinguish clearly dependent from independent variables in this complex picture. I side with those who warn that including everything under social capital renders the notion itself meaningless (Ostrom and Ahn, 2002). Equally, I resist the idea that self-serving networks which take advantage of the state and its resources should be seen as particular forms of social capital. On the contrary, the existence of such networks undermines social trust and makes people cynical towards the newly proclaimed and barely inaugurated rule of law. The general accepted norm of fairness and trustworthiness which serves as the framework for fostering collective action for potentially each and every person in any possible combination should be contrasted with closed status groups or informal networks acting at the expense of others. The former fosters trust, honesty and development; the latter perpetuates mischief, distrust and inequality of opportunity. The government and the class of administrators have an essential role to play in order to assure the passage from the status society inherited from communist times to the essentials of a modern society. The public is aware of the lack of fairness of the society and does blame it on the government (see Table 12).

TABLE 12: ROMANIAN PUBLIC OPINION ON LAW AND LAW ENFORCEMENT

<i>Variables</i>	<i>Yes</i>	<i>No</i>	<i>Don't know</i>
Laws are currently enforced and binding	12	85	6
All citizens are equal in front of the law	17	78	5
Laws are proper and fair	28	65	7

Source: Metromedia Barometer of Opinion.

With a notable exception (Della Porta, 2000), most of social capital literature, follows in the steps of Putnam to assume that basic or structural low interpersonal trust undermines public trust, collective action and development. Although a lengthy discussion is needed here to clarify these relationships, for the purpose of this paper I will only show that mistreatment of the administration, therefore direct negative experience, is undermining social capital even in a complex model testing also interpersonal trust, frustration with social disparities of the transition and residual communism. Negative experience with the administration predicts low institutional social capital in all the three countries surveyed.

The three models in Table 13 test, therefore, our hypothesis that administration or government behavior directly undermines social capital. Other causes of low trust in the public sector may be grouped according to three basic factors: frustration with the transition, measured by the comparison of one's current living standard against that under communism and envy towards those who did better; ideology and residual communism, which may still influence the perception of the public sector by the citizens; individual performance, as it was mentioned above that civic competence makes a lot of difference in the way a citizen handles his or her relationship with the administration. To avoid colinearity, I did not use the factor of civic competence created, but a factor score of political competence, one's inclination towards trust in others (interpersonal trust), and one's membership in various associations. The last two are widely tested in the social capital literature. Finally, we used the direct questions on mistreatment by a civil servant as a proxy for administration's performance.

Models varied slightly from country to country, but the state performance hypothesis remained stable across the three of them. Each of the hypotheses was validated or revalidated to some extent. Some degree of frustration with the socially painful transition is visible in all the countries, as is the personal factor. Individuals, who are more politically competent and higher on interpersonal trust, do tend to give more credit to the state as well. Those who score high on residual communism are more likely low on social capital in all the countries. Frustration with transition, including an association between poverty and low social capital, is stronger in Bulgaria; lower social trust in urban areas as compared to rural areas surfaced again in Romania as well as in Slovakia in simpler variants of the model. This finding goes against the bulk of traditional literature which states that peasants, not urban dwellers, are those distrustful,

TABLE 13: ASSOCIATION BETWEEN INSTITUTIONAL SOCIAL CAPITAL AND ABUSE BY ADMINISTRATION	
<i>Independent variables</i>	<i>SLOVAKIA</i>
	<i>BULGARIA</i>
	<i>ROMANIA</i>
	<i>Status</i>
EDUCATION	-0.041 (0.031)
WEALTH	-0.008 (0.008)
AGE	-0.000 (0.001)
TOWN SIZE	0.018 (0.051)
MALE	0.045 (0.051)
REGIONAL DEVELOPMENT INDEX	
	<i>Frustration with transition</i>
Subjective welfare	0.262 (0.097) **
Social envy	-0.071 (0.026) **
	<i>Individual civic competence and trust</i>
Civic membership	-
Interpersonal trust	1.312 (0.135) ***
Political sophistication	-0.050 (0.034)
Ideology and residual communism	
Self-assessed ideology	-0.022 (0.027)
Communism good idea	-0.072 (0.028) *
	<i>State performance</i>
Abused by a civil servant	-0.149 (0.051) **
Adjusted R ²	0.18

Significance level: * = $p \leq 0.05$, ** = $p \leq 0.01$, *** = $p \leq 0.001$
 OLS Regression with dependent variable 'Is the state to be trusted?'; Non-standardized coefficients with std. errors in parentheses.

but it is well in line with my general hypothesis. It is in the recently urbanized areas, where local governments face more complex tasks, where citizens are more self-assertive and rural and urban life styles meet, that the clash between the government and the governed is more likely.

Does it make sense to call this phenomenon “corruption” after all? The plain answer is no. Framing this as individual derailment from a general norm of impartiality and fairness can lead to the wrong anti-corruption policy, because it implies the accent should be put on repressing deviant individual behavior. But as this inevitably fails, as the same informal networks cut across judiciary and law-enforcement agencies, it means that the only people who can occasionally be touched by a repressive policy are those who, rather exceptionally, are not part of any network or status group.

Miller et al. (2001, pp. 289-299) have recently proposed a comprehensive and general set of solutions: downsize the state, improve openness and transparency, empower citizens, improve administrative efficiency, encourage officials by salary increases and impose tighter control and stricter penalties. Most assistance programs can claim they already cover some part of this vast program, but to little effect. More than general objectives, even those on which there is some agreement, concrete instruments seem to be missing. Some are emerging, however, from the best practice on ground and should be considered within the general framework of fewer regulations and better enforcement of those remained in place.

One Agency to Bind Together Administrative Ethics and Performance.

Too many pieces of legislation compete and overlap already on corruption and accountability, while crucial areas remain not addressed at all. The civil servants laws are lengthy, wordy and failed miserably to prevent cronyism and politicization. More often than not, they do not cover conflict of interest properly, not even while the person is in office, not to speak of periods immediately before or after. They carry no penalties for infringement of incompatibilities between the position of civil service and “economic activities” other than, at worst, dismissal. The issue of efficiency is not at all addressed in these laws. Other legislation, especially to regulate conflict of interest, is missing. Conflict of interest is not only a widespread practice in these countries, but it is legal in many cases and embedded in the new legislation knowingly and unknowingly. The law of public television in Romania (1998) allows producers to sit in the supervisory board, therefore approving their own shows and budgets, for instance.

What could help is the adoption of one clear, legally binding for the whole public sector, code of conduct to spell not only regulations, but also norms and desired practice, and to provide a comprehensive guide for every situation. Models are available, such as the Code of Conduct of the American Federal Office for Government Ethics. Not only does such a Code need to be adopted, but also an agency must be

created and empowered with its enforcement (Office of Ethics). This agency should be an autonomous body, with special status to protect agents from political interference and a head appointed by the Parliament. The main task of the Office for Ethics will differ from that of the Ombudsman, which pleads from keeping the two separate: not the pursuit of infringement of good conduct, but the implementation of standards of conduct fully, agency by agency. This means setting performance targets, creating indicators and organizing feedback from consumers on a regular basis. As part of the European integration process, certain bodies were created under the banner of continuous education of civil servants, for instance, but without any mention of ethics and performance whatsoever. Bringing together the ethics and the performance of the administration in one agency makes sense, as the two are strictly related.

Making Transparency the Norm

Good anti-corruption strategies must grant an important role to instruments already at hand. The Freedom of Information Acts (FOIA) adopted in these three countries are virtually accountability bills, asking every public agency to make every record transparent and to publish a yearly report on the spending of public money. They also require that every non-classified piece of information should be made public ex-officio. If these Governments are serious about an anti-corruption, they should thoroughly implement FOIAs. If tender procedures and motivations for selecting winners were made accessible to the public, many acts of corruption would be prevented. Political will is best shown in the using of already available tools, not in the proposal of further strategies or legal drafts. Here is the test case for the Governments. There was also intense activity from the part of the civil society in advocating for these bills and assisting implementation. In the most advanced case, Bulgaria, there are clear indications that the bill is working. The governments must continue implementation. For the larger South-Eastern area a good spill-over effect is already at work, with Serbia moving to adopt a FOIA with the assistance of Romania and Bulgaria. This best practice should be moved further to the East in post-Soviet countries, whose administration is plagued by a similar disease. But for the implementation to succeed, it needs a coalition of the media and NGO community to act on behalf of consumers.

Empowering the Consumer through NGOs Acting as Ombudsmen and Auditors

The majority of citizens who complain of abuse by the administration suggest that the philosophy “the public is our customer” is far from gaining acceptance in the administrative culture, not to speak of implementing it. Assuming that the public agencies will meet some success in achieving the objectives set for the first year of FOIA implementation, at least formally, by publishing some documents, the public will

have the possibility for the first time to read the spending report and the budget of public agencies. However, most of the public is neither willing, nor competent, for such a task. What is needed, therefore, is some intermediate agent to act *on behalf* of the public, competent enough to check expenditures reports, but independent enough to be able to follow suit in any event. It may turn out that the reports are fair and accurate, and this must be made public by an independent source, since the lack of trust in these citizens in their public institutions is notorious. Or, alternatively, it may turn out that they are not fair and accurate, or that essential data is missing or misused, in which case action must be taken. However, reading a budget and suing the Government require certain skills. Thus, the solution is to have intermediates acting on behalf of the public, local NGOs or other community organizations (such as Chambers of Commerce) checking reports and filling complaints on behalf of citizens, in the first years after the enactment of the law. In Bulgaria this is working already, with organizations such as the AIP (Access to Information Program) or NGO Ombudsmen assisting reform of municipalities. But this best practice needs to be spread. The differences between assisting implementation and letting it go on its own can be seen in other countries. In Albania, where the law was adopted hastily, after insistent international advocacy, then left to itself, nothing changed, and, after several years have passed, it is hard to dig it out from public indifference and skepticism.

Making Representatives at Least Look Accountable

Politicians in these three countries are perceived by the public, justly or unjustly, as being above the law. Representatives deserve a special chapter, as they enjoy the lowest position in public trust, and the public is outraged by the fact that they approve their own budget. Instead of trendy projects to change the electoral system to a first-past-the-post systems (to escape the party list allegedly responsible for the lack of accountability), more accessible steps can be taken to the same end. These include a more restrictive approach to parliamentary immunity and making votes in the Parliament more transparent, American-style (the represented should get to know how their representative voted on a certain bill, which is not always the case now). Both would help to make representatives more accountable in the eyes of the public, if only to a limited extent. Of course, nothing can substitute parties' reform to drag East European political parties out of the low confidence area they have been in for the past decade, but this is already another story.

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