

# **Barriers to Participation: The Informal Sector in Emerging Democracies**

*The Case of Hungary*

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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.<sup>1</sup> The economy was liberalised relatively fast, several restrictions and state control over foreign trade, currency issues, licensing, investment and employment was released. 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. Even at the beginning of the transition process benefits of having a registered business were higher than the costs of registering and operating a business.

What happened next is a kind of challenge to the simple interpretation of the role of transaction costs. Transaction costs of registering and operating a business (including money, time and effort) slowly, but safely started to grow for two reasons, *a*) regulation on licensing became more and more extensive; *b*) enforcement of declaring a higher proportion of income became more intensive. This means that although, generally speaking, tax rates became somewhat lower, taxes and contributions were paid after a higher proportion of income. At the same time, most of the estimates say the share of the informal sector in the Hungarian economy has decreased in this period, with other signs like number and quality of tax returns, and less cases of non-payment problems also supporting this statement. At the first sight, this seems to be a contradiction. Higher transaction costs and lower share of informal sector?

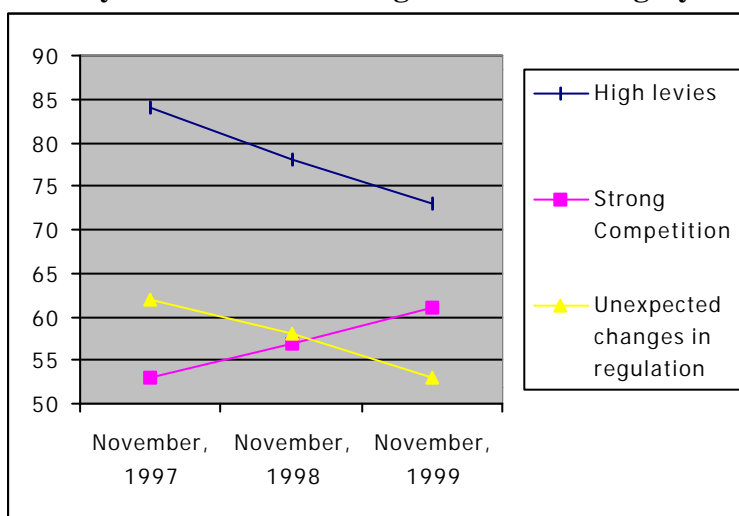
One potential way to address this contradiction is if we think about transaction costs in relative terms, and not as amounts of time and money derived from what the rules say. The key notion is learning process. If entrepreneurs learn to comply with the existing rules the actual level of effort may

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<sup>1</sup> Authorities had to survey all pieces of regulation they had issued before, and find good arguments if they wanted to keep them alive.

be lower even if obligations prescribed are more complicated. **Chart 1** shows, 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, showing that they spent 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. So one of the key elements of making formality more attractive is to reduce the role of income redistribution systems. This happened in Hungary from the mid nineties (see **Chart 2**). The explanation for this is not only the lower level of income centralisation and a more stable legal and regulatory environment, but more importantly the improved capacity of SMEs to comply with the rules.

**Chart 1**  
Intensity of Obstacles of Doing Business in Hungary



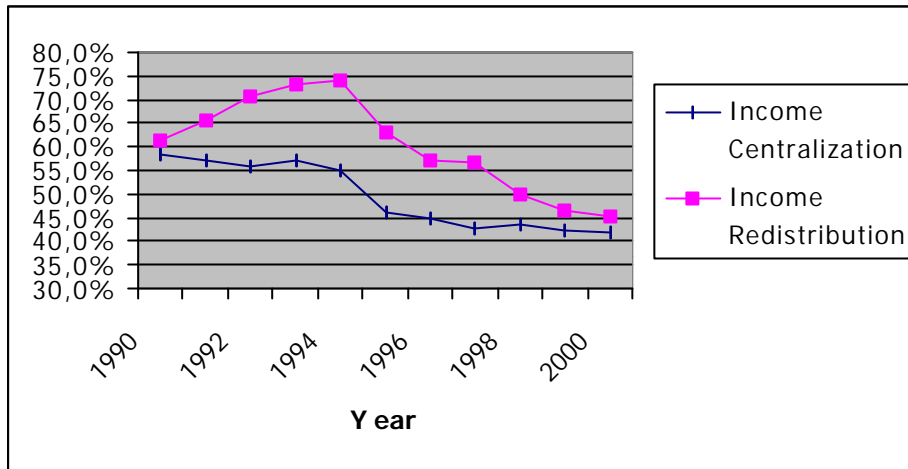
Source: Business survey data by the Institute for Small Business Development

Taxation is always one of the most problematic issues for SMEs. More than 70% of 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 probable of acceptable quality. For the majority of businesses complying with the rules of taxation and paying social contributions means consulting with the accounting firm they contracted with not only keeping the cost of compliance low but also reducing the risk of additional expenses coming from being fined for errors and mistakes in the tax returns.

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

**Chart 2**

**Level of Income Centralisation and Redistribution in Hungary, 1990-2000**



Source: Official budget statistics

Income centralisation = 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 the 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, there seems to be a kind of development in the actions of the government and the Parliament which contributed to turn back the increase of the informal sector. The key points are minimising registration costs at the beginning of the transition process, with providing the opportunity to deduct costs from the tax base, compensating high tax rates, in a sense, by following a not very consequent and rigorous tax collection practice. Later on, when the early transition crisis was over, economic growth started and the number of registered businesses stabilised, the government started to send signals to the small businesses indicating what is 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 is a gradual increase if the proportion of formally declared income. An other element of this strategy is, that the level of minimal payment (mainly social security contributions) has been raised year by year.

How can governments be motivated in trying to push down income centralisation, what is a 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 communities of the society to reduce levies, leave more income at the entities it was originally

produced at.<sup>2</sup> This resulted in a political bidding process by political parties about reducing income centralisation, becoming especially intensive during election campaigns indicating, that reducing government involvement in the economy is easier if it is a widely shared value in the society.

### **Comparison of Two Stages**

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

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

### **Lessons**

1. Making distinction between the following the types of activity is important.

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<sup>2</sup> This message was often weakened by requests for more funds from the budget by the same interest groups.

- business aspects of criminal activity (like trade of drugs, illegal weapons)
- business activity where the only income is from cheating taxes (illegal oil trade, reimbursing VAT with forged invoices)
- and informality (not registering a business or tax evasion of otherwise normal business activity)

Against criminal activity the whole range of enforcement strategies should be used including adequate legislation, efficient organisations and low tolerance. Almost the same should be done with activities where the only source of income is cheating with taxes, the only difference is that the reason of these activities are very often the weakness of legislation.

Unregistered business activity or tax evasion should be treated in a different way. People who are in the informal sector can not shift to the formal one overnight. Institutions can not be reformed from one day to another, democratic processes need time, and understanding and applying to the new rules is a learning process. So, governments may consider to be tolerant, provided there is a clear and continuous development towards the strategic goal, the efficiently working formal economy.

## 2. Timing and sequencing of policy measures is important

The first strategic goal can be getting businesses to be registered 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 them further benefits of being formal. High tax rates and rigorous enforcement practices in this phase may neutralise low entry cost. Complying with an increasing amount of rules may be a result of a several-year-long gradual process.

## 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. Considering informality as a hidden support (a kind of tax exemption) for the local business does not work on the long run, because it distorts allocation decisions and disintegrates the economy.