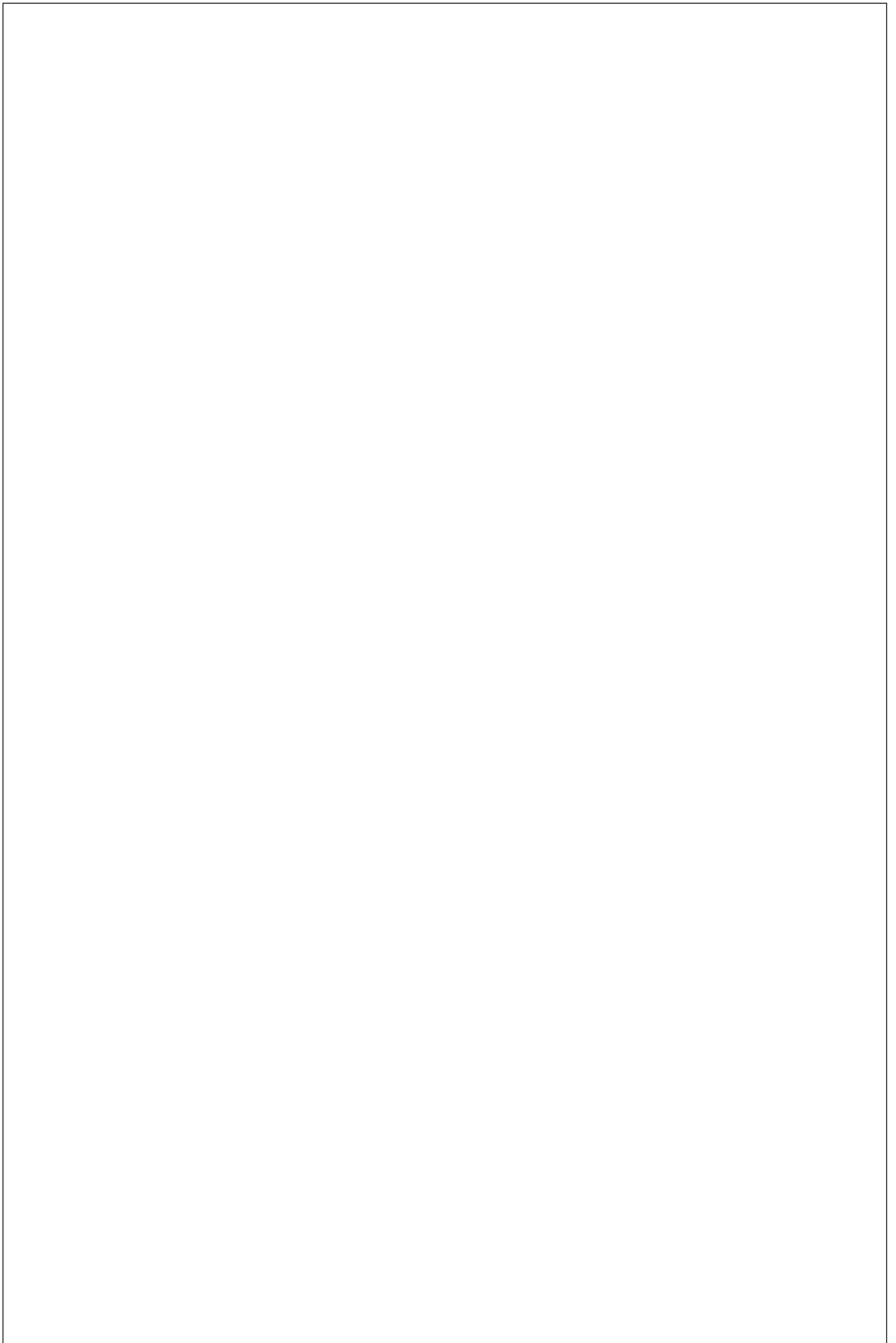


# **The Informal Economy in Southeast Europe**



## CHAPTER 10

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

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### **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<br>of<br>households | Declared income        |                          | Desired<br>income<br>$H^*$ | Potential<br>informal activity<br>$H^* - (V_b + V_s)$ |
|--------------|----------------------------|------------------------|--------------------------|----------------------------|---|
|              |                            | Main activity<br>$V_b$ | Second activity<br>$V_s$ |                            |   |
| $V < H^*$    | 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<br/>V<sub>b</sub></i> | <i>Second activity<br/>V<sub>s</sub></i> | <i>V<sub>a</sub></i> | <i>H</i>               | <i>Main activity<br/>V<sub>b</sub></i> | <i>Second activity<br/>V<sub>s</sub></i> | <i>V<sub>a</sub></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

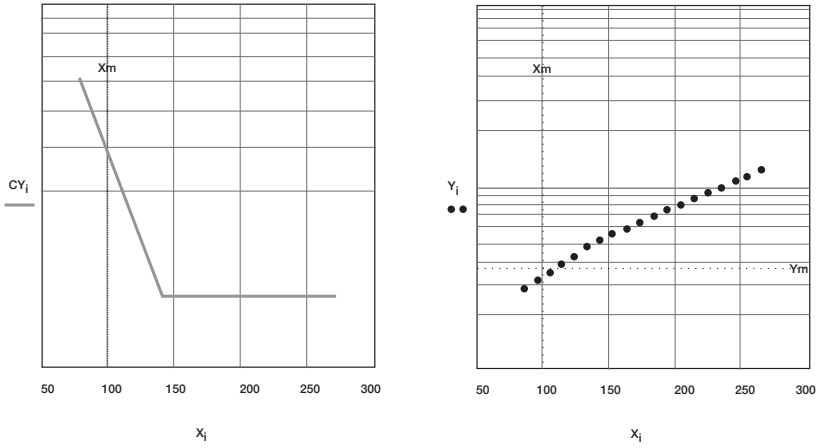


FIGURE 1b

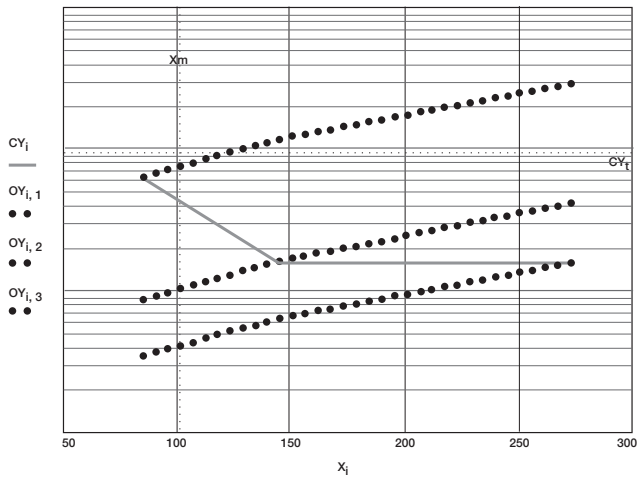


FIGURE 2a

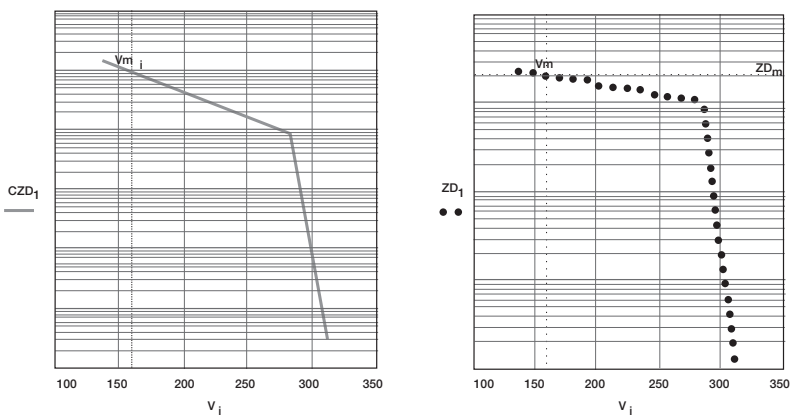


FIGURE 2b

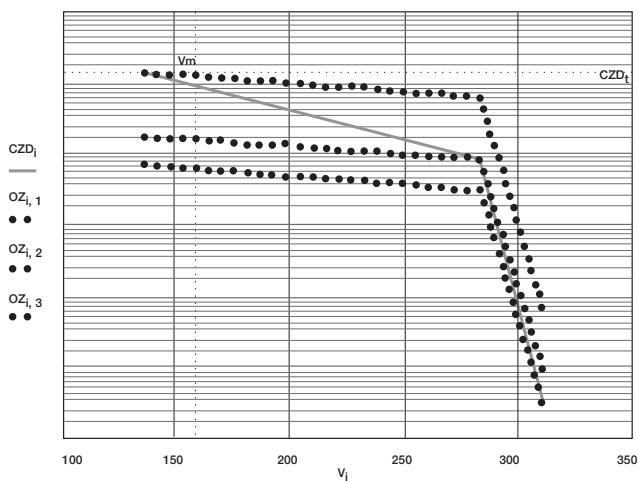
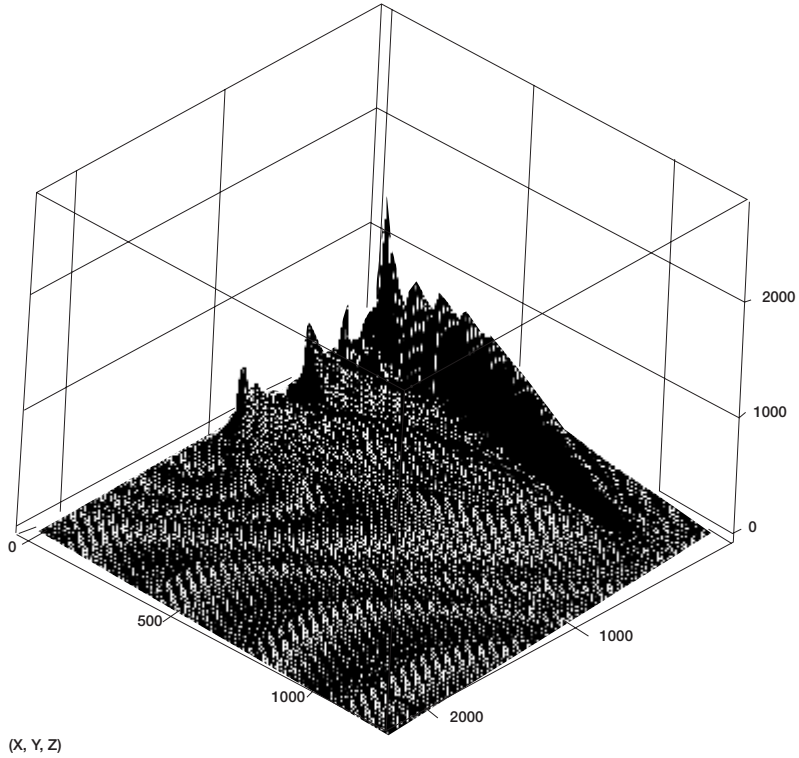


FIGURE 3



### 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

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

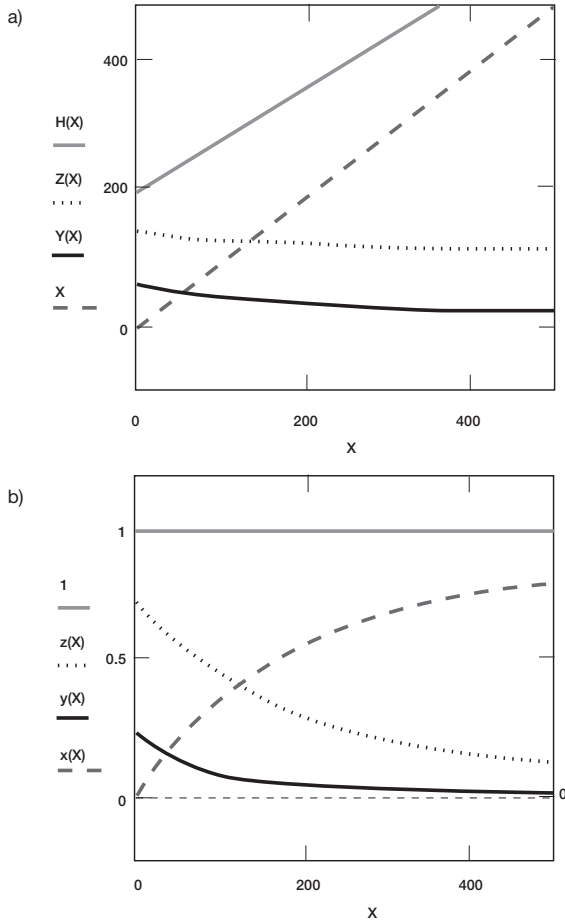
was used as a constraining relation and

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

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.

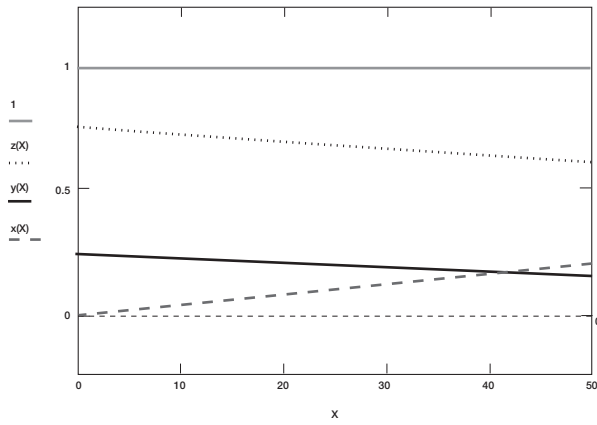
FIGURE 4



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

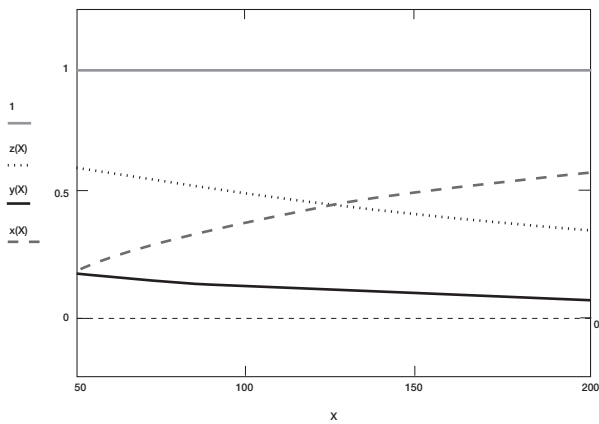
1) Transitional regime from  $z-y-x$  to  $z-x-y$  (Figure 5)

FIGURE 5



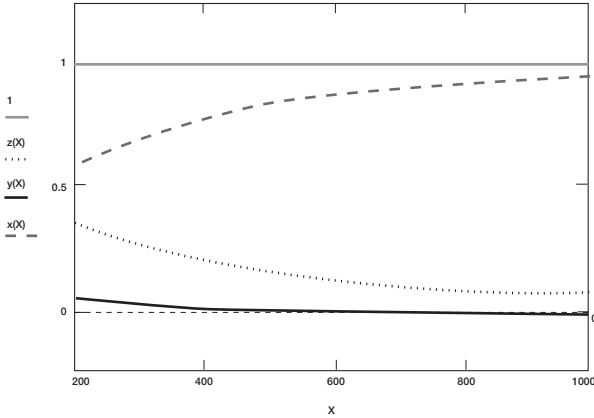
2) Transitional regime from  $z-x-y$  to  $x-z-y$  (Figure 6)

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 economies<sup>1</sup> 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.<sup>2</sup> 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

<sup>1</sup> 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.

<sup>2</sup> 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>   |  |
|--|--|--|--|
| <b>REGULAR</b>                                 | <b>NON-OFFICIAL</b>                          | <b>SOCIAL</b>  |  |
| (Formal)<br>Regular,<br>official<br>employment | Unpaid family<br>workers;<br>volunteer labor | <b>DOMESTIC</b><br>Domestic<br>production for<br>own consumption | <b>COMMUNAL</b><br>Social exchange<br>of products<br>and labor |

*Illegal*

| <i>Official</i>   | <i>Integrated</i>                                   | <i>Alternative</i>                                     |  |
|---|---|--|--|
| <b>CRIMINAL</b>   | <b>HIDDEN</b>                                       | <b>NON-REGULATED</b>                                   | <b>BLACK (Underground)</b>                                 |
| Mafia and<br>racketeering;<br>criminalization<br>of the economy | Hidden privatization;<br>corruption;<br>tax evasion | Employment on a<br>non-labor or<br>fake labor contract | Employment and self-<br>employment without<br>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 change<sup>3</sup> 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

<sup>3</sup> 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.<sup>4</sup> 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 poorer<sup>5</sup>, 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 1996<sup>6</sup>. The following results were presented by Kyle et al. (2000),

<sup>4</sup> 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).

<sup>5</sup> 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.

<sup>6</sup> 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.<sup>7</sup> 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 66<sup>th</sup> to 47<sup>th</sup> place for the period 1998-2001<sup>8</sup>. (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 domestic<sup>9</sup> 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.<sup>10</sup> 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

<sup>7</sup> 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).

<sup>8</sup> 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)

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

<sup>10</sup> 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.<sup>11</sup> 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 levels<sup>12</sup> 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

<sup>11</sup> 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).

<sup>12</sup> 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.<sup>13</sup> Exploitation is obvious. 34 percent of the children contribute a part of their income to the family budget; 64 percent

<sup>13</sup> 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**

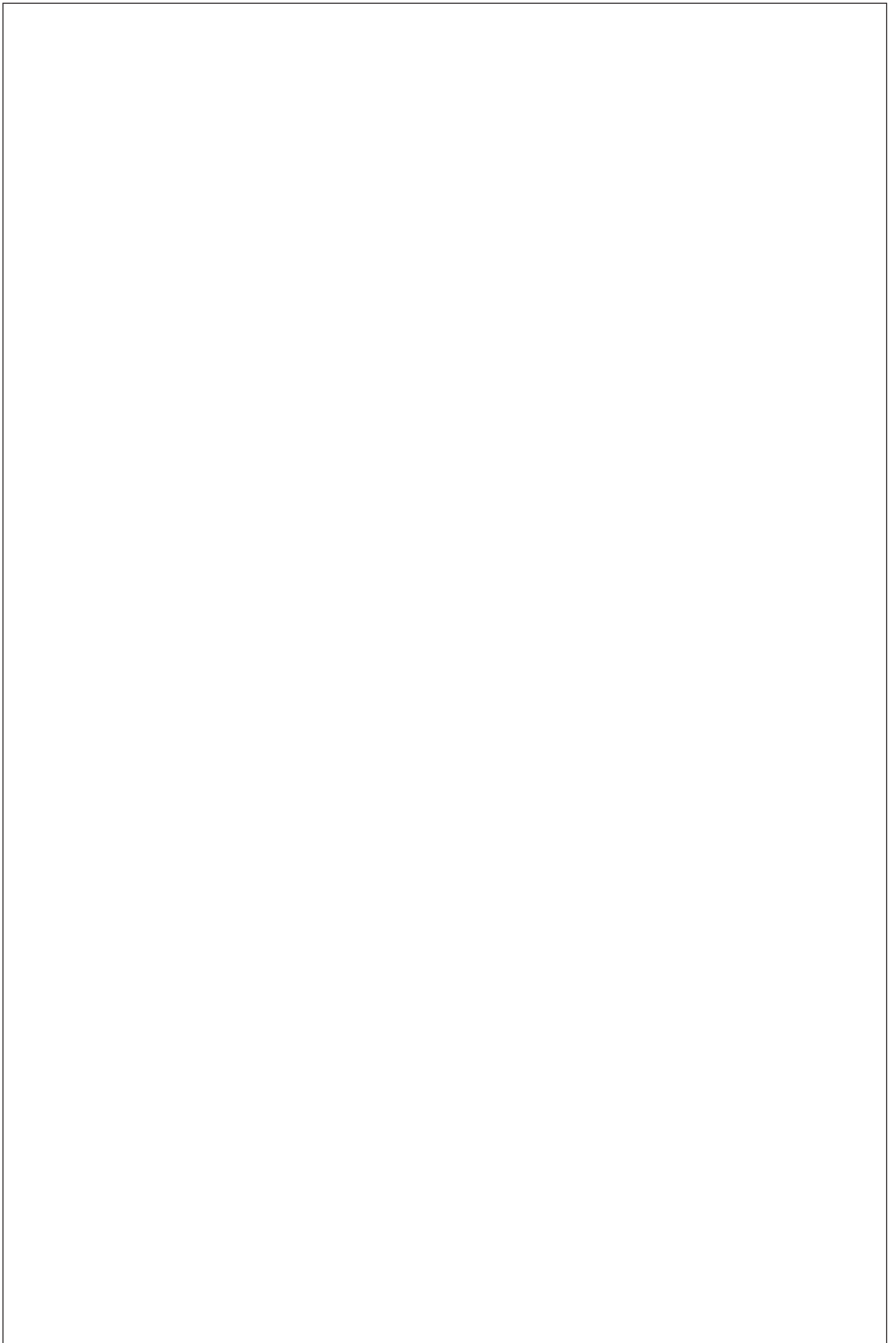
The informal economy in Bulgaria flourished during the 1990s. Such a finding cannot be surprising given the background of the entire process of transformation. The former socialist countries were challenged to create as quickly as possible a new system, based on market forces and the reign of economic 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:

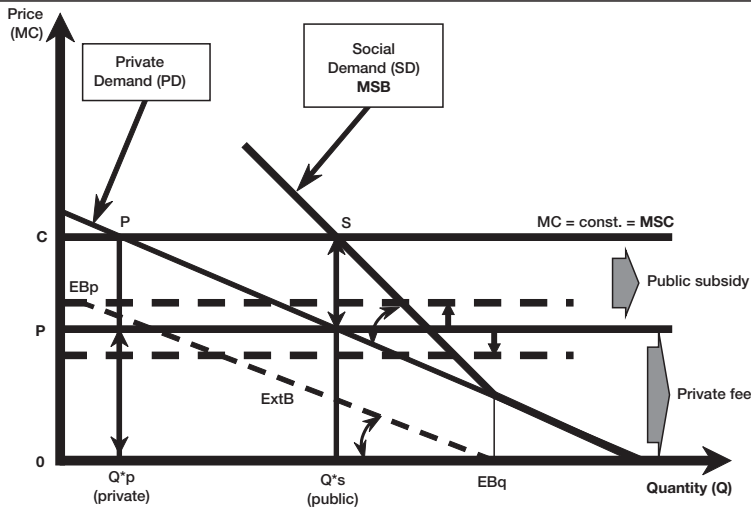
First, the non-equilibrium combinations in the 2nd, 3rd and 6th quadrants are most typical when the state is in a superior position vis-à-vis that of the citizens. Under these circumstances a rational individual is motivated to avoid taxes by the excessive claims of the society on the income generated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

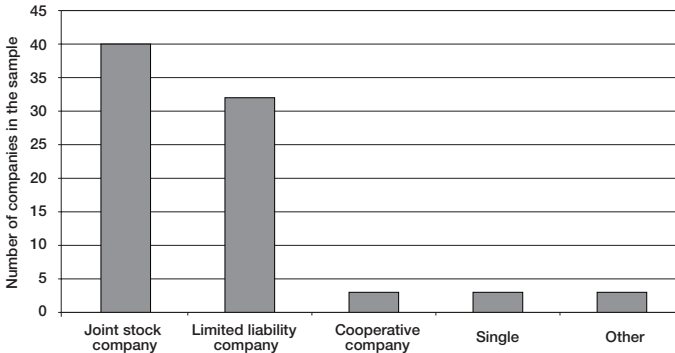
Under the conditions of high unemployment and high business risk, firms and their employees undertake common, low-conflict actions for the reduction of fiscal and insurance payments related to labor contracts. The threshold level for this process to start decreases with the increase of the size of the 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.<sup>1</sup>

The full distribution of answers is shown below:

FIGURE 2A: LEGAL FORM



<sup>1</sup> Research was carried out in the framework of the program INTERREG M 6.3.



FIGURE 2B: PERIOD OF ESTABLISHMENT

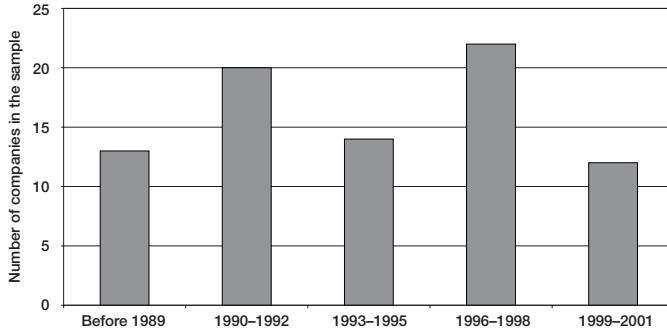


FIGURE 2C: INDUSTRIAL SECTOR

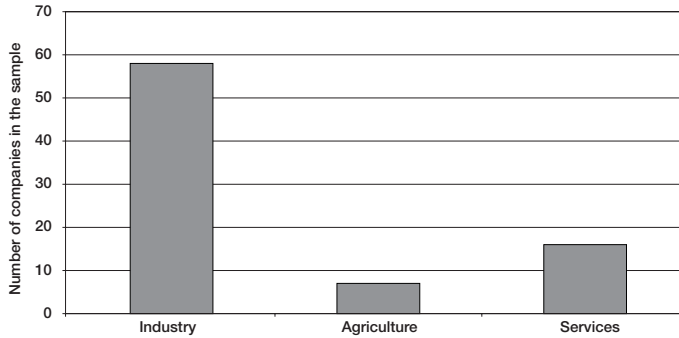


FIGURE 2D: TYPE OF OWNERSHIP

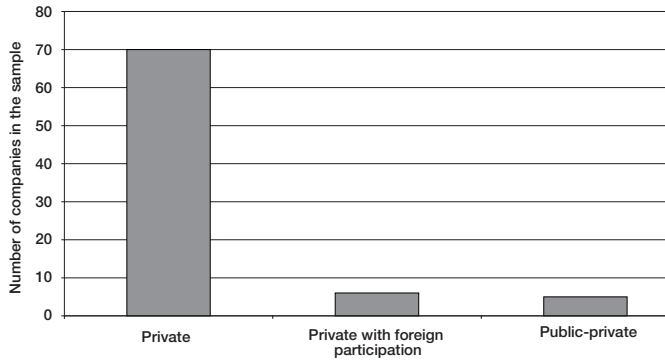


FIGURE 2E: NUMBER OF EMPLOYEES

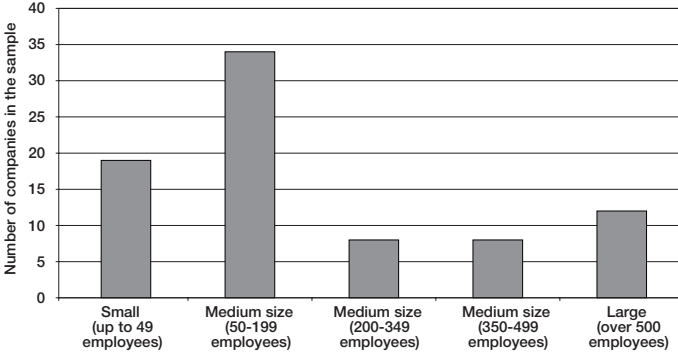


FIGURE 2F: LABOR UNION

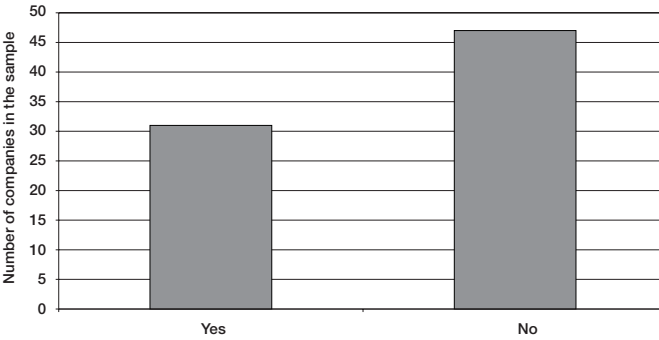


FIGURE 2G: INTRODUCED QUALITY STANDARDS

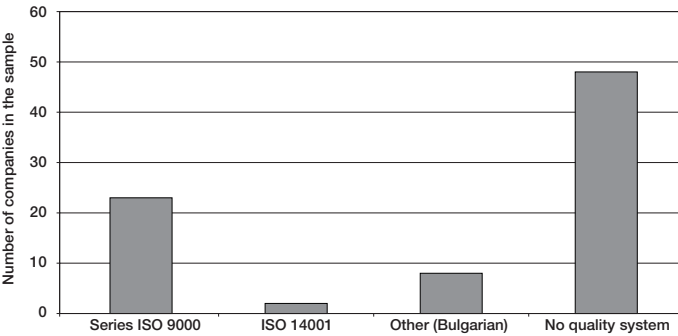


FIGURE 2H: TO WHAT DEGREE DO YOU BELLEVE THAT HUMAN RESOURCE MANAGEMENT CONTRIBUTES TO THE SUCCESS OF YOUR BUSINESS?

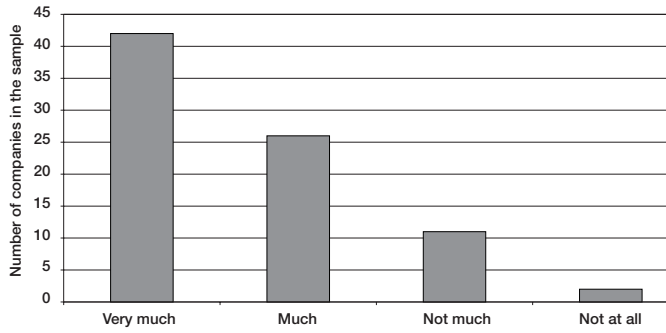


FIGURE 2I: DOES YOUR COMPANY OPERATE A HUMAN RESOURCE DEPARTMENT?

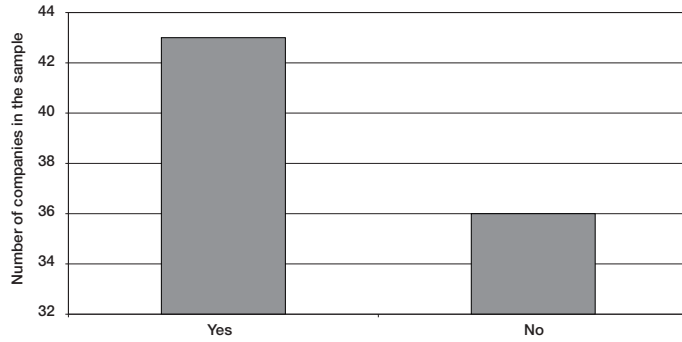


FIGURE 2J: WHO IS RESPONSIBLE FOR HUMAN RESOURCE MANAGEMENT?

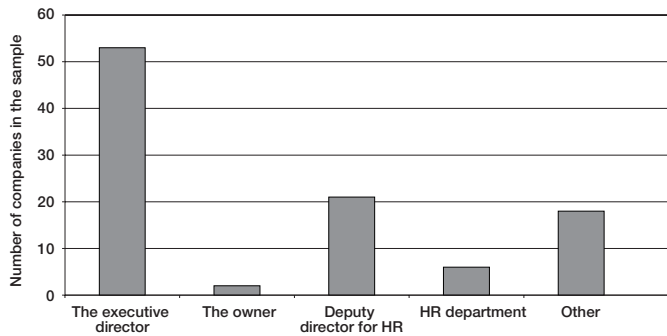
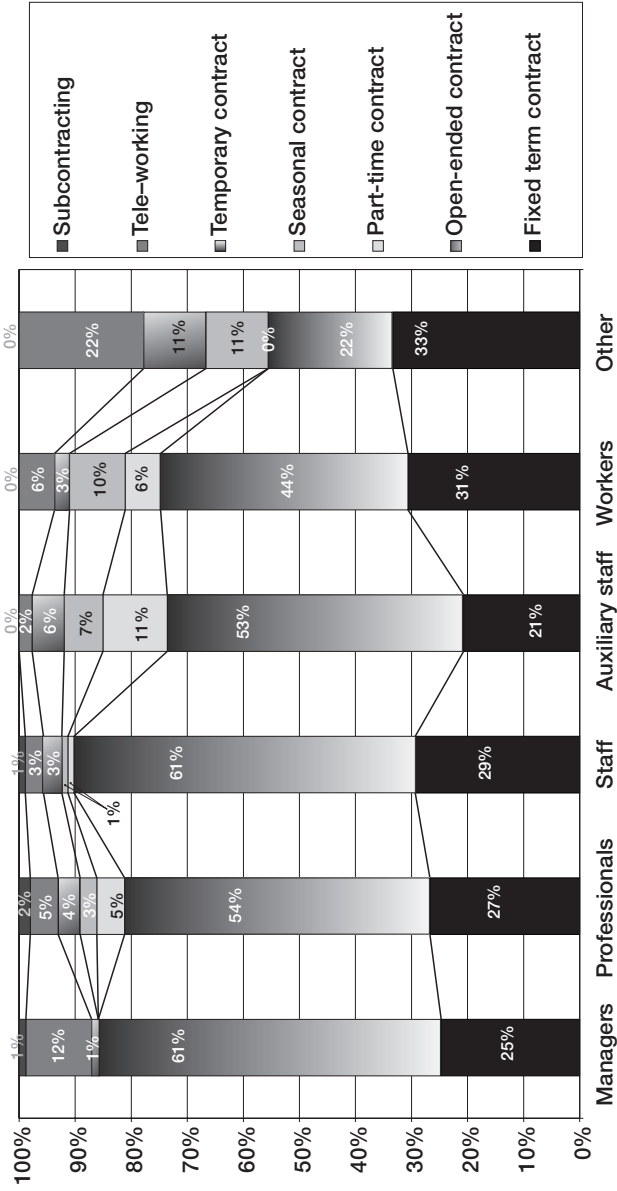


FIGURE 3: TYPE OF CONTRACTING ACCORDING TO THE DIFFERENT OCCUPATIONAL CATEGORIES OF THE EMPLOYEES



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:

$$(1) Y_{\text{FTC}} = a + bX_{\text{HIERARCHY}},$$

where: Y = distribution of fixed term contracts (FTC);

X = hierarchy status;

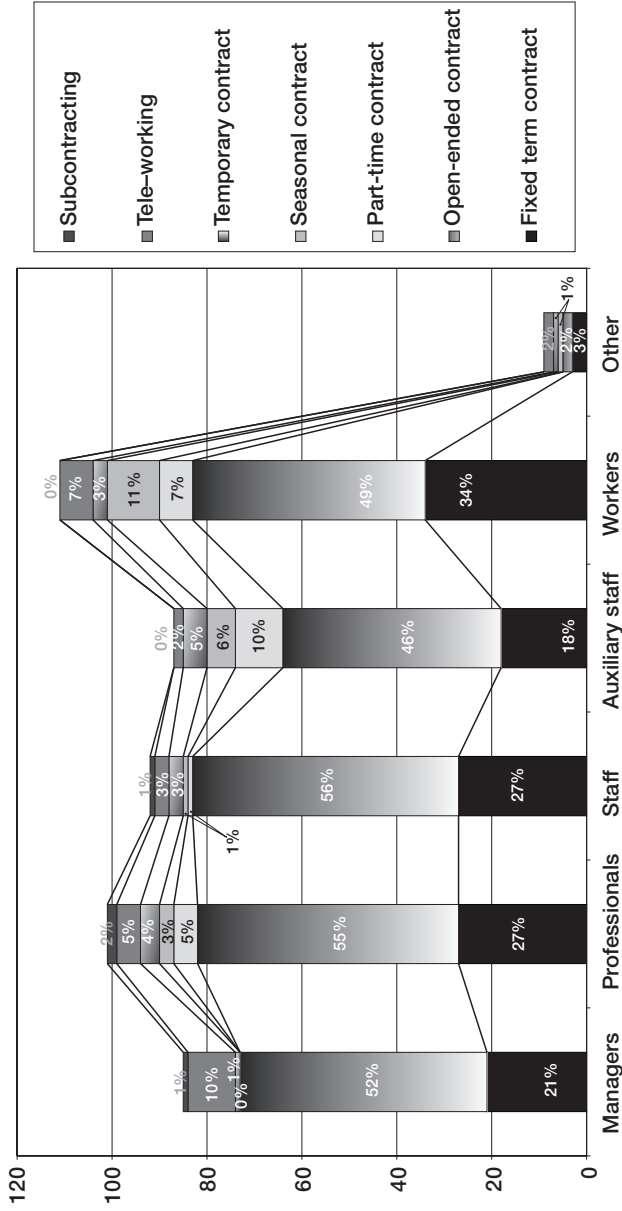
- b) The distribution of fixed term contracts according to the existence of local labor union:

$$(2) Y_{\text{FTC}} = a + bX_{\text{UNION}},$$

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)                   |

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## 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

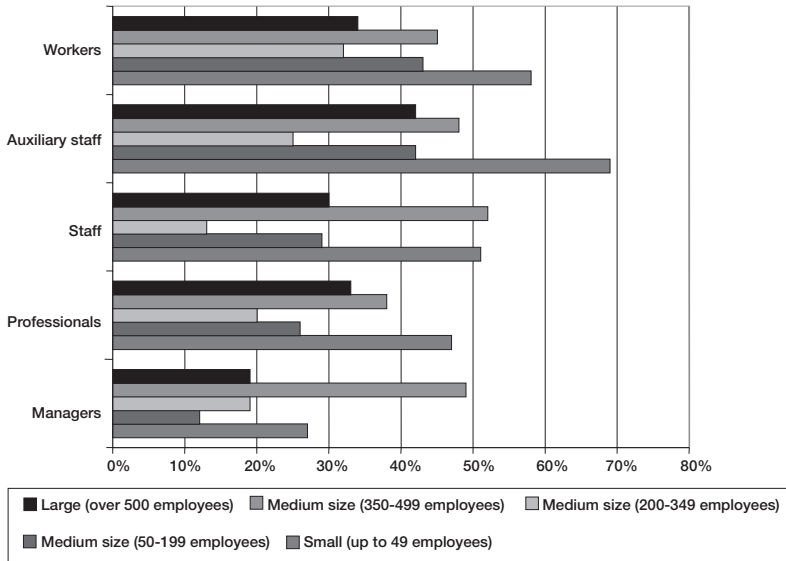
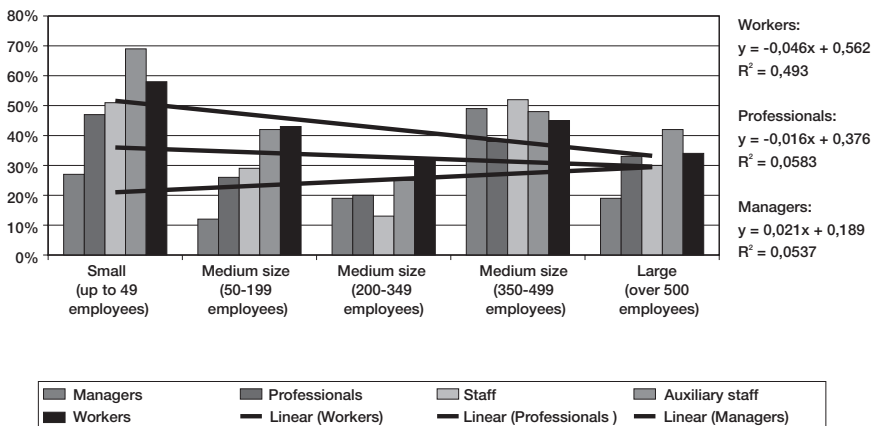


FIGURE 6: DISTRIBUTION OF FIXED TERM CONTRACTS FOR MANAGERS, PROFESSIONALS AND WORKERS AT THE BULGARIAN SMALL, MEDIUM SIZE AND LARGE COMPANIES





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

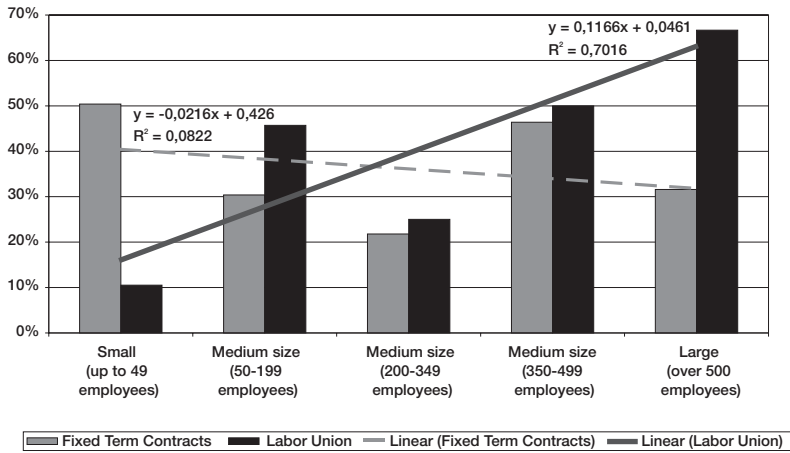
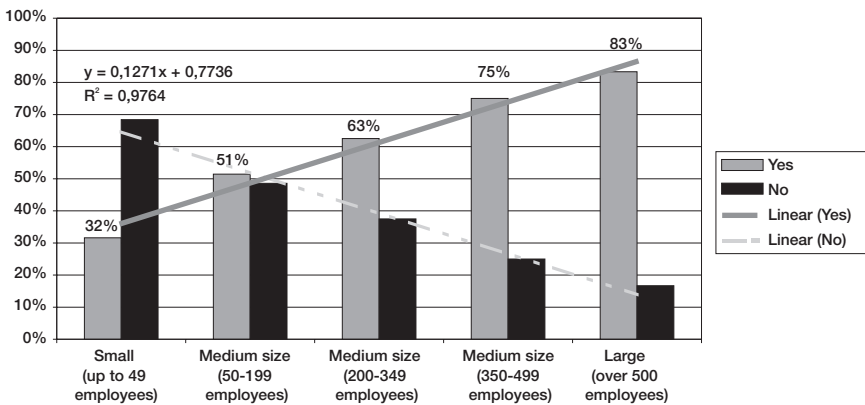


FIGURE 8: DOES YOUR COMPANY OFFER RETIREMENT BENEFITS (PUBLIC & PRIVATE) TO ITS EMPLOYEES ON TAXABLE INCOME BASIS?



## 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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