

## THE COST OF INFORMALITY OF THE FIRM

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### ABSTRACT

Informal economy is an area that has been a subject of a lot of studies. Because of the nature of the informal economy, it is not easy to study and to calculate it. In this paper we analyze some cost of informality of the firms.

Informal economy means hidden economy. As such, the firms that are working on informal sector, hide their activity from official authority. For big firms, to hide their activity is very difficult. For this reason, the firms that work in the informal sector tends to stay small in order not to get caught on their informal activity.

This stops these company to take the benefits of economy of scale.

Moreover, the firms that work in informal sector compete with the companies that work on formal sector. This have an impact on development of the companies that work on formal sector.

As a result, many of the companies in economy tend to stay small even though it is not effecient to do this.

Recently, in Albania, a new Law have been in power to avoid the informality in the companies. The result of these changes will be shown on the comming years, but based on the experiece of other countries, this is not the way of fighting informality.

*Key works: Informal economy; small firms; Formal sector; fiscal policy.*

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## Introduction

The informal economy is a broad concept. It has different names in the economic literature; underground, shadow, hidden, informal, unofficial, unreported, or unrecorded economy. The “underground economy” — defined as economic activities which are not registered, reported, taxed or regulated but which produce for legal markets — has been mainly explained, on the basis of standard economic arguments, as engendered by excessive taxation and regulations.

As (Tanzi, 1998) remarks, exist at least two definitions and thus two measures of the black economy. The first, is connected to the production (or income) missed in the official statistics; the other, refers to “...revenue not reported to, and not discovered by, the tax authorities”. Consequently, “...the first measure implies that the country is richer than the official statistics show”, the second (namely, tax evasion) indicates that the tax administration draws less revenue than it should.

Increasing attention has been paid by many developed and developing countries in recent years to the black economy and its consequences. A recent study by (Schneider, Buehn, & Montenegro, 2010), for 162 developed and developing countries overall the world for the period between 1999 and 2006/2007, found that the black economy has reached remarkable proportions, with an average value of 34.5% of official GDP of those countries. Almost all studies of the shadow economy phenomena came to the conclusion that the main cause of the black economy (informal economy) is a high tax and social security burden.

The existence of the black economy creates a distortion in the market competition as a result of the unequal production situations between the producers in the formal economy compared to the producers in the black economy. This leads to significant distortions in official economic and social indicators. Most economists agree that there is a strong bidirectional causal relationship between the tax system and the size of shadow economy. The shadow economy reduces government revenues due to tax evasion, which, in turn, reduces the quality and quantity of public goods and services provided by governments. In order to cover its overall need for tax revenue, the government may raise tax rates. The result is often an increase in the size of the shadow economy and more tax evasion.

Measuring the size of the shadow economy in the countries and territories of Southeastern Europe (SEE) with the help of traditional methods can be a difficult task, especially because there is still a lack of uniform and full data coverage. In this article we apply a basic method

using fiscal data that are available for all Balkan countries and territories. In the second part of this article, data from national accounts is used to provide further estimates. The study is done for Albania.

Since 1997 Albania has made considerable efforts to introduce a modern tax regime, structured on standard EU modeled VAT systems for indirect taxation and corporate and personal income tax for direct taxation. It is implementing a number of programs to upgrade the customs and tax administrations. Over the last five years the country has built a stable and open macro-economic framework, completed economic liberalization and enjoyed a sustained economic expansion, albeit from low levels, supported by a growing private enterprise sector.

However, in spite of these positive elements, the share of the black economy in GDP does not appear to have receded. Indeed, the indications are that the black sector has been the most dynamic component of the Albanian economy in recent years. For example, Albania has one of the highest VAT, corporate income tax and social contribution rates among the countries of South East Europe, but at the same time it has close to the lowest ratio of tax and social contribution revenues to GDP.

Informality poses different cost on firms. We will discuss the causes and cost of informality on micro level and aggregate level.

## Literature Review

### Cost of Informality of the firm

Informality imposes a lot of costs on the economy. Researchers studied the cost of informal economy in the 1970s but the activity took off after the study of (De Soto, 1989). In his study De Soto argues that as a result of the strong and complicated regulatory system and corruption and incompetence of the public sector and a weak judicial system, there are a lot of small informal firms in Peru. Most importantly, problems with the property rights enforcement and a lack of access to property registration lie at the heart of the problem, as small business-owners are trapped in a sub-optimal situation in which they lack access to legality and formal credit sources, and they have constantly to escape the control of the state as well as potential extortion from public officials. As a consequence, a lot of businesses with the potential to grow and create jobs are instead kept at a small scale of production so that they never reach their full potential.

From the point of view of the firms, many potential costs have been put forward in the literature both from the economic efficiency and from the public choice point of view. For instance, (Loayza, 1997) argue that via tax evasion informal firms create an advantage on the market since they are free of taxes and workers working without paying contribution. As (Loayza, 2007) mentions, the informal sector generates a negative externality that compounds its adverse effect on efficiency: informal activities use and congest public infrastructure without contributing the tax revenue to replenish it.

On the other side, corruption, poor public service and poor judicial system push the workers and firms to not pay taxes and to stay in the informal economy. In this sense, informality leads to a situation where the provision of public goods is always sub-optimal, causing frustration in the formal sector, whose actors then see little benefits from being law-abiding citizens. (Torgler, Schneider, & Georgia State University, 2007) went further to this argument. In their study, they did the analysis of how tax morale affects the size of the informal sector. They found that in the countries where individuals have faith in their institution and believe that their taxes are used in a good way, the informality tends to be lower. The existence of a large informal sector on the other side, destroys the faith of the individuals on their institutions and stimulates corrupt behavior. A report done by (Bradley & Stephens, 2007) argues how the informality affects the probability of a firm to be subject to bribery, and they found that there is a link between informality of the firms and the incidence of corruption. On the other side, informality, even in firms that work in formal market, is associated with weaker performance. The study also found that regulatory measured as the percentage of sales reported by the firm for tax purposes affects the productivity of the labor, productivity in total and the average wage in the firm.

Many studies emphasize the lack of production in quantity as a cost of informality. This is another important potential cost often cited in the literature, coming from efficiency considerations. If a big number of informal firms stay small, don't grow, it is possible that they never reach an efficient scale of production. Some studies done by the McKinsey Global Institute have put the attention on policy makers. The study concludes that the informality not only keeps the companies from growing but also the cost advantage from not paying taxes and being more competitive in the market compared to the formal firms, and take more market share from this formal firms. These studies attempt to quantify the losses that economies suffer from having

large informal sectors, and the potential productivity gains that would take place if informal businesses operated formally.

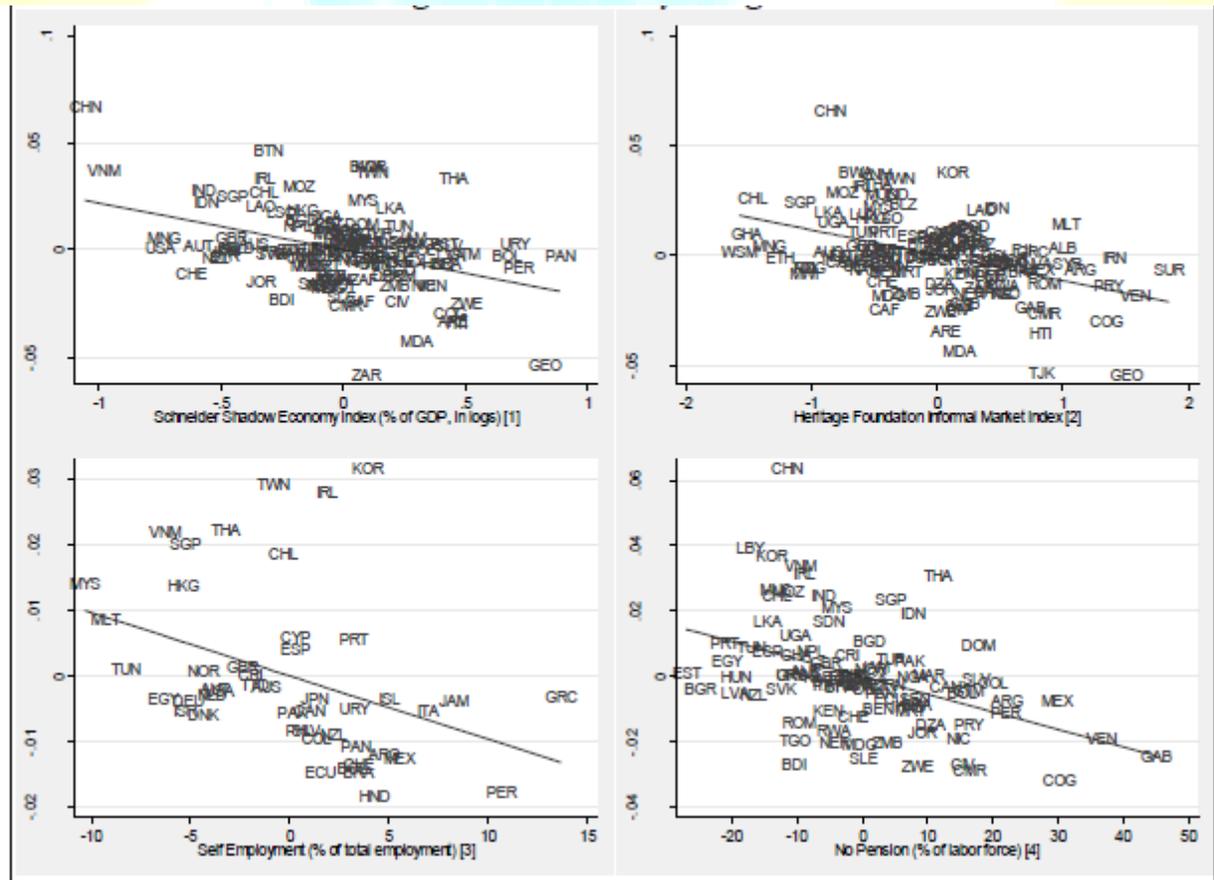
(Farrell, 2004) argue that informality alone can explain only a part of the difference between labor productivity in Turkey and in the US, and that in the absence of —barriers and in a full-compliance scenario, productivity in Turkey could reach 70 percent of US productivity, in contrast to the current 40 percent, on average. 41. The evidence on the importance of scale inefficiencies coming from informality is, however, inconclusive. Despite the attention they have received, these studies fail to take into account the many inherent differences between formal and informal firms. As said above, it is evident that the firms that work in informal economy do not grow, partially because they are managed by not educated individuals but also they are missing the infrastructure. They hide the income, and in this way it is not easy for them to use these money to grow. So for many of this firms that are working in informality it is not easy to move to the formal area. (Maloney, 2004) found that in the Latin American countries there is little evidence that the informality is the cause for letting the firms that work in informality to not grow. In other words, the small firms are likely to stay small regardless of their status (informal or formal). This study brings the argument that informality happens as a result of complicated regulation, including tax evasion, Law issues and corruption. A study done by (Farrell, 2004) argued that the main reason for small companies to stay informal and unregistered is the high cost of registering them.

### Aggregate Cost

As we discussed so far, informality of firms may cause costs on growth and development. There is a link between informality and income. In some countries have been found that there is a link between informality and development.

The relation between informality and income seems to come in fact from common determinants of both. Following the observation of aggregate correlation, a few studies have tried to capture a causal relation statistically. (Loayza, 2007) analysis the average growth of countries over a long period of 20 years as a dependent variable, and estimates the impact on growth of informality for over 100 countries. The partial regression plots controlling for initial GDP per capita (1985) are

depicted in Figure 1. The —effect of informality on growth is found to be negative and significant, with a magnitude such that one standard deviation in the size of the informal sector leads to a decline of 1 to 2 percentage points in the rate of per capita GDP growth. This study carried out by (Loayza, 2007) shows that there is a strong relationship between informality and growth. However, as the authors in this area generally acknowledge, this relationship may not necessarily be a causal one: it could be that informality is a symptom of other underlying causes, which are at the heart of a weak economic growth rate. Indeed, when other aspects are taken into account in the estimation, informality tends to lose all its explanatory power, suggesting that this —third common caudal factor explanation is in fact the correct one.



Source: Loayza 2007

However, they find that the relationship tends to lose its significance once other controls are introduced.

From the social protection point of view, informal employment has potential important costs. Informal workers, whether self-employed or salaried, generally lack the basic protection they need to face unforeseen shocks (illness, disability, etc.), as well as the benefits that will allow them to get through periods when they cannot earn income, such as old age or maternity.

In Albania, lately has been a change on the Law (“PËR KONTRIBUTET E DETYRUESHME DHE PËRFITIMET NGA SISTEMI I SIGURIMEVE SHOQËRORE DHE SIGURIMI I KUJDESIT SHËNDETËSOR,” n.d.) regarding informal employment. On 2015 the fine for non registered workers is 5 times more than before. With this Law coming on power has been a big change on this sector. Firms have registered workers and government have collected more money from social security taxes.

The above represent obstacles to doing business which discourage formality, but in addition, the issue of bribery and corruption is particularly noteworthy in Albania. (Rose-Ackerman, 1997) studied the proportion of firms that frequently bribe public officials to obtain licenses or permits and/or to avoid safety and other inspections) is only exceeded in a few countries in the South East European (SEE) region, such as FYR Macedonia, Bosnia and Herzegovina, and Serbia and Montenegro. The “time tax” (*i.e.* the proportion of senior managements’ working time spent dealing with public officials) is also more severe than in any other SEE transition country, thus providing a strong incentive for firms to avoid any form of bureaucracy and taxation possible.

Turning to the nature of the black economy, (Ruli, 2003) points out that private economic activity was banned by law until 1990, which means that the black economy has grown very rapidly to current levels. (Gërxhani, 2003) argues that the economic crisis during the period 1990 – 1992 was crucial in that the “problems of high unemployment, poverty and social insecurity created by economic disaster were extremely severe.” This has undoubtedly acted as a strong impulse for people to respond creatively to their difficulties by participating in the black economy.

Ruli argues that although informality runs deep, its nature varies according to certain main forms (2003):

- The activity of rural farmers, which accounts for 50% of GDP but does not contribute to tax and social security since this is legally exempted by Government.

- The micro businesses owned by individuals or families, which are mainly temporary and generally unregistered. Registered SMEs, operating at various levels of formality.
- Illegal and criminal activities, sometimes disguised as legal businesses. Of all these, Ruli argues: “The most worrying occurrence 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 these kinds of businesses, which account for the largest part of the country’s economic activities.” (2003, p.245), with the trade (especially retail), transportation (goods and passengers), services (such as bars and restaurants), construction and production activities highlighted as being particularly important in terms of black economy.

A survey undertaken in Albania by ACER (1999) illustrates the nature of fiscal evasion, from a company perspective:

- 75% of firms stated that fiscal evasion occurs “very frequently”.
- 73% stated that they hide their real profits (20% on average before taxes).
- 94% of the evasion is caused by the existing tax system and policies.

The structural nature of enterprises in Albania also plays a role in relation to the black economy. (Muço, Sanfey, Luçi, & Hashorva, 2004), analyzing data from the Administrative Register (activities registered with the fiscal and legal authorities) and the Statistical Data (business surveys), note that the typical Albanian enterprise may be characterized as being very small, reflecting the predominance of agricultural activities in the economy and the decline in importance of large, state owned enterprises. 94.7% of firms employ 33% of employees in firms of 1-4 employees. In other words, one-third of employees work in family businesses. They also note that the bigger the firm, the fewer the number of registered employees and that, between 1998 and 2002, total employment shrunk at the same time as the number of firms was expanding. These trends are rapidly changing the socio-economic profile of the country. In the short term, emigration continues to have positive effects, such as the continuing high levels of remittances from those living and working abroad, which play a significant role in macro-economic stability as well as investment (including in enterprises), injection of know-how, support to the standards of living and alleviation of poverty. At the same time, remittances fuel the black economy since they are typically channeled outside of the commercial banking system, which complicates detection of size and impact.

## Conclusions and Discussion

Informality poses cost to the firms. Most important one is the lack of scale production. The firms in informal economy stay small and they tend to not develop.

Developing countries, reforms aim instead at encouraging micro- and small-firm owners to formalize and pay their contributions.

In Albania, Law has been an important part in the game of informality. The fiscal policy has been changed very often. Lately the Law is making very easy for the small business to work in formal economy. But this has to be seen in the coming years. Sometimes the policy of no taxes from small firms makes the medium and big companies to go small and also the small companies to lose the desire to grow.

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