

# Informal Economy

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## INFORMAL ECONOMY

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## Informal Economy of Armenia Reconsidered

Hrant Mikaelian, Yerevan

### Abstract

Informal relations are quite common in Armenia and include broad spectrum of relations within the society. Despite the fact that during the recent years, the government has taken some efforts to decrease corruption and formalize some of activities, the struggle affected the most obvious manifestations of corruption, whereas an informal approach to the problem solving is still considered a model in the society. Certainly, this applies not only to politics, but also to the economy.

### The Shadow Economy in Armenia—Its Size and Dynamics

In Armenia, the discussion on informal economy is rather politicized, usually having very weak or no scientific basis. Government estimates informal economy between 30 and 40%, while opposition politicians use higher estimates, exceeding 45%.

As it was noted, there are different methods of calculating the shadow economy. Most of existing estimates refer to period of the mid-1990s to the mid-2000s. They are presented in Figure 1 on p. 5.

As it can be seen from Figure 1, different methods of calculation of the informal economy produce not only different results for the same period, but also, what is even more important, different trends.

The problem is not with the authors of these calculations, but the methodologies themselves seem doubtful and not likely to ensure accurate estimate of the size of the shadow economy. Therefore, it does not seem worth to reproduce these estimates and bring them until 2014. However, it is possible to assume the volume change of the shadow economy by using indirect indicators.

Gutmann believed that illegal operations are carried out in cash, while for the rest of the economy the share of cash out of the money base remains constant in a long run. According to his method, the exceeding volume of cash within the economy, compared to demand deposits, indicates presence of the shadow economy. Since 2008, there was a sharp decline in the share of cash in circulation, demonstrating a reduction of the informal sector. The same can be said concerning the change of the money multiplier ( $C/D$ ), which indicates the ratio of cash in circulation to the demand deposits in recent years. In 2008 it consisted 3.2 and by the end of 2014 it has decreased to 1.9.

The taxes to GDP ratio also can be used as an indicator for the presence of shadow economy. It is based on the assumption that GDP is accounted better than the taxes are collected. If there was no change in tax size, while taxes to GDP ratio changes, the decrease in the ratio can indicate growth of the grey sector and tax evasion. By the same token, the growth of the ratio is a sign

of the informal economy decreasing. Since 2007, budget revenues grew faster than GDP and budget incomes/GDP ratio has reached its post-Soviet peak (25.1%) in 2014; the same can be said for the tax revenues (23.5% of GDP). These data are presented in Table 1 on p. 5.

According to the data presented in Table 1, the tax income to GDP ratio has grown from 20.5% in 2009 to 23.5% in 2014. This indicates a clear trend showing a decline in the volume of the shadow economy. All five statistical rows indicate the same trend. It shows that the anti-corruption reforms have been rather successful in decreasing informal transaction in the Armenian economy. The rest of this article tries to examine if this reduction can be attributed to a process of formalization of large businesses, SMEs or individual employment.

### Are Monopolies and Big Businesses Going Formal?

Informality is not unique to Armenia. In many other post-socialist economies, as well as the developing economies outside the Europe and Central Asia region, local business elites enjoy monopolistic position or oligopoly in various commodity markets. These businesspersons often come from the administration, law enforcements or security agencies, or represent late Soviet nomenclature. What really makes Armenia different from the most other post-Soviet and many post-socialist countries is more profound change of political elites: very few of the local communist elite were able to keep their position after the revolutionary changes of 1988–1992. These changes run deep and impacted all levels of the Armenian society. According to the Life in Transition Survey 2010 (by EBRD), having parent being member of the Community party has a slight negative impact on household assets. Thus, the new elite in Armenia has grown and structured virtually from nothing; cooptation mechanisms were varying from education to brave military past, from connections to business skills. It is against this background that one has to examine the connection between large businesses and the political sphere.

According to the BEEPS 2009 database, 19% of the Armenian economy is monopolized. More than any

other country in Eastern Europe and Central Asia, This is caused by the relatively small size of the Armenian economy, the absence of other economic centers in the country outside Yerevan, the “transport deadlock” status of Armenia (Armenia is landlocked country, blocked by Turkey and Azerbaijan).

The linkages between big business and politics and their apparent ability to avoid the constraints that seem to apply to other firms became, in the more recent years, a subject of public debate. But at the same time, one can observe a growing contribution of big businesses to taxes.

In 2008, the 25 largest taxpayers have paid 23% of total taxes, and in 2014—25% while in the first quarter of 2015, this share reached almost 27%.

As for taxpayers holding 26–100 places in the taxpayer information listings, these companies precisely belong to a group led by local big business owners (so called “oligarchs”). The taxation level grew in this category even faster than among the top-25. A preliminary conclusion would consider that these companies started to formalize their assets as a result of the gradual eradication of the “special agreements” which they enjoyed previously. However, since these companies compete to the rest economic enterprises, the change in the share of paid taxes might also be caused by the increase of the market share and additional studies are needed to be able to give a conclusion concerning that issue.

### **The Informal Economy, Corruption and SMEs**

Small and medium enterprises are also often in the shadow. Corruption collusion allows SMEs owners to save a significant part of their turnover, thus increasing their competitiveness.

It is generally assumed that corruption and tax evasion are the results of weak institutions. Overregulation can push businesses moving in the shadow, or at least creates incentives for corruption. Thus a closer look at the dynamics of Armenia’s position in the World Bank Doing Business ranks presented in Table 2 on p. 6 can be helpful.

Until recently, paying taxes in Armenia faced serious burden of overregulation, which could be one of the factors supporting the informal economy. While in “paying taxes” subrankings, Armenia has recorded noticeable progress during recent years, the international trade remains a problematic sphere. Therefore, despite of the good performance in other areas, problems in tax and customs everyday practice and regulations are sufficient to push a significant part of business into the shade.

Moreover, in the provinces of Armenia, which are significantly poorer than Yerevan, tax evasion is often

included in the companies’ business strategy. Therefore, when the crisis of 2008–9 hit Armenia, the state started to take measures aiming at increasing of the level of tax collection. Many of SMEs in the regions have closed, being unable to remain competitive. Fighting corruption and enforcing tax collection can have many indirect effects, especially in countries like Armenia, where the informal sector provides a “cushion” against economic hardship.

### **Informal Employment in Armenia**

Informal labor activity in Armenia involved a significant portion of the adult population. Approximately half of the population is considered to be self-employed or informally employment, which ends up to be de facto the same. Most of those people are active in the agricultural sector, which in Armenia is based almost entirely on small farms. In 2013, 444,000 self-employed were active in agriculture, while it was estimated that 146,000 were informally employed outside the agricultural sector, i.e. 19.7% of all employees in the non-agricultural sector (in 2009 their share was 24.6%). Informal employment in the non-agricultural sector can take many forms: informal employment in formal enterprises or informal enterprises, self-employment, partial declaration of wages,

Informal enterprises are more frequent outside the capital. In Yerevan, about 19% of workers are employed in the informal sector, in other towns the number is about 29%, and in the villages already 81% of employment refers to the informal sector. Excluding agricultural sector, the informal economy in the rural area would consist of 27% of total employment. Informal economy reveals gender imbalance as well: men make up 65% of all formally employed, while among informally employed their share drops to 53%. Thus, the share of informally employed is higher among women, depriving them of the guarantees provided by the labor code. and making them more vulnerable

By sectors, the largest share of informally employed in 2009 were involved in the construction works—the figure reached 58% of all those employed in this field. Informal employment was high in the field of most of the services as well (wholesale and retail trade, repairs—38.7%, hotels and restaurants—38.5%, transport, storage, and communications—21.5%), whereas in the real estate, renting, and business activities it was as low as 9%, education 1.2%, and in financial intermediation it was non-existent. 22.4% of involved in the industry were informally employed 22.4%. The average for the non-agricultural sector—as has been said consisted 24.6% in 2009 and 19.7% in 2013, showing the decrease of one-fifth during four years.

## Conclusion

The informal economic relations, despite of the decline in recent years, still remain widespread phenomenon for Armenia. They involved both large companies and small and medium businesses.

Armenia has virtual secondary trade and renting markets operating via newspapers like “Gind” and internet-sites like <[www.list.am](http://www.list.am)>. Except for the selling apartments and advertisement used by the trade chains, most of the deals in these markets are informal. Renting real estate is officially taxed at 10%, but the government ignores the fact that virtually all real estate renting transactions other than renting company offices are informal.

In recent years, the reforms have been carried out in many areas of the economy and public administra-

tion. Largely, the reforms were the result of the political and the 2008–2009 economic crisis and forced the government of Armenia to seek incentives to improve the quality of administration, since foreign direct investment had a sharp decline since the beginning of the world crisis, while the initiative to open borders with Turkey had failed.

However, the reforms led to a significant reduction of the shadow economy, according to all the indirect indicators. As in many other aspect of economic development, the success of these reforms depends on their continuation. If they stop, there is a risk of gradual pull-back to ineffective governance and an increase of the shadow economy.

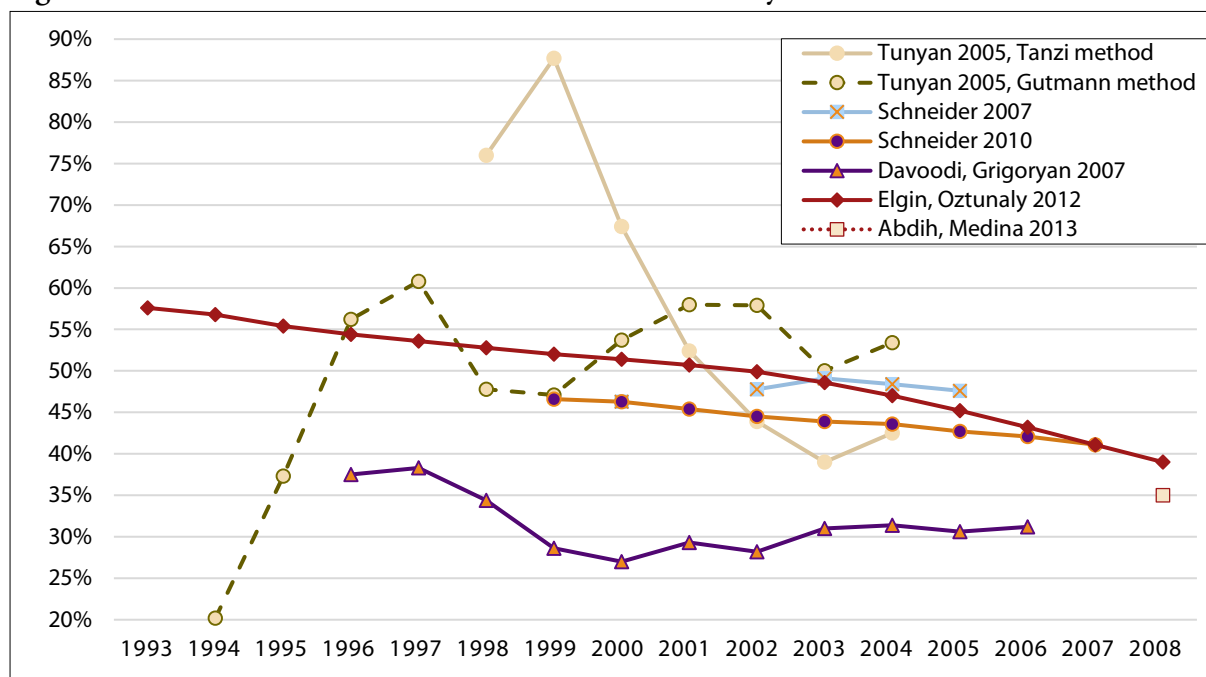
### *About the Author*

Hrant Mikaelian is a researcher in social sciences at the Caucasus Institute, Yerevan.

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Figure 1: Past Estimates of the Size of the Informal Economy of Armenia



Sources can be found in "Further Reading" section. Compiled by Hrant Mikaelian

Table 1: Indirect Indicators of the Shadow Economy

	Money multiplier (C/D) <sup>a</sup>	Velocity of money <sup>b</sup>	CG budget incomes ratio to GDP <sup>b</sup>	Taxes to GDP ratio <sup>b</sup>	Share of cash in circulation of money supply, % <sup>a</sup>
2007	2.483	4.568	22.2%	15.7%	47.3%
2008	3.171	5.068	22.4%	20.6%	44.9%
2009	2.708	3.881	22.7%	20.5%	34.9%
2010	2.372	3.823	23.2%	20.8%	33.6%
2011	2.127	3.377	24.0%	21.1%	31.2%
2012	2.378	2.994	24.4%	22.5%	28.7%
2013	1.935	2.795	24.9%	23.4%	25.1%
2014	1.898	2.680	25.1%	23.5%	20.7%

<sup>a</sup> Amount of cash is given at the end of respective year

<sup>b</sup> The ratios were calculated using GDP accounted by the SNA-1993 methodology for the whole period (1991–2014)

Source: National Statistical Service of Armenia, author's calculation. Compiled by Hrant Mikaelian

**Table 2: Paying Taxes and Trading Across Borders in Armenia, According to the WB Doing Business Index<sup>a</sup>**

	Period	Overall position	Paying taxes rank	Number of payments per year	Hours spent on paying taxes per year	Total tax rate (% of profit)	Trading across border rank	Docs to export	Docs to import
2015	Jun. 2013–May 2014	45/189	41	10	321	20.4	110	5	8
2014	Jun. 2012–May 2013	37/189	103	10	380	38.8	117	5	8
2013	Jun. 2011–May 2012	32/185	108	13	380	38.8	107	5	8
2012	Jun. 2010–May 2011	55/183	153	34	500	40.9	104	5	8
2011	Jun. 2009–May 2010	48/183	159	50	581	40.7	82	3	6
2010	Jun. 2008–May 2009	43/183	153	50	958	36.2	102	5	7

<sup>a</sup> World Bank frequently changes the methodology of the rank, adding new parameters. However, revised data is not included into the table – the information concerns only data that was actual by the time of publishing each report and not revised.

Sources: World Bank Doing Business Rankings (2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015). Compiled by Hrant Mikaelian

**Table 3: The Share of Taxes Paid by the Top-100 Tax-Payers of Armenia**

	Total amount of tax incomes of the budget, bln. AMD	Taxes (share), paid by top-25 tax payers	Taxes (share) paid by the next 75 tax payers <sup>a</sup>
2008	736.4	171.9 (23.3%)	98.7 (13.4%)
2009	642.8	148.8 (23.2%)	83.5 (13.0%)
2010	718.4	169.1 (23.5%)	94.8 (13.2%)
2011	797.0	192.9 (24.2%)	106.8 (13.4%)
2012	898.4	224.8 (25.0%)	125.0 (13.9%)
2013	1000.9	258.9 (25.9%)	151.2 (15.1%)
2014	1064.1	264.7 (24.9%)	171.6 (16.1%)
2015 1 <sup>st</sup> quarter	232.5	61.9 (26.6%)	36.4 (15.7%)

<sup>a</sup> This includes 26-100 positions of the full list.

Sources: Taxpayer Information Listings, Tax Service of Armenia (2008–2015). Compiled by Hrant Mikaelian



## The Informal Economy in Azerbaijan

Farid Guliyev, Baku

### Abstract

This article looks at various estimates of the scale and composition of the informal economy in Azerbaijan, focusing on the extent and structure of informal employment. It shows that informal economic activity makes up a considerable part of the country's GDP and that the share of informal employment is high. The extent of the informal economy has negative consequences for the state's collection of taxes and the social security protection of those employed without contract. Challenges for the foreseeable future include the ability of an oil-dependent economy to create jobs for the growing number of youths, risks associated with social security exclusion of informal workers, and the lack of political will to implement structural reform to eliminate informal payments and bureaucratic control of the economy.

### Size and Composition

"The work of a taxi driver is very hard here," says a cab driver as he is driving me along the newly refurbished roads in Baku's downtown area. He owns the cab that has no meter installed, fares are negotiated in advance, and you receive no receipt after you have paid. This taxi driver, just like many others in Azerbaijan, works informally, without a labor contract and without social protection benefits. Unlike newly sprung taxi service companies, such as Baku's so-called London cabs, his business is not registered and he does not pay taxes. Traffic police officers who supervise the area of the city where he works "demand kickbacks or '*kontur*' by the end of every week" [in local parlance, '*kontur*' refers to cellphone refill/prepaid balance]. He also complains that periodically he needs to call his connections in the city traffic police department whenever the old police inspectors are replaced with new ones who have a larger appetite for bribes.

The story of my taxi driver is not uncommon. A large chunk of the Azerbaijani economy, measured as a fraction of GDP and total employment, is officially unregistered and informal, and it is routine for many Azerbaijanis to make use of informal payments to get things done. Following International Labor Organization (ILO) definitions, the informal economy covers "all economic activities by workers and economic units that are—in law or in practice—not covered or insufficiently covered by formal arrangements... Activities are not included in the law, which means that they are operating outside the formal reach of the law."<sup>1</sup>

Some estimates suggest that as much as 60% of Azerbaijan's official GDP is informal or shadowy (in Azeri: '*kölgə iqtisadiyyatı*', '*qeyri-rəsmi iqtisadiyyat*', '*gizli iqtisadiyyat*'). Estimates by Friedrich Schneider and collaborators at the World Bank (2010) suggest that Azerbaijan

has one of the largest shadow economies in post-communist Eurasia. Despite the slight reduction in levels of informal economic activity from 61.0% of GDP in 1999 to 52.0% of GDP in 2007, the average size of the informal economy for the entire period is still fairly large, 58.0% of GDP.<sup>2</sup> According to an alternative measure by Abdih and Medina (2013), the size of the informal economy in Azerbaijan, as of 2008, was 31.5 % of GDP (cf.: Armenia—35 %, Georgia—30.1, Kazakhstan—33.0).<sup>3</sup> According to official statistics, the size of the shadow economy is about 7–8% of GDP (as of 2014). Local economist Ali Masimli thinks that neither the World Bank's figure of 60%, nor the official state statistics figure of 7–8 % is accurate. He estimates the level of informal economy to be around 33%.

The precise size and scale of informal activities is difficult to approximate given the hidden nature of the activity and unreliability of official statistics. Researcher Leyla Sayfutdinova notes that the figure of 60% may be an underestimation because macroeconomic measures relying on official statistical reports tend to underappreciate the real extent of informal activities. Using the method of mirror statistics to estimating the gap in export-import turnover statistics from 2003–2009, economist Gubad Ibadoglu (2012) finds a discrepancy of \$10.6 billion. Another economist Ogtay Hagverdiyev believes that Azerbaijan's biggest pool of reserves lies in the shadow economy dominated by monopolies linked to state officials who are popularly referred to as "oligarchs."

1 ILO, <[http://www.ilo.org/ilc/ILCSessions/104/media-centre/news/WCMS\\_375615/lang--en/index.htm#>](http://www.ilo.org/ilc/ILCSessions/104/media-centre/news/WCMS_375615/lang--en/index.htm#>)

2 Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, "Shadow Economies All Over the World: New Estimates for 162 Countries from 1999 to 2007," World Bank Policy Research Working Paper No. 5356, June 1, 2010, available at SSRN: <<http://ssrn.com/abstract=1645726>>.

3 Yasser Abdih and Leandro Medina, "Measuring the Informal Economy in the Caucasus and Central Asia," IMF Working Paper WP/13/137, May 2013, <<http://www.imf.org/external/pubs/ft/wp/2013/wp13137.pdf>>.



## Informal Employment

Informal practices also prevail in labor relations and workforce participation. Sayfutdinova cites previous research putting the early 2000s informal employment figure at about 38% of the total labor force.<sup>4</sup> According to the latest ILO employment data, as of October 2009, 407,000 persons held informal jobs in Azerbaijan, accounting for 26.5% of non-agricultural employment. When divided by gender, the share of informal employment is higher for women than men: 254,000 women and 153,000 men were informally employed, which represents respectively 41.7% and 16.6% of non-agricultural employment in the country.<sup>5</sup> In terms of occupational composition, a majority of informal workers are low-skilled labor employed as market (bazar or 'tolkuşka') vendors, shop-keepers, shuttle traders (informally speaking, engaged in 'alver', literally: 'buying and selling'), nannies and owners of small businesses. A large number of informal workers are also employed seasonally in the construction sector. A smaller fraction of self-employed are high-skilled professionals working as freelancers in language translation, training, and consulting services, according to the World Bank 2010 living conditions assessment report.<sup>6</sup> These categories of self-employed often operate without registration and pay no taxes.

Official statistics report around 2.1 million people of the total population of 9.4 million as being employed in the private sector. However, the state statistical agency notes occupations for only 800,000 of those employed in this way, while the remaining 1.3 million are put into the category of private or natural person. It is plausible that the vast majority of those who fall under this category are self-employed or hold informal jobs mainly in subsistence agriculture.<sup>7</sup>

According to the above-cited 2010 World Bank report, the share of the workforce without contracts increased from 45.3% in 2003 to 59.5% in 2006 (more

recent figures are not available). Of 59.5% of all the workers thus employed in 2006, about 71% were rural residents indicating a strong urban-rural divide. Of the total number of 223,000 people employed in construction, a sector that alongside services has expanded after the start of the oil boom, only 25% had written labor contracts with their employers.

Another aspect of the demographic dimension of informal employment is the sectoral composition of the Azerbaijani labor force. While the lion's share of Azerbaijan's economic output is driven by oil production, the hydrocarbon industry is capital, not labor, intensive, and does not generate many jobs. The oil and gas sector employs only 1% of the total workforce. In contrast, the sluggish agricultural sector which contributes only about 5% of GDP provides employment for 37% of the total labor force (World Bank 2015). A sizable fraction of the informal workforce is made up of those who are employed in subsistence farming and agricultural production mainly for family consumption. A lack of opportunities in rural areas drives many, especially male, Azerbaijanis to seek a job outside the country, mainly in Russia. A majority of Azerbaijani labor migrants in Russia are typically employed without written contracts.

One reason for this distorted pattern of employment in Azerbaijan is the country's oil rentier economy, which generates about 75% of government revenue, but employs only a small fraction of the country's workforce. Because the government does not rely on domestic taxation, it has weak incentives to nurture productive forces outside the oil sector and require their registration for the purposes of extracting taxes. Therefore, a large part of non-oil employment is either self-employed or employed without labor contract. While in recent years the authorities have made tax reporting easier, including via e-services, it remains to be seen whether these technical improvements will incentivize those informally employed to actually declare their incomes and lead to a greater formalization of the economy.

Undeclared or informal jobs also mean that many Azerbaijanis cannot enjoy social insurance benefits toward which they also contribute from very little to nothing. The informal economy weakens the system of social protection in Azerbaijan because those informally employed do not pay income taxes or social security contributions. Unregistered, self-employed workers shun declaring income and reporting unpaid family employment, thus evading social security taxes. As a result, they also remain left out of pension coverage.

## Informal Payments

Many informal or self-employed find it more expedient to pay "informal fees" to local tax inspectors than

4 Leyla Sayfutdinova, "Negotiating Welfare with the Informalizing State: Formal and Informal Practices Among Engineers in Post-Soviet Azerbaijan", *Journal of Eurasian Studies* 6:1 (2015): 24–33, DOI: <<http://dx.doi.org/10.1016/j.euras.2014.08.002>>

5 ILO Department of Statistics, "Statistical Update on Employment in the Informal Economy", June 2011, <[http://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/presentation/wcms\\_157467.pdf](http://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/presentation/wcms_157467.pdf)>.

6 World Bank, "Azerbaijan: Living Conditions Assessment Report", Report No. 52801-AZ, March 1, 2010, <<http://datatopics.worldbank.org/hnp/files/edstats/AZEstu10.pdf>>.

7 The data that follows in this section are taken from: Gursel Aliyev, Anar Valiyev, and Sabina Rustamova, "Social Protection and Social Inclusion in Azerbaijan", Report for European Commission Directorate-General for Employment, Social Affairs and Inclusion 2011, <<http://ec.europa.eu/social/main.jsp?catId=89&langId=en&newsId=1045&moreDocuments=yes&tableName=news>>.

register their business with relevant tax authorities and pay official tax. In fact, informal payments are pervasive. According to the EBRD's Life in Transition survey II (LiTS II 2010) report, a vast number of Azerbaijani respondents reported unofficial, out-of-pocket payments for public services: 72% said they paid bribes when dealing with public health services, 65%—in primary/ secondary education, 66%—traffic police, 60%—official documents, 65%—vocational education, 63%—social security benefits, 65%—unemployment benefits, and 61%—civil courts.<sup>8</sup>

Between 2006 and 2010, perception of corruption in Azerbaijan increased five fold from 14% in 2006 to 65% in 2010 (LiTS II 2010). Although such a jump in venality perception may look unrealistically dramatic, it might reflect the change in informal practices and a certain commercialization of informal public-private transactions. While in the 1990s and early 2000s people relied mostly on personal networks, relatives, connections and favors (for which 'tapş' is the local equivalent) to get around cumbersome bureaucracy and dealing with public officers, the new reality demands paying cash. In other words, cash has increasingly been replacing favors.

As a way of tackling bureaucratic corruption, in 2012 the president issued a decree establishing a new service under the umbrella of the State Agency for Public Service and Social Innovations, "ASAN Service" (in Azeri: 'ASAN xidmət'), which is based on a one-stop shop model and acts as a facilitator between citizens and state agencies. This system allows citizens to enjoy a variety of public services, such as the granting and renewal of identity documents, registration of taxpayers, and a notary service. ASAN Service can be considered as a "pocket of efficiency" within the Azerbaijani state bureaucracy, which is generally perceived as lacking in capacity and highly corrupt. However, while as a standalone entity ASAN may be efficient, it may not be the most efficient way to overcome the pathologies of the inertia-driven old bureaucratic system. Moreover, ASAN represents a characteristic of government decision-making of the oil boom era that avoids implementation of painful reform and instead throws money at problems. The problem with the ASAN model is that fundamentally it preserves the old, clientelistic system that breeds corruption. In fact, it postpones the much-needed reform in the areas of government policy-making and bureaucratic performance. A cursory look at the World Bank's Governance Indicators for Azerbaijan shows that there has not been much improvement in

governance over the past years since the introduction of ASAN, especially in such crucial areas as control of corruption, regulatory quality and rule of law. The country falls behind the regional average (Europe and Central Asia) on all governance indicators. All this shows that ASAN is just a cosmetic measure that masks the real problems of rampant administrative and political corruption. It is hard to imagine if the government could have afforded keeping this "double bureaucracy" had it not enjoyed access to enormous oil revenues as it has.

Another widely spread informal practice is paying salaries in envelopes. Many state employees are paid two salaries: an official one (in Azeri: 'rəsmi maaş') and unofficial one, delivered in an envelope ('zərfdə maaş'). This is possibly done for two reasons: first, firms and state agencies under-report officially paid wages to avoid paying social security or income taxes. A second reason why particularly public sector employees may be remunerated this way is because unofficial payments may be used as a mechanism of political control. Unreported wages can always be qualified as an illegal payment and turned against public officials deemed to become disloyal, turning into rivals or enemies.

## Challenges Ahead

There are several challenges ahead, including:

- *Social protection:* Since only those with formal job contracts are entitled to social security benefits, the vast majority of the informally employed are not included in the social security system, which means they get neither a pension nor unemployment benefits. In fact, about 65% of the Azerbaijani working age population had no pension insurance as of 2007, although these figures might have changed for recent years.<sup>9</sup> Without measures to effect the state's infrastructural capacity to enforce the mandatory labor contract and tax reporting, informal employees will continue to be in a vulnerable position and potential economic crisis will hit informal employees more severely than those with a formal contract who can enjoy at least some social safety nets.
- *Youth influx:* A greater challenge for the authorities is how to maintain a large public sector to provide jobs for young people as Azerbaijan will experience an influx of large numbers of youth ('youth bulge') in the next decades. The state statistics committee indicates that the state sector employed 25.9% of the total workforce in 2013, down from 33.2% in 2000. According to the 2013 Caucasus Barom-

8 Life in Transition Survey II, <<http://www.ebrd.com/news/publications/special-reports/life-in-transition-survey-ii.html>>

9 World Bank, World Development Indicators, 2012, p. 78, <<http://data.worldbank.org/sites/default/files/wdi-2012-ebook.pdf>>.

eter, however, more than 40% of employed respondents chose “employment in a state organization” as their job status. At the start of 2014, young people (under 25 years of age) and those under 35 constituted 40% and 60% of the total population respectively.<sup>10</sup> Continued reliance on oil and gas exports, stagnant agriculture and weak non-oil sectors in general will limit the government capacity to create jobs for these young people, many of whom will seek employment outside the official realm. The impending decline in oil revenue will constrain the government’s ability to maintain large numbers of people on the state payroll. A potential oil-induced crisis will

reduce government spending and hurt job opportunities in construction and services that have normally been financed through public investment projects.

- *Political will:* Finally, the biggest challenge is the lack of incentives among the Azerbaijani political elites to carry out structural reform that would address the root causes of informal economic activities. The influx of oil money has so far allowed the government to mimic public service reform. However, without deep structural change, it is unlikely that the government will manage to curb informal payments and transition informal economic activity into the formal realm.

#### *About the Author*

Farid Guliyev, Ph.D. Jacobs University, Bremen (2014), is an independent researcher based in Baku. His current research focuses on the comparative study of political institutions, governance of natural resources, and public policy in developing countries. Personal web site: <<http://sites.google.com/site/fareedaz>>

<sup>10</sup> World Bank, “The Jobs Challenge in the South Caucasus—Azerbaijan”, January 6, 2015, <<http://www.worldbank.org/en/news/feature/2015/01/06/jobs-challenge-in-the-south-caucasus-azerbaijan>>.

## Institutional Trust and the Informal Sector of Georgia

Philippe Rudaz, Zurich

### **Abstract**

This article uses empirical data from Georgia to show how informal sectors participants—self-employed entrepreneurs and micro firms—are organized. Though they differ in their activities and education, they display the same motivation, attitude to formality and attitude to risk. Facilitating business registration through tax incentives is therefore not sufficient. The article also identifies the low level of trust in institutions as a barrier to the inclusion of the informal sector into the formal structures of the economy.

### **The Importance of Informality**

With 1.8 billion workers and accounting for 60 percent of total employment in 2009, the informal economy is actually the norm, according to the OECD.<sup>1</sup> Echoing these figures, another study estimates that half of the workers in the developing world are self-employed and many of these individuals participate in the informal economy. Four decades after the term “informal” was introduced and in spite of much misuse and abuse, the concept has proven to be useful.

But scholars still struggle with two features of informality: The diversity of informal activities and the potential of informal sectors for a country’s economy. These are two issues that are important for social and economic policies. Small and medium enterprise (SME) and entrepreneurship policies are incomplete if they fail to take into account the informal sector and its potential in terms of employment and GDP. From that point of view, the integration of the informal sector into the formal economy is actually at the heart of the transition process in the former communist countries. This article discusses the case of Georgia along two dimensions. At the micro level of enterprises, it focuses on the degree to which independent firms are organized. At the

<sup>1</sup> According to the OECD data <<http://www.oecd.org/dev/poverty/isinformalnormalmessagesfiguresanddata.htm#data>>

macro level of the country, the reach of official governance is the main topic.

### **Informality Does Not End at Business Registration**

In Georgia, more than 50% of the labor force is considered to be self-employed and non-observed (which is another label for the informal economy). These workers contribute approximately 20% of the country's GDP, according to official state estimates.<sup>2</sup> By some definitions, the informal sector is as much as 30% of Georgia's GDP.<sup>3</sup>

The drastic reforms that followed the Rose Revolution did not manage to better integrate the informal sector into the formal one. Taxes and procedures have been reduced and streamlined without increasing the level of tax compliance among the self-employed. There is little mobility between different status-levels of economic occupation, which is an indication of a segmented labor market.

The recent Academic Swiss Caucasus Net (ASCN) study on the emergence of entrepreneurship<sup>4</sup> in Georgia tried to determine to what extent the informal sector, represented by the self-employed, constitutes an entrepreneurial resource. It surveyed a cohort of self-employed, micro and small enterprises every 6 months during two years in three regions of Georgia. The interplay between available resources, perceived opportunities and socio-economic institutions, in conjunction with the motivation and vision of entrepreneurs, together shape entrepreneurship as it is emerging in Georgia. Entrepreneurship, in this study, is considered to be the “*process of discovering and exploiting profitable opportunities.*” But the data produced by the project shows that this process is not taking place among the self-employed and micro firms. Rather, entrepreneurship rather starts with small enterprises.

Indeed, micro enterprises, which are made up of individual entrepreneurs but registered as such to benefit from a special tax regime, display many similar characteristics to the self-employed. While they differ in their activities and level of education attained—micro enterprise workers are better educated, sometimes holding university degrees, and are more active in trade and services, while the self-employed are mostly engaged in agriculture—the two groups display the same motiva-

tion, attitude to formality and attitude to risk. The holding of accounting books stems from being registered, so half of the micro firms keep accounting records of their business, while only 4% of the self-employed do that. However, like the self-employed, 70% of the respondents do not have bank accounts and 90% of them conduct their business without written contracts. By the same token, around 35% of the self-employed and micro enterprises do what they do by default. Seizing opportunities is a motivation for only 5–10% of both groups. Fear of failure would prevent more than 50% of both groups from starting new activities or proposing new services or products. Half of the self-employed and micro enterprises would not be ready to enroll in training courses, even if the lessons could improve their businesses. Seventy percent of them would not be ready to take more financial risks to develop their activities.

Registering a business activity is one step that entrepreneurs can take in order to formalize the way they operate, but is certainly not the only one. Holding accounting records, operating with written agreements, processing transactions via bank accounts are also features of formality. Informality does not end at registration. In other words, it is not only determined by tax compliance, but also by a certain way of organizing business activities.

The low score of the self-employed group for these variables should not come as a surprise. However, one can notice that registration did not make the business operation of micro enterprises more formal. From that point of view, self-employed and micro enterprises should be grouped together. Entrepreneurship and formality then starts with small enterprises, which show distinct characteristics that differentiate them from the self-employed and micro firms. Small enterprises all maintain accounting records, hold bank accounts, tend to plan the development of their activities, show more willingness to take risks and are better informed.

### **The Reach of Governance and Trust in Institutions**

The ASCN dataset also provides information about the other dimension of informality: the reach of official governance. Tax rates and licenses and permits are not viewed as a major obstacle. Self-employed, micro and small enterprises do not have any reasons to complain and do not report having any problems whatsoever with any state administration. Micro businesses in Georgia are exempt from taxes; licenses and permits are completely liberalized and brought to the minimum. Likewise, the labor code is quite liberal and is not thoroughly enforced. The low enforcement level and the fact that micro and small businesses rarely employ a hired work-

2 According to Geostat and own calculation.

3 Defined as “those economic activities that circumvent the costs and are excluded from the benefits and rights incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit, and social systems”.

4 “The emergence and evolution of entrepreneurship in Georgia”, Academic Swiss Caucasus Net, unpublished results.

force can explain the fact that the respondents believe that the amendments made to the code in 2013 do not concern them.

The gap between the reality of the socio-economic fabric in Georgia and the economic policy of the government reflects the dilemma of economic reforms in transition. The imperatives of reforms demanded non-interference with the economy to avoid supporting any particular actors, but which actually prevents the development of SMEs. The “policies vacuum” created by the retreat of the previous government gave rise to numerous measures and development projects sponsored by national and international agencies and NGOs. These measures significantly enhanced the business environment, but they are of a tactical nature and cannot replace strategic and comprehensive economic policies that are needed to integrate the informal economy into the formal one. In other words, dismantling the old Soviet bureaucracy is only half of the challenge. The other half is institutional building, which is still problematic in Georgia.

A quick look the Caucasus Barometer database spanning from 2008 to 2013 tells us a lot about the relationship between state institutions and its citizens. By focusing only on the percentage of respondents that “fully trust” some Georgians institutions, one can classify them in three categories:

1. Institutions fully trusted by more than 50% of the respondents from 2008 to 2013, even if that percentage slightly decreased.
2. Institutions fully trusted by less than 50% of the respondents, but have seen their “trustworthiness” increase from 2008 to 2013.
3. Institutions fully trusted by less than 50% and have seen their “trustworthiness” decrease from 2008 to 2013.

Table 1 on p. 13 is the result of that categorization.

The table makes clear that the institutions most appropriate to carry out reforms and policies to integrate the informal economy into the formal one are not

trusted by Georgians and that what trust there was has actually dropped between 2008 and 2013. The only relevant institution with regard to the establishment of a more inclusive market economy that has enjoyed increasing trust from respondents is the executive government. But local governments, which could be instrumental in formalizing the economy, are trusted by only a quarter of the respondents.

The lack of trust that characterizes these institutions is a barrier to the creation of a more inclusive market economy. The policies, efforts, programs and communication of these authorities suffer from a trust deficit. The problem has less to do with the quality of the institutions than the implementation style of the policies and the lack of mechanisms to consult and include private sector actors and civil society within the policy-making process.<sup>5</sup>

Such an interpretation of this empirical evidence suggests that the persistence of the informal economy is not related to economic development only, but to institution and state building as well. This finding explains why, in many transition countries, the informal economy has grown in spite of many reforms (Krstic and Sanfey, 2011, Lukiyanova, 2015) and why it is also an issue in developed economies as well. According to some estimates, the informal sector reached an average of 21% of GDP in Belgium and Portugal and 25% in Italy between 1991 and 2005 (Schneider and Buehn, 2012).

In Georgia, the informal sector can be viewed as a healthy distance that the state imposed between small businesses and itself. By not interacting anymore with small business, the state does not constitute a barrier. On the other hand, Georgia did not succeed—as measured by Western standards—to establish the elementary platform for the development of a true liberal market economy. It is as if the state interpreted “not interfering” with the economy as “not caring” about it. This misinterpretation is all the more visible when looking at the official status of the self-employed. They are beyond the state’s reach, for better or for worse.

#### *About the Author*

Philippe Rudaz, Ph.D. University of Fribourg, Switzerland, is the main coordinator of the ASCN research project “The Emergence and Evolution of Entrepreneurship in Georgia.”

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<sup>5</sup> The link between the design and the quality of institutions and the size of informal sectors has been established, with perhaps too much focus on the tax and regulatory environment (Jonson et al., 1998, Hibbs and Piculescu, 2005, Schneider et al., 2010). On the other hand, the lack of trust that impedes the institutions mentioned might also be due to a lack of inclusion of the broader civil society into the policy-making process.



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**Table 1: Trust Toward Institutions (2008–2013)**

High trust (above 50%) even if slightly decreased or increased	“Trustworthiness” below 50%, but slightly increased	“Trustworthiness” below 50%, and decreased
Religious authorities (86–81%)	<i>Executive government (31–39%)</i>	Health care system (62–44%)
Army (75–72%)		EU (54–33%)
Police (53–58%)		UN (48–30%)
Educational system (55–55%)		Media (50–24%)
		<i>President (50–24%)</i>
		<i>NGOs (35–23%)</i>
		<i>Local government (36–28%)</i>
		<i>Parliament (35–28%)</i>
		<i>Court system (27–22%)</i>

## CHRONICLE

## From 24 June to 8 July 2015

24 June 2015	The IMF, EBRD, Asian Development Bank and World Bank send a joint letter to Georgian Prime Minister Irakli Garibashvili requesting that he not strip the National Bank of its supervisory functions over the banking sector
25 June 2015	Georgian Defense Minister Tina Khidasheli visits NATO headquarters in Brussels for a planned meeting of defense ministers
26 June 2015	Armenian President Serzh Sarkisian announces that the case of a Russian soldier accused of killing seven members of an Armenian family is handed over to Armenian investigators
27 June 2015	Armenian President Serzh Sarkisian vows to provide financial help to Armenians to cope with a planned increase in electricity prices amid protests in the capital Yerevan
28 June 2015	Thousands of demonstrators protesting rising electricity prices defy police's orders to clear Yerevan's central Baghramian Avenue
29 June 2015	Georgian Prime Minister Irakli Garibashvili says in a newspaper interview that he will always support introducing a constitutional clause that defines marriage as the union of a man and a woman
29 June 2015	Georgian Foreign Minister Tamar Beruchashvili meets with Belarusian Foreign Minister Vladimir Makei on the sidelines of a meeting of Eastern Partnership countries in Minsk
30 June 2015	The Georgian Parliament supports a proposal that would repeal imprisonment for the possession and personal use of small amounts of marijuana
1 July 2015	A court in Azerbaijan sentences 10 people to jail for joining the Islamic State
1 July 2015	Russia says that Georgia's NATO integration is a "security threat" and in conflict with the August 2008 cease-fire agreement during the 32 <sup>nd</sup> round of Geneva talks
2 July 2015	Turkmenistan's President Gurbanguly Berdymukhamedov pays a first official visit to Georgia and discusses energy projects with Georgian leaders, including a potential transit route for Turkmen gas to European markets via the South Caucasus
2 July 2015	The Azerbaijani Foreign Ministry protests plans by the leader of the disputed region of Nagorno Karabakh, Bako Sahakian, to visit London
3 July 2015	In a second reading, the Georgian Parliament passes a legislative package envisaging the decoupling of intelligence and security agencies from the Interior Ministry
5 July 2015	A missing tiger from Tbilisi's zoo is found dead three weeks after the zoo flooding
6 July 2015	The Armenian police forcibly clear the last demonstrators on Baghramian Avenue in the capital Yerevan
8 July 2015	Sixteen U.S. senators write a letter to Azerbaijani President Ilham Aliyev citing concerns about a crackdown on civil society in Azerbaijan
8 July 2015	Georgia holds joint military exercises at the Vaziani base outside Tbilisi together with five NATO members

*Compiled by Lili Di Puppò*

*For the full chronicle since 2009 see <[www.laender-analysen.de/cad](http://www.laender-analysen.de/cad)>*



## WORKSHOP

## Call for Applicants for PhD Students and Early Postdoctoral Researchers Workshop on Research Methodology (Working Languages: English and Russian)

2–3 October 2015, Ivane Javakhishvili Tbilisi State University, Georgia

Deadline 31 August 2015

Ivane Javakhishvili Tbilisi State University is pleased to invite PhD students and early-stage postdoctoral researchers (up to 2 years after defending their doctorate) enrolled in universities based in the South Caucasus (Armenia, Azerbaijan and Georgia) and working in any discipline related to the social sciences, to join a two-day workshop on research methodology.

The workshop will benefit from the support and expertise of a team of international scholars who have experience in a wide array of methodological approaches and data collection methods in the field of social sciences. The event is built on the experience of previous successful training events organised for the Baltic region and we hope to use a similar approach to benefit local students.

The workshop will be a valuable opportunity for doctoral students and scholars from the region to present their research and receive tailored feedback from international experts, while at the same time networking and getting to know each other. Participants will:

- deliver a presentation on their methodological approach and to receive feedback from peers and senior scholars
- receive access to a large network in the region and beyond with a perspective of creating synergies across countries and regions
- attend a training session on how to prepare an abstract for an international conference

Please send an abstract (max 300 words) and a short biographical statement with contact details to Prof Ketevan Kutsishvili by the 31<sup>st</sup> of August 2015.

[ketevan.khutsishvili@tsu.ge](mailto:ketevan.khutsishvili@tsu.ge)

To ensure full consideration please cc also to:

Alisa Datunashvili [adatunashvili@gmail.com](mailto:adatunashvili@gmail.com)

Anete Grosberga [ms.aneteg@gmail.com](mailto:ms.aneteg@gmail.com)

You can refer to the above addresses if you have any queries

Abstracts should briefly outline the theme of the ongoing research project and its methodology and data collection methods. There is no obligation to submit a full paper in advance of the workshop, but if you wish to do so we will assign you a discussant who will provide you with tailored feedback and advice.

### Financial conditions

Accommodation and meals will be provided during the two days of the event for all participants but participants should take care of their own travel arrangements.

## ABOUT THE CAUCASUS ANALYTICAL DIGEST

Editors: Denis Dafflon, Lili Di Puppo, Iris Kempe, Natia Mestvirishvili, Matthias Neumann, Robert Orttung, Jeronim Perović, Heiko Pleines

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The Center for Security Studies (CSS) at the Swiss Federal Institute of Technology (ETH Zurich) is a Swiss academic center of competence that specializes in research, teaching, and information services in the fields of international and Swiss security studies. The CSS also acts as a consultant to various political bodies and the general public.

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### ASCN

ASCN (<[www.ascn.ch](http://www.ascn.ch/)>) is a programme aimed at promoting the social sciences and humanities in the South Caucasus (primarily Georgia and Armenia). Its different activities foster the emergence of a new generation of talented scholars. Promising junior researchers receive support through research projects, capacity-building trainings and scholarships. The programme emphasizes the advancement of individuals who, thanks to their ASCN experience, become better integrated in international academic networks. The ASCN programme is coordinated and operated by the Interfaculty Institute for Central and Eastern Europe (IICEE) at the University of Fribourg (Switzerland). It is initiated and supported by Gebert Rűf Stiftung <<http://www.grstiftung.ch/en.html>>.

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