Albania's Informal Economy: An Impediment to Economic Development? *

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"The improvement of fiscal administration is considered of special importance by the government both to overcome the challenges for the country's long-term development and European integration and to secure the financial resources that are necessary for the implementation of the GPRS. The main objective[...] of the reform of the fiscal administration will be ... [to] increase budget revenues by expanding the taxable base and reducing the informal economy ..."

Government of Albania (2001, p. 59)

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1. Introduction

The ongoing negotiations with the European Union (EU) on a stabilization and association agreement (SAA) reflect the recognition of the progress[1] made thus far during Albania's—at times troubled—transition. In order to advance these negotiations, strict adherence to the standards of a European pre-accession country[2] is required, politically as well as economically. With regard to the latter, Albanian policy-makers—having passed the stage of post-crisis stabilization—are now in a position to focus their energies on the more complex challenges of economic development. In complementing the politico-economic integration in Europe with a comprehensive strategy for socio-economic development (NSSED; formerly GPRS),[3] the government seeks to overcome the legacy of half a century of misguided economic policies that had left the country with widespread poverty, a decrepit public infrastructure, and weak public institutions. However, corrective public investments, expected to generate important *crowding-in* effects, presume the access to increasingly larger budgetary resources. As Albania is about to become ineligible to important sources of highly concessional foreign financing, this—already crucial—condition is gaining even more urgency. Recent problems with revenue collection, as evidenced by the consistently low revenue-to-GDP ratio and repeated shortfalls relative to initial budget projections (IMF 2003a), raise the concern whether (and under what conditions) it is reasonable to expect that the

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* Insightful comments by Hossein Samiei, Jan Kees Martijn, Ivanna Vladkova-Hollar, Karen Ongly, David Hamoodi, and participants of the Bank of Albania's 4th International Conference on the *Albanian Economy: Performance and Policy Challenges*, held in Saranda during September 11–12, 2003, have considerably improved this paper and are gratefully acknowledged. The views expressed in this article are those of the author and should not be attributed to the IMF. The standard disclaimer applies.

[1] See, e.g., IMF (2002, 2001a). The economic stabilization program was required to overcome the socio-economic crisis caused by the disastrous collapse of the pyramid schemes in 1997; see Bezemer (2001) and Jarvis (2000).

[2] On October 21, 2002, the Council of Ministers of the European Union decided to invite Albania to start SAA negotiations; see EU (2002a,b). During the opening ceremonies of the SAA negotiations, the President of the European Commission, Romano Prodi, stressed that Albania—"a potential candidate" (Prodi 2003a)—was taking "first step down the road to Albania becoming a full member of the European Union," which implied that the government accepted "a major commitment" in a wide range of areas, including the "completion of a market economy" (Prodi 2003b).

[3] See Government of Albania (2001) and, on the recent experiences in implementing the strategy's measures, Government of Albania (2003) and IMF (2003b).

realization of Albania's ambitious development goals, including the continued maintenance of macroeconomic stability, can indeed be achieved within the timeframe envisaged by the NSSED.

Subsequently, policy measures designed to increase budgetary revenues remain at the very center of any development strategy in Albania, circumscribing the enormous—but certainly not unique—challenge the government is facing; viz., to simultaneously strengthen revenue collection, upgrade public services, and improve the strained taxpayer relations with the formal private sector. This *is* possible; and it has been successfully demonstrated by other, particularly smaller transition economies (e.g., the Baltic countries). As will be argued in the following, a replication of these experiences in Albania presupposes a considerable correction to key elements of the underlying economic regime. As succinctly noted by Alesina (1999),

> "improving government performance to achieve social goals means switching from a tax-evading economy with no infrastructure and with mistargeted safety nets to a tax-paying formal economy with relatively small but efficient social safety nets. However, many of these reforms are not likely to be successful without a reduction in corruption and bureaucratic inefficiency" (p. 229).

Alesina's characterization of a government that is *too small* and *too ineffective* to tangibly improve the socio-economic environment is rooted in the rapidly growing literature on informal markets;[4] particularly, the seminal studies by Loayza (1997) and Johnson, Kaufmann, and Shleifer (1997), who argue that economies with large informal sectors tend to be stuck in a "bad" equilibrium with a low-quality public goods and a high degree of fiscal evasion. Analyzing a large number of transition economies in eastern Europe and the former Soviet Union (excluding Albania), they find that businesses react to an increasing degree of "politicization" of private-sector activities[5] with a trend withdrawal from the formal sector, implying that macroeconomic stabilization without accompanying reforms to strengthen market-supporting institutions does not suffice to maintain high rates of economic growth. Like many other authors, Friedman et al. (2000) substantiate this finding, arguing that "[d]iscretion in the application of rules, and the corruption that this produces, seems to have a more important effect" (p. 481) than, e.g., higher marginal tax rates, which are frequently cited as a principal reason for large informal sectors.

Apart from the pleasure derived from the puzzle work necessary to estimate the "hidden" elements of economic activities, a large part of this literature is motivated by the attempt to identify the effects of economic informality on growth and economic prosperity. Most researchers have found a negative correlation between these two variables,[6] for mainly three reasons. First, a

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[4] For a survey of the corresponding literature, see, e.g., Schneider and Enste (2000a,b)

[5] Johnson, Kaufmann, and Shleifer (1997) define the *politicization* of economic life as "the exercise by politicians of control rights over businesses. ... Typically, politicians use these rights to pursue their own interests, such as maintaining employment in certain firms, supporting politically friendly and punishing politically unfriendly entrepreneurs, and subsidizing their allies. Politicians also use these rights to enrich themselves by offering firms relief from regulation in exchange for bribes. Political control generally reduces the profitability of doing business, and therefore adversely influences entrepreneurial activity and economic growth" (pp. 159–60).

[6] Notable exceptions include Cassel (1986, p. 93) or Gretschmann (1984, p. 120) who argue that informal markets represent, respectively, an "economic buffer" or a "stabilizer of last resort" that permits households and firms to more easily adjust to a deteriorating economic environment. In his empirical study, Bhattacharyya (1993) showed that the informal sector had positive effects on both consumption and investment expenditures for the U.K. during 1960–84, a point that Schneider (1998) supported analyzing German and Austrian data. Other authors, such as Asea (1996), argue that owners of informal firms tend to be greater risk-takers and, as a result, provide the economy with a higher degree of competition, thereby closely reflecting Schumpeter's (1942) ideal of an innovative and creative entrepreneur.

large informal sector leads to an increase in economically non-productive activities (particularly the concealing, protecting, or detecting of hidden and illegal economic activities) and, subsequently, to a considerable waste of scarce resources (Shleifer and Vishny 1993). Second, it tends to cause a misallocation of production factors, principally because informal enterprises—unable to (fully) make use of market-supporting institutions, such as police, courts, or banks—employ an insufficiently capital intensive production technology, which will make their goods and services ultimately uncompetitive (de Soto 1989). And finally, a large informal economy results in an important sum of foregone tax revenues (Loayza 1997), which—particularly in countries like Albania—reduces economic welfare as urgently required (social) infrastructure investments cannot be made, thereby holding back private-sector activities.

Therefore, to assess a country's medium- to long-term growth potential and define policy priorities, an understanding of the size of the informal market (relative to formal activities) is crucially important. Contrary to most other transition countries, for which a considerable literature has developed that provided estimates of the size of their informal sectors, very little research has been done to approximate the magnitude—and/or composition—of Albania's shadow economy (and, therefore, the implicit extent of fiscal evasion). One notable exception is Schneider (2002), who used a method combining the physical input (electricity), currency demand, and model-based approaches[7] to estimate Albania's shadow economy. With the caveat of "unreliable figures" (cf. footnote in Table 5, p. 14), he estimated that around one-third of total economic activities in 2000 were informal.[8] This figure is comparable to the one used by Albania's Statistical Institute (INSTAT) when calculating official GDP figures.[9] The Albanian media, however, have periodically suggested that the size of the informal sector could, in fact, be considerably larger.[10] This paper will look at several macroeconomic indicators and discuss whether they could indeed be consistent with the suggestion of a larger-than-currently-estimated informal sector.

2. The Informal Sector and Economic Development

Defining the Informal Sector

There is an intensive academic debate taking place on the "correct" definition of the *informal economy*, a thorough discussion of which exceeds the scope of this chapter.[11] In this paper, the term "informal economy" will be defined to comprise both "hidden" and "illegal" economic activities, of which the revenues *should* have been reported to the tax authorities but, for some reason, have been concealed from them—for the following reasons:

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[7] For a discussion on the various estimation techniques, see the various articles included in the June 1999 *Economic Journal* discussion on "Controversy: On the Hidden Economy" as well as Schneider and Enste (2000b), Tanzi (1986), and Feige (1986) and the authors cited therein.

[8] According to Schneider's (2002) estimation method, the size of Albania's informal sector is comparable to those in Lithuania (30.3 percent), Croatia (33.4 percent), Bosnia and Herzegovina (34.1 percent), Romania (34.4 percent), and Bulgaria (36.9 percent).

[9] INSTAT's estimate is based on a survey method analyzing the economic activities of small, medium, and large enterprises in different sectors of the economy.

[10] In its December 16, 2002 issue, the daily newspaper *Dita*, e.g., mentions on page 1 that 50–60 percent of the Albanian economy is informal, with smuggling of imported goods being the principal component ("Ekonomia, 60 përqind informale").

[11] For an in-depth discussion on the benefits and limitations of alternative definitions, see, e.g., Schrage (1984) and Thomas (1992).

First, the "hidden" economy includes activities that, apart from breaking the tax law, are principally legal, such as unlicensed micro-enterprises, unregistered barter trade, under-invoicing, and the smuggling of non-prohibited commodities. Thus, these types of activities are largely viewed as a problem of fiscal evasion that represent a vital challenge to economic policy-making. Second, the informal sector is defined to also include those activities that, by their very nature, are "illegal". As a result, organized (economic) crime activities[12]—which include primarily the trafficking of arms, drugs, and women—are considered as well. While these represent, first and foremost, a problem of law enforcement, this definition will be used to permit subsequent studies estimating the relative size of informal activities that rely on macroeconomic data; these types of analyses would naturally encounter additional obstacles if they had to separate those activities that are, in principle, legal from those that are not.[13] In the following, the "informal sector" will be defined as the sum of all undeclared commercial activities that, *de facto*, contribute to national income.

As the participation in the informal economy represents a violation of the legal norm (even if the activities are *per se* legal), unofficial activities tend to be accompanied by an increased level of public corruption, whereby (poorly paid) officials accept bribes in exchange for protection or other favors to the detriment of the state. In recent years, a rather extensive literature has developed showing that, in a system rooted in bribery and corruption, economic incentives are distorted "as government officials and favored private individuals receive a larger share of public benefits or bear a lower share of the cost of public goods" (IMF 2000, p.130), which results in lower private investments, lower government revenues, while increasing inequality and poverty; see Mauro (1995), Tanzi and Davoodi (1997, 2000), Gupta et al. (1998), and Abed and Gupta (2002), with the key arguments being nicely summarized in Tanzi (1998). The large majority of recent studies confirms the existence of a negative correlation between corruption and growth, thereby stressing the crucial importance of improved "governance" as a core element in successful economic reform programs.

The Informality "Trap"

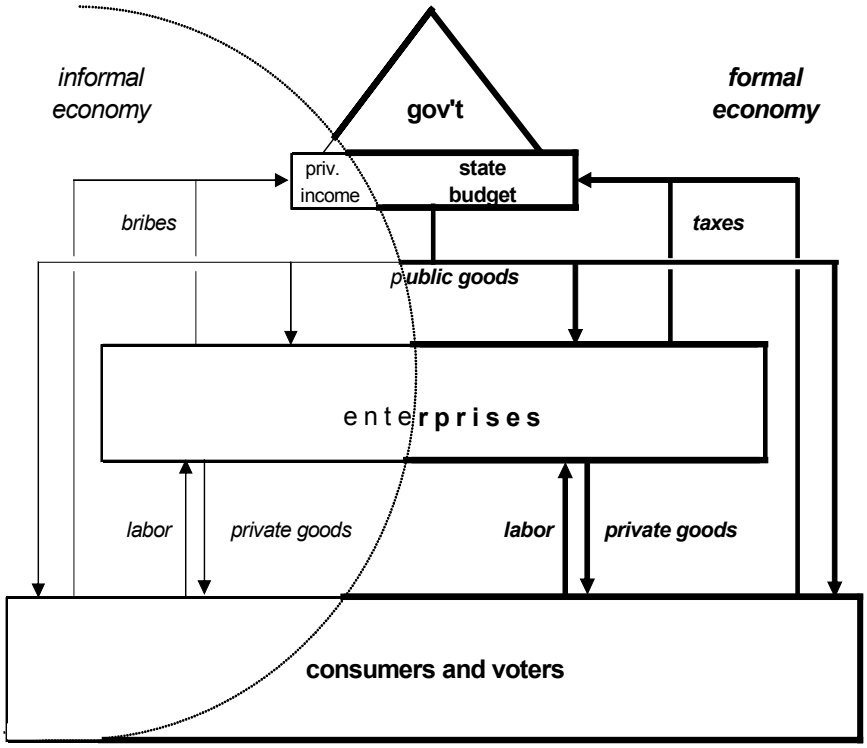
For a policy-maker, the most difficult aspect of reversing the trend increase in the relative size of the informal market is the juxtaposition of *private benefits* and *public costs*. As summarized in Figure 1, every market participant in the informal economy benefits—directly and personally—in some way: (i) individuals tend to receive higher net-of-tax salaries and are able to buy private goods and services at lower prices; (ii) firms can produce more competitively without the costly and often very time-consuming interaction with government officials; and (iii) corrupt officials and politicians receive additional private income (bribes) in exchange for accommodating those participating in, and profiting from, the informal economy. By contrast, the corresponding costs are all "public" in nature. They include, for the most part, reduced fiscal revenues and, subsequently, lower expenditures on—generally valued—public goods such as hospitals, schools, universities, roads, or the continuous provision with electricity and water.

Typically, households, firms, and government officials understand that everyone would benefit from a more "formalized" environment, in which the degree of fiscal evasion is low and the quality of public goods high. However, due to this conflict between private benefits and public costs, no economic actor is truly prepared to "voluntarily" take the first step in the direction towards increased economic formalization. The certain reduction in private benefits derived from informal activities weighs higher than the uncertain expectation of improvements in the provision of public goods—i.e., economies that have developed a substantial informal sector tend to be stuck in a

[12] See also Altvater and Mahnkopf (2002) and Naylor (2002).

[13] For example, how would one separate the fraction of private cash transfers that represent remittances in the narrower sense of the term from those that correspond to ill-begotten profits of crime?

Figure 1. The Stylized Dual Economy

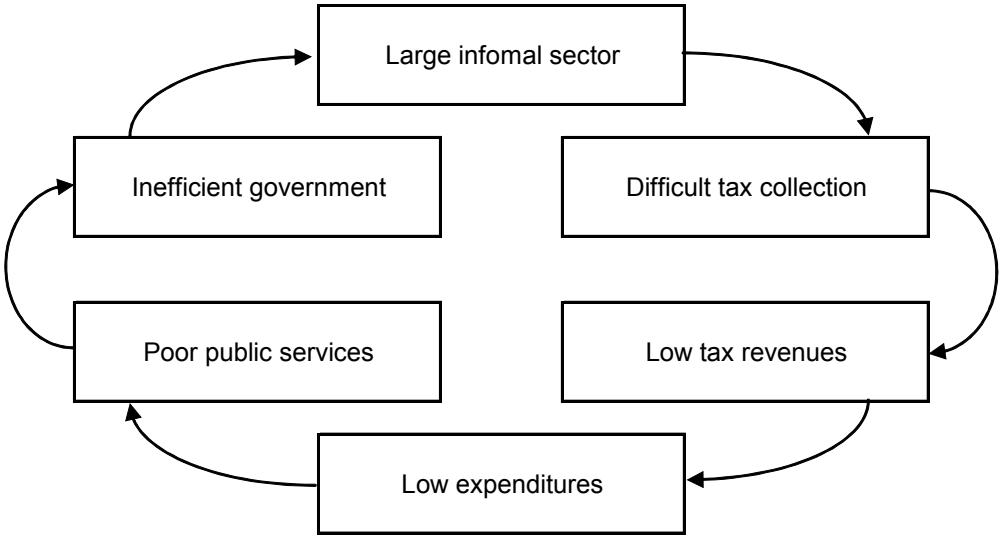


"vicious cycle" (Alesina 1999), where the large degree of informality complicates the government's task of collecting revenues for the budget. With low tax revenues, expenditures for important public goods will be low as well, which, in turn, will be reflected in their substandard quality (thereby constraining private-sector investments). With an inefficient public sector, taxpayer discipline will remain low, leaving the economy being stuck in a fiscal trap (Figure 2).

Conditions for a Trend Reversal

Economists tend to represent such a situation in a *dual equilibrium* model, in which an economy without credible, firm, and coordinated actions by all market participants will not be able to "automatically" find a path (back) towards the superior outcome with high-quality public goods and a high degree of tax discipline. Even in free-market economies, the only actor capable of initiating and coordinating necessary measures remains the government. The dual equilibrium interpretation of economies with large informal sectors implies that—with the "wrong" policies (or no policies at all)—an economy could converge to, and subsequently be "stuck" in, an equilibrium with a large informal sector, a weak tax collection rate, low tax revenues, and poor public services, reinforcing economic incentives to (continue to) operate informally. Placing the discussion on the growth implications of a large informal economy in a dual equilibrium framework means that an economy requires an impulse to find the virtuous path towards the "superior" outcome. Such a credible stimulus, strong enough to change people's behavior, would

Figure 2. The Vicious Circle



need to combine the government's (credible) political commitment for reform with the economic agents' recognition of an overall changed environment. The SAA negotiations, with a view towards eventual EU membership, could perceivably represent a sufficiently momentous event to permit the implementation of those—politically often very difficult—measures that are necessary to reverse the trend increase in economic informality. In this task, the principal challenge typically relates to the need to have structural reforms implemented at the expense of—typically well-connected—vested interests.

Looking at the experience of other transition economies, it is not surprising to see a possible relation between efforts to join the EU and a decline in informal activity. For example, when taking the informal-sector estimates by Johnson, Kaufmann, and Shleifer (1997) and re-arranging them according to the countries' status vis-à-vis the EU, it becomes evident that a decline in the relative size of shadow economies is observed in those countries that were expected to join the EU in the "first wave" of enlargement (see Table 1). While the figures do not define causality, the implication of the almost uniform trend reversal in the relative size of the informal market in prospective EU accession countries during the mid-1990s would be consistent with the policy implications of a dual-equilibrium explanation of informal-market activities.

Several economists[14] have long argued that the existing incentive structure in economies with large informal sectors—resembling the "prisoner's dilemma" discussed in game theory—prevents economic actors from sudden (unprovoked) changes in their conduct, for a simple *political economy* argument: as individual participants in the shadow economy, whether in form of a worker, consumer, voter, or tax-payer, benefit from the *status quo*[15] as much as firms profit from relatively lower labor costs, regulations, and tax obligations, elected politicians have no incentive to propose a reform that reduce their voters' economic advantages. Hence, a strategy aimed at

[14] See, e.g., Hofreither and Schneider (1989) or Chapter 9 in Schneider and Enste (2000).

[15] Under *ceteris paribus* conditions, the participation in the informal market increases net wages and maximizes, subject to the household's budget constraint, the consumption of private goods.

Table 1. Transition Economies: Estimated Size of the Informal Sector
(In percent of GDP; unless otherwise indicated)

	1995 Population (in million)	1990	1993	1995
EU accession countries*		**17.4**	**20.7**	**15.5**
Czech Republic	10.3	6.7	16.9	11.3
Estonia	1.5	19.9	24.1	11.8
Hungary	10.2	28.0	28.5	29.0
Latvia**	2.5	12.8	31.0	35.3
Lithuania**	3.7	11.3	31.7	21.6
Poland	38.6	19.6	18.5	12.6
Slovak Republic	5.4	7.7	16.2	5.8
Other transition countries*		**15.8**	**35.8**	**41.8**
Azerbaijan	7.7	21.9	51.2	60.6
Bulgaria	8.4	25.1	29.9	36.2
Georgia	5.4	24.9	61.0	62.6
Moldova	4.4	18.1	34.0	35.7
Romania	22.7	13.7	16.4	19.1
Russia	148.1	14.7	36.7	41.6
Ukraine	51.7	16.3	38.0	48.9

Source: Johnson, Kaufmann, and Shleifer (1997, p. 183).

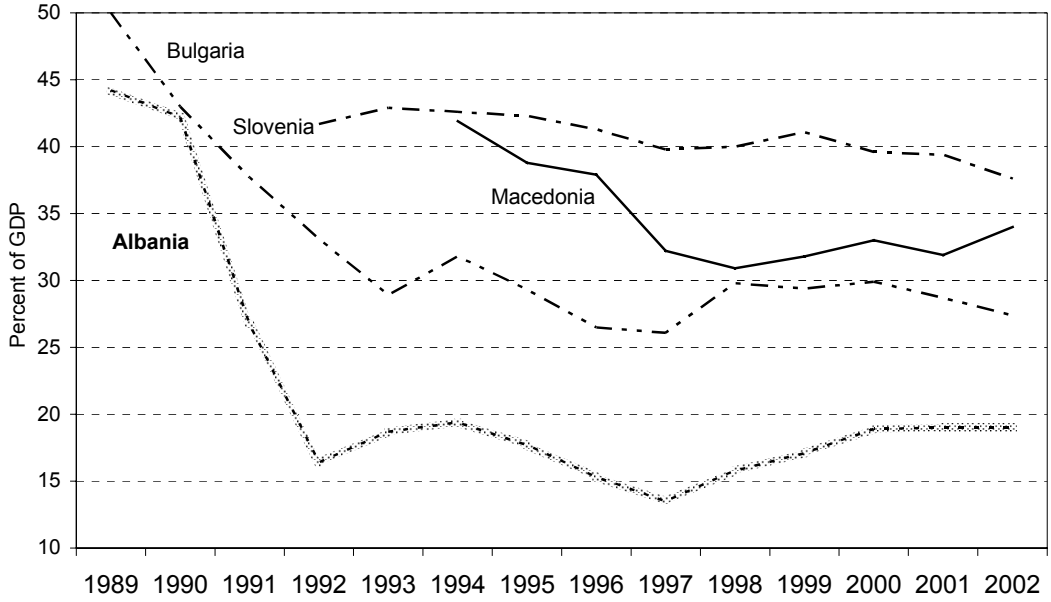
* Weighted according to population (IMF, 2001b).

** Initially not regarded as a "first round" accession country.

formalizing economic activities has only a chance to be successful if the corresponding costs of changing one's behavior are more than compensated by (i) (the expectation of) an accompanying tax cut; (ii) improvement in available (and generally valued) public goods; and/or (iii) other tangible benefits (such as a possible EU membership in the foreseeable future).

Accordingly, firms' rational decision on whether or not to (fully) operate in the formal economy hinges on the trade-off between the benefits of having (unimpeded) access to public goods—and/or other benefits listed above—and the private costs of having to pay taxes and comply with regulations (net of the concomitant risk of detection and penalty). Subsequently, policies designed to (re-)integrate the shadow economy with the formal one need to jointly address the "free rider" problem, which allows informal enterprises to benefit from (a certain number of) public goods without contributing to their provision, and a "coordination failure" dilemma à la Cooper and John (1991), according to whose succinct characterization "mutual gains from an all-around change in strategies may not be realized, because no player has an incentive to deviate from the initial equilibrium" (p. 4). If the starting point is a sub-optimal equilibrium (in this case, one with an inefficient public sector providing an insufficient amount of low-quality public goods), enterprises are willing to register their activities and comply with the laws and regulations *only if* they feel sufficiently certain that their respective competitors will comply as well. Otherwise, the cost of compliance will continue to exceed its benefits.

Figure 3. Tax Revenue Developments, 1989-2002



Source: Tanzi and Tsibouris (2000, p. 18), and various IMF Country Reports.

3. The Informal Economy in Albania

A detailed and reliable estimation of the size and composition of Albania's informal market—given the limited nature of data even on formal-sector activities—is, no doubt, a very challenging exercise, and further research is needed.[16] This paper will unambitiously restrict itself to an examination of several important macroeconomic indicators that should help to better understand the situation in Albania. As mentioned in the introduction, current GDP estimates incorporate an assessment of informal activity at about one-third of total output. Data on tax collection, however, suggest that this tentative assessment could well be on the low side. Figure 3 summarizes the key differences in tax-revenue collections among several countries in the region. Whereas even the relatively poorly performing transition countries in South-Eastern Europe managed to collect tax revenues, including social contributions, of around 30 percent of GDP during 2000–02 (Table 2), the corresponding figure for Albania stood at less than 20 percent, notwithstanding the gradual—but consistent—improvement in tax collection since 1997. Still, only a relatively small fraction of the loss in enforcement capacity experienced in 1991–92 could be recovered.[17] As Figure 4 indicates, the reason for the considerable difference in performance is not the level of tax rates levied in Albania (which are comparable to those in neighboring countries) but the difference in tax-collection efficiency.

[16] For a discussion on the indirect methods used to approximate the size of shadow economies, see, e.g., Feige (1989) and Schneider and Enste (2000a). Johnson, Kaufmann, and Shleifer (1997), Lackó (2000), and Schneider and Enste (2000b) provide estimates for other transition economies.

[17] The very steep drop in tax revenue collection in 1991–92, by about 25 percentage points of GDP, was caused by the economic collapse and social anarchy following 48 years of communism and isolationism (for a comprehensive analysis of the particular challenges during early transition years, see, e.g., Blejer et al., 1992).

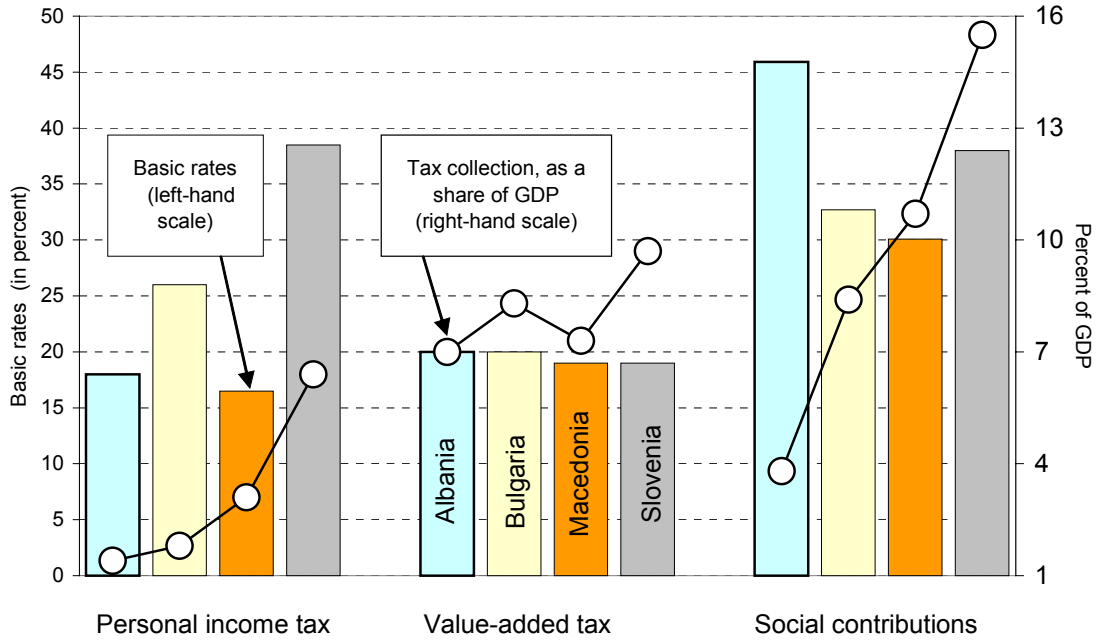
Table 2. Tax Revenues, 2000-02

(In percent of GDP)

	2000		2001		2002	
	tax, customs, social security	*of which:* social security	tax, customs, social security	*of which:* social security	tax, customs, social security	*of which:* social security
Albania	18.9	3.6	19.0	3.7	19.0	3.8
Bosnia-Herzegovina	42.6	15.9	40.2	14.7	41.6	15.2
Bulgaria	29.9	8.3	28.7	7.8	27.4	7.3
Croatia	42.1	13.3	41.2	13.2	41.1	12.5
Macedonia, FYR	33.0	10.6	31.9	10.8	34.0	10.6
Moldova	22.3	5.6	22.4	6.3	--	--
Romania	29.2	10.8	28.0	10.7	27.6	10.7
Russian Federation	35.3	7.9	34.9	7.4	34.9	7.7
Serbia-Montenegro	35.3	12.5	35.5	11.1	39.4	10.6
Slovenia	39.6	13.7	39.4	13.6	37.4	13.4

Source: Various IMF Country Reports.

Figure 4. Tax Collection Efficiency



Source: Various IMF Country Reports.

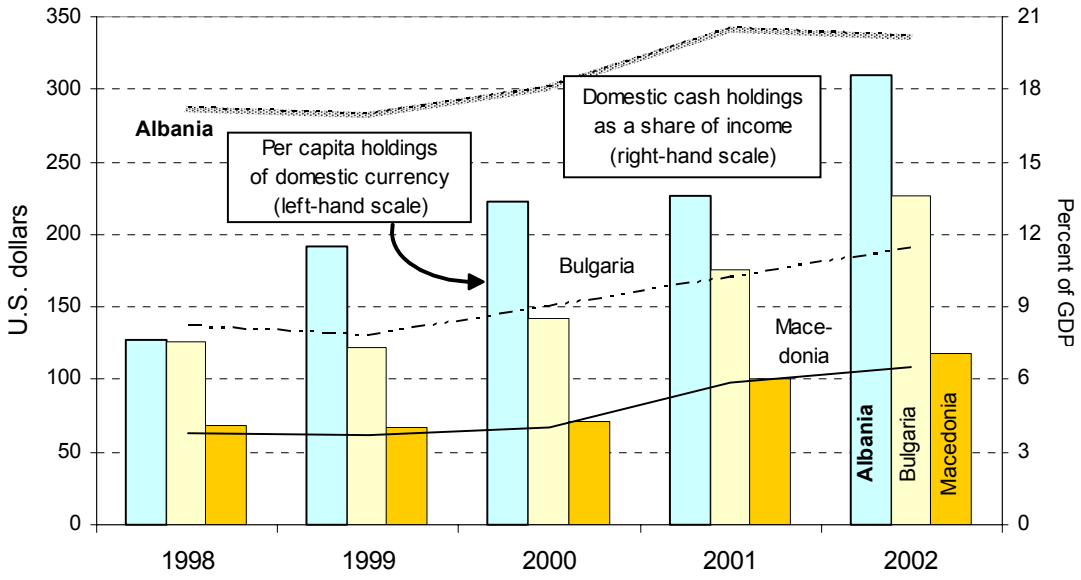
Table 2. Frequency and Extent of the "Bribe Tax"

	Percentage of firms making bribes frequently		Average bribe tax as a percentage of annual firm revenues	
	1999	2002	1999	2002
Albania	**46.7**	**36.4**	**1.7**	**3.3**
Bosnia and Herzegovina	20.5	22.4	2.1	0.9
Bulgaria	23.0	32.8	1.3	1.9
Macedonia	33.0	22.7	1.4	0.8
Slovenia	7.7	7.1	1.0	0.8

Source: EBRD (2002, p. 28).

Pervasive smuggling, underreporting on invoices, falsification of balance sheets, and a general weakness in (tax) law enforcement have, thus far, defined limits to domestic revenue collection and, subsequently, the government's ability to provide public goods at an adequate level (and in a satisfactory quality). Breaking up the figures on a tax-by-tax basis (again, see Figure 4), one sees that the worst-performing tax in Albania are social-security contributions. With somewhat higher rates, Albania managed to collect about 3.8 percent of GDP in 2002, compared to Bulgaria's 7.3 percent or Macedonia's 10.7 percent. It is encouraging to see though that Albania's authorities have reacted and, with the help of their international development partners, begun to devise a

Figure 5. The Importance of Domestic Cash, 1998-2002



Source: Various IMF Country Reports; and IFS data.

plan to transfer the collection of social-security contributions to the tax department, thereby allowing the social-security institute to focus its efforts on improving the targeting of entitlements.

However, administrative weaknesses are only one part of the reasons explaining the large difference between Albania and its neighbors. Governance problems remain a serious obstacle. For example, the EBRD's 2002 *Transition Report* showed that, whereas the percentage of firms decreased somewhat that relied on pecuniary "inducements," the average "bribe tax" that firms paid almost doubled during 1999–2002 to 3.3 percent of revenue (Table 3), placing Albania in the unflattering neighborhood of the Kyrgyz Republic, Azerbaijan, and Georgia. Not surprisingly, the generally ineffective and—at times—arbitrary administration in the customs and tax departments has recently been identified by a comprehensive study on investment barriers as a principal deterrent to (foreign) investment. The combination of, in the regional context, average tax rates, low revenue collections, and high "tax bribes" is certainly consistent with a large shadow economy.

Further indications can be found when analyzing recent monetary data. Informal economic activities tend to be cash-based (cash is anonymous), and the demand for cash, relative to overall output, is frequently used to approximate developments in the informal sector of the economy—particularly if the demand for cash increases at a pace faster than considered justified by economic fundamentals. In this context, high per-capital cash holdings and particularly an increase in the demand for cash by 3 percentage points of GDP during 1998–2002 could be taken an indicator of such development (Figure 5). However, further—and more in-depth—studies would have to (i) separate the demand for cash from the aftermath of, and the behavioral changes from, the collapse of the pyramid schemes in 1997 and the episode of heavy deposit withdrawals in early 2002; (ii) identify the relation of cash holdings and deposits in light of the large drop in real interest rates during this period; and (iii) include estimates of circulating foreign cash into the equation. Given Albania's income level, together with the circulation of a considerable amount of foreign cash, the per capita amount of domestic cash, both over time and relative to neighboring countries, is very large and, *a priori*, would seem to support the supposition of an informal sector that is larger than the official estimate (and larger than those in neighboring countries).

These macro data allow for a very rough and preliminary approximation of the estimated size of Albania's informal market. Assuming that the share of the informal sector relative to GDP in Bulgaria is approximately correct (see Table 1) and given an effective tax burden of around 50 percent,[18] the 8½ percentage point difference in the tax collection rates between the two countries (see Figure 3) would imply that the majority of economic activities in Albania could, in fact, be informal. This is a hypothesis and, by no means, an estimate (or proof), based on the analysis of various indicators that, however, appear to be consistent with such a claim. This has to be confirmed (or refuted) by thorough empirical studies.

4. Formalizing the Shadow Economy: Recommended Measures

Albania's informal sector represents a considerable share of economic activities, and it could easily jeopardize the realization of Albania's medium-term goals of socio-economic development and European integration. While budgetary revenues, relative to the performance of Albania's

[18] For households, the average income tax rate is about 18 percent, with employee contribution to the social security institute representing roughly 12 percent. If, of the remaining 70 percent, three-quarter is consumed, another 11 percent will be paid in VAT and, correspondingly, 7 percent for excise. The remaining 2 percent would reflect other taxes.

economy, is weak, formal private sector activities are discouraged by (i) strained taxpayer relations and poor public services; (ii) inadequate tax enforcement; (iii) excessive permit and licensing requirements; (iv) the existence of a competitive disadvantage relative to informal market participants; and (v) a weak public infrastructure.

To move Albania away from this "sub-optimal equilibrium" requires concerted efforts. The government's principal challenge, at this stage in Albania's development phase, lies in the adoption of measures aimed at improving "governance" and strengthening of public institutions, including customs and tax administrations. A successful strategy would have to stand on two pillars—viz., (i) providing better "public goods" (that is, improving governance, the quality of public services, and taxpayer relations, accelerating the implementation of NSSED investments, and ensuring progress with the SAA negotiations); and (ii) the development of a credible anti-evasion action plan.

In Albania's case, it is not high tax rates *per se* but, to a large extent, the ineffectual and discretionary application of tax laws and governmental regulations that has created the conditions under which the shadow economy is growing. Consequently, the government needs to find a way to raise public awareness of the government's increasing commitment to resolutely addressing fiscal evasion (which, in itself, should help to improve tax discipline) while enhancing taxpayer relations. The authorities could achieve this, for example, by hosting a series of workshops (or brainstorming sessions) charged with improving the comprehension of (i) the amount of foregone tax revenues; (ii) the main channels used to bypass the tax and customs directorates; and (iii) effectiveness of possible policy measures aimed at closing the loopholes. Undoubtedly, "fighting evasion" is a very broad and rather ambitious goal, with the public's expectation of actual improvements being low for as long as this publicly stated policy goal is not underpinned by practical steps to address the issue commodity by commodity, tax by tax, and problem by problem. Apart from the finance ministry and the tax and customs departments, several other parties have strong interest in improving the situation, most important of which are the formal enterprises experiencing a distinct cost disadvantage in the marketplace vis-à-vis their informal competitors. Their advice should thus be actively sought in any discussion on a detailed anti-evasion strategy.

Whether one takes a particular excise commodity (cigarettes, fuel, coffee, or alcoholic beverages) or a specific tax, the formal enterprises that are active in these markets would, in all likelihood, respond very positively to an invitation to engage in a direct dialogue with the finance ministry and the tax and/or customs directorates to (i) identify the main source of leakages; (ii) discuss the related weaknesses in public administration; and (iii) propose policy measures to remedy the situation. Also, the banking system—together with the customs and tax directorates—could support efforts to identify ways to encourage payments through the banking system and to facilitate, particularly, *cashless* customs and tax payments, either through the use of direct deposits (say, directly at the point of entry at the border), bank-guaranteed checks, direct money transfers, or the increased use (and acceptance) of credit cards.

At the end of such a consultative process, the resulting policy proposals, together with a firm timetable, should be publicly presented as a comprehensive anti-evasion strategy, thereby (i) increasing public awareness of the government's commitment to address this problem in a serious, comprehensive, and forceful manner; (ii) bolstering efforts in securing both higher revenue levels; (iii) supporting the government's objective in implementing key medium-term policy goals as, for instance; identified in the NSSED; and (iv) starting to change the widespread perception of evasion being an "acceptable" way of doing business by communicating the costs to the country as a whole, including its effect on the prospect for eventual EU membership.

In devising such a "carrot and stick" strategy, the government can—and should—rely on every economic actor that will benefit from a situation characterized by a low degree of fiscal evasion and the provision of high-quality public goods. These include (i) those government officials that have a genuine interest in securing and increasing the budget's revenue base to accelerate the

implementation of priority investments (which will increase the popular appeal of those politicians overseeing such a reform); (ii) the large number of formal businesses that seek fairer competition, improved public services, and lower tax rates in the medium term; and (iii) the many households (voters) that would welcome better roads, schools, and hospitals and, more generally, a more responsive and effective government. One has to keep in mind though that there are also a large number of vested (private) interests both in the public and private sectors, who—at times, considerably—benefit from the *status quo*. These would have to be sacrificed for the sake of a public good. Not surprisingly, any proposal of this type tends to be unpopular and encounter active resistance.

However, by (i) fragmenting a big problem in a large number of smaller ones; (ii) sensitizing the public that there is indeed a serious and credible commitment by government to make substantial progress (which, in the context of the starting negotiations on an SAA, is a very convincing period of time to make such an announcement); and (iii) explicitly requesting private-sector input, the government should be able to build a momentum that, over the short to medium term, secures higher tax receipts while strengthening the government-business relationship. At the same time, firms will benefit from fairer competition, improved public services and, possibly, lower tax rates in the medium term, as will Albanian citizens from the realization of NSSED investments and a generally more responsive and effective government. The prospect for progress in the process of European integration alone should give the government and additional—and very important—impetus to underpin, with concrete actions, the efforts to increase governance and reduce the size of the informal market. The public needs to be convinced, with tangible measures, that Albania, like other transition countries before it, is indeed *en route* to becoming a modern, prosperous, and European economy. Principally, there is no reason why it should not be able to do so.

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