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## **Politico - Economic Institutions and the Informal Sector: A Spontaneous Free-Market in Albania**

### **I. Introduction**

All over the world, new free-market economies are developing. Though these countries generally differ in essential features like culture, political background, or economic potential they are often characterized by a history of large scale government and massive bureaucratic intervention in the economy. One of the major problems in the transition to a free market economy is overcoming the lingering influence of these, and other relevant institutions.

Different countries address this problem in various ways. The relevant politico-economic institutions are i.a., the democratic decision-making bodies (voter influence on policies); the central banking policies (independent or not); the organization of privatization of industries; the regulation of private firms; and the role and influence of private banks.

When these institutions are unfavorable for the development of free market economies, one reaction in many countries is a spontaneous development of informal economies. I would like to study the role of the informal economy in the transition from a centrally planned economy to a free market economy and the importance of institutions in the evolution of the informal sector. I intend to use the Albanian case as one of the cases to study. The research is intended to be a combination of a theoretical and empirical study. For the empirical part, it will be a major difficulty to obtain adequate data. I shall show below that the survey method is an interesting way to get relevant information, however. I have participated in the organization of such a survey for Albania.

### **II. The Informal Sector**

The informal sector of the economy is often thought to be a major problem: clandestine, unregistered and illegal. However, it is also, in practice, a spontaneous and creative response to the formal economy' s incapacity to satisfy basic human needs.

Black marketeering is often the masses' response to a system, which has left a large proportion of society in poverty. The possibilities to develop talents and individual economic potential are limited through bureaucratic and legal restrictions. As a reaction, many people have simply renounced legality. Where there are no jobs, they invent jobs, learning in the process all they never taught. They turn their disadvantages into advantages, their ignorance into wisdom.

Thus, the informality is the refuge of individuals who find that the costs of abiding by existing laws in the pursuit of legitimate economic objectives exceed the benefits. Aside from encompassing activities undertaken just outside the law; informalities also encompasses those for whom the state has created a system of exemptions offering legality, but without providing the benefits and the protection that the law extends to formal activities. (H. De Soto, "The Other Path").

### **III. ALBANIA**

For the majority of formal or legal business in Albania, the single greatest expense, in both money and time, is dealing with bureaucratic obstacles. The former governments of Albania and other similar countries were essentially antidemocratic, legislating behind closed doors and reacting and responding to interest groups without taking into account the needs and desires of the majority of the population.

Now, in these developing countries, because of the deficient legal institutions that they use to govern themselves and to regulate their economic activity, money is wasted. Economic opportunities are missed, both those that could be exploited with purely internal resources and those that require the addition of international resources for their effective realization.

As everywhere else, especially in transitional countries, the informal (black, underground, shadow, gray) sector was also appeared in Albania. The establishment of a legal and institutional framework for a market economy in the Albanian society has caused new economic, political and sociological phenomena. Inter alia, Albania is facing a high level of illegal employment, widespread tax evasion and a large informal economy in general.

This situation was partly conditioned by economic and financial factors such as the United Nations embargo on Yugoslavia, large scale migration of Albanians to Western countries, extended contacts with neighboring countries, etc. Social factors such as the cultural mindset and traditions and the slow implementation of governmental programs on professional education, training and retraining of workers from former state enterprises have also contributed in encouraging the growth of the informal economy in Albania.

### **III. 1. Background**

#### ***1.1. Reasons for the Current Situation (up to 1996)***

In 1992, Albania became the last of the Central and East European countries to allow political pluralism, establish democratic institutions and introduce market mechanisms. These moves followed deep economic recession, bordering on chaos, during the period 1980-92 when Albania was effectively isolated from the modern world. GDP fell by 10 per cent in 1990, 30 per cent in 1991 and 10 per cent in 1992. Previous export-import arrangements could no longer be sustained, state enterprises became bankrupt and closed down, agricultural collectives collapsed, investment activities practically ceased and hidden inflation became open, over 400 per cent in 1991.

Problems of high unemployment, poverty and social insecurity created by economic disaster were extremely severe. These were exacerbated first by government policies of trade and price liberalization and later by the anti-inflationary measures imposed on Albania by the International Monetary Fund. In 1992 it was estimated that nearly half the working population was unemployed, while many of those employed did not receive their full wages or salaries. Per capita GDP had fallen to US\$ 258, comparable to the poorest developing countries. According to “*Albanian Report 1995*”, the rate of hidden unemployment was about 34 per cent. The Albanian people were obliged to find their own ways to survive. They went out on the streets to sell whatever they could, they set up their shops, and they built their houses without permission. Consequently, a great variety of illegal or informal money-making activities came into existence or became more widespread. Some were pernicious. These included smuggling, cross-border employment, production and sale of narcotic plants, prostitution (inside and outside Albania), usurious money-lending and

extensive graft by government officials and the police. Others were more legitimate, including a proliferation of small-scale street vendors in Tirana and the other major cities and towns. Based on the fact that until recently, usurious money-lending was a widespread phenomenon in Albania, I would like to say something about it.

Most of individual savings were not being deposited into the banking system to support the investments in the economy and furthermore to contribute in higher rates of overall growth (later on will be explained the reason why). They were mainly focused in the informal market, which emerged in Albania. According to the non-official data, it is believed that the money-borrowing firms and foundations have absorbed more than 1.5 billion USD.

The informal money-lending market began in 1992, by a Swiss businessman of Albanian ancestry. He obtained exclusive contracts from the government in several areas in industry, transport, services, tourism, etc. He offered to borrow money with a rate as high as 10 per cent per month, and several million dollars were placed into his fund. With the change of regime in May 1992, he disappeared, and hundreds of investors believed they had lost all their money. In 1996, he reappeared and returned over 3 million USD, which reimbursed all the principal to the investors. He also made press statements praising the money borrowing system and how he hopes to return to Albania in the future.

### ***1.2. Money Market***

Originally, private business' could borrow money from three second level banks in Albania: Savings Bank, Commercial Bank, and Rural Bank, as well as SME foundation. Due to a lack of experience and incompetence as well, the banks found themselves in 1996 with more than 30 per cent of their loans not being paid in time. These problems, along with diminishing of households savings/deposits, put the banks into difficult situation, hence, they lowered the amount available credit to businesses. Grants and inexpensive credit were available from German, Italian and American funds, but not enough to fulfill the borrowing needs of the business community. The sole Joint-venture bank, between the National Commercial Bank and Banca di Roma, only dealt with money transfers and payments. In 1996, three new private banks were licensed as branches of their headquarters' banks in other countries. Despite many requests and applications from different firms, no license was

given to establish an Albanian owned private bank. The authorities stated that no one showed the financial capacity to sustain a private bank.

Mainly, as in other Central and Eastern European countries, in Albania the state sector provided the physical capital for the new emerging private business. As expected, this physical capital was not sufficient. It was redistributed only to a few number of people, and furthermore, additional capital was needed to start a business. The raising of capital, either for starting a business or for growth of an existing business, remains the largest problem for Albanian businessmen. This phenomenon was highly problematic in Albania, because while in other CEEs the foreigners had been a catalyst by providing the essential initial capital, their influence was not so essential in Albania. What is more, firms cannot grow without access to capital. In May 1996, Tirana stock exchange was opened, but it has not shown any ability to attract capital for business growth. It has not attracted any funds from households savings or access capital from businesses. It has focused its activity on trading in Treasury Bills, and the second level banks are its only clients.

The overall economic situation at the end of 1996 was a state budget deficit at 10.1 per cent of GDP; a trade deficit of 400 million USD, and inflation rising at a rate of 17.40 per cent. During December 1996 - January 1997, every policy change or evidence of social unrest was reflected in the exchange rate, where the Albanian currency (Lek) has depreciated more than 25 per cent<sup>1</sup>.

As an alternative to the formal financial institutions, the illegal system of investing in Ponzi schemes and usurious money lending became very popular. In short, some of the reasons why this market emerged in Albania are believed to be:

1. The high interests of usury companies (5 - 10 per cent per month), foundations (about 50 per cent), their long activity (over 2-3 years), and interactions with the money laundering and other suspicious activities. This overcasting activity is impossible in a simple pyramidal game and in a small country such as Albania.
2. Depositing the money in these usury companies was the easiest way, also the most dangerous, and the people favored these because of laziness inherited from the dictatorship of the past.

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<sup>1</sup> RECA F., "Albanian Financial Indicator: Special Focus on Informal Money Market", January 1997.

3. Objective and subjective difficulties have extended the process of returning property and compensation to the ex-owners, so as a result, investment of the post capital has been limited.
4. An inefficient banking system, delays in services and the lack of a modern payment system, etc. This led consumers to make their transaction in "cash".
5. Economic reform and bank privatization were delayed, and didn't give individuals other alternatives for depositing savings in private banks that were competitive with state. This gave "usury" firms the ability to solicit most of the private savings in the economy.
6. Government apathy in preventing the "usury" phenomenon.
7. Lack of experience in relation to the pyramidal schemes. This is related to the history of development of the capitalism in Albania before and after the Second World War.

### ***1.3. Sources of Information and Statistics***

National economic and social statistics in Albania are still incomplete and unreliable, though efforts are now being made to upgrade them. The main sources of information, also used in the survey of Albanian Center for Economic Research (ACER), are the offices of the social services, the Institute of Statistics, independent surveys, financial police, tax offices and banks.

The most reliable information comes from independent surveys conducted by various research institutes, including the Albanian Center for Economic Research. In the past two years ACER, in particular, has carried out various relevant surveys on activities in the informal sector. These include:

- Survey of the informal financial market;
- Survey of second jobs of Government officials; and
- Survey of street vendors in Tirana.

### ***1.4. Types and Structure of Registered Unemployment***

There are four main types of unemployment in Albania:

- **Structural Unemployment**: This includes all those people who were formerly employed but whose abilities do not match present requirements. Many of these had been trained in state industries which have since gone bankrupt. Others were in activities which have

been overtaken by new technologies or stifled by imports. Some people in structural unemployment can be considered unemployables because of their inability or unwillingness to integrate themselves into the formal market economy.

- Frictional Unemployment: This includes all those who are in the process of changing jobs or have moved from rural occupations, where there are no prospects, to seek better employment opportunities in the cities and towns. In 1993, those in frictional unemployment were estimated at 467,000.
- Seasonal Unemployment: This is mainly seen in agriculture, construction and tourism, all of which have experienced little development in recent times. As a result, many Albanians have been seeking, formally or informally, off-season employment in other countries, such as Greece and Italy.

### ***1.5. Types of New Private Sector Activities***

Since 1992, the private sector has emerged as the most dynamic and influential contributor to Albania's development, helping the economy to recover from severe depression and start to expand. GDP reportedly increased by 11 per cent in 1993, 7 per cent in 1994 and 16 per cent in 1995. A major element of Government policy during this period, apart from liberalization of all prices except a few ones, was to privatize all farm land. This was completed by 1994 and there are now 520,000 private farmers providing most of the country's needs for milk, meat, fruit and vegetables and, indeed, a substantial portion of the products sold by street vendors. Another element was privatization of all services and small enterprises, and privatization of larger enterprises following. In 1995, 2,306 state enterprises were privatized, 80 per cent by auction, and the total number of registered private enterprises in Albania is now over 60,000.

#### **What about the new enterprises (starting over)???**

The main areas of registered private sector activity in Albania are now, reportedly, trading (about 50 per cent), food processing (about 20 per cent), construction materials (about 10 per cent), with most of the rest in textiles, clothing, footwear and various types of consultations, though data on output are not readily available.

### ***1.6. The Employment Gap***

These developments did not have an immediate effect on reducing recorded unemployment. This is because the private sector initially absorbed labor from those still employed in the state sector rather than from those made redundant. This phenomenon is related to the fact that the privatization of state enterprises takes a shorter time than the creation *de novo* of new private enterprises.

Moreover, the state sector itself began to be rationalized. By 1993, over 60 per cent of the 1991 employees of state enterprises had lost their jobs while employment in state services was cut by 15 per cent.

Although registered private sector activities have grown rapidly in the past four years, they could not by themselves have led to a reduction in the rate of registered unemployment from 36 per cent in 1991 to 13 per cent in 1996. Furthermore, the level of unemployment benefit for those registered is only 66 per cent of the minimum wage of about US\$ 33 a month, which itself is insufficient for basic needs. There has thus been a need for the unemployed to seek out ways of supplementing this benefit. Indeed, as will be seen later, there appears also to be a need for employees in the state sector to supplement their wages and salaries.

The potential for obtaining gainful employment, full or part time, in registered state or private enterprises or offices is very limited, both in terms of jobs available and the low level of wages and salaries. It is therefore apparent that either the official statistics on unemployment are a substantial understatement of the real situation or that those who are not employed in registered activities are gainfully employed elsewhere in the economy, i.e. in the informal sector.

## **III.2. Survey of Street Vendors in Tirana**

### ***2.1. Role of Street Vendors in the Informal Sector***

#### What about the wholesale services??

Retail services in Tirana are an extremely important part of economy. There are about 24,000 private businesses registered, of which more than half are in the retail sector. These range from the most exclusive fashion shops, modern supermarkets and expensive restaurants, at one extreme, to ambulant vendors selling a few cigarettes or packs of

chewing gum at the other. Between these extremes there are many different types of retail outlets: specialist shops, general stores, bars and cafes which are solidly built; temporary buildings, including kiosks and awnings, some specializing but most supplying similar ranges of packaged or loose foods, soft drinks, snacks, cigarettes and other common consumables. Little is known about the commercial activities of all these different types of registered retail outlets. Competition is extremely fierce, which leads to expectations that many will not survive. Yet, up to 1996, most commercial businesses appeared to be prospering.

At a lower level of activity, in terms of capital outlays, range of products supplied and, probably, turnover and profits are the street vendors. Street vending is considered to be one of the most important and visible activities in the Albanian informal sector. There is hardly a street in Tirana without a full complement of street vendors and the total number is probably over 5,000 or 50 per cent more than the registered private enterprises. Street vending started when people began to invade the public thoroughfare, the use of which is open to everybody, in order to sell goods and services and for commercial transactions - without obtaining permits, giving receipts, or paying taxes. Most of them are fruit and vegetable sellers, closely followed by sellers of cigarettes, soft drinks, snacks and common consumables. But there is, again, a very wide range of activities, with some vendors selling newspapers, books, clothing, kababs, plumbing and electrical equipment, second hand goods or hardware.

## ***2.2. Number and Types of Vendors Included***

The ACER survey of 373 street vendors in Tirana in 1996 has thrown considerable light on the real economic situation in Albania. The survey, covering perhaps 7 per cent of the total number of vendors in the city, was based on a random selection of vendors by 13 interviewers at the same time of day in different regions of the city.

No types of vendors were excluded from the survey, though responses from a further 50 vendors were inadequate or incomplete and could not be used. ACER considers the survey to be as representative as possible under the difficult circumstances involving all surveys of the informal sector.

## ***2.3. Registration Processes and Informal Alternatives***

80 per cent of vendors responding to the survey said that they possessed no official license or registration for their activity. This does not, of course, mean that they do not have to obtain, and pay for, some form of “*permission*” to locate where they are. Following it will be shown that one way of providing this “*permission*” is bribing the officials.

The formal registration process for street vendors is as follows:

- The prospective entrepreneur goes to the district law court and presents his proposal verbally;
- The lawyer appointed by the chairman of the district law court will decide whether to accept the proposal or not on the basis of commercial law;
- If accepted, the prospective entrepreneur pays a fee of 500 Leks and will receive a written verdict to be used in the local tariff and tax office;
- The local tariff and tax office will give the prospective entrepreneur a license to carry out the private business in his selected field of activity; and
- The prospective entrepreneur can start business and be obliged to contact, on a monthly or quarterly basis, the tariff and tax office to report his income and, therefore, pay the relevant tariffs and taxes.

For other types of enterprises, the process is more complicated.

However, due to well-known features of bureaucracy especially in former communist countries, this formal process was shown to be very slow, involving a considerable amount of wasted time, and sometimes costing more than the license because officials wanted to be bribed to process the license application. It is for these reasons that the majority of vendors preferred to use informal alternatives.

The most common informal alternative is to pay the local license inspector or policeman a regular monthly sum (perhaps 500 Leks for a good location) for him to ignore that official registration procedures are being broken. Another alternative is to associate a stall with a fixed or temporary retail outlet which is formally registered. Payment in this case would depend on the type of family (or other) relationship between the street vendor and the owner of the retail outlet.

#### ***2.4. Reasons for Becoming a Street Vendor***

For 90 per cent of those interviewed, being a street vendor is a new type of activity. 49 per cent of these claimed to have lost their previous job and some were receiving unemployment benefit. A further 26 per cent had changed occupations to increase family income. A few (5 per cent) were school-age children not attending school. Most of the rest proved to be those in the age-group 20 - 30 who are either unable to attend university or cannot receive other types of useful training. **(something broader about this)**

For 61 per cent of respondents being a street vendor is not their only activity in the informal sector. Most (68 per cent) refused to say what else they did. Of those who responded it appeared that renting living space in houses or apartments was an important contribution to monthly income, while others were involved in other types of (usually imported) goods.

### ***2.5. Education Levels and Experience***

Data from the survey have shown a very high level of education among street vendors. 68 per cent of street vendors have completed secondary education, with a further 20 per cent having graduated from university. All the remaining 12 per cent had completed elementary schooling.

Previous activities of street vendors, especially during the Communist period, vary widely. While most (60 per cent) had been workers, an unexpectedly high proportion (14 per cent) had been military officers and a further 16 per cent had been government officials.

### ***2.6. Family Situation***

Street vendors who are members of families with five or more persons, none of which are in formal employment, made up 42 per cent of the total number surveyed. However, it is mainly the men who operate as vendors (81 per cent of the total), with the women taking greater responsibility for other family obligations. In Tirana, as well as other cities, the extended family has been transformed into a network of commercial and productive relations.

83 per cent of those surveyed admitted to a monthly family income of more than 8,000 Leks, 15 per cent to 5,000 - 8,000 and 2 per cent under 5,000. Only 45 per cent of this income is derived from street vending, however, showing that in many cases vending

serves as an income-supplementing activity rather than as a prime source of income. Other important sources of income are remittances from family members who are working abroad, activities in the informal credit market, renting of living space and various state financial benefits. 87 per cent of vendors said they were receiving at least some form of financial benefit.

A second survey carried out by ACER confirmed that many people use informal activities to supplement their incomes from formal employment. The survey showed that 33 per cent of officials in government ministries have a second job and that incomes from these second jobs are equal to or greater than their regular incomes.

#### **IV. The Influence of the Informal Sector**

The effect that the collapse of the so-called pyramid-schemes had on the whole Albanian society are a first extreme example of how the informal sector can have crucial influence on the politics and economics of a society. Moreover, it is generally believed that the informal sector has made a vital contribution to the development of the Albanian economy, during the past few years, helping it out of recession and into sustained growth. An essential aspect of the informal sector is that it provides families with employment, as well as supplementary income, in the absence of other possibilities. People have learned how to create more jobs and more wealth in some areas than was offered them by the still powerful state. The social problems are enormous, but it common thought is that the situation would be infinitely worse without the informal marketeers. Most important is perhaps the mentality of people working in the informal sector. They firmly believe that the individual, private initiative and enterprise should be responsible for leading the battle against underdevelopment and poverty. When the legal institutions did not allow them to pursue this belief, they resorted to the informal sector.

If the informal sector has had a positive effect on economic growth, the question is: to what extent? Again, negative experience of Albania with the informal financial market, pyramidal schemes (Ponzi schemes) raise important questions. Due to the fact that this informal activity emerged in Albania, most of individual savings were not being deposited into the banking system, where they would support investments in the economy. Furthermore, the very high

level of unlicensed activities among street vendors has negatively corresponded to a very high level of unrecorded income-earners.

Whatever the undoubted benefits, for families and national economic development, of the mushrooming of informal sector activities, including street vending, these activities have serious repercussions on Albania's fiscal system as well. They distort the rational allocation of financial benefits to those that really need them while at the same time understating the monetary base for taxation purposes (**more**).

90 per cent of street vendors interviewed said that they did not pay any state or municipal taxes, and those few that did, admitted that these were compulsory social security payments in establishments where they had formal employment. Overall, payment of taxes and social security represented only 6 per cent of family expenditures with only one-third of this amount deriving from informal sector activities. Yet, as noted above, 87 per cent were in receipt of some form of financial assistance.

## **V. Transforming the Informal Sector to a Formal Economy**

If the informal economy is truly so essential for economic development, its legalization may be a necessity. More generally, the improvement and modernization of the legal and institutional framework is a necessity for the development of the private sector and the whole economy of country like Albania. The lack of an adequate system of private banking and stock exchange and the related success of the Ponzi-schemes in Albania is an example of how institutions can play an essential role in these developing countries.

In this respect, elsewhere, I have formulated some policy recommendations for the Albanian government (Klarita Gerxhani: "Unregistered Employment and Fiscal Implications: Aspects of Informal Sector in Albania", 1997). Some suggestions are:

- The reduction of entry barriers in the legal labor market should be realized through shortening the time required for registration of a private enterprise; through a better informative system related to the registration procedure, and following a more open policy for the changes in legal and institutional framework of the market economy.

- A reform and renovation of the managerial structure of bureaucracies is needed, as well as a more efficient design of subsidy programs.
- International assistance must be directed at creating and reinforcing legal institutions that make governments accountable to the people, oblige them to inform the public, and offer an environment in which property rights are well-defined and secure. This foreign assistance can be also directed to the provision of training opportunities for those who leave the school, as well as retraining opportunities for others.
- Government has to include in its programs measures to strengthen and protect property rights; to ease rules and regulations on upgrading or creation of new enterprises; to encourage financial institutions to provide greater access to credit to all sectors of the population; and to restructure the administrative apparatus of the state, simplifying it and making it more accountable to the people. The most difficult step of all for the Government is to develop fair, affordable, easily understandable and generally acceptable systems of taxation and social security benefits for the population, including the introduction and possible application of private pension schemes in Albania. This is so that the national budget will have resources for providing employment-creation incentives while at the same time ensuring a better redistribution of wealth.
- Appropriate macroeconomic policies and the corresponding investments are needed, but the most important element is the microeconomic measures to promote and protect property rights; facilitate access to business and transactions among individuals, and give people the necessary confidence to save, invest and produce.

## **VI. Research Needed**

Despite these preliminary policy recommendations, a much deeper and more thorough study is needed of the informal sector as a transitional phenomenon; its links with the institutional development of a country; the basic steps of its legalization; the interdependence of formal and informal sectors in long-run developments, etc. The Albanian case can be used as a case to study, among other possible cases, but the issues raised are far more general for economies in transition. Also, a comparison between informal sectors in developing and developed market economies can shed light on the relevant factors in countries in transition. The research should combine elements of theoretical and empirical methods.

