CONSEQUENCES OF INFORMAL ECONOMY
A CASE OF ALBANIA

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Abstract

Informal Economy has taken attention of a lot of researchers lately. This has been due to the causes and consequences of policies related to the informal economy. The informal economy is difficult to measure because of its hidden nature. Different methods have been used to measure the informal economy. The methods are classified as direct and indirect methods. Direct method is not easy to use since the individuals that work on informality are not open for the information. Macroeconomic methods help in calculating indirectly the informal economy. In this study analyze the consequences of the informal economy. Tax evasion is calculated based on informal economy. It is shown that the informal economy has an impact on monetary policy, the level of unemployment and the distortion of a country's national statistics. The study is concluded by giving some recommendations for reduction the impact of distorting of informal economy. The policymakers will increase the effectiveness if they take into account the existence of the informal economy.

Keywords: Monetary Appoach, Informal Economy, Consequenses, Tax Evasion, Tax Rate

INTRODUCTION

Although recently the interest in measuring informal economy in different countries has been increased, little interest has been shown to investigate the consequences of the informal economy. Taxation is the main cause of the informal economy (Schneider & Enste, 2000)

(Torgler, Schneider, & Georgia State University, 2007). As a result of the informal economy, the government collects less tax. Such as lack of tax revenues in the informal sector is regarded as the main consequences of this economic sector.

Also, the informal economy negatively affects economic official statistics. So it is imperative that policymakers consider the existence of the informal economy when they make economic policies and they collect and generate statistical reports. Some of consequences of informal economy are explained in this paper. One of the main consequences of informal economy is and tax evasion.

Tax evasion in general refers to illegal practices to escape from taxation. To this end, taxable income, profits liable to tax or other taxable activities are concealed, the amount and/or the source of income are misrepresented, or tax reducing factors such as deductions, exemptions or credits are deliberately overstated (Alm & Martinez-Vazquez, 2007) and (Sandmo, 2005). Tax evasion can occur as an isolated incident within activities that are – in other aspects – legal. Or tax evasion occurs in the informal economy where the whole activity takes place in an informal manner – this means the business is not only evading tax payments but is also not registered as formal enterprise at all.

The tax evasion in Albania for the perios of 1993-2013 is calculated. In this paper we asnwer the following question:

1. What is tax evasion and what is the size of tax evasion in Albania for the period 1993-2013.
    The effective tax rate will be applied on the size of Informal Economy in order to calculate annual tax evasion in Albania for the period 1993-2013.

2. What is the impact of the informal economy on the informal economy in Albania?
Macroeconomic impacts will be analyzed in the existence of the informal economy in different parts of the Albanian economy. In particular, study will examined the impact on the revenues of the state budget, fiscal and monetary policies.

LITERATURE REVIEW

The growth of the informal economy is caused by various factors. The most common causes by (Cassel & Cichy, 1986), (Tanzi, 1983), (Schneider & Enste, 2000) are: increased burden of taxes and social security contributions; the increase of regulations and control of the formal economy (official); reduction of weekly working hours; early retirment; unemployment; and the decline of civic virtue and loyalty towards public institutions.

(Davis & Henrekson, 2004) were guided by a simple theory to investigate long-term response to national differences in the tax rates on labor income, wages and consumption. The theory assumes that the increase in tax rates leads to a reduction of working time and increases

the size of the economy the informal, and changes the course of the industry in the market, changing demand for labor in a way that expands the negative effects on the job market and focus on the effects of less skilled. They also describe the conditions where least squares regression provides unbiased estimates of the overall impact of taxes and indirect effects that include government spending and tax revenues. Regressions for samples of rich countries in the mid-1990s show that the standard deviation of the tax rate is by 12.8 percentage points to 122 fewer hours of work per adult per year in the market, a decrease of 4.9 percentage points in relation to employment population, and an increase in the informal economy 3.8 percent of GDP. This also leads to employment lower at 10 to 30 percent as it leads to added value stock in (a) the retail trade and repairs, (b) the food, drinks and accommodation, and (c) a wider group industry which includes wholesale trade.

(Bajada & Schneider, 2009) examined the relationship between unemployment and the informal economy. They discussed participation in the informal economy by those who claim to be unemployed and get benefits from state unemployment fund but secretly work in the informal economy. By doing so, they were the first who made an attempt to assess the contribution of unemployment in the informal economy activity. They showed that the extension and expansion of the informal economy is influenced by changes in the unemployment rate. A significant positive relationship between the activity of the informal economy and unemployment can be said that cycles generates employment in the informal economy, which is supported by social assistance payments, and distorts the balance of the social security system. They found that changes in cycles of unemployment contribute to employment in the informal economy, which seems to increase the duration of unemployment.

Gomis-Porqueras, Peralta-Alva, And, & Waller, 2011 built a dynamic general equilibrium model of tax evasion where the actors chose to report some of their income. Unreported income requires the use of a cash payment method to avoid registration. Waller improved the model of using the money, the interest rate and GDP data to support the size of the informal economy for 30 countries and estimates compared with traditional assessments.

CONSEQUENCES OF INFORMAL ECONOMY

During the estimate of Informal Economy in Albania the variables are defined. As it has been studied by economist, the causes of informal economy are: effective taxe rate, intervent of the governemnt in economy, rate of unemployment (D. Giles, Tedds, & Werkneh, 2002), Inflation rate (D. E. A. Giles, 1999), etc.

The existence of this informal economy has it consequences. Some important consequences are: increasing rate of GDP si (Adam & Ginsburgh, 1985) (Kaufmann & Kaliberda, 1996); the growth rate of money in circulation; the growth rate of privat consumption; tax evasison.

Tax Evation

Tax evasion is an hidden and illegal activity. As such it is very difficult to accurately estimate it. Many economists as (Tanzi, 1983)(D. E. A. Giles, 1999) and (Faal, 2003), estimated the size of tax evasion in some countries based on their calculations of economy informal in these countries. They estimated tax evasion assuming that the informal economy should pay taxes with the same tax rate as the formal economy.

According to Tanzi (page 230 of "The Underground Economy in the United States") , this assumption " provides reasonable estimates that can be made based on the information that is available".

We use the methodology of these economists to calculate the amount of tax evasion in Albania by applying the effective tax rate of income and VAT on the amount of informal economy of Albania.

To calculate the annual tax evasion, EFT, we simply apply the annual income tax (t = Tax revenue / GDP) on the value of the informal economy, the EIT:

EFT = Wit x Tt

Where:

EFT – annual tax evasion

Wit – informal economy (in albanian lek)

Tt – effektive tax rate

This gives us an annual tax evasion. To calculate the part of the tax evasion that comes as an effect of nonpayment of VAT, we multiply the value of informal economy with annual tax burden of VAT. In the same way we calculate the part of tax evasion as a result of non-payment of income tax.

The table 1, presents the calculation of the annual amount of tax evasion in albania and the contribut of effective tax rate of income and sales tax (VAT).

Tax evasion in Albania for the period of 1993 - 2013 is estimated to be around 645 billion leks based on monetary approach model, while the average annual measures of fiscal evasion is estimated to be 30.760 million.

The exsitence of tax evasion lead the government to collect less taxes, so the government budget collected less revenue creating in this way a gap between the actual tax revenues and potential tax revenues, which consequently increases the budget deficit. This gap

between actual and potential tax revenues creates adverse consequences for the economy. Lack of income to the government causes a lack of public works and services that government should provide for the country. In order for the government to compensate the lack of funds from tax revenues and to cover all the financial needs of its public budget, government increases taxes. This tax increase will push individuals to increase their activity in the informal sector to avoid paying taxes. The result can be a vicious circle, that leads to a growing informal economy and growing tax evation, that disorient and worsen the economy even more.

From the other side, the government could be forced to borrow money from domestic sources (financial institutions and banks in the country and issue obligacione and bonds) or from external sources to cover the budget deficit as a result of tax evasion. This increase in public debt will be associated with an increased debt obligations as a result of the interest and principal payments from the public loan, payments that will worsen even more the budget deficit and would also contribute to a worsening economy.

Tax evasion was estimated based on the average tax rate applied on formal economy. Table 1 and Figure 1 show the size of informal economy and tax evasion calculated according to the monetary approach method.

Table 1: The size of Tax Evasion according to Monetary Approach method

Years	Effective rate of tax on income	Value of informal economy (in million lek)	The value of Tax Evasion (in million lek)
1993	10.94%	44,341.99	4,849.93
1994	10.69%	46,316.62	4,948.99
1995	9.27%	47,889.12	4,437.07
1996	6.27%	46,164.08	2,893.46
1997	6.93%	52,146.13	3,616.27
1998	10.56%	77,467.41	8,182.70
1999	11.19%	91,421.84	10,228.95
2000	12.17%	106,553.55	12,965.54
2001	13.06%	124,767.04	16,293.51
2002	13.90%	139,493.49	19,391.62
2003	14.37%	157,084.52	22,566.50
2004	15.07%	178,865.19	26,951.89
2005	14.25%	188,664.70	26,887.40
2006	16.75%	231,627.21	38,797.82
2007	17.85%	280,835.28	50,137.52
2008	18.73%	335,609.82	62,848.00
2009	18.28%	345,847.42	63,233.75
2010	18.28%	366,665.27	67,015.29
2011	18.40%	386,170.29	71,056.27
2012	17.38%	381,716.78	66,334.07
2013	16.51%	377,459.36	62,325.48

Figure 1: The Trend of Tax Evasion by the Monetary Approach Model
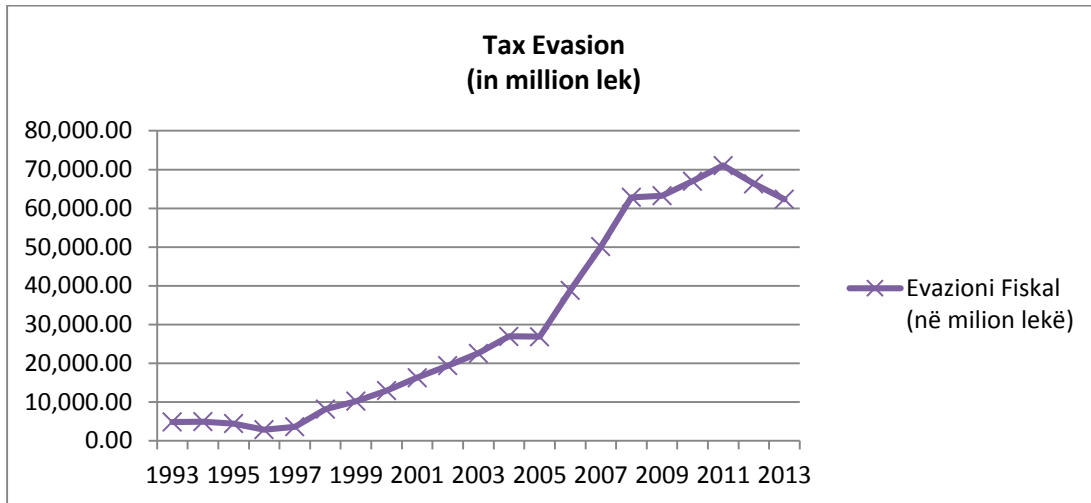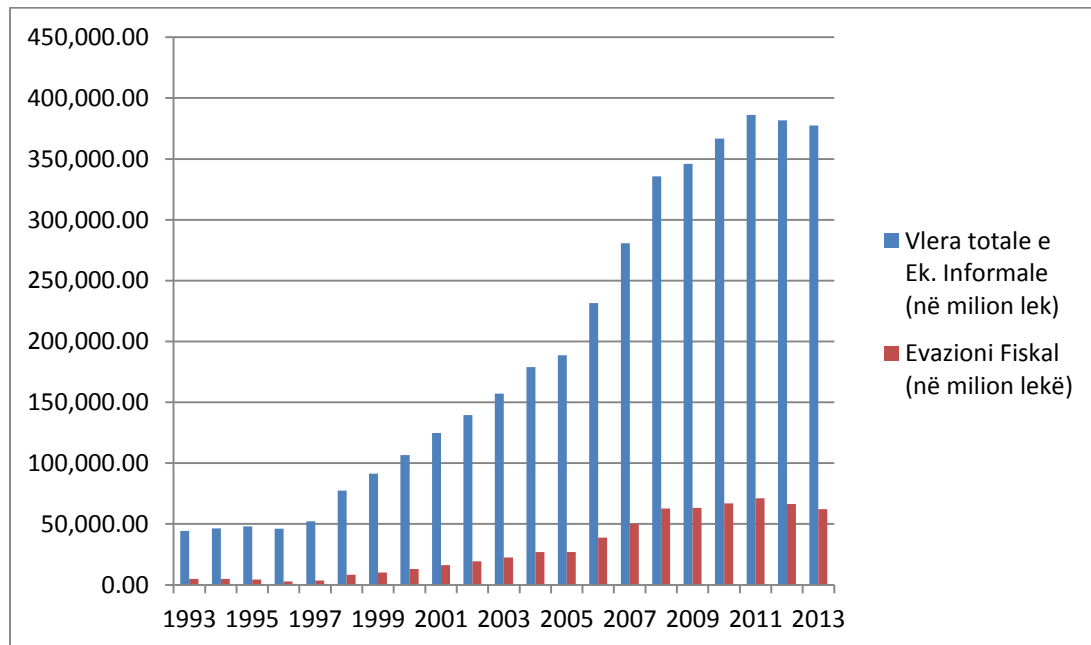
**Tax Evasion
(in million lek)**

Fig.2 Informal Economy and Tax Evasion by Monetary Approach Model

The Size of Firms

Informal economy means hidden economy. As such, firms that work in the informal sector, hide their activities from official authorities. For large firms this concealment of economic activity is very difficult. For this reason, firms that work in the informal sector tend to not enlarged but stay small in order to not be detected by the authorities for their informal activity.

This prevents the firms to obtain the benefits of economies of scale (Economy of scale). Also, companies that work in the informal sector compete with companies that work in the

formal sector. This makes the expansion plan for the companies working in the formal sector to be affected by the existence of the informal economy. As a result, most companies tend to stay small even if it is not efficient to do so.

Monetary Policy

Transactions in the informal sector sare mainly paid in cash in order to avoid paying taxes in this sector. These have an impact on the demand for money.

An increase of the informal economy leads to an increase in demand for money in circulation. The supply of money in circulation is calculated by the Central Bank (Bank of Albania) based on the expected increase in official GDP, the supply of money in circulation would be less than the demand. This will increase the pressure on interest rates and prices in general.

Also, an increase in public debt by the government to cover the budget deficit as a result of tax evasion, will have an impact on interest rates in the private sector banking savings deposits, which will also cause an increase in the interest rate and consequently an increase in the cost of investments.

The Accuracy of Statistical Data

Official national statistics on the informal economy do not accurately represent results for the country's economic performance. Given that the informal economy is an economy of unreported, then this economy is not part of oficial GDP. As such, GDP is not the real values of the economy. Also, all other economic indicators that are expressed as a percentage of GDP are overrated. For example, budget deficit, current account deficit, and public debt as percentage of GDP will be higher than the actual value if the informal economy would be reported.

On the other hand, the informal economy is unreported, underestimates the GDP per capita in the country, given that is often used as an indicator of the standard of living in the country and as a comparative index among countries.

CONCLUSIONS

This study shows the consequeses of Informal Economy. It showed that one main consequences of informal economy is tax evasion. The tax evasion was estimated by appplying the effective tax rate on the informal economy according the the monetary approch mode.

Other consequences of the informal economy are incorrect statistical data, monetary policy, the size of firms ect. Some of the informal economy consequences can be mitigated if

policymakers, when developing their policies, take into account the existence of the informal economy. It is recommended the creation of a specialized department in the institute of statistics which have experts that periodically measure the informal economy in Albania and ensure that they include the results on official statistics.

The calculated tax evasion in Albani can be used on future studies regarding macroeconomic indicators as monetary policy.

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