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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.¹⁰ 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

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¹⁰ 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.¹ 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

¹ 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.² By some definitions, the informal sector is as much as 30% of Georgia's GDP.³

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 entrepreneurship⁴ 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.⁵

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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⁵ 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>