Informality and Challenges of Fason Sector' Businesses

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Abstract

The paper aims to study informality, as one of the current problems in Albania. The focus of the paper is in apparel sector, due to the importance it has, in the Albanian economy and as one of the sectors most affected by three aspects of informality picked in this study, as the fully undeclared work, under-declared employees and under-declaring real annual revenue/profit. This study is focused on all apparel companies registered in the NRC, localized in Tirana. This study aims to have a respond on the research question: What are the factors affecting the growth of informality? Primary data were collected through personal face-to-face interviews, with high levels of management (owners, managers, chief financial officer). Tax evasion, considered as the subject of the three aspects mentioned above, based on the theoretical model used, is the dependent variable. The main findings of this study provide answers to research questions, highlighting the factors that encourage informality, as tax rates, the level of penalties, compliance costs, and the size of the company and the educational background of the directors of the company. Limitations of this study are the lack of a full rate of return of responses, only a sector involved in the study, and the study is localized only in Tirana. Informality is a challenge for businesses and the main objectives of the government to fight for, and therefore the value of this study lies in the fact that it serves to stakeholders, government, and businesses. The main implications raised from analysis are important for businesses to raise their awareness for benefits of becoming formal and for government, to design some policy recommendations on formalizing the business community and help on a better business climate

Keywords: *Informality, Fason sector, Tax evasion, Tax rates*

Introduction

The informal economy is a term open to a number of interpretations. In Albania, the roots of informality date since the initial phase of transition to a market economy. Recently, informal activity in Albania is a very important indicator. The definition of the informal economy assessed in this paper include: Fully undeclared employees – that do not have any contract at all, under-declared employees – which receive envelope wages, declaring only part of their salary and, under-declaring real annual revenue/profit.

The aim of the paper is to find concrete factors that stimulate informality, and identify several incentives to reduce the level of informality; to understand why firms choose to be informal, to find main obstacles of doing formal business; and to give some recommendations to help reduce the level of informality. The research question of this study is: What factors affect the growth of informality?

The paper is organized in five sections in addition to this one. The second section consists of literature review, which reflects a set of definitions on the concept of informality and main reasons why it's considered important. Sub-Section 2.1 consists of recent studies conducted in Albania to identify some of the causes that stimulate informality; and gives some information related to the sectorial analysis. The paper analyzes Fason sector. Reasons behind this choice relate to its importance in the Albanian economy and because many studies consider this sector as one of the most affected by informality. The third section consists of methodology and conceptual model. The fourth section reflects the findings of the research, descriptive and regression analysis, while the fifth section provides the discussion of the results, conclusions and recommendations.

The focus of this study is all companies operating in fason sector, registered in NRC, localized in Tirana. The total number of respondents is 80 individuals; representatives (owners, managers, chief finance) of different companies, 58 are business units operating in the clothing industry, and 22 firms operating in the shoe industry.

Literature Review

The concept of informality is very complex, because of the difficulty to determine a single definition of informality. The term "informality" is first used in 1970 to describe the economic activities taking place outside state regulation. The report published by the International Labour Organization in 1972 highlighted

the duality that separates formal and informal economic activities. Informality describes a variety of activities that produce goods and services by individuals to avoid disclosure of their work and income. The current situation indicates that the informal economy is steadily increasing in developing countries, particularly in rural areas. The biggest challenge is the development of supportive and innovative policies to recognize the contributions of the informal economy. Informal economy includes all unregistered, unrecognized, unprotected, or unregulated activities by public institutions (International Labour Office, 1972, pp. 25). These activities are rarely supported mainly by policymakers and government. Individuals aren't informal, but their actions and activities are. De Soto (1989), notes that there is a boundary or barrier between formality and informality in legal terms and suggests that the line between informality and formality is broad. The definition of informality is a challenge in itself, for its own nature not easily observable. Often, we face the dilemma whether informality involves legal activities or non-legal. Informality is a set of unregistered, but legal activities, which could bring additional revenue in the budget. Haka (2013), tackled that there is a difference between "gray economy" / "shadow economy" and "black economy"; the first one includes all activities that are legal, but there are not paid taxes and social security for these activities, while "black economy" refers to illegal activities as weapon's trafficking, drugs, prostitution, etc., (pp. 7)

A broad definition of the informal economy is "unreported income from the production of legal goods and services; barter or cash transactions, that all these economic activities should be taxed at the time they are reported to the relevant authorities" (Schneider & Enste, 2000, pp. 78). Problems associated with policy making in the informal economy are influenced by the way informal economic activities are defined on different approaches. Economists and statisticians are interested in measuring the contribution of informal economic activity in the overall economy of a country. Labor activists are concerned about improving the standards and conditions of employment of workers engaged in informal activities. Depending on the different perspectives, it is solved and framed informality, by objectives.

Kikilias (2003) tackled that an improvement of confidence in government and quality of public services can play an important role in reducing informality, increasing the benefits provided to taxpayers from paying taxes (pp. 2). Regulations and bureaucracies, which provide property rights, make the informal economy more attractive and this is one of the most powerful ways to reduce informality and improve the level of institutional and bureaucratic quality, functioning of law & justice and legal structure of property rights. Khamis (2009) highlighted that primarily, age; marital status; and level of education are significant determinants of whether an individual has social insurance and a written contract or not (pp. 12).

Companies do not declare systematically real wage levels and, thus, do not pay enough social security. This process is realized in cooperation with employees, who generally prefer direct cash salary than social benefits in the future. Fully-undeclared employees, as an informal activity, means "hiding" the employee or "gray" employment, which can be defined as employment that aims to produce products and services within the legal parameters but one or more of these requirements are not met. Perry, Maloney, Fajnzylber, Mason & Saavendra-Chanduri (2007) stressed that in countries with a high level of development, there is a trend towards a lower level of informality (pp. 6). Friedman, Johnson, Kaufmann, & Zoido-Lobato (2000) said that high taxes are currently accompanied by an activity with a low level of informality, as a percentage of GDP, according to which entrepreneurs choose informality not to avoid formal taxes but bureaucracy and corruption (pp. 461). Some authors focus on one aspect and others to more than one factor. OECD - Investment Compact for the Ministry of Economy of Albania (2004) presents some of the causes that encourage informality are state intervention in the market in term of taxation; regulations or numerous, often contradictory laws; multiple authorizations for license; insufficient police authorities and judicial support; lack of control on the distribution of subsidies and incentives for households and firms; a strict regulation of the labor market; failure to apply by entrepreneurs, the laws governing tax liability, welfare, and environmental protection; lack of wiliness from individual employees to be formalized, in order to be able to receive a pension or subsidy; globalization and its effects on competition, immigration and the labor market. It mostly affects seasonal workers and unskilled workers in construction, transport, textile industry, agriculture, trade and services. It is noted that overloading regulations doesn't affect informality, but the low quality of the informal economy regulations, due to the informal economy and undeclared workers do. It should be aimed institutional strengthening and increasing the quality of bureaucracy, which minimize the revision of policies when governments change (Kikilias, 2003). Corruption and the shadow economy are two complements that mostly happen in countries with low income (Dreher & Schneider, 2010).

Gerxhani (2002) stressed that most of the unreported income in the informal sector is the result of a deliberate attempt to evade taxes, in fact, in the literature, non-reporting of income and tax evasion are almost synonymous (chapter 2, pp. 11). Related to this issue, there have been studies that suggest that the informal sector is not only a survival mechanism for poverty, but a mechanism by which qualified and skilled individuals avoid income taxes. Studies in developing countries have shown that informal sector is considered as an opportunity for survival. The informal sector is often characterized by its potential on investment and economic growth. Various studies have shown that: Tax evasion and tax rate increases and decreases with the level of penalties (Friedland, 1978; Collins, Muphey, & Plumlee, 1990);

Fiscal evasion reduces with audit trails (Friedland, 1978); Tax evasion is lower when revenues are used to provide a public good (Alm, 1991); The decision to tax evasion is done together with the decision to work (Collins, Muphey, & Plumlee, 1990); Tax evasion grows with the income(Giese & Hoffman, 1999).

Informality in Albania

Albania, due to the recognition of its efforts in advancing economic and democratic reforms, has received EU candidate status in June 2014, thus, making an important step forward its goal of EU membership. However, the EU has announced that formal negotiations for EU membership address several key priorities, mainly reforming the country's finances and reducing corruption. Implementation of the measures needed to address these issues will help to promote transparency, accountability, rule of law and basic values for a democratic system. At most, Albania faces many challenges in building a more transparent business environment and source of corruption have created the conditions for one of the largest informal economies in the world. Thus, a joint effort to reduce informality is a proper way to have an overall approach to the process of economic and democratic reform in Albania.

According to a recent World Bank report, (2015), 36% of Albania's economy is informal, which has prevented the country's economy grow. Reducing informality will require a commitment of the public and private sectors, to implement joint solutions that encourage entrepreneurship, protect the rights of business owners and improve democratic governance. The informal economy is an important contributor to employment and production in Albania, but tax evasion is a very controversial issue. Government and employees' associations recognize that informal activities provide a substantial contribution to the economy. But all of this contribution has consequently significant cost in terms of reduction of taxes, lack of employee protection and unfair competition by companies.

One of the latest studies, which stress informality in Albania, was conducted by the American Chamber of Commerce, under the name "Index Business AmCham", otherwise called ABI, which is an annual index created by American Chamber of Commerce in cooperation with Konsort Ltd., which measures the perception of AmCham members about the business climate in Albania. This index measures important elements such as government policies, tax rates, corruption, informality, the application of the law, and also elements linked to the performance of businesses and the economy. AmCham study on ABI (Business Index American Chamber of Commerce) for the period 2014-2015, showed an indication of 42.77% for 2014, and with a growing trend for 2015. Compared to 2013, we observed an improvement of the business climate in 2014. However,

45% of AmCham members continue to view the business climate in Albania in 2014, as unfavorable, or very unfavorable. Expectations for the business climate in 2015 is 45.15%, and consequently higher than the indicator of 2014. According to AmCham Albania (2015), three main concerns include the formal economy (28.04%), government bureaucracy (31.31%) and monopoly or unfair competition (31.78%).

National Business Forum (2015, p. 2) stressed two main problems for the Albanian business community are high taxes and unfair competition from other unregistered businesses; also enterprises included in this study estimate three main barriers that prevent the formalization of informal businesses are obligations to pay taxes; higher risk to be controlled by tax control authorities and higher risk to be controlled by the Labour Inspectorate.

Sectorial description

Fason industriy represents a non-agricultural private sector and represents the majority of exports. In fact, this industry is one of the most successful industries in the country where many small firms are being strengthened and transformed into large companies. Textile and their accessories represent the largest category of exports in Albania. In 2008, this industry represents over 48% of exports, expressed in monetary value, around $ 500 million. Number of employees in the clothing / textiles industry is approximately 110,000 annually. Based on data obtained from the Albanian Chamber of Fason, in 2010, clothing / textile and shoe / footwear industries represented 36% of total exports and numbered about 540 companies nationwide. In addition, clothing / textile and shoe / footwear sector is the only sector in Albania with a positive trade balance over the years. In Albania there are about 1335 companies operating in the sector of clothing / shoes, which have more than 10-15 years of experience and have produced and still continue to produce products for famous companies in Italy, Germany, Spain, etc

Methodology

This paper is based on a survey targeted businesses registered in the National Registration Centre, operating in fason sector, localized in Tirana, which consist of different sizes. According to a study in 2015, conducted by the Albanian Chamber of Fason (CFA), the number of businesses operating in Albania are 1335 business units in this sector. According to information received by the CFA, in its study related to the database of the apparel sector, clothing and footwear industry, it shows that there are 173 registered business entity operating in this industry. According to information received by the CFA, in its study related to the database of the apparel

/ clothing sector, and footwear industry, it shows that there are 173 registered business entity operating in this industry. Because of the focus on a specific area, like that of Tirana district, the population of this paper is 173 business units. After verification, only 150 businesses are continuing their activity in this industry. With a margin of error of 5% and 95% confidence level, the sampling should be 109. The response rate is 73%, 80 questionnaires. The survey method used to collect primary data was face to face interviews with respondents. The survey was conducted with a limited positions within the company, who were better informed and have the permission to give data which are considered sensitive/and share their experiences and their perspectives, as owners / managers / chief finance. The questionnaire was designed based on an extensive literature review. It includes questions on to the business perception on the overall state of the economy and business climate. This questionnaire is built in each of the four blocks of questions, general data, fiscal matters, labor force, and barriers / obstacles to be formal.

Conceptual Model

This paper is based on a conceptual model, adopted from the Kosovo Foundation for Open Society and Riinvest Institute for Research and Development (2015) model. This model is used before from Allingham and Sandmo (1972), and in 2015, is adapted to the "To pay or not to pay" study in Kosovo. According to this model, the dependent variable "Fiscal Evasion" includes three main forms of informality, as: Fully – undeclared workers, under declared workers and under-declaring the real annual revenue / profit. This model presents a fully and clear background of main factors that indicate informality, in displayed forms mentioned above. The independed variables of this model are: a) traditional determinants (tax rate and fine rate), b) institutional determinants (trust in government and compliance cost), c) firm's characteristics (firm's size and legal status), and d) owner characteristics (male, education), (Figure 1). The questionnaire was designed based on variables of the model.

According to the model, if all other factors are constant, an increase in the tax barrier will lead to 2.4% growth of tax evasion. So, the positive correlation between tax rates and tax evasion is consistent with the theoretical research done in this area, mainly in countries in transition. Increased fines and penalties bring evasion of obligations. According to this model, trust in government is an important element that affects the pursuit of the strategy of being formal or informal. Individuals who have trust in government are inclined to think that their country, government and legal system work better and, therefore have a greater tendency to avoid evasion, thus creating a gap between the firm and the election of informality. Another element is the cost of compliance, which collects the financial costs and time,

while waiting for more frequent bureaucratic processes. Firms spend more time dealing with paperwork and other requirements are more likely to avoid taxes. There is a strong correlation between the size of the firm and its tendency towards informality. Large firms are in an inverse connection with tax evasion, because the tendency is that small firms tend to avoid taxes, to be informal. The owner characteristics include gender of the company owner, and his/her education. If the business owner is male and if his education is high and professional, means a positive correlation with fiscal evasion. Having a specific background indicates that this individual doesn't tend avoid its obligations

FIGURE 1: Conceptual Text
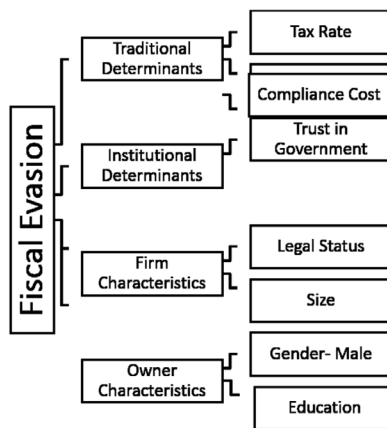
Source: (Kosovo Foundation for Open Society & Riinvest Institute
for Research and Development, 2013, pp. 17-20)

The above model is the basis of preparation of the questions addressed respondents in the fason sector. Tax evasion is the main element and the subject of this model. For each of the determinants, there is a question in the questionnaire. This model helps to combine its elements and to formulate with them the hypothesis, H1: High taxes, frequently penalties, high administrative costs, companies with a small number of staff, with male, and not high educated owner education, will bring a growth in fiscal evasion.

Data analysis and research findings

The population of this paper includes all clothing / textile and shoe / footwear registered companies. It is worth mentioning that 12 of respondents declared that their company was not registered in the same year that they started their

business activity. Mostly, the businesses were characterized by a large number of employees, 65% of them were part of the 50-20000 employees. In addition, the level of undeclared taxes and declaring the real annual profit is mainly in the first category, 0%-20%.

A very high percentage of respondents, namely 57% of them evaluate the level of penalties from tax administration as too high and frequent. They are convinced that their competitors try to avoid tax obligations, and this percentage is 66.3%, which means that more than half of the number of respondents thinks that it is possible, and highly possible for competitors to avoid taxes, and to have informal activities in their company. Their conviction continues with 57.5% that it is possible and very possible that competitors corrupt tax officials to avoid penalties, which are categorized in "high level" to a large percentage of respondents.

Registered businesses were asked about some informal practices and their frequency in their respective sector. According to the survey results, the majority of businesses (55%) consider that the practice "Paying an employee in cash" happens almost always and often. A practice which happens "almost always" and "often" for 62% of surveyed businesses, is "hiring a worker without a contract". Business solution is often under - declared employees, to increase benefits for owners, because they do not pay enough taxes, and chooses to pay their employees with envelope wages. Businesses face a lot of barriers or obstacles to become totally formal. Listing some possible obstacles, it turns out that corruption is the most likely obstacle for businesses.

The paper aimed to go deeper and assess the level of the abovementioned informal perspectives as preliminary foreseen when defining the informality approach. Surveyed businesses were required to provide only one response about the percentage of the annual reported sales on tax authorities. The response gives tax compliance rate that after subtracted from 100%, takes us to perceived level of tax evasion. Average values of all responses provide the overall level of tax evasion in the country. Based on the data of the study, surveyed businesses affirm that on average, businesses in their industry report 69% of their annual sales to the tax authorities, which indicates that 31% of sales are evaded.

It is conducted a reliability analysis of this model. The Cronbach's Alpha is 0.058 for all the variables listed in (Figure 1). In addition, it is should be noted that there is no significant relationship between trust in government, legal status of the company and the fiscal evasion. For this reason, the two variables mentioned above are eliminated and the paper conducted the analysis with a modified model. The level of reliability of the modified model, Cronbach's Alpha is 0.901. This modified model has been the basis of the hypothesis, as a response of the research question.

Various studies have shown that trust in the government and the public services quality affects the reduction of informality; other researchers also state that in

countries with a high level of development, people have a tendency towards a lower level of informal activities. In this model, results noted that there is no significant relationship between the level of trust in government and fiscal evasion.

Regression analysis

The conceptual model used for this study provides the possibility of creating a regressive equation among the factors that influence and stimulate tax evasion. Before the regression analysis, it is conducted a Multicolinearity analysis, and all the independent variables are at the interval (-0.7 - +0.7). The regression equation has the form mentioned below.

Hypothesis, H1: High taxes, frequently penalties, high administrative costs, companies with a small number of staff, with male, not high educated owner education, will bring a growth in fiscal evasion, consist of providing the response to the question research, what are the factors that influence and lead to informality.

TABLE 1: Regression analysis

	p-value	B
Tax rate	0.004	7.167
Fine/ Penalties	0.003	1.391
Compliance cost	0.046	5.259
Size of the company	0.019	0.004
Owner gender (male)	0.005	-7.277
Eduation	0.05	-4.669
Constant		-10.384

Source: Authors calculations based on the survey

Fiscal Evasion = -10.384 + 7.167 Tax Rate + 1.391 Fines / Penalties + 5.259 Compliance cost + 0.004 Size of the company − 7.277 Owner gender (male) − 4.669 Education

It should be noted that there is a positive correlation between the level of taxes and informality, with an increased tax rate, grows the trend of businesses to be informal; an increased level of frequently penalties expressed the incresead business interest on tax evasion; an increase numerous bureaucracies encourages businesses to avoid their obligations; the smaller the company, the more chance for informal activities; education and gender of its owner, especially if female owner education is not high affects the desire for informality. Hypothesis, H1: High taxes, frequently penalties, high administrative costs, companies with a small number of

staff, with male, and not high educated owner education, will bring a growth in fiscal evasion; not fully confirmed, because the fiscal evasion of this model is more likely to happen in the companies owner is female and highly educated.

Conclusions and recommendations

This study conducted an examination of the business challenges and levels of different perspectives of informality. The survey confirmed that the main problems for the biggest part of the Albanian business community are high level of taxes and (Unfair) Competition from other unregistered businesses. The majority of surveyed businesses admitted that working with the tax administration brings not only financial costs for them. On the basis of these findings, author can modestly list several recommendations on minimizing the level of informality by businesses and in pursuing several strategies in government fight against informality. According to the model used, this is a significant important relationship to the company's characteristics and tax evasion, starting with owner gender and his education.

Education was the variable that directly impact on how they assess informality based on the information that they have. Therefore, a valid recommendation addressed to businesses suggests a better knowledge / information of taxes, because often, it may be possible to avoid tax for lack of information about fiscal packages.

While, the strategies pursued by the government are not the most effective one in various aspects. Numerous bureaucracies' prevent business to act formally. Government should find ways on reducing the unnecessary bureaucracies in order to minimize informality. A valid recommendation for the government is to facilitate the procedures, simplifying payment of taxes, and carried them online for all types of businesses, and small ones. The biggest obstacle for businesses to operate as a formal unit, are tax rates. A good analysis of the types and amount of taxes will help on trying to minimize excessive and higher levies; to increase the number of individuals who give away their desire to be informal, with tax cuts.

A better analysis of laws concerning aspects of declared employees after the disclosure of their 48 hours before they are hired is an impossible procedure, especially in the sector of Fason, where there is a lack of high number of qualified employees and training them before being part of the staff takes a lot of time.

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