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## The Informal Economy in Azerbaijan

Farid Guliyev, Baku

### Abstract

This article looks at various estimates of the scale and composition of the informal economy in Azerbaijan, focusing on the extent and structure of informal employment. It shows that informal economic activity makes up a considerable part of the country's GDP and that the share of informal employment is high. The extent of the informal economy has negative consequences for the state's collection of taxes and the social security protection of those employed without contract. Challenges for the foreseeable future include the ability of an oil-dependent economy to create jobs for the growing number of youths, risks associated with social security exclusion of informal workers, and the lack of political will to implement structural reform to eliminate informal payments and bureaucratic control of the economy.

### Size and Composition

"The work of a taxi driver is very hard here," says a cab driver as he is driving me along the newly refurbished roads in Baku's downtown area. He owns the cab that has no meter installed, fares are negotiated in advance, and you receive no receipt after you have paid. This taxi driver, just like many others in Azerbaijan, works informally, without a labor contract and without social protection benefits. Unlike newly sprung taxi service companies, such as Baku's so-called London cabs, his business is not registered and he does not pay taxes. Traffic police officers who supervise the area of the city where he works "demand kickbacks or '*kontur*' by the end of every week" [in local parlance, '*kontur*' refers to cellphone refill/prepaid balance]. He also complains that periodically he needs to call his connections in the city traffic police department whenever the old police inspectors are replaced with new ones who have a larger appetite for bribes.

The story of my taxi driver is not uncommon. A large chunk of the Azerbaijani economy, measured as a fraction of GDP and total employment, is officially unregistered and informal, and it is routine for many Azerbaijanis to make use of informal payments to get things done. Following International Labor Organization (ILO) definitions, the informal economy covers "all economic activities by workers and economic units that are—in law or in practice—not covered or insufficiently covered by formal arrangements... Activities are not included in the law, which means that they are operating outside the formal reach of the law."<sup>1</sup>

Some estimates suggest that as much as 60% of Azerbaijan's official GDP is informal or shadowy (in Azeri: '*kölgə iqtisadiyyatı*', '*qeyri-rəsmi iqtisadiyyat*', '*gizli iqtisadiyyat*'). Estimates by Friedrich Schneider and collaborators at the World Bank (2010) suggest that Azerbaijan

has one of the largest shadow economies in post-communist Eurasia. Despite the slight reduction in levels of informal economic activity from 61.0% of GDP in 1999 to 52.0% of GDP in 2007, the average size of the informal economy for the entire period is still fairly large, 58.0% of GDP.<sup>2</sup> According to an alternative measure by Abdih and Medina (2013), the size of the informal economy in Azerbaijan, as of 2008, was 31.5 % of GDP (cf.: Armenia—35 %, Georgia—30.1, Kazakhstan—33.0).<sup>3</sup> According to official statistics, the size of the shadow economy is about 7–8% of GDP (as of 2014). Local economist Ali Masimli thinks that neither the World Bank's figure of 60%, nor the official state statistics figure of 7–8 % is accurate. He estimates the level of informal economy to be around 33%.

The precise size and scale of informal activities is difficult to approximate given the hidden nature of the activity and unreliability of official statistics. Researcher Leyla Sayfutdinova notes that the figure of 60% may be an underestimation because macroeconomic measures relying on official statistical reports tend to underappreciate the real extent of informal activities. Using the method of mirror statistics to estimating the gap in export-import turnover statistics from 2003–2009, economist Gubad Ibadoglu (2012) finds a discrepancy of \$10.6 billion. Another economist Ogtay Hagverdiyev believes that Azerbaijan's biggest pool of reserves lies in the shadow economy dominated by monopolies linked to state officials who are popularly referred to as "oligarchs."

1 ILO, <[http://www.ilo.org/ilc/ILCSessions/104/media-centre/news/WCMS\\_375615/lang--en/index.htm#>](http://www.ilo.org/ilc/ILCSessions/104/media-centre/news/WCMS_375615/lang--en/index.htm#>)

2 Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, "Shadow Economies All Over the World: New Estimates for 162 Countries from 1999 to 2007," World Bank Policy Research Working Paper No. 5356, June 1, 2010, available at SSRN: <<http://ssrn.com/abstract=1645726>>.

3 Yasser Abdih and Leandro Medina, "Measuring the Informal Economy in the Caucasus and Central Asia," IMF Working Paper WP/13/137, May 2013, <<http://www.imf.org/external/pubs/ft/wp/2013/wp13137.pdf>>.

## Informal Employment

Informal practices also prevail in labor relations and workforce participation. Sayfutdinova cites previous research putting the early 2000s informal employment figure at about 38% of the total labor force.<sup>4</sup> According to the latest ILO employment data, as of October 2009, 407,000 persons held informal jobs in Azerbaijan, accounting for 26.5% of non-agricultural employment. When divided by gender, the share of informal employment is higher for women than men: 254,000 women and 153,000 men were informally employed, which represents respectively 41.7% and 16.6% of non-agricultural employment in the country.<sup>5</sup> In terms of occupational composition, a majority of informal workers are low-skilled labor employed as market (bazar or 'tolkuçka') vendors, shop-keepers, shuttle traders (informally speaking, engaged in 'alver', literally: 'buying and selling'), nannies and owners of small businesses. A large number of informal workers are also employed seasonally in the construction sector. A smaller fraction of self-employed are high-skilled professionals working as freelancers in language translation, training, and consulting services, according to the World Bank 2010 living conditions assessment report.<sup>6</sup> These categories of self-employed often operate without registration and pay no taxes.

Official statistics report around 2.1 million people of the total population of 9.4 million as being employed in the private sector. However, the state statistical agency notes occupations for only 800,000 of those employed in this way, while the remaining 1.3 million are put into the category of private or natural person. It is plausible that the vast majority of those who fall under this category are self-employed or hold informal jobs mainly in subsistence agriculture.<sup>7</sup>

According to the above-cited 2010 World Bank report, the share of the workforce without contracts increased from 45.3% in 2003 to 59.5% in 2006 (more

recent figures are not available). Of 59.5% of all the workers thus employed in 2006, about 71% were rural residents indicating a strong urban-rural divide. Of the total number of 223,000 people employed in construction, a sector that alongside services has expanded after the start of the oil boom, only 25% had written labor contracts with their employers.

Another aspect of the demographic dimension of informal employment is the sectoral composition of the Azerbaijani labor force. While the lion's share of Azerbaijan's economic output is driven by oil production, the hydrocarbon industry is capital, not labor, intensive, and does not generate many jobs. The oil and gas sector employs only 1% of the total workforce. In contrast, the sluggish agricultural sector which contributes only about 5% of GDP provides employment for 37% of the total labor force (World Bank 2015). A sizable fraction of the informal workforce is made up of those who are employed in subsistence farming and agricultural production mainly for family consumption. A lack of opportunities in rural areas drives many, especially male, Azerbaijanis to seek a job outside the country, mainly in Russia. A majority of Azerbaijani labor migrants in Russia are typically employed without written contracts.

One reason for this distorted pattern of employment in Azerbaijan is the country's oil rentier economy, which generates about 75% of government revenue, but employs only a small fraction of the country's workforce. Because the government does not rely on domestic taxation, it has weak incentives to nurture productive forces outside the oil sector and require their registration for the purposes of extracting taxes. Therefore, a large part of non-oil employment is either self-employed or employed without labor contract. While in recent years the authorities have made tax reporting easier, including via e-services, it remains to be seen whether these technical improvements will incentivize those informally employed to actually declare their incomes and lead to a greater formalization of the economy.

Undeclared or informal jobs also mean that many Azerbaijanis cannot enjoy social insurance benefits toward which they also contribute from very little to nothing. The informal economy weakens the system of social protection in Azerbaijan because those informally employed do not pay income taxes or social security contributions. Unregistered, self-employed workers shun declaring income and reporting unpaid family employment, thus evading social security taxes. As a result, they also remain left out of pension coverage.

## Informal Payments

Many informal or self-employed find it more expedient to pay "informal fees" to local tax inspectors than

4 Leyla Sayfutdinova, "Negotiating Welfare with the Informalizing State: Formal and Informal Practices Among Engineers in Post-Soviet Azerbaijan", *Journal of Eurasian Studies* 6:1 (2015): 24–33, DOI: <<http://dx.doi.org/10.1016/j.euras.2014.08.002>>

5 ILO Department of Statistics, "Statistical Update on Employment in the Informal Economy", June 2011, <[http://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/presentation/wcms\\_157467.pdf](http://www.ilo.org/wcmsp5/groups/public/---dgreports/---stat/documents/presentation/wcms_157467.pdf)>.

6 World Bank, "Azerbaijan: Living Conditions Assessment Report", Report No. 52801-AZ, March 1, 2010, <<http://datatopics.worldbank.org/hnp/files/edstats/AZEstu10.pdf>>.

7 The data that follows in this section are taken from: Gursel Aliyev, Anar Valiyev, and Sabina Rustamova, "Social Protection and Social Inclusion in Azerbaijan", Report for European Commission Directorate-General for Employment, Social Affairs and Inclusion 2011, <<http://ec.europa.eu/social/main.jsp?catId=89&langId=en&newsId=1045&moreDocuments=yes&tableName=news>>.

register their business with relevant tax authorities and pay official tax. In fact, informal payments are pervasive. According to the EBRD's Life in Transition survey II (LiTS II 2010) report, a vast number of Azerbaijani respondents reported unofficial, out-of-pocket payments for public services: 72% said they paid bribes when dealing with public health services, 65%—in primary/ secondary education, 66%—traffic police, 60%—official documents, 65%—vocational education, 63%—social security benefits, 65%—unemployment benefits, and 61%—civil courts.<sup>8</sup>

Between 2006 and 2010, perception of corruption in Azerbaijan increased five fold from 14% in 2006 to 65% in 2010 (LiTS II 2010). Although such a jump in venality perception may look unrealistically dramatic, it might reflect the change in informal practices and a certain commercialization of informal public-private transactions. While in the 1990s and early 2000s people relied mostly on personal networks, relatives, connections and favors (for which 'tapş' is the local equivalent) to get around cumbersome bureaucracy and dealing with public officers, the new reality demands paying cash. In other words, cash has increasingly been replacing favors.

As a way of tackling bureaucratic corruption, in 2012 the president issued a decree establishing a new service under the umbrella of the State Agency for Public Service and Social Innovations, "ASAN Service" (in Azeri: 'ASAN xidmət'), which is based on a one-stop shop model and acts as a facilitator between citizens and state agencies. This system allows citizens to enjoy a variety of public services, such as the granting and renewal of identity documents, registration of taxpayers, and a notary service. ASAN Service can be considered as a "pocket of efficiency" within the Azerbaijani state bureaucracy, which is generally perceived as lacking in capacity and highly corrupt. However, while as a standalone entity ASAN may be efficient, it may not be the most efficient way to overcome the pathologies of the inertia-driven old bureaucratic system. Moreover, ASAN represents a characteristic of government decision-making of the oil boom era that avoids implementation of painful reform and instead throws money at problems. The problem with the ASAN model is that fundamentally it preserves the old, clientelistic system that breeds corruption. In fact, it postpones the much-needed reform in the areas of government policy-making and bureaucratic performance. A cursory look at the World Bank's Governance Indicators for Azerbaijan shows that there has not been much improvement in

governance over the past years since the introduction of ASAN, especially in such crucial areas as control of corruption, regulatory quality and rule of law. The country falls behind the regional average (Europe and Central Asia) on all governance indicators. All this shows that ASAN is just a cosmetic measure that masks the real problems of rampant administrative and political corruption. It is hard to imagine if the government could have afforded keeping this "double bureaucracy" had it not enjoyed access to enormous oil revenues as it has.

Another widely spread informal practice is paying salaries in envelopes. Many state employees are paid two salaries: an official one (in Azeri: 'rəsmi maaş') and unofficial one, delivered in an envelope ('zərfdə maaş'). This is possibly done for two reasons: first, firms and state agencies under-report officially paid wages to avoid paying social security or income taxes. A second reason why particularly public sector employees may be remunerated this way is because unofficial payments may be used as a mechanism of political control. Unreported wages can always be qualified as an illegal payment and turned against public officials deemed to become disloyal, turning into rivals or enemies.

## Challenges Ahead

There are several challenges ahead, including:

- *Social protection*: Since only those with formal job contracts are entitled to social security benefits, the vast majority of the informally employed are not included in the social security system, which means they get neither a pension nor unemployment benefits. In fact, about 65% of the Azerbaijani working age population had no pension insurance as of 2007, although these figures might have changed for recent years.<sup>9</sup> Without measures to effect the state's infrastructural capacity to enforce the mandatory labor contract and tax reporting, informal employees will continue to be in a vulnerable position and potential economic crisis will hit informal employees more severely than those with a formal contract who can enjoy at least some social safety nets.
- *Youth influx*: A greater challenge for the authorities is how to maintain a large public sector to provide jobs for young people as Azerbaijan will experience an influx of large numbers of youth ('youth bulge') in the next decades. The state statistics committee indicates that the state sector employed 25.9% of the total workforce in 2013, down from 33.2% in 2000. According to the 2013 Caucasus Barom-

8 Life in Transition Survey II, <<http://www.ebrd.com/news/publications/special-reports/life-in-transition-survey-ii.html>>

9 World Bank, World Development Indicators, 2012, p. 78, <<http://data.worldbank.org/sites/default/files/wdi-2012-ebook.pdf>>.

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.<sup>10</sup> 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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<sup>10</sup> 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.<sup>1</sup> 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

<sup>1</sup> According to the OECD data <<http://www.oecd.org/dev/poverty/isinformalnormalmessagesfiguresanddata.htm#data>>