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## Global Forum on Competition

### COMPETITION POLICY AND THE INFORMAL ECONOMY

#### Contribution from Romania

-- Session II --

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## COMPETITION POLICY AND THE INFORMAL ECONOMY

### --Romania--

#### 1. Definition of informal economy

1. Most authors trying to measure the informal economy (or underground economy) face the difficulty of how to define it. One commonly used working definition is: “all currently unregistered economic activities which contribute to the officially calculated (or observed) Gross National Product”.

2. These very diverse sectors and kinds of informal economies in Romania can be grouped in four types (R. Neef, 2004):

- 1) **Informal dependent activities.** The people and households involved in such activities live in poverty, engage in informal activities - mostly subsistence farming and occasional labour, day work, transport or construction, but also some small handicrafts or street trading - and their main source of income is survival- level.
- 2) **Informal supplementary activities.** These activities are far less obvious, but are part of the strategies applied by the population as far back as the time of the “shortage economy”. They are informal supplementary activities, practiced within households that are not poor, in order to complement their formal incomes, or improve their standard of living. The activities in this category are much more numerous than those in the first category. These include farming and the sale of products thereof, qualified trades, professional services and temporary work abroad. Most of these households have at least one formal jobholder, some using for personal gain the resources at their place of employment, such as materials, equipment, working time, infrastructure, or clients. Few of these benefit from stable social transfers, in most cases pensions. They receive supplementary income from agriculture (or land they own), qualified trades or even small businesses.
- 3) **Informal enterprises.** Most of the people in this group lack adequate material and financial capital, and are therefore unable to officially start up a business. They are mostly active in labour-intensive industries, such as trade, professional services (computer operation, accounting, tutoring) etc. Most of these are family businesses, and the formal jobholders in the household provide the basic liquidity for the firm. A great deal of energy and time at work is the substitute for little capital. Others, to our knowledge, a minority, have available basic assets and property, excellent qualifications and a network of well-placed relations. They know “who needs to be known” to establish modern farms, transportation companies, micro- construction or specialised production companies. There is no data on these small, informal enterprises (evading taxes and using unregistered workers) to allow for a quantitative or typological estimation. The line between informal enterprises and formal ones engaging in a limited number of informal practices fluctuates and is impossible to approximate. It is more a difference of intensity than one of form.
- 4) **Criminal economic activities.** They are active in the most diverse fields and have a variety of forms, (these include theft, drug producing and dealing, and finance criminality). Some are just distributive, tapping resources from the economy. Others manufacture illegal products or use illegal distribution chains. Their profits do not depend on the number of working hours spent or on their own accumulation, but rather on risk-taking, blackmail or violence. Illegality is the core of criminal economic activity, and constitutes its difference from other types of informal economies that may include many illegal elements or manipulations, but which be put aside if other legal resources were substituted.

## 2. Causes, characteristics and size

3. The informal sector is a critical component of many economies in Eastern Europe, considered by some as the “shock absorber of transition”. The economic, social and political re-engineering which characterises transition to a market economy and western style democracy creates many uncertainties as well as many opportunities; a large part of this process has actually happened outside of official channels through informal relations and activities.

4. In this context, many problems emerge, since it is widely believed that high tax rates and ineffective tax collection by the government are the main causes contributing to the rise of the underground economy. The economists have already established a relationship between tax rates and the amount of tax evasion or the size of the underground economy: the higher the level of taxation, the greater the incentive to participate in underground economic activities and escape taxes. However, corruption is an important factor that can not be neglected. Moral issues, related to the fairness and the asymmetry of the relationship between the individual and the State, and structural flaws in the legislation are also considered as catalysts for economic fraud.

5. General wisdom says that the sectors in which underground activities mainly occur are: repair and maintenance of vehicles and domestic appliances; clothing and footwear production (including repairs); construction; agriculture; transport; wholesale and retail trade; tourism, hotels and restaurants; real estate; education; health; business and personal services.

6. At the macroeconomic level there are several so-called indirect methods used to estimate the size and dynamics of the underground economy, reported in literature as “Monetary Approach”, “Implicit Labor Supply Method”, “National Accountancy”, “Energy Consumption Method”, etc. Unfortunately, many times there are large differences among the estimated shares of informal or underground economy obtained by various methods. For instance, a study published by L. Albu<sup>1</sup> shows that: “the figures range between about 20% of GDP, obtained on the basis of the energy consumption method (Enste and Schneider, 2000) and more than 45% computed using the monetary approach (French, Balaita, and Ticsa, 1999). Also, the figures (based on the national accounts methodology) reported by the National Institute for Statistics (NIS) increased (mainly due to changes in methodology); from about 5% in 1992, to 18% in 1997 and to 20-21% in 2000-2001. Adding to these figures about 7% of GDP, representing the estimated average level of self-consumption in the case of a rural household, legally non-registered but informal, it results that during the last years the informal economy accounted for 25 - 28% of the national economy”.

7. Many transition economies have experienced a surging business activity in the informal sector. Some of this activity is illegal (criminal), for example arms trafficking. Such activity will not become formal, regardless of improvements in the business climate. Other activities, like mom-and-pop retail trade or small production units operate merely for the subsistence of their owners and do not generate enough revenue to make their inclusion in the tax base meaningful. However, there exists a considerable share of business activity that is semiformal, e.g., the company is registered but most employees are not etc.

8. Unofficial enterprises can be medium or even large enterprises with sophisticated activities. This happens because an enterprise is able to keep activities ‘blended’ i.e. part formal and part informal or unofficial.

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<sup>1</sup> “A Model to Estimate Informal Economy at Regional Level: Theoretical and Empirical Investigation” - Lucian-Liviu Albu, Institute for Economic Forecasting, Romanian Academy, Paper prepared for the International Conference on Regional and Urban Modeling, Free University of Brussels, June 1-2, 2007

9. Businesses in the subsistence end of the informal sector spectrum hold little potential for “graduating” to the next levels. Business failure rates are high because of high localised competition and lack of information or access to other markets. Moreover, many of these enterprises are short-lived until the household finds other sources of income that enables it to recover or surpass its living standards.

10. Unofficial enterprises in the small and medium end of the informal sector whose owners and employees are highly educated and have sophisticated skills hold the greatest potential to ‘breakthrough’ to the formal sector. This sub-sector is where there is a great deal of mixed activity, enterprises that may be formally registered, but some of their activities or employees are not officially reported. Improvements to the business and regulatory environment may provide incentives for these potentially dynamic enterprises to go formal. However, many authors believe that such businesses structure their supply and customer relationships in ways that make it difficult to go “legal” later; also opportunities to modernise are often dismissed and productivity of informal companies stays below half the average of legitimate companies.

### **3. Level playing field and productivity**

11. The expansion of the underground economy relative to GDP has important consequences for public finances. Businesses in the underground economy escape taxation, so that the transfer of scarce resources to the underground economy undermines the tax collection and consequently reduces the supply of essential public goods, such as macroeconomic stability, public order or law enforcement. Furthermore, a vicious cycle may emerge since budgetary concerns generated by low tax collections may generate increased tax rates imposed on formal businesses. In addition to exaggerating the unearned cost advantage of informal ones, higher taxes eat up revenues that formal companies would otherwise invest in R&D.

12. Informality stifles economic growth and productivity in two ways. First, the powerful incentives and dynamics that tie companies to the grey economy keep them subscale and unproductive. Second, the cost advantages of avoiding taxes and regulations help informal companies take market shares from bigger, more productive formal competitors.

13. In many sectors of the economy entire informal value chains have a substantial cost advantage over their formal counterparts. In addition, customers of an informal business expect low prices, and many would go elsewhere if it transformed itself into a formal company and had to raise them.

### **4. Competition enforcement**

14. A sector where the Competition Council was very recently faced with a substantial underground economy is the cereals market and its downstream markets.

15. In 2007, upon receiving signals from the market and the press, the Competition Council opened an ex-officio investigation on the general bakery market regarding potential price agreements between producers. Subsequently, RCC opened a sectoral enquiry on the upstream market, respectively on the market of cereals used for the production of general bakery products. Both actions are still ongoing, although in their final stages of completion.

16. The analysis of both markets revealed a high percentage of underground activity. In the first investigation, even if formal players interviewed accused large portions of the market being affected by informal players, evidence showed that the informal players were small operators, in villages and the peripheral area of small cities. Difficulties in the assessment of the market and market shares of formal players, affected by lack of figures from the informal side, were not detrimental to the case since RCC was investigating a per se infringement. The large number of small informal operators, though, has a large influence on the price of bread.

17. Apparently such operators are part of an informal distribution chain, so cost advantages that create pressures on formal competitors result not only from tax evasion, but also from lower costs in raw materials, storage etc.

18. Data from the sectoral enquiry on the market of cereals used as raw material in the market of the initial investigation confirmed the spillover effect of underground activity in all downstream markets onto the final product market, affecting the behaviour and pricing policy of formal bread producers.

19. Most of the bread producers declared that they are forced to keep their profit margins very low to stay on the market. Oddly enough, the ordinary bread consumer may find an apparent positive aspect of the pressure of the underground economy on the formal one: without the tax evaders, the price of bread would soar.

20. However, for the more trained eye, large bread producers do not seem to be in any threat of exiting the market. Bread is a basic food product and therefore demand for bread is highly inelastic. Moreover, the lack in sophistication of the customers and low level of income per capita of the Romanian general population as opposed to more developed economies may mean that an increase in prices for bread would paradoxically generate an increase in the quantity demanded (the Giffen effect). The size of the informal bread producers makes it impossible to believe a scenario where consumers, especially those from the big cities where most of the bread produced in large factories is distributed, would shift their buying habits so much as to travel large distances to seek for cheaper bread.

21. Baking is not a capital intensive industry. It manufactures generally low-cost goods from product components. It is however true that a low profit margin will keep companies from investing in quality improvements or brand diversification and thus generate cost efficiencies that would make them more competitive on the market.

22. Evaluating the size of the informal economy in the grain market proved to be an almost impossible task, since statistical data available from various institutions was incompatible due to different methods of estimation. The mechanism for granting subsidies for agriculture could have provided also a good approximation of internal production of grain; however, certain subsidy beneficiaries tend to declare fictitious figures for their production, accusing unfavourable weather for low levels of productivity and selling the undeclared grains on the black market. Also, according to information received, large quantities of cereals were imported and exported illegally. Players on the market placed the size of the "black market" at 40%.

23. Financial Guard controls on these markets revealed losses for the State budget of almost 21 million EUR only from bread producers investigated in 2007. 8 out of 10 undertakings investigated were evading taxes. Total figures for tax evasion from all markets using cereals are impossible to estimate.

24. The Competition Council will communicate the findings of the investigation reports to the relevant authorities that have the necessary tools to get these markets back to a certain degree of normality.

## **5. Advocacy**

25. All types of informal activities have something in common: the entrepreneurs who pursue them believe the benefits of informality outweigh their costs. Some activities will always stay informal: illegal activities like drug trafficking is one example; house-cleaning is another example. No improvement in the regulatory environment will change their status. Fortunately, such activities account for a small share of GDP. Many activities that now take place in the informal or semi-formal economy may be legalised if the costs of staying informal would rise and its benefits would fall.

26. Several changes need to take place in order to improve the environment for operating a formal business.

- Reducing barriers to entry on markets.
- Streamlining administrative process.
- Adequate fiscal policy, assisted by efficient tax collection and control instruments/organisms.
- Eradicating corruption.
- Enhancing access to capital.

27. Most of these actions are beyond the attributions and mission of the competition authority, but rather fall under the responsibility of other governmental institutions.

28. Advocating removal of excessive regulations that create high barriers to entry is however a task that a competition authority can and should perform in order to promote and preserve free competition on the markets.

29. A good example on this topic is the taxi services market. Although the case was extensively presented in a previous submission of the Romanian Competition Council for OECD's Competition Committee Roundtable on taxi services in 2007<sup>2</sup>, recent and relevant evolutions justify an additional brief presentation.

30. Until 2002, in Romania taxi services were regulated at local level by each local public authority, by means of decisions of the local councils. At the end of 2002, the Parliament adopted a law regarding taxi and for-hire services; this law established the general rules of functioning for these services, enforced at national level. Local authorities were now empowered both to define the dimension of the market by establishing a maximum number of licenses and to issue regulations regarding minimum and maximum tariffs for taxi services. Moreover, these decisions were to be made upon consulting the respective professional associations.

31. RCC led a sustained advocacy activity, informing the Government, the Parliament and the General Council of Bucharest about the anti-competitive aspects in the law and proposing<sup>3</sup> their elimination. Our position was also presented publicly, in several articles, press releases and interviews in the mass-media, underlying each time the negative effects of the restrictions existing in the taxi law.

32. Discussions took place also with the professional associations in the field and with the legislators for finding less harmful solutions from the competition standpoint. RCC insisted on eliminating minimum tariffs and refraining from consulting the professional associations on tariffs and number of licenses.

33. Regarding the limitation imposed to the number of licenses, it was suggested that the limitation should be eliminated in two years time, in order to give stakeholders the possibility to adapt/ prepare themselves to face up to the competition on a free market, without such entry barriers. If necessary, such limitation might only be maintained in big cities where heavy traffic might justify it; as soon as traffic

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<sup>2</sup> See OECD Policy Roundtables - "Taxi services: Competition and Regulation" - pg.222 Romania, <http://www.oecd.org/dataoecd/49/27/41472612.pdf>, or on OLIS, DAF/COMP(2007)42

<sup>3</sup> The competition law in Romania allows the competition authority to propose modifications of the normative acts which contain provisions with an anti-competitive effect

issues are addressed, this limitation should be also eliminated. This opinion was upheld by local authorities in small towns that considered limiting the number of licenses not justified.

34. Several draft laws regulating the taxi services that incorporated our comments were submitted to the Commissions of the Parliament and extensively debated. In 2007, the Romanian legislator issued a new law regarding local public transportation, which included taxi and for-hire services. The new law contained several provisions that were supposed and may have been indeed a disincentive for the informal economy in the sector and most certainly contributed to the welfare of the consumers.

35. However the restriction regarding the maximum number of licenses was maintained along with other anticompetitive provisions that are not relevant for this topic.

36. At present a maximum number of four authorisations per 1,000 people are issued. Taxi licenses are assigned for a five years period, with a possibility of renewal.

37. For example, before this restriction was introduced, in Bucharest there were about 7,000 taxi authorisations. Their number increased in 2004 to 8,500 and at present there are 10,000 authorisations. Although remarks were made at the previous debate on this issue that taxi services in Bucharest seem to be quite competitive and the quality of services beneficial for the customers, and with good reason, signals from the market show that the limitation imposed on licenses, aided by other secondary factors not necessary related to regulation, such as corruption, mentality and social issues, led to the proliferation of a quite substantial informal market.

38. According to the testimonials, big taxi companies currently do not have staff to operate their licensed vehicles, due to low salaries and high daily targets imposed. However, they keep their current licenses and would rather keep cars parked in company parking lots than downsizing business to increase productivity. As a result, even if on paper 10,000 taxis operate within city limits, in reality figures are significantly lower. The local council has more than 1500 applications for licenses on the waiting list, and in the meantime most of the applicants are forced to operate illegally.

39. The professional associations on the market right now are divided in two sides: big companies on one side and small or independent operators on the other side, most of them currently without licenses. The first declare themselves quite satisfied with the current state of regulations and are quite eager to participate in consultations on tariffs. The latter accuse the first of closing the market. Even if one might argue that a substantial presence of big operators on the market is not necessarily a bad thing for the quality and safety of services, since obviously big companies have the necessary resources to observe quality and safety regulations, there is always a concern related to prices. An absence of small and independent operators on the market might provide breeding grounds for concerted practices. Moreover, the resulting oligopoly is artificial and not the result of normal competition.

40. Currently, RCC has several ongoing investigations on local taxi markets regarding possible price agreements.

41. Social movements and public protests of taxi drivers occurred repeatedly in recent months: public rallies and demonstrations, hunger strikes, open letters to the regulators and the Government, even a letter to the European Parliament. The Mayor of Bucharest had several meetings with representatives of discontented taxi drivers and agreed to try to increase the limit of maximum licenses. This solution would provide however only temporary relief.

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