

Informal Economy and SLIP Agenda In Russia and Hungary

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Abstract

This research is devoted to the analysis of the informal economy and its reactions to the economic policy reforms. The interrelation between those two phenomena is investigated on the example of impact which the SLIP agenda reforms had on the informal sectors of Russia and Hungary during the two decades of the economic transformation. The theory chosen for this analysis is New Institutionalism and its two related concepts of transaction and transformation costs resulting from formal institutional framework. The difference in the implementation of SLIP reforms, which changed radically institutional environment in Russia and Hungary, explains divergent trends in the development of the respective informal sectors. Whereas in Hungary stepwise implementation of the SLIP agenda resulted in the inverted U-shape of the trajectory of growth of the informal economy, in Russia a partial and misconceived reform agenda resulted in the growth of the informal sector in the 1990s and its entrenchment in the 2000s decade.

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Introduction

Informal (or shadow) economy has always been one of the ‘evergreens’ of development economics and economic policy. This is due to several reasons. Firstly, informal economy constitutes the part of economic activity from which the state administration does not obtain revenue in the form of taxes. This might have different negative repercussions for the general economic policy of the state including growing budget deficits and permanent deterioration of tax morality. Secondly, informal economy can be a source of different types of illegal activities, which is a problem in itself, as crime rates grow and social security - and consequently confidence in the government - deteriorates. Thirdly, in the long run, a high level of informal economy is negatively correlated with sense of justice among population, law abidance, and trust, all of which are important if market economy is to function. What follows from these considerations is that there is a necessity of better understanding the mechanisms underlying the appearance and functioning of the informal economy. Therefore, research in this field is always policy relevant in terms of measures enhancing the transfer of economic activities to the official, ‘aboveground’ sector.

The approaches to the study of informal economy range from survey-based investigations of one aspect of informal economic activity in one country (microeconomic approaches) to large panel data analysis with estimates of the shares of informal sectors involving most of the world economies (macroeconomic approaches). In this context, assessment of the impact of economic policy on the informal economy as a whole belongs to the latter group of contributions. This is exactly the stance taken in this paper: the following chapters are dedicated to analysis of SLIP agenda transformation reforms and their impact on informal economies in Russia and Hungary. Few words should be said on SLIP agenda, the choice of cases, and the relevance of the research.

The abbreviation SLIP agenda stands for Stabilization, Liberalization, Institutions, Privatization and denotes the package of economic reforms which were implemented by Central Eastern European countries during the process of economic transition from socialism to the market economy in the 1990s and 2000s. Since the reform package was formally identical for all countries in the region, it allows to conclude on how the difference in implementation across the countries resulted in different shares of informal sectors in respective economies. Such comparison is particularly instructive in the case of Russia and Hungary. Both countries in the first years of economic transformation possessed similar shares of the informal economy of 30% of GDP¹. However, with the advantage of hindsight it is possible to conclude that whereas in Hungary the informal economy remained on the same level through the 1990s and declined significantly by the end of the decade, the Russian informal sector was on the increase until 1998 and then it became entrenched, so that nowadays the informal economy in the Russian Federation is estimated to be 40-45% of GDP². Hence the puzzle: why did not the SLIP policies strengthening the government and removing many of the factors contributing to persistence of the informal economy³ lead to the fall of the share of informal economy in Russia in the 2000s? In which way was the implementation of the same SLIP agenda different during the Hungarian transformation causing the decrease of the informal sector in the country?

There are several grounds which allow to answer those questions on the basis of comparison of Russian and Hungarian cases. Firstly, the scope of the present research does not allow conducting a fully fledged comparative analysis of all post-Socialist economies. Russia and Hungary at the same time are indicative examples, each representing one of the

¹ Schneider F., Buehn A. "Shadow Economies & Corruption All Over the World. Revised Estimates for 120 Countries". *Economics: The Open-Access, Open Assessment Journal*. Vol. 1 2007-2009. (October 27, 2009)

² Ibid. and Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010), pp 82-87

³ Those include recentralization of the administrative system on federal and local levels, improvements of judiciary, lower rates of inflation and unemployment, significant decrease in the tax rates with the adoption of the new Tax Code in 2000 etc.

two groups of transition economies: the Newly Independent States (NIS, post-Soviet republics) and East-Central European EU members, which were part of the socialist camp two decades ago. Moreover, informal economy was not a new phenomenon in both countries at the time when socialist economies were dismantled⁴. Before the radical transformation of the economic system was launched in both countries in the early 1990s, the informal sectors in Russia (Soviet Union back then) and Hungary amounted to 5-7% of GDP⁵. Secondly, the phenomenon of the entrenched informal economy comes out as a puzzling phenomenon only in Russia. It is true that other post-Soviet republics have comparable shares of the informal economy; however, Russia was the only country from the group where the last decade was marked by a second wave of SLIP reforms directed among other goals towards combating informal economy; and those reforms did not bring the expected results, which needs to be explained. Finally, the question of accessibility of data should be accounted for.

The rest of the thesis is structured in the following way. Firstly, a theoretical framework for further empirical analysis is set up. Afterwards, the Hungarian and Russian cases are investigated along the lines of the established theoretical framework. Analyzing the implementation of the SLIP agenda in both countries, each element of it related to informal economy will be discussed separately. The channels of impact of the policies on informal sectors will be investigated in detail. This goes contrary to the traditional analysis of SLIP agenda implementation, when reform package as a whole is reviewed in a chronological order. When analyzed separately, the channels of impact of economic reforms on the informal sector stand out more clearly, which facilitates giving a comprehensive answer to the questions posed above. At the same time, since the empirical analysis will derive from the structural elements of reforms and not from their time span, certain data asymmetry appears between the Hungarian and Russian cases. Namely, the Hungarian case includes data mainly

⁴ Kornai J. "Individual Freedom and Reform of the Socialist Economy". *European Economic Review* 32 (1988)

⁵ Ibid. and Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010), p 68-70

from the 1990s until 2000, as by that time SLIP was implemented in the country and the informal economy declined to the level where it remained through the 2000s decade. In Russia, the implementation of SLIP had two periods: the reforms of 1991-1998 and of 1998-2004, while the informal economy became entrenched in the second period. However, since the main focus of this research is on links between the same sets of policies and reactions of informal economy to them, data asymmetry does not deter the comparability of the findings, which are discussed in the Conclusions section of the thesis.

Chapter 1 - Informal economy, Its Factors and SLIP Agenda:

Theoretical Framework

1.1. *New Institutionalism as Theoretical Framework*

In order to conduct a well-grounded analysis of informal economy and its interaction with SLIP agenda policies, an overarching theoretical framework should be chosen which would put an emphasis not only on the two phenomena *per se*, but also on the causal links and relations existing between them. Such a theoretical framework was developed by the New Institutional School of economic thought in the works of Ronald Coase, Douglass North, Mancur Olson, and others. The School expands and modifies the assumptions of the Neoclassical theory of economic development by underlining the imperfect nature of information available for market actors and the primary role of institutions (both formal and informal) as determinants of the firm's behavior and strategies of its interactions with other market actors.

One of the central concepts of New Institutionalism, which is also the grounding theory for the present research, is the notion of transaction and transformation costs. Douglass North in his major work "Institutions, Institutional Change and Economic Performance" gives the following explanation of these two types of costs⁶. As institutions are certain formal and informal rules which regulate human activities in every society, they aim at improving the lack of information through the establishment of patterns of behavior known to all members of society. The clearer the information is, the closer an economic system is to the neoclassical model of perfect market. However, North emphasizes that often institutions are not conducive to the creation of a transparent market, but on contrary they may hinder private initiatives through the creation of different barriers and obstacles for entrepreneurial activity. In reality,

⁶ North, D.C. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press (1990) pp 61-73

every economic system possesses a unique combination of rules, an original institutional framework, where both progressive and inefficient institutions are present, whereas a net effect of all institutions results in either a pro-developmental or a more stagnant, counterproductive economy.

The abovementioned efficiency of institutions on the microeconomic level manifests itself through higher or lower transaction and transformation costs. Every exchange which takes place in the economy is transaction and it is carried out in accordance with the established rules, i.e. institutions. The character of institutions will determine the transaction costs which the firm will face. There might exist an institutional framework, where some transactions are banned or are impossible to carry out due to high transaction costs. For example, the government might adopt certain legal regulations which prohibit particular types of transactions or it may as well tax the transactions or create administrative barriers in the form of additional special permissions and licenses, which lowers cost efficiency of the firm.

The existence of transformation costs in turn can be explained using a similar logic. These costs relate to the expenses which the firm bears in the process of production, or in other words in the process of transforming productive resources into goods or services. Institutions play an important role in this transformation process, as they impose additional costs which are afterwards accounted for in the price of the final product. For example, different restrictions on buying and selling land or bureaucratic procedures related to the access to technology (intellectual property rights or access to communication technologies which are state-owned) increase the price of a good or a service by an amount which depends on how well-designed those regulations are and how efficiently they are enforced.

1.2. Informal Economy: Definition

As it was shown, the concept of transaction and transformation costs gives a clue for understanding the interactions between the state and firms, the influence of the government's

decisions on the strategy and market behavior of the private actors, and the role institutions play in the production process and more broadly in decision making and cost-benefit calculations undertaken regularly by firms. Deriving from the New Institutional approach to the analysis of firms' behavior, it is possible to proceed to the issue of the definition of informal economy. The problematic nature of defining informal economy is illustrated by the fact that existing literature on the topic did not produce so far a single consensual definition of informal economy. Instead, there exists a myriad of terms including "subterranean; hidden; grey; shadow; informal; clandestine; illegal; unobserved; unreported; unrecorded; second; parallel and black" economy⁷.

For the purposes of this research, I adopt the term informal economy defined as an economic activity, when economic actors "circumvent the costs and are excluded from the benefits incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit and social security systems"⁸. This definition is a logical continuation of the New Institutional approach outlined above. The primary role here is given to private economic actors and the cost-benefit analysis, which they carry out with regard to formal institutional environment in which they operate. Namely, if the transaction and transformation costs imposed by the governmental economic policy are too high, a firm may decide to circumvent those costs by transferring its activities in the informal sector, where a formal institutional framework does not apply, but alternative informal institutions are in action. By going underground, the firm naturally deprives itself from the benefits granted by the existing formal rules, as those benefits are lower than the costs imposed by the regulations.

This New Institutional definition of informal economy opens the way for the further analysis of informal sectors in Russia and Hungary for the following reasons. Firstly, out of

⁷ Feige E. L. "Defining and Estimating Underground And Informal Economies: The New Institutional Economics Approach". *World Development* Vol. 18, N 7 (1990), pp 994-999

⁸ Ibid.

all definitions this one is the broadest; it includes all types of ‘hidden’ economic activities from clearly illegal activities to legal but still not registered activities. Since in this research the central focus is on general trends in the behavior of informal sectors, the chosen definition allows capturing the hidden activities in their full scope. Secondly, the definition emphasizes the relation between the informal sector and the policies and regulations imposed by the state. The concept of ‘informality’ should be understood here as an antonym to conformity with the officially adopted rules and control. In this sense, the term informal economy creates a theoretical background to establish the links between the development of shadow activities and the policies of central government directed towards transferring those activities to the formal, official economy. Finally, informal economy is usually approximated empirically as the aggregate income created in shadow in proportion to the registered GDP. This type of measurement allows answering the questions stemming from the empirical puzzle described in the introductory part. Here, the issue of the availability of empirical data comes to the fore. From this point of view, the usage of the term informal economy gives way to further analysis, as the already existing research makes the proportions of informally generated incomes to registered GDP available for most of the economies around the world⁹.

1.3. Factors of Informal Economy

As the issue of definition of informal economy is settled, the focus should move to determinants (or factors) of the informal economy. The underlying idea here is the above discussed cost and benefit analysis by economic actors - mainly firms and individual entrepreneurs – regarding the transfer of their activities from the official sector to the informal. Through unfolding the cost and benefit sides of the decision making by firms, it is possible to list the factors (determinants) which either contribute to the persistence of

⁹ For more details see the estimates by Schneider and Buehn for 120 countries in Schneider F., Buehn A. “Shadow Economies & Corruption All Over the World. Revised Estimates for 120 Countries”. *Economics: The Open-Access, Open Assessment Journal*. Vol. 1 2007-2009. (October 27, 2009)

informal economic activities or cause their decline. In other words, what follows is the analysis of potential transaction and transformation costs resulting from the regulatory activity of the state, which may push the firm underground.

It should be noted that there exists a broad consensus in the literature with regard to the main determinants of informal economy. One of the most often named factors contributing to the persistence of informal economic activities is a complicated system of taxation with an overall high level of tax rates¹⁰. High tax burdens are the constituent part of transformation costs. They may cause a decline in the profitability of the firm, and an incentive to increase competitiveness through tax evasion (i.e. through lower costs of production) increases.

The second factor of informal economy, which was tackled above, is ill-designed regulations adopted by the state in the sphere of corporate governance, but also in the sphere of labor relations¹¹. With regard to corporate governance, the primary focus is on bankruptcy and insolvency regulations. When state regulations here are lax, no market clearance takes place and uncompetitive firms continue functioning. This increases transaction costs, since the reliability of contractors is unknown and inter-firm relations are influenced by side-factors such as state support for certain agents and the system of personal connections and bargaining for the subsidies. Consequently, an excessive reliance on state support, but also on shadow, informal financing evolves. This latter point is important, as the market players do not enjoy an equal status and equal access to resources. Instead, a preferential treatment of certain actors disadvantages the others, while the overall transparency of the market and so the information availability in the broad sense decline. Moreover, under dysfunctional bankruptcy and

¹⁰ Schneider F., D. H. Enste. *The Shadow Economy. An International Survey*. UK: Cambridge University Press, 2002 pp 57-76 and Johnson S., D. Kaufmann, P. Zoido-Lobaton. "Regulatory Discretion and Unofficial Economy". *The American Economic Review*, Vol. 88, No. 2 (May, 1998)

¹¹ Epstein R. A. "The Moral and Practical Dilemmas of the Underground Economy". 103 *Yale Law Journal* 2157, (1994) and Volkov V. *Violent Entrepreneurs*. Cornell University Press (2002) pp 37-50.

insolvency laws, the management of the firm is inclined to forge the data about the performance of the firm in order to retain its position¹².

The third factor which is positively correlated with informal economy is the lack or malfunctioning of institutions. In a country where the rule of law is weak and the judicial system is dysfunctional, there is little room for effective guarantees of private property and contract enforcement¹³. Consequently, private firms might turn to alternative means of contract enforcement such as the mafia or personal connections with high level state bureaucrats. Whereas in the two previous cases the factors related rather to the higher transaction and transformation costs of operating officially, this factor relates to the lack of benefits which functioning 'aboveground' brings to the firm.

The fourth factor of informal economy related to the mentioned issue of enforcement of formal rules is corruption, which also increases the entry costs for a new firm and regular costs for operating firms¹⁴. Here, the degree of discretion possessed by state bureaucrats is crucial. In highly corrupt states, state officials often enjoy excessive degrees of discretion to make decisions, while control over their activities and responsibility is lacking. Under such conditions high bureaucratic barriers and corruption might force the firm to carry out its activities in whole or in part in shadow in order to circumvent the costs.

The fifth and the last factor of informal economy discussed here is high rates of inflation. They are also positively correlated with the share of the informal sector. When prices are volatile and are constantly changing, there is more room for creative accounting in a firm. Moreover, with high rates of inflation unofficial barter payments (non-money-based

¹² Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010), p 71

¹³ Volkov V. *Violent Entrepreneurs*. Cornell University Press (2002) p 41

¹⁴ Johnson S., D. Kaufmann, J. McMillan, C. Woodruff. "Why Do Firms Hide? Bribes and Unofficial Activity after Communism". *Journal of Public Economics* 76 (2000).

transactions) become more attractive and economically reasonable to use¹⁵. Capital flight is another effect of high inflation which relates to informal economy phenomena.

All of the abovementioned factors rarely act individually. A simultaneous presence of several factors contributing to the expansion of the informal sector is explained by causal links which exist among them. For example, weak predatory states are often corrupt, which translates into the lack of impartial judiciary, but also oftentimes into loose fiscal policies leading to macroeconomic imbalances. This logic leads to the conclusion that only a systemic reform and not simple tinkering of isolated economic problems can be effective in reducing the share of informal sector. However, systemic reforms also require exceptional political and economic conditions, for which reason informal economy along with corruption remains a problematic issue for policy making and policy advice.

1.4. SLIP Agenda, Its Impact on Informal Economy

Since the point of economic reform was tackled, the SLIP agenda should be discussed in detail. SLIP as a policy package was first proposed as a part of the Washington Consensus to Latin American countries, and later on proved to be crucial for the post-Socialist transition economies¹⁶. The Stabilization part included the commitment to price stability and fiscal discipline (small budget deficits). Liberalization consisted of opening up trade - including overall low tariffs instead of quotas - and capital accounts; competitive exchange rates; reform of taxation system through major tax cuts and broadening of tax base; deregulation of labor markets and abolition of regulations impeding market access and competition, and price liberalization. The Institutions component consisted of building up capable disembedded

¹⁵ Rosser J. B. Jr., M. V. Rosser, E. Ahmed. "Multiple Unofficial Economy Equilibria and Income Distribution Dynamics in Systemic Transition". *Journal of Post Keynesian Economics*, Vol. 25, No. 3, Spring (2003)
Johnson S., D. Kaufmann, P. Zoido-Lobaton. "Regulatory Discretion and Unofficial Economy". *The American Economic Review*, Vol. 88, No. 2 (May, 1998)

¹⁶ Marangos J. "Was Shock Therapy Consistent with the Washington Consensus?" *Comparative Economic Studies* 49 (2007) and Havrylyshyn O. "Growth Recovery in CIS Countries: The Sufficient Minimum Threshold of Reforms". *Comparative Economic Studies* 50 (2008)

bureaucracies; the establishment of rule of law and impartial judiciary; guarantees of private property rights and effective contract enforcement; the creation of functional financial institutions (e.g. independence of Central Bank) and new mechanisms of financial intermediation. Finally, Privatization of state property was to be conducted through open auctions, where foreign and domestic bidders would take part on par. At the same time, rapid privatization or privatization through vouchers was strongly opposed¹⁷. The crucial point with regard to the implementation of SLIP agenda was that it had to be implemented in the definite sequence (stages): Stabilization was to be first; then after the government controlled the economic situation, liberalization could follow complemented by institutions. Only after these tasks were completed - i.e. when the market was freed from excessive regulations and the 'rules of the game' were established - could privatization be introduced.

Whereas the point of how the SLIP reforms consensus reforms became a reality for East European countries will be revealed in detail later on, the focus should now move on to the channels through which those policies could contribute to the decline in the share of the informal sector. Here, the factors of informal economy should be juxtaposed with the policy agenda of SLIP. This allows integrating the theoretical premises of the existence of informal economy and the reform policies of the state in transition from socialism to market. In a broad sense, all components of SLIP refer to the idea of institutions and related transaction and transformation costs introduced by the New Institutional economics. As part of neoliberal thinking, the SLIP package meant to abolish numerous impediments for the development of a private sector, to reduce the role of the state in the economy and to create more transparent environment with accessible information for market players. In other words, SLIP agenda policies were to significantly reduce the transformation and transaction costs faced by the

¹⁷ Marangos J. "Was Shock Therapy Consistent with the Washington Consensus?" *Comparative Economic Studies* 49 (2007)

newly established market actors in the transition process. Therefore, many of the components of SLIP were in an unintended way directed towards countering informal economic activities.

The stabilization component of SLIP could affect the informal sector through greater price stability. Liberalization would act through a more transparent taxation system with overall lower tax levels, deregulation of markets, and an easier market access for new-comers and enhanced competitiveness of the firms. Price liberalization in turn would allow departing from the economy of shortages typical for Socialism and creating a market economy where the price would play the role inherent to it under the conditions of the market. Institutions would counter the informal sector by offering higher benefits for the private sector to operate “in the light”, as property rights and contract enforcement will be insured and the rule of law will be enhanced. The main tool to achieve these latter aims would be building up government capacities and independent judiciary. Development of financial institutions would grant the opportunities for legal finance and investment. Finally, Privatization would bring about mass firm restructuring and management turnover, which would translate into the abolition of creative accounting practices and misuse of assets by the previous management. Through all of these channels the SLIP agenda was to affect informal economy, whereby its impact would be realized through the stages outlined above as the stages of implementation of SLIP policies. Consequently, at the initial stage of stabilization one would expect an increase of informal economic activities, as the other components of SLIP are not in place: Institutions and Liberalization are still to be designed; therefore, the rule of law cannot be effectively ensured, contract enforcement is vague, while the property relations are to be regulated in the further stage of Privatization. However, with the step-by-step advancement of the SLIP reform agenda informal economy should decline, since most of its factors are removed by the new economic reforms.

1.5. Conclusion

As the issue of setting up a theoretical framework is settled, let me briefly summarize what was achieved in this chapter. The overarching theoretical framework chosen for present research was granted by the New Institutional School of economic thought. The concept of transaction and transformation costs which firms face due to an imperfect nature of the market and institutional environment allowed defining informal economy as an economic activity, when economic actors “circumvent the costs and are excluded from the benefits incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit and social security systems”¹⁸. Afterwards, through unfolding the cost and benefit sides - i.e. through an analysis of potential transaction and transformation costs – it was possible to create a list of causes of informal economic activities. These were tax burden, ill-designed regulation of corporate governance and labor relations, lack of institutions, inflation and corruption. Those factors were later on juxtaposed with components of SLIP agenda, which in turn allowed establishing clear channels through which SLIP could influence informal economy. Hereby, the theory predicted that at the initial stages of implementation of SLIP the share of informal economy was to rise; then after a stepwise completion of the implementation of reform package, informal activities would experience decline and the share of informal sector was to diminish. How this theoretical framework works in practice, whether its predictions regarding the behavior of informal sector are true and whether it helps to solve the puzzle outlined in the introduction, is discussed in the following chapters of the thesis, where the framework is applied to the informal economies and reform agendas in Russia and Hungary.

¹⁸ Feige E. L. “Defining and Estimating Underground And Informal Economies: The New Institutional Economics Approach”. *World Development* Vol. 18, N 7 (1990), pp 994-999.

Chapter 2 - Implementation of SLIP Agenda in Hungary, Its Impact on the Informal Sector

2.1. Initial Economic and Political Conditions in Hungary

This chapter is devoted to the analysis of the impact which the SLIP reforms had on informal economic activity in Hungary from 1990 until the early 2000s. Before proceeding to the discussion on the channels of impact of reform policies on informal economy, it should be stated that the Hungarian case is specific and different from the Russian case (and from other Eastern European countries) in a certain sense. Namely, Hungary after the collapse of socialism found itself in more favorable economic conditions than other transition countries: a number of reforms needed for setting up a market economy were already in place before 1990. The Western style taxation system, bankruptcy, competition and corporate laws were adopted by the end of 1980s; the legal infrastructure of the economy had many of the essential elements needed to insure the functioning of the free market¹⁹. This had a double effect on the nature of the Hungarian economic transformation. On the one hand, the country had more favorable starting conditions and, therefore, could avoid most of the drastic consequences which ‘shock therapy’ policies in Russia or Poland for example brought about. On the other hand, the new democratic government had a weaker reform mandate since the need for radical reforms was not perceived by the electorate²⁰. The above described situation became characteristic for the whole period of transformation in Hungary and translated in practice into rivalries inside the government and tensions between the government and the trade unions and different social groups.

¹⁹ Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) p 70-74

²⁰ Ibid. p 71

2.2. Macroeconomic Stabilization and Informal Economy in Hungary

The trend described above is well illustrated by the efforts of several successive governments to achieve macroeconomic stabilization. Since this research concentrates on price stability as a channel for diminishing informal economic activities, it is time to discuss it in detail. Fight with inflation which was part of macroeconomic stabilization was one of the challenges for the Hungarian government in the 1990s. As Table 1 shows, the initial levels of inflation in Hungary were high, and effective price stability was established not earlier than 1999.

Table 1
Inflation in Hungary 1991-1999
(average consumer prices, % change)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999
Hungary	34.234	22.950	22.451	18.866	28.303	23.428	18.314	14.175	10.031

Source: International Monetary Fund, World Economic Outlook Database, April 2011

However, the level of inflation in Hungary which in normal terms would be perceived as high became a natural outcome of the reforms undertaken in the period under consideration. Consequently, inflation did not become the most serious concern in the area of stabilization in the transition decade. This was due to several reasons. Firstly, in the same period the majority of the neighboring reforming states were experiencing hyperinflation (Russia, Ukraine or Poland for example)²¹, therefore, the indicators for Hungary did not provoke strong concerns among international actors or within the government itself. Secondly, there were more acute problems which were to be solved first, such as ever growing budget deficits, overshooting of current account and the need to define the strategy with regard to foreign debts²². Thirdly, as the overall economic situation was perceived as

²¹ Aslund A. *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia*. Cambridge: Cambridge University Press (2007) p. 111

²² Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) pp 71-73

stable in the short run and price liberalization was effective in most of sectors of the economy since the late 1980s, government could avoid the problem of skyrocketing inflation resulting from the oversupply of money typical for the Soviet model when combined with freeing the prices during the transition²³. Moreover, in 1990 a stand-by agreement was reached with IMF, which further stabilized fiscal and current accounts and broadened the room for further structural reforms²⁴.

Those included recurring attempts to reach a balanced budget through different types of austerity measures. Deficits in Hungary were one of the main reasons for serious macroeconomic imbalances, whereby current account deficits reached 9% of GDP in 1993-94²⁵. At the same time, inflationary pressures resulting from the fiscal deficits were softened, through more stable profit tax revenues and increasing savings²⁶. The first attempt at systemic fiscal adjustment was envisaged in the Kupa Program, when the cuts on the expenditure side (mainly of subsidies) were projected together with minor improvements on the revenue side in form of partial tax reforms. However, the Minister of Finance Kupa fell victim of inner political struggles within the government and the program never became reality in full²⁷. Further adjustment reforms gained momentum not earlier than 1995, when a new reform package was announced by Lajos Bokros, the newly appointed Minister of Finance. Among the measures adopted that year were the 9% up-front forint devaluation, an imposition of import surcharges, cuts in social spending (sick pay, child allowances), and cuts in personnel spending. In order to counter inflation resulting from devaluation, nominal spending was frozen, which led to a decrease in real public sector wages and real expenditures²⁸. Those

²³ Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) pp 71-73

²⁴ Ibid. p 75

²⁵ EBRD *Transition Report*. London.(1994)

²⁶ Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) p 96

²⁷ Ibid. pp 101-102

²⁸ Ibid. 109

austerity measures were for natural reasons highly unpopular among the electorate²⁹; some of them were reversed later on under successive governments. However, the Bokros Package led to a major improvement of macroeconomic performance; since 1995 the inflation was diminishing and after 1999 it never reached double digit values.

The above described favorable initial conditions and the reform packages adopted enabled the government to constrain the inflation on a constant although high level and reach macroeconomic stabilization by the mid-1990s. A massive capital flight typical for CIS countries in the 1990s was avoided. Moreover, since the inflation remained stable over the transition decade, it increased the calculability of costs for private firms which acted as a disincentive for them to transfer their activities to the shadow. However, this does not imply that creative accounting practices and tax evasion did not take place. On the contrary, those phenomena were widespread in the early 1990s in Hungary; nevertheless, inflation was not the explanatory variable here, but rather the changeability of the taxation system and inefficient tax administration, which are discussed in the following parts of the chapter.

2.3. Liberalization and Informal Economy in Hungary

Since the issue of the taxation system was tackled, let me now turn to the next stage of SLIP reforms, which is liberalization. As it was established in the first chapter, liberalization affects informal economy through channels such as liberalization of prices; taxation system reform introducing lower levels of taxes and more professional and transparent system of tax collection; major deregulation of markets and creation of more favorable conditions for the entrants of new market players and enhanced competition resulting from it.

It was already mentioned that the liberalization of prices occurred in Hungary already in the late 1980s, which allowed softening the shortages of major consumer goods, for which

²⁹ Cook L. J., Orenstein M. A., Rueschemeyer M. (eds.) *Left Parties and Social Policy in Post-communist Europe*. Boulder, CO: Westview (1999) p 95

reason the Hungarian economy was oftentimes labeled “market socialism”³⁰. With the fall of Comecon, further steps towards liberalization of trade and prices were undertaken. The process of price liberalization went overall smoothly probably with the exception of the prices for fuels. In September-October 1990 the new government of Antall envisaged the program of subsidy cuts for fuels in order to consolidate the budget. This plan provoked a taxi driver strike and the government was forced to start negotiations with trade-unions, which ended in the curtailing of plans to cut the subsidies. It demonstrated the government’s weak mandate for reforms and led to a reshuffling of the cabinet³¹.

The taxation reform, which is next channel of influence of state policy on informal economy was implemented with more mixed results. Similarly to price liberalization, a large part of the taxation system was reformed before the economic transformation. Fiscal reforms of 1988 introduced VAT and personal income tax in Hungary, which together with other systemic adjustments created a Western-style tax system. However, at the beginning of transformation there was a broad consensus among economists and reform-minded politicians that a further reform of taxation needs to be designed³². In spite of this, the practical implementation of the tax reform turned to be thorny, and political struggle was accompanying all the attempts of consecutive governments to carry out fiscal reform. For this reason the taxation system created as a result of reform brought mixed results in terms of its impact on the informal sector.

Firstly, the taxation system inherited from Socialist times was characterized by a large number of tax exempts and provided a preferential treatment for prioritized industries (mainly heavy industry). The first step on the way to tax reform, therefore, was the abolition of the preferences and the creation of more equal conditions for the market players. However, this

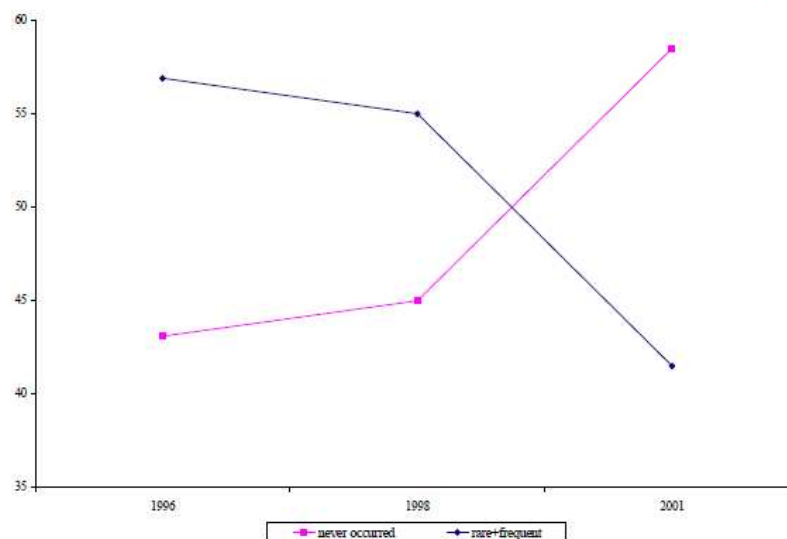
³⁰ Csaba L. *The New Political Economy of Emerging Europe*. 2d ed. Budapest: Akadémiai /Kluwer (2007) pp 319-322

³¹ Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) p 74

³² Csaba L. “Macroeconomic Policy in Hungary: Poetry versus Reality”. *Soviet Studies* 44(6) (1992) p. 952

equalization was achieved only partially. On the one hand, uniform corporate income tax was effectively introduced. In the first years of transformation it was stepwise reduced to 36%, and with the adoption of the Bokros Package to 18% in 1995³³. On the other hand, the new type of preferential treatment was created when large companies and the companies with the majority of foreign ownership were able to get access to tax reliefs and exempts, which placed small enterprises in disadvantage, as they were to pay the taxes in full³⁴. What follows from this development is that the involvement of large and medium enterprises into informal economic activities was on decline over time, as the benefits from going underground diminished. As the graph from a preliminary survey results by Toth and Semjen demonstrates (Figure 1), after 1998 the majority of medium and large firms disengaged from unregistered transactions³⁵.

Figure 1
Subjective* incidence of unreported sales amongst the competitors of the interviewed firms: the total share of „rare” and “frequent” answers contrasted to “never occurred” answers, 1996-2001, percent



* As perceived and assessed by the interviewed company executives.

Source: Semjen A., Toth I. J. “Unofficial Economic Activities and Fiscal Discipline in Hungary as Mirrored in Consecutive Enterprise Surveys on Tax Behaviour”. *KTK/IE Discussion Papers* 2002/11 (2002) p.18

³³ Toth I.J., Semjen A. “Tax Behavior and Financial Discipline of Hungarian Enterprises” in L. Csaba (ed.) *The Hungarian SME Sector Development in Comparative Perspective*. Budapest: KOPINT-DATORG. (1998) p 114

³⁴ Ibid pp 106-107

³⁵ Toth I.J., Semjen A. “Unofficial Economic Activities and Fiscal Discipline in Hungary as Mirrored in Consecutive Enterprise Surveys on Tax Behaviour”. *KTK/IE Discussion Papers* 2002/11. (2002) p.18

The change in the structure of informal economy in Hungary in the same period can further explain the responses of different types of private actors to tax reform. While most of the large and medium size firms left the informal sector by the end of 1990s, the informal economy became almost exclusively concentrated in SME sector. The main sectors where the share of informal economy remained significant were agriculture, construction, retail trade and services³⁶. Moreover, from a territorial point of view, large shares of informal economy corresponded to the poorly developed rural regions of the country dominated by the small business such as Eastern Hungary³⁷, whereas in the more developed Western regions with more large scale industries and higher FDI inflows informal sector declined. These observations are supported by the statistics regarding the implicit tax rate on labor in Hungary in the second half of the 1990s. As Table 2 indicates this tax rate, which is used to approximate an average effective tax burden on labour income in the economy, is on the same level for Hungary and Scandinavian socialist economies, while the EU average is lower by 4-5%.

Table 2
Implicit Tax Rate on Labour in Hungary and Selected EU Countries in 1995-2001
(Ratio of taxes and social security contributions on employed labour income to total compensation of employees)

<i>Country\Time</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
Hungary	42.1	42.1	42.5	41.8	41.9	41.4	40.9
EU Average (27 countries)	36.9	37.3	37.3	37.3	37.1	36.9	36.5
Denmark	40.2	40.2	40.7	38.9	40.2	41	40.8
Finland	44.3	45.3	43.6	43.8	43.3	44.1	44.1
Poland	36.8	36.3	35.9	35.6	35.8	33.6	33.2
UK	25.7	24.8	24.4	25	25.1	25.3	25
Spain	29	29.5	28.7	28.6	28.3	28.7	29.5

Source: EUROSTAT. *Statistics Database*.

³⁶ Renoy P., Ivarsson V., Van Der Wusten-Gritsai O., Meijer E. "Undeclared Work in an Enlarged Union. An Analysis of Undeclared Work: In-Depth Study of Specific Items", *Employment and Social Affairs, European Commission* May (2004)

³⁷ Toth I. J. "Social Determinants of Undeclared Work in Hungary". *Wargo Research Papers* December (2008). Available from http://wargo.hu/tij/publications/uw_hungary_en_081216.pdf [10.04.2011] p. 10

This overall high tax rate on labor in areas with low salaries acted as a disincentive for employees to work legally, while the cost of labor for firms was high. Consequently, the cost-benefit calculations of small firms disadvantaged by the preferential taxation system and high labor costs explain structural and geographical changes of informal economy in Hungary. The cost-benefit calculations of employment-seekers point in the same direction, as tax evasion and pocket salary payments translated for them into more disposable income. By all of the described shortcomings of taxation system, it should be noticed that entrepreneurs underlined the improving quality of Hungarian tax administration and the increasing calculability of government strategy with the advancement of fiscal reforms. Interestingly, the results of the survey carried out by Toth and Semjen indicate that oftentimes entrepreneurs underlined the importance of the stability of tax rates, which was central for the calculation of business projects and not that much the need for simplification of the existing arrangement³⁸.

Another channel of impact of liberalization on informal economy is the deregulation of market, which also implies low entry barriers for new businesses. Similarly to the case of the taxation system, some steps towards deregulation were made in Hungary already under Socialism. However, when the transition started, most administrative restrictions and barriers for private enterprise were abolished including the abolition of the National Planning Office³⁹. A significant deregulation in Hungary in the first years of transformation is well illustrated by the survey conducted by Laki in the foreign language teaching sector⁴⁰. Whereas under socialism there were less than 10 private foreign language schools and courses, in the first year of transition their number skyrocketed to around 200. At the same time, according to Laki, HUF 50 000 (or around EUR 200) were enough at the beginning of the transformation

³⁸ Toth I.J., Semjen A. "Unofficial Economic Activities and Fiscal Discipline in Hungary as Mirrored in Consecutive Enterprise Surveys on Tax Behaviour". *KTK/IE Discussion Papers* 2002/11. (2002) p 22

³⁹ Bönker, F. *The Political Economy of Fiscal Reform in Central-Eastern Europe*. Cheltenham, UK: Elgar (2006) p73

⁴⁰ Laki M. "Evolution of the Market for Foreign Language Teaching Services in Hungary". *Post-Communist Economies* 19 (3) September (2007) pp 388-390

to start a new business in the discussed sector⁴¹. The results are similar for other sectors of the economy, which means that the markets in the transition years in Hungary from the outset became competitive in nature and that the deregulation policies adopted by the government were in line with the requirements of the SLIP reform package.

2.4. Institution Building and Informal Economy in Hungary

Liberalization in Hungary was followed – and to an extent paralleled – by the building up of market institutions, i.e. formal rules of the game for market players, as well as by the creation of supporting organization such as independent courts, new professional bureaucracy and law enforcement organs. This process of institution building was thorny, as the practical functioning of institutions requires social trust and a gradual change of mentality and culture towards law abiding behavior and primacy of law. This latter change referred not only to the general public, but also to the staff of administrative and law enforcement bodies, since the trust in the rules can be built only when the official authorities enforcing those rules abide them themselves.

Some of the steps in the direction of the creation of a new market-oriented institutional framework were undertaken in the initial stages of economic transformation in Hungary. For instance, in the first several years the legislation ensuring private property and inheritance rights, crediting, contract enforcement and alike was passed. However, the effective implementation of those laws came only later, since the creation of supportive law enforcement organs took longer time. For example, at the beginning of transition, there was evident lack of judges who would be competent enough to solve complex civil lawsuits or bankruptcy cases⁴². Due to the lack of implementation capacity, new institutions often had a nominal character, whereas in reality informal institutions such as personal connections were

⁴¹ Laki M. “Evolution of the Market for Foreign Language Teaching Services in Hungary”. *Post-Communist Economies* 19 (3) September (2007) pp 388-390

⁴² Gray C. W., Hendley K. “Developing Commercial Law in Transition Economies. Examples from Hungary and Russia”. *Policy Research Working Paper 1528*. WB: Policy Research Department. November (1995) p 12

present on the market. This explains the high incidence of informal economic phenomena such as undeclared payments and transactions, tax evasion and payments in kind in the early years of transition in Hungary.

However, with the advances of market reforms, growing macroeconomic stabilization and privatization, many of the described above bottlenecks connected to governance quality were overcome, which in turn increased the role of formal institutions in the economy. The consolidation of institutional framework and higher efficiency became reality in the second half of the 1990s. Here it is useful to refer to the Corruption Perception Index (CPI) in order to assess the quality of governance and, therefore, of practical enforcement of formal rules. On the scale from 1 to 10, whereby 10 is a largely corruption-free state and 1 is corruption-dominated state, Hungary had a permanent score around 5.0 since 1995 and continues to have it nowadays⁴³. This is comparable to the scores of the East European EU member states, and Hungary performs better than Italy or Greece. Since the incidence of corruption was rather low, the administrative costs for firms to enter the market were low as well. Indeed, CPI does not allow discerning the divergent performance of different branches of state administration; neither does it show the changing level of professionalism of the state bureaucracy. One might argue that administration may be largely corruption free, but still not performing its role appropriately due to the lack of practical skills. All these objections are true; however, CPI allows concluding that on the macro level Hungarian state bureaucracy was to a large extent corruption free, which *per se* is a positive development in terms of informal economy. In practice this implies that the transaction and transformation costs for market players were lower, since the corruption component of these costs was rather small.

At the same time, the issue of professionalism of state bureaucracy and different agencies might be also approximated through the Worldwide Governance Indicators issued

⁴³ Transparency International. *Corruption Perception Index 1995-2010*.

annually by the World Bank. Firstly, Hungary scores high (~76 out of 100) in the late 1990s on the Control of Corruption dimension⁴⁴, which confirms the results of CPI. Secondly, on the Rule of Law and Governance Quality dimensions, Hungarian indexes for the late years of transition are both on the level of 80 out of 100, which is a sign that the consolidation of institutions was realized largely after 1995⁴⁵. Again those indexes are only a rough approximation of the process of institution building in the country; therefore, the only conclusion which can be drawn from them is that the business environment improved significantly in the second half of transition decade and that administrative costs for the private sector were decreasing, whereas the benefits granted by the formal institutions were expanding. An important factor for consolidation of institutions in Hungary was the preparation for accession to European Union, when EU conditionality worked as a motivating factor to ameliorate the quality of the legal framework in the country and make it consistent with Western European standards. For example, international accounting standards were adopted, and competition and financial supervision agencies were established⁴⁶. All these led to a further amelioration of conditions for the private sector and made institutional framework in Hungary more coherent and efficient in terms of regulating economic interactions between private and public sector.

The last element of institution building which should be discussed here is financial institutions which play a crucial role in the decision making of market players, since the availability of legal, official financing is often the decisive factor for the firm in its decision to operate above- or underground. The development of financial institutions followed a similar logic as it was in the case of other institutions discussed above. Hungary started economic transformation with few commercial banks which were mostly publicly owned and insolvent

⁴⁴ World Bank. *Worldwide Governance Indicators. Different Years.*

⁴⁵ Ibid.

⁴⁶ Csaba L. "Hungary: the Janus-Faced Success Story" *Research Paper 2009/13*. UN: UNU-WIDER p.2

by international accounting standards⁴⁷. For instance, Hungarian banks were recapitalized four times between 1992 and 1994 with a value equivalent to 9% of 1993 GDP⁴⁸. Therefore, in the early 1990s a phenomenon of inter-enterprise crediting evolved, which not only made the private sector more vulnerable to the “domino”-type of external shocks, but also reduced the controllability of crediting in general. However, after 1995 Bokros Package when foreign investors became more confident in the stability of the macroeconomic situation in Hungary, privatization of publicly-owned banks accelerated while new branches of foreign banks were established in the country as well. This gave access for Hungarian firms to official loans and made credits more accessible⁴⁹, so that informal crediting and shadow financing schemes stopped playing significant role in the second half of the transition decade.

2.5. Privatization and Informal Economy in Hungary

The last structural part of reforms in Hungary, which was already mentioned several times above was privatization. In the context of privatization in Hungary, the reforms of corporate and bankruptcy regulations should be discussed, as those are naturally connected to the issue of management turnover and changing property structure. Hungary opted for auction-based privatization for cash with an equal participation of domestic and foreign bidders⁵⁰. The first steps towards changing the property structure in the country were made already by the socialist government in 1989. However, as the theory of transition reforms predicts privatization without effective institutions, liberalized markets and institutions cannot be fully realized. Therefore, in the first five years of transition, privatization brought rather mixed results. Firstly, it went on a slow pace, much slower than promised by the central

⁴⁷ Gray C. W., Hendley K. “Developing Commercial Law in Transition Economies. Examples from Hungary and Russia”. *Policy Research Working Paper 1528*. WB: Policy Research Department. November (1995) p 16

⁴⁸ Ibid.

⁴⁹ Keren M., Ofer G. “Globalization and the Role of Foreign Banks” in G. Kolodko ed. *Emerging Market Economies: Globalization and Development*. Aldershot: Ashgate Publ. (2003)

⁵⁰ Aslund A. *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia*. Cambridge: Cambridge University Press (2007) pp 155-159

government. Although Prime Minister Antall announced in the first year of transition that by 1995 50% of state-owned assets will be sold, by mid-1994 only 11% were effectively privatized⁵¹. This delay of privatization prevented effective management turnover in the public sector; tax evasion, illegal employment, and corruption flourished, so that this initial five years of transformation were labeled by Endre Sik – a prominent scholar in the area of informal economy – as “transition from second economy [shadow markets under socialism] to informal economy [of capitalist type]”⁵². At the same time, different types of cross-ownership, joint-ventures, pyramid holding structures emerged which gave more room for the management of large state-owned enterprises to evade taxation and social payments⁵³.

By the middle of the 1990s, privatization in Hungary virtually came to a halt⁵⁴, which was problematic also in terms of macroeconomic stabilization efforts, as much of fiscal adjustment until that time was based on the revenues generated from selling state-owned assets. A new impetus to privatization was produced by the Bokros package, as it led to significant improvement of macroeconomic balances in Hungary. Consequently, foreign investors became much more confident about investing in the Hungarian market. At the same time, the government started to more effectively promote the transition of state-owned assets to the private sector. This led to an FDI boom in Hungary, and the country became one of the champions among post-Socialist countries in terms of foreign investment⁵⁵. This also implied the privatization of state-owned banks, when many of them were sold to foreign companies. The same tendency was observable in other sectors of economy, so that by the 2000s, 40% of productive assets in Hungary were owned by foreigners⁵⁶. At the same time, as it was

⁵¹ Stark D. “Recombinant Property in East European Capitalism”. *The American Journal of Sociology* 101 (4) January (1996) p 998

⁵² Sik E. “From Second Economy to Informal Economy”. *Journal of Public Policy* 12 (2) (1992) p 154

⁵³ Stark D. “Recombinant Property in East European Capitalism”. *The American Journal of Sociology* 101 (4) January (1996) p 999

⁵⁴ Csillag I. “Privatization and the Mew Government” in C. Gombar, E. Hankiss, L. Lengyel, G. Varnai (eds) *Question Marks: The Hungarian Government 1994-1995*. Budapest: Korridor (1995). pp 307-312

⁵⁵ Csaba L. “Hungary: the Janus-Faced Success Story” *Research Paper 2009/13*. UN: UNU-WIDER p.2

⁵⁶ Ibid.

mentioned before the second half of the 1990s saw consolidation of institutions, which together with privatization contributed to a rising competitiveness of Hungarian markets and also to disengagement of large enterprises from informal economic activities.

Privatization also brought along corporate restructuring, as simultaneously with privatization process new bankruptcy and insolvency laws were adopted. In 1992 after adoption of the law, there were more than 4 200 bankruptcy filings and 10 000 liquidations during one year⁵⁷. This impressive number, nevertheless, cannot be interpreted as a complete success of the new legislation, since the managers of state-owned enterprises were often misusing this law themselves. Namely, the bankruptcy procedures were often initiated by the managers themselves, as this was an opportunity to privatize assets avoiding strict controls and regulation of the State Property Agency (SPA) which was responsible for administering privatization in Hungary. If the court would decide the bankruptcy case positively, it could sell it directly, and the SPA would not be able to intervene⁵⁸. However, functioning of the bankruptcy laws followed the same logic, as the process of privatization, i.e. with rising standards of judicial system and state bureaucracy, as well as certain modifications to the law the abuses of it were declining in number. By the end of the 1990s bankruptcy and insolvency procedures were much more efficient, whereby EU accession and Europeanization of institutional framework played important role.

The process of privatization and corporate restructuring in Hungary can also be traced with help of EBRD Transition indicators. Again they illustrate only the general trends and overall performance of the governmental agencies and serve as proxy measures of overall success or overall failure of the adopted policies. Since 1996 Hungary scores 4.0 and 4.33 out of 4.5 for large and small scale privatization respectively⁵⁹. In the period from 1989 to 1996

⁵⁷ OECD. "Economic Survey of Hungary 1993". *OECD Economic Surveys*. Paris: OECD (1993).

⁵⁸ Stark D. "Recombinant Property in East European Capitalism". *The American Journal of Sociology* 101 (4) January (1996)

⁵⁹ EBRD. *EBRD Transition Indicators*.

the scores were rising gradually from 1 to 3.67 for both types of privatization. This confirms the described above statements about initial drawbacks in privatization and its acceleration after the adoption of Bokros Package. The development of corporate restructuring is also illustrated by EBRD Transition Indicators where Hungary achieved the score of 3.0 in 1992⁶⁰. This rise of Enterprise Restructuring indicator reflects the adoption of the new bankruptcy law. Further progress on this dimension was in 1998 (the indicator rose to 3.33), which confirms the thesis about overall advancement of privatization and corporate restructuring with consolidation of institutions and effective macroeconomic stabilization by the end of the 1990s. In terms of informal economy, completion of privatization and corporate restructuring meant the reduction in the number of risky cross-ownership enterprises and pyramid-like holdings; market competition was enhanced through adequate regulation of property relations, which acted a disincentive for firms to engage into underground activities. Moreover, management turnover resulting from privatization and tougher competition on behalf of foreign corporations which entered the market gradually forced domestic corporations to be law abiding in their business activities.

2.6. Conclusion

As it was shown in this chapter, the experience of economic reforms in Hungary in 1990-2001 supports empirically the theoretical framework discussed previously. Not only the trajectory of growth and later decline of informal economy in Hungary has the inverted U-shape, but its growth and gradual decline can be attributed to the economic reforms undertaken in the country following the SLIP package. Indeed, the stepwise character of reform dictates that at the initial stages of transformation, when institutions and privatization are still to come and macroeconomic stabilization is the main concern of the government, informal activities will spread through most of sectors of the economy. In the Hungarian case

⁶⁰ EBRD. *EBRD Transition Indicators*

this was true since in the first five years of transformation illegal payments, tax evasion, unreported employment and sales became wide spread geographically and in terms of number of sectors where they were used while informal economy as a whole grew to 40% of GDP.

However, by the end of 1990s the situation gradually improved. Macroeconomic stabilization was achieved with the adoption of the Bokros Package; liberalization and deregulation of the markets contributed to a more competitive character of economic development of the country; institution consolidation took place by the end of the decade whereby EU conditionality played important role; and finally privatization - which accelerated after 1995 - together with the bankruptcy law contributed to a significant restructuring of the market and the creation of a more transparent property structure than the one which was typical for the initial years of transformation. All of those structural improvements through the channels described in the chapter counteracted the incidence of informal economy in Hungary; therefore, the share of the informal sector declined to 20% of GDP by 1999. It shrank in terms of size, geographical spread, and sectors, where it was present initially. The fact that informal economic activities became concentrated mainly in the small business sector in branches such as agriculture, construction, retail trade and services can be explained by the remaining shortcomings of the regulation and general disadvantaged position of the small business in terms of taxation and some administrative barriers in forms of costly technological licensing and alike.

Chapter 3 - Implementation of the SLIP Agenda in Russia, its Impact on the Informal Sector

3.1. Initial Political and Economic Conditions in Russia

This chapter is devoted to the analysis of the second case which is the Russian Federation, its informal economy and the influence of SLIP policies on underground economic activities. While the Hungarian case confirmed the theory established in the first chapter in a “positive” sense, meaning that the advancement of the SLIP led to the decline of informal sector, the Russian case study supports the theory in a “negative” way. Namely, in the Russian case exactly the lack of well-designed policies, a misconceived reform agenda and numerous drawbacks in the liberalization of the market contributed to the entrenchment of the informal sector, when the majority of the market players are involved until nowadays in underground economic activities.

While the detailed account of how this happened is presented in the following sections of this chapter, here initial political and economic conditions which existed before economic transformation should be briefly discussed. Firstly, economic transformation reforms started in Russia relatively late – in 1991; therefore, the gradual process of transition from socialism to the market took longer and was completed later than in West-rim post-socialist states. Secondly, Russian reformers did not possess the advantages which the Hungarian government enjoyed in terms of structural changes completed before the process of transition. The Soviet economy of the late 1980s was characterized by strict price controls, overall deficits of all types of goods and a high level of indebtedness to international lenders. Private property existed on the fringes of the system; entrepreneurship was limited to a small cooperative type of business⁶¹. Thirdly, political conditions were also not favorable for economic reform, as with the collapse of the Soviet Union, Russian central government had to face the threat of

⁶¹ Nove A. *Economic History of the USSR 1917-1991*. 3d ed. London: Penguin Books pp 394-420

state dissolution, while different fractions in the government had diametrically opposite views regarding the course of future reforms and the form of new political regime. No market institutions existed at the beginning of transformation, and what is worse, only few reformers had sufficient professional knowledge of how market economy should work and what policies are required for that⁶². Since the boundaries of the power of different central and local authorities were still to be defined, the whole economic reform agenda was oftentimes overshadowed by political struggle and confrontation.

The whole transformation process in Russia takes longer account than in Hungary and can be divided into two distinctive periods. The first period (1991-1998) was characterized by a lack of coherency in economic reforms and all the negative political and economic conditions described above apply to this period. Here, recurring attempts to implement each part of the SLIP agenda were undertaken; however, the majority of them brought mixed results at best. This was the time of the upswing of the informal economy in Russia when it reached 45% of GDP⁶³. The second period which started after 1998 and continues until nowadays saw the departure from the methods of policy making of the previous period. Numerous improvements on different dimensions of the SLIP agenda became reality under Primakov's premiership and later Putin's presidency⁶⁴. However, these improvements did not lead to a decline of the informal sector, which remained at the same level of 40-45% of GDP⁶⁵. The rest of the chapter is divided into two subchapters according to this periodization, whereby the relevant channels of impact of economic reform on informal economy in Russia are investigated.

⁶² Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) pp 93-100

⁶³ Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010) p 72

⁶⁴ Shevtsova L. *Putin's Russia*. Washington: Carnegie Endowment for International Peace (2003) pp 19-24

⁶⁵ Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010) p 84

3.2. First Period of Reforms and Informal Economy in Russia (1991-1998)

3.2.1. Stabilization and Informal Economy in Russia

Following the same sequence of investigation as in the case of Hungary, the first part of the reform agenda in Russia to be discussed here is stabilization and more precisely its price stability element, which has an impact on the incidence of informal economy. As Table 3 indicates Russia experienced massive hyperinflation in the first several years of transition.

Table 3
Inflation in Russia 1993-1998
(average consumer prices, % change)

Country	1993	1994	1995	1996	1997	1998
Russia	874.622	307.634	197.471	47.742	14.767	27.675

Source: International Monetary Fund, World Economic Outlook Database, April 2011

In contrast to Hungary, inflation became the main concern for Russian reformers in the transition decade and all macroeconomic stabilization policies were directed mainly to constrain the growth of prices. Inflation in Russia was strongly correlated with an upswing of the informal economic activity due to several reasons. Firstly, since suppressed inflation in the old Soviet model was high, the liberalization of prices adopted in the first year of transition resulted in express oversupply of money on the market⁶⁶. The loss of life-long savings from Soviet times destroyed the remaining trust of the population in the banking sector and more generally in the reform agenda promoted by market-oriented liberal parties.

Secondly, one of the causes of hyperinflation was the existence of the ruble zone. With the dissolution of the USSR, all former Soviet republics with the exception of the Baltic states continued using Soviet ruble as their currency. Although the only central bank which was responsible for the emission of money was the Central Bank of Russia (CBR), the supply of money was increasing rapidly since the national central banks of the CIS countries started to

⁶⁶ Ahrend R., Tompson W. "Fifteen Years of Economic Reform in Russia" *OECD Economics Department Working Paper* 430. May (2005) pp 6-8

give credits without being controlled by any external actor⁶⁷. Due to the unlimited crediting in former SU republics but also in Russia, rubles flooded the markets of all CIS states. In terms of informal economy, this meant that the managers of state-owned industry got access to virtually unlimited financial resources and were constantly using those in personal gains since regulations in this area were non-existent. This ill-designed practice, however, was not discontinued until 1994, as the Head of CBR Victor Gerashchenko, who had a strong political standing, was advocating unlimited crediting for the industry in order to prevent industrial decline in the country⁶⁸. Moreover, Gerashchenko supported direct credits of the Central Bank to industrial enterprises, whereby the terms of credits were often negotiated in person by managers and CBR officials with the involvement of different corruption schemes⁶⁹.

Thirdly, as a consequence of the above described lousy fiscal policies, budget deficits reached the level of 30% by early 1992 and – after some fiscal adjustment measures - were fluctuating on the level of 10% until 1995⁷⁰. At the same time, bank runs occurred several times when the banking system was experiencing liquidity problems; currency reforms, the dismantling of ruble zone and the nationalization of ruble did not increase popular confidence in the national currency. This is why the quest for foreign currency (back then for US dollars) became the name of the game for the majority of the population, for which reason “pocket” salary payments (in Russia they were labeled “salaries in envelopes”) were widespread throughout the transition decade in all sectors of the economy⁷¹. Needless to say, for most employees the main official job place was only one of the many sources of income since unofficial employment was omnipresent.

⁶⁷ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) pp 119-130

⁶⁸ Aslund A. *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia*. Cambridge: Cambridge University Press (2007) p 44

⁶⁹ Ibid, p 47

⁷⁰ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 275

⁷¹ Morozova N.V. “Transformation of Shadow economic Relations in the Economy with Market Orientation”. *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010) pp 74-76

3.2.2. Liberalization and Informal Economy in Russia

Similarly to controversial stabilization policies, liberalization also contributed through the channels predicted by the theory not to decline but to rise of informal economy in Russia. As the scale of suppressed inflation inherited from Soviet economy was high, the liberalization of prices was introduced already in early 1992: 90% of retailer and 80% of producer prices were freed⁷². However, this contributed to the upswing of inflation, while the prices for the most essential consumer goods - such as bread, milk or baby food - remained under state control, which gave an impetus to illegal speculation of this goods on the black markets. The same applied to energy resources market. Here, a powerful industrial lobby managed to convince the government to keep export quotas and preserve the prices on the level lower than the world prices. Consequently, the country was “flooded” with cheap petrol, while those who had access to export channels engaged in speculations and were able to accumulate huge capital on the price differentials between domestic and world prices⁷³.

Another liberalization channel through which economic reforms could influence informal economy was the creation of an efficient tax administration, the lowering of tax rates and the establishment of a more transparent taxation system. In this area, most reforms undertaken in Russia during the first period of transformation failed and were the core reason for the persistence of informal economy. First of all, it should be mentioned that the Soviet taxation system was very different from the market taxation systems. No centralized authority responsible for tax collection existed under Soviet arrangement. Instead the Ministry of Finance and some other executive bodies were responsible for collecting taxes from large

⁷² Ahrend R., Tompson W. “Fifteen Years of Economic Reform in Russia” *OECD Economics Department Working Paper* 430. May (2005) pp 6-8

⁷³ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 151

state-owned corporations which were the core of the tax base⁷⁴. As this system could not operate in new market conditions, it was reformed in a number of ways.

The old taxes were replaced by the corporate income tax of 32%, 28% VAT and the payroll tax of 38%⁷⁵. However, those taxes were not uniform across the country as local governments had a right to also impose local taxes, so that for instance in some regions the overall rate of taxation for business constituted around 54% of corporate income⁷⁶. Such rate *per se* was high enough to cause large scale tax evasion. Nevertheless, the situation was further complicated by other factors. For instance, as the newly established State Tax Service (STS) responsible for the collection of taxes was technically not equipped and not able to collect taxes from individuals, the main strategy was to at least increase the collection of taxes from large corporations. However, the corporations being mostly state-owned were dependent on subsidies and were not economically viable; therefore, STS from the beginning concentrated on the sector where the possibility to raise taxes was low⁷⁷. On the other hand, since STS did not virtually collect taxes from small businesses and newly established larger enterprises, the illusion that taxes were rather voluntary contributions and not obligations became deeply rooted in the private sector. The lack of capacity of part of STS and the large scale tax avoidance resulted in tax arrears amounting to 5% of GDP by October 1996⁷⁸. The number of firms with large tax debts rose to 3 375 by the end of 1997⁷⁹. All attempts to resolve this problem through the establishment of high-rank commissions headed by the Prime Minister failed, which further supported a common belief that not paying taxes was not a serious offence.

⁷⁴ Kornai J., Haggard S., Kaufman R.R. (eds) *Reforming the State. Fiscal and Welfare Reform in Post-Socialist Countries*. Cambridge: Cambridge University Press (2001) p 60

⁷⁵ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 187

⁷⁶ Ibid. pp 200-207

⁷⁷ Kornai J., Haggard S., Kaufman R.R. (eds) *Reforming the State. Fiscal and Welfare Reform in Post-Socialist Countries*. Cambridge: Cambridge University Press (2001) p 61

⁷⁸ Ibid. p 62

⁷⁹ Ibid. p 63

The efforts to establish tax administration and price liberalization were paralleled by measures directed towards the deregulation of the market, which is important in terms of informal economy as it opens access to new market players and lowers transaction and transformation costs through the abolition of different sorts of control. In this area, Prime Minister Yegor Gaidar managed to persuade Yeltsin to issue a Presidential decree allowing the freedom of trade by individuals and firms of all tradable goods in the spots available for this⁸⁰. As a consequence, cities and towns of Russia were overwhelmed by street trade which occupied most squares, roads and other public areas. However, since the local authorities could not tax traders or gain any income from them in any other way, the pressure for renewing regulation was growing.

This resulted in another Presidential decree introducing obligatory licensing for every type of commercial activity. In reality, this meant more corruption in local administrations, which translated into higher costs for legal traders. Moreover, police started to persecute all traders who did not have relevant licenses, therefore, street trade started to contract as early as 1993⁸¹. As this sector became more concentrated, it was trapped by organized criminal groups, when entrepreneurs had to pay not only to state administration and police, but also to mafia structures for protection. At the same time, in sectors such as energy resources and agriculture, deregulation was very partial if any, and most old monopolistic structures were preserved. As it was said before, prices in those sectors also remained under the administrative regulation of the state. Preservation of those monopolies created powerful lobbies in the government which opposed further steps towards liberalization. This was the case as the monopolies were not profit maximizing, but were totally dependent on state

⁸⁰ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 142-145

⁸¹ Ibid.

subsidies⁸². This in turn contributed to the incidence of corruption in those companies, as subsidies are easier to hide and use for personal gains than official profits.

3.2.3 Institution Building and Informal Economy in Russia

Deficiency and lack of institutions were mentioned several times in previous parts of this chapter. Therefore, the institution building process and its impact on informal economy in Russia should be investigated in more detail. Officially, private property was guaranteed by the Constitution and by respective laws implementing constitutional provisions; the judicial system as well as other state organs such the discussed STS were in place as well and in theory could ensure contract enforcement and the observation of private property rights. However, the practical functioning of institutions was contested by a low sense of justice and legal culture in Russia inherited from the Soviet times, the weakness of the political system and a fragmented federal structure of state, which translated into the divergence of legal regulations across the country.

In the first period of economic transformation, one of the major shortcomings of Russian institutional environment was an express lack of implementation capacity in all spheres of formal regulation. The process of transformation of the Soviet bureaucratic apparatus was slow due to several reasons. Firstly, the establishment of new, professional bureaucracy was costly; it required retraining of staff and increasing the material support for state officials in order to avoid corruption. These tasks could not be completed in Russia in the first period of transition since budget deficits were extremely high and expenditures on the bureaucracy were not among priority spending articles. Secondly, a fragmented and constantly changing federal structure of the state did not allow conducting coherent reforms in the area of institution building, as different federal administrative units enjoyed different degrees of autonomy and at times were conducting their own policies contrary to those of the

⁸² Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 149

federal government⁸³. Thirdly, the lack of administrative capacity was not among top concerns for Russian reformers, as macroeconomic imbalances and liberalization were much more urgent policy goals and all resources were assigned to solve the problem in those areas.

Consequently, law enforcement bodies such as police and the court system were staffed with cadres who worked there since Soviet times and who were oftentimes corrupt already by the time transition started. Another problem was that the old administration and law enforcement organs were to adjust to the new rules and regulations adopted by the state and enforce the compliance with formal institutions which were hostile to most old-school bureaucrats⁸⁴. Under these conditions, an informal sector flourished, as ability to enter the market and contract enforcement became dependent upon mafia-like structures, which Volkov calls ‘violent entrepreneurs’⁸⁵. These criminal groupings started as racket gangs on the open air markets, but later on with the development of the informal sector and the stagnation of formal institutions, their organization became more sophisticated. Having an internal code of behavior and certain parallel rules, the organizations of violent entrepreneurs managed to destroy the monopoly of state on violence and to become a better protection for small businesses than police and other state organs⁸⁶. Therefore, in the SME sector monthly payments to these quasi-mafia structures became a regular part of expenses. In a sense the development of these criminal structures reflects the theoretical prediction that when formal institutions do not perform their function, society invents a parallel informal institutional structure which has higher efficiency.

Much more can be said on the lack of administrative capacity and the quality of institutions and governance in Russia in the first period of transition, however, the scope of this research dictates to take a short-cut way and to refer to the Worldwide Governance

⁸³ Sakwa R. *Russian Politics and Society*. 4th ed. NY: Routledge (2008) pp 245-255

⁸⁴ Ibid. pp 125-128

⁸⁵ Volkov V. *Violent Entrepreneurs*. New York: Cornell University Press (2002) pp 27-32

⁸⁶ Ibid.

Indicators⁸⁷ and CPI. In WGI Russia scores ~28 and ~20 out of 100 for Rule of Law in 1996 and 1998 respectively and around 18 out of 100 for Control of Corruption in both years. The Government effectiveness indicator for Russia in 1996 and 1998 is ~26 and ~37 respectively. On all of these dimensions Russian scores are very low, which reflects the lack of government capacities, weak law enforcement and omnipresent corruption which plagued all organs of state without exception. CPI for Russia is extremely low as well in the 1990s: most of time slightly less than 2.5, reaching its minimum of 2.27 in 1997⁸⁸. This reflects the high magnitude which corruption took in the country in the first period of transition. It not only paralyzed the work of the whole state bureaucracy and law enforcement in Russia, but it also destroyed the incentives for entrepreneurs to operate officially through higher entry and operation costs when all the permits and licenses were connected to bribery and other forms of corruption. All this created the atmosphere of distrust to the state and its ability to sustain law and order; informal methods of doing business fully or partially became habitual for Russian economy after a decade of transition from socialism to the market.

As for financial institutions, the Central Bank often acted against the policies approved by the Parliament, and in fact a large part of the inability to cope with inflation in Russia in the early 1990s was due to the Central Bank's loose policies towards the financial sector. Not only was CBR supporting unlimited crediting for the private sector, which led to lousy budgetary policies and numerous tax arrears of large industries, but it also did not perform its functions with regard to the regulation of banking adequately. By 1994, 2 457 private banks were operating in Russia⁸⁹, which opened a way to shadow crediting and illegal finance for private firms, but also in the cases when the banks were going insolvent population was more

⁸⁷ World Bank. *Worldwide Governance Indicators. Different Years.*

⁸⁸ Transparency International. *Corruption Perception Index 1995-2010.*

⁸⁹ Robinson D.O. "Banking Crisis and Recovery" in Owen D., Robinson D.O. eds *Russia Rebounds.* Washington: IMF (2003) p 124

and more losing confidence in the new economic order and in financial institutions specifically.

3.2.4. Privatization and Informal Economy in Russia

While still having problems with stabilization and lacking institutions, Russian reformers launched the privatization program in 1991. This program was radically different from the Hungarian one, as the Russian government thought to transfer state-owned assets to private owners as quickly as possible through a rapid voucher-based privatization of large corporation and auction privatization of small enterprises. Privatization of small enterprises went first, as it was easier to introduce from the political point of view. By September 1994 more than 80% of small firms were privatized, although the majority of them actually were not privatized through auctions, but usually they were first rented and then bought out by the employees⁹⁰. This already showed the closed character of privatization and since management turnover did not take place, the quality of services in the SME sector did not improve.

The privatization of large state enterprises was carried out differently. The state issued vouchers with the nominal value of 10 000 rubles and distributed them among all adult citizens of the Russian Federation⁹¹. Then large state-owned enterprises were turned into-joined stock companies, whereby all shares of these companies were to be sold on the open auctions for vouchers⁹². The whole voucher-based privatization took 2 years – indeed an unprecedented speed - in which the majority of state-owned assets were transferred to private hands. However, there were numerous difficulties connected to voucher privatization. Firstly, people did not know what to do with the vouchers; therefore, they started to sell them on the black market for a lower price to illicit dealers who in turn were accumulating them or reselling. Secondly, the auctions were often not transparent and directors of the factories were

⁹⁰ Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) p 250

⁹¹ Boycko M., Schleifer A., Vishny R. *Privatizing Russia*. US: MIT Press (1997) p. 83

⁹² Aslund, A. *How Russia Became a Market Economy*. Washington: Brookings Institution Press (1995) pp 252-253

distributing shares among the workers of the factory and later on buying those shares for low prices. Thirdly, even if the procedure worked well, people could not become effective shareholders since their shares were too small. As a consequence, most new small shareholders resold their shares shortly after buying them.

This ill-designed policy resulted in the high concentration of productive assets in the hands of former industry managers, who later on were labeled as oligarchs⁹³. The creation of this economically powerful group had numerous negative long-term repercussions for the further development of Russia. From the point of view of informal economy, it created the conditions on the market when the entries of new firms were limited, while the state became largely dependent on the oligarch class, as oligarchs created powerful lobbies in regions and in the central governments and had high leverage in negotiations with the state. This in turn led to the creation of the system, when the state (which was weak before) merged with the business elite, so that central policies started more and more reflecting the interest of large capital, rather than long-run development perspectives. The described situation is illustrated by EBRD Transition Indicators, where Russia scores 3.0 out of 4.5 in terms of large scale privatization throughout 1990s⁹⁴. Moreover, since the establishment of oligarchic ownership led to the lack of managerial turnover, corporate restructuring did not take place (1.67-2.0 out of 4.5 for corporate restructuring in 1991-1998⁹⁵ in EBRD Transition Indicators).

As a consequence of deficient reform strategies in all areas of stabilization, liberalization, institution building and privatization, the informal economy in Russia flourished in the first period of economic transformation (1991-1998) reaching the level of 45% of GDP⁹⁶. It spread through the country and became noticeably high in the regions with the least progress in the four reform areas. Parallel institutional framework was created with

⁹³ Volkov V. *Violent Entrepreneurs*. Cornell University Press (2002) p xiii.

⁹⁴ EBRD. *EBRD Transition Indicators. Different Years*.

⁹⁵ Ibid.

⁹⁶ Morozova N.V. "Transformation of Shadow economic Relations in the Economy with Market Orientation". *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010) p 72

informal financing, taxes in form of payments to mafia-like structures in exchange for protection and contract enforcement. Tax evasion and other types of non-compliance with formal rules became one of the main strategies to increase competitiveness. All sectors from energy resources, machine building and construction to retail trade and agriculture had large shares of informal economic activity, whereby virtually every firm in either of the ways was engaged into different types of unregistered activities and non-compliance with rules⁹⁷. This confirms the theory outlined in the first chapter, as the costs imposed by deficient official rules in the form of administrative and tax burdens were high, while the benefits from operating officially in terms of protection of property rights were virtually non-existent.

3.3. Second Period of Reforms and Informal Economy in Russia (1999-2010)

Let me refer again to the puzzle described in the introductory part of this paper. The question posed there was why the informal sector in Russia became entrenched at the level of 45% of GDP despite those improvements which were brought about by the second wave of reforms under the Presidency of Putin. To resolve this puzzle, the reforms referred to in the question should be discussed. The Russian government being unable to cope with inflation introduced a new exchange-rate based strategy to achieve price stability in 1994-1995. This policy resulted in the appreciation of real exchange rate, when Russian ruble doubled in value during 1995⁹⁸. Although this strategy brought the inflation down to double-digit numbers, it led to the decrease of Russian exports and put large state-owned enterprises on the verge of bankruptcy. Moreover, unlimited crediting created a bubble in the banking sector, which burst as a consequence of the Asian financial crisis of 1997. The financial crisis of 1998 in Russia put an end the system of the exchange-rate based arrangement adopted in 1995 and acted as a “cold shower” for Russian leadership. The new government headed by Primakov adopted

⁹⁷ Morozova N.V. “Transformation of Shadow economic Relations in the Economy with Market Orientation”. *PhD Dissertation: 08.00.01*. Moscow, Russian State Social University (2010) pp 72-82

⁹⁸ Ahrend R., Tompson W. “Fifteen Years of Economic Reform in Russia” *OECD Economics Department Working Paper* 430. May (2005) p 12

radical fiscal adjustment; pro-cyclical fiscal expansion was abandoned, public spending was cut⁹⁹. New tight fiscal policy backed by growing oil prices on the world market translated into balanced budget and inflation was brought down to 20% by 2000. The disciplined fiscal policies were continued and Stabilization which failed in the previous decade finally materialized. Therefore, inflation and macroeconomic imbalance channels affecting the size of informal sector were largely removed from the scene. There were significant improvements in the other parts of SLIP agenda as well.

Table 4
Inflation in Russia 2000-2009
(average consumer prices, % change)

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Russia	20.776	21.461	15.783	13.666	10.887	12.683	9.679	9.007	14.108	11.654

Source: International Monetary Fund, World Economic Outlook Database, April 2011

In the field of liberalization, major tax reforms were implemented. New legal provisions demanded payment of taxes in cash; barter operations typical for the previous decade were eliminated from the tax system. At the same time, devaluation of ruble boosted exports and allowed the government to suspend extensive subsidizing of the industry. Furthermore, already in 2000 the new tax code was adopted. It significantly simplified the taxation system and reduced the taxes for corporations. For instance the abolition of turnover tax reduced the costs for industry by about 8.5%¹⁰⁰; corporate income tax was reduced to 24%¹⁰¹. In the area of deregulation some steps were taken to ease the entry for new firms to the market, when the number of business activities requiring licensing was reduced from five hundred to one hundred¹⁰².

⁹⁹ Shevtsova L. *Putin's Russia*. Washington: Carnegie Endowment for International Peace (2003) pp 19-24.

¹⁰⁰ Ahrend A. "Accounting for Russia's Post-Crisis Growth". *Working Paper N 404*. OECD Economics Department. Paris: OECD (2004) .

¹⁰¹ Sakwa R. *Putin: Russia's Choice*. London: Routledge (2004) p 190

¹⁰² Ibid.

The position of state was strengthened by recentralization of administrative apparatus; more powers were transferred from the regions to federal government. Simultaneously, Putin, who assumed Presidency in March 2000, took a hard stance against oligarchs, as a consequence of which two of them left the country (V. Gusinsky and B. Berezovsky) and another one was imprisoned recently (M. Khodorkovsky)¹⁰³. These measures boosted Putin's popularity, as oligarchs were generally seen by population as the enemies of ordinary citizens. This fight against oligarchy allowed to somewhat distance the state from business interests, whereby the federal government gained room to conduct independent policies. With the rest of the oligarchy the informal agreement was reached that the state would not re-nationalize the assets which they acquired in privatization, while the oligarchs would not intervene into the policies of state¹⁰⁴. The further strengthening of institutional environment was to be enhanced through the adoption of the governance code, reforms of judiciary and police, and the introduction of different measures against corruption in state administration and social security sphere.

What follows from this description of reforms is that according to the theory set out in the first part of this paper, the informal sector was to contract due to the removal of different factors contributing to its existence. However, instead of contraction entrenchment took place. How does this fit into the theoretical framework? Or does it refute the theory? The answer is that the entrenchment of informal economy only confirms theoretical propositions made at the beginning. Indeed, the second wave of reforms in Russia improved entrepreneurial environment in certain areas; nevertheless, new developments took place which did not allow completing the initial liberalization program, while the bottlenecks in the spheres of implementation capacity and professionalism of bureaucracy remained unchanged since the first period of reforms.

¹⁰³ Aslund A. *Russia's Capitalist Revolution*. Peterson Institute (2007) pp 226-228

¹⁰⁴ Ibid.

One of the major unresolved problems of the second period of reforms in Russia was the lack of progress in banking sector. Privatization in the 1990s created not only condensed property structure in Russia, but it also seriously hampered development of independent banks. A phenomenon which emerged in Russia was the merger of large corporations owned by oligarchs with the banking sector. Multilayer holdings were created, whereby each large corporation had also its own bank, insurance and transportation companies¹⁰⁵. Consequently, the banks' main function was to ensure financing of the enterprises to which they were attached. A small number of independent banks was established as well but they were expressly undercapitalized and the interest rates were too high for firms to engage in borrowing. Therefore, accessible crediting for SME did not materialize in Russia in the second period of reforms, which became a serious barrier for new firms to enter the market and compete with already existing market players.

This situation could hardly be overcome, as the deal reached between the state and oligarchs under Putin's Presidency implied that the state would not intervene in the corporate business. This arrangement was disadvantageous for other reasons as well. Firstly, liberalizing reforms were possible not in the last turn because powerful industrial lobby was interested in them. When the subsidies for large industry were cut, the policy of enterprises shifted towards more conventional long-run goals typical for any business in market economy. This required the abolition of barriers and the lowering of taxes. Therefore, those reforms were supported by industrial unions when Putin's government proposed them¹⁰⁶. However, large businesses were not interested in the development of SME sector, as this could change the structure of the market and diminish the economic influence of the oligarchy. More competitive environment was not a desirable development for large corporations which were interested in preservation of a quasi-oligopolistic structure of the Russian market. For this reason, further

¹⁰⁵ Sakwa R. *Russian Politics and Society*. 4th ed. NY: Routledge (2008) p 301

¹⁰⁶ Shevtsova L. *Putin's Russia*. Washington: Carnegie Endowment for International Peace (2003) p 180-184

liberal reforms were opposed by the oligarchy and the government had to abandon them soon after 2001. As a consequence, small business sector did not expand, its share in GDP remained on the level of 10-15%, while large holdings stood for one third of tax revenues and a quarter of Russian export¹⁰⁷.

Secondly, oligarchic property and large holdings meant that many monocities¹⁰⁸ became de facto property of the owners of large corporations, whereby local administrations were controlled by the oligarchs. This hampered the creation of disembedded bureaucracy in Russia, but also gave high leverage to oligarchic class in political sphere, as many monocities became hostages of the large capital. Thirdly, the silent deal with oligarchs meant more autonomy for the state to advance its policies, but not more competition or corporate restructuring. EBRD Transition Index confirms this statement, as Russia in the first decade of the century never managed to score more than 2.33 out of 4.5 on Enterprise Restructuring dimension¹⁰⁹. Furthermore, the index for Large Scale Privatization even declined from 3.33 in early 2000s to 3.0 out of 4.5 in 2004-05¹¹⁰, which reflects the renationalization of assets in the oil and gas industries resulting from the fight against oligarchs. This renationalization of strategic corporations in the energy sector also implied that the prices in this branch of industry are to remain heavily controlled by the state, which was illustrated during the recent petrol crisis in 2011 which spread throughout the country¹¹¹. The government introduced a ceiling of prices for petrol in response to the rise in prices which took place in the sector since the early 2011. Corporations complied with price regulation; however, they stopped to supply petrol to some of the regions of Russia such as Altai, Far East and Tuva etc. The deficit of petrol provoked mass resentment in the country, which in turn forced Putin to convene a

¹⁰⁷ Sakwa R. *Putin: Russia's Choice*. London: Routledge (2004) p 190

¹⁰⁸ Industrial cities where employment was largely dependent on functioning of one enterprise or group enterprises belonging to the same owner.

¹⁰⁹ EBRD. *EBRD Transition Indicators. Different Years*.

¹¹⁰ Ibid.

¹¹¹ Belton C. "Russia to Cut Petrol Exports as Fuel Crisis Hits". *Financial Times Online*. April 28, 2011

meeting with the representatives of major corporations from the industry and to order them to deliver petrol and diesel fuel in a necessary quantity to the suffering regions¹¹². Such deficits occurred not only in the energy sector, but also in the food industry (deficit of buckwheat and salt in 2010), which is indicative of the stalled liberalization of prices and consequent drawbacks to administrative methods of price regulation.

At the same time, progress in institution building was slow; corruption despite numerous efforts to counter it remained on the same level. One of the explanatory factors here is the recentralization of state and shift of the balance of power to the executive branch. Due to this development, the judicial system is often affected by the political pressures from local and central government¹¹³. Moreover, no effective external pressure for institutional reform in the form of the EU for example existed in the case of Russian institutional reforms. A dismal situation in the question of corruption and fight against it, at the same time, is reflected also by CPI. Throughout the 2000s decade, the index for the Russian Federation remained on the same extremely low level as in the previous decade – 2.5 out of 10¹¹⁴. The Worldwide Governance Indicators demonstrate the same trend. The results for Control of Corruption rose slightly in the first several years of Putin's Presidency (from 11 out 100 in 2000 to 24 out of 100 in 2004), however, they fell back to the 2000 level of 11 by 2009¹¹⁵. The Rule of Law indicator remained essentially on its 1998 low level of 18 through the 2000s decade, while on the dimensions of Regulatory Quality and Governance Effectiveness Russian scores nearly doubled reaching the level of ~40 out of 100, which is still low in comparison with developed market economies¹¹⁶. Lack of improvement in these areas but also the quasi-oligopolistic closed structure of the market translated into the low number of foreign firms' entries to Russian market. This in turn exacerbated the problems in the development of the independent

¹¹² Belton C. "Russia to Cut Petrol Exports as Fuel Crisis Hits". *Financial Times Online*. April 28, 2011

¹¹³ Shevtsova L. *Putin's Russia*. Washington: Carnegie Endowment for International Peace (2003) p 189

¹¹⁴ Transparency International. *Corruption Perception Index 1995-2010*.

¹¹⁵ World Bank. *Worldwide Governance Indicators. Different Years*

¹¹⁶ Ibid.

banking sector, but not only. In contrast to Hungary where the competition with neighboring states for FDI resulted in the increase of institutional quality, Russia did not have any coherent stance towards attracting foreign firms; therefore, presence of more market efficient Western firms could not play any role in improvement of competitiveness of Russian market or in reforms of institutional environment conducive for entrepreneurial activity.

3.4. Conclusion

In the view of the above said the solution for the puzzle is as follows: omnipresent corruption, weak institutions and the disadvantageous property structure (concentrated oligarchic property) led to the entrenchment of the informal economy in Russia in the second period of reforms in 2000s under Putin's Presidency. More concretely, whereas stabilization removed the inflation factor of the informal sector and liberalization led to better regulatory performance and tax compliance, a new centralized arrangement and the agreement with oligarchy blocked further structural reforms. The judicial system in the second period of reforms did not become independent from the executive branch of power and the state was still too weak to conduct effective fight with corruption. Consequently, institutions protecting entrepreneurship remained largely formal arrangement, whereas a parallel system of rules based on corruption evolved. Moreover, since the liberalization of prices was partial, the SME sector never became functional in Russia. Underdevelopment and subsidiary role of banks and other financial institutions contributed to the stagnation of entrepreneurship and created barriers for new firms to enter the market. For business community this meant that the benefits of formal rules were still low and the penalties for going underground could not be realized due to the lack of implementation capacity of the state. Therefore, private firms could continue using informal operations and corruption as the means to increase their competitiveness. At the same time, entry of foreign firms to the Russian market could not help to improve the situation since the government did not undertake any steps to attract

foreign capital on a mass scale to Russia due to the abovementioned intertwining of state and business, as well as the quasi-oligopolistic market structure where large corporations were not interested in more competitive character of the market.

Conclusion

The analysis of the informal sectors in Russia and Hungary and of the impact of the SLIP transformation reforms on them required establishing a broad theoretical framework. Such an overarching theory for the analysis of economic policies and their impacts on decision making by market players was New Institutionalism with its two central concepts of transaction and transformation costs of production resulting from the quality of the institutional environment. From this point, the analysis went further to identify structural parts of costs resulting from institutional framework. Those parts were the causes of informal economy; among them lack of price stability, overregulation and high taxes, deficient institutions and corrupt implementing organs of state as well as lack of corporate restructuring could be found. Afterwards, the concept of the SLIP agenda was introduced, and its constituent parts such as stabilization, liberalization, institutions and privatization were juxtaposed to the determinants of informal sector. This allowed identifying specific channels through which the implementation of the SLIP could influence the incidence of informal economy.

Later on, the Hungarian and Russian informal economies of the transition period were analyzed through the prism of the outlined theoretical framework. On the basis of this empirical analysis, it is possible to make several conclusions regarding informal economy and economic reform agenda. Firstly, the two empirical cases illustrate that informal economy is a systemic phenomenon, and its roots are to be found in the ill-designed regulation of the market. As soon as different institutional costs in a broad sense are removed through economic reforms, informal economy declines. Therefore, the often-met political statements that the tax revenues will increase overnight after informal sector is eliminated by controlling organs of the state are not more than populism, an attempt to please the electorate with unfeasible promises. The only way leading to reduction of informal sector is systemic

economic reform which implies redefinition of institutional framework for the economy in a way that will abolish different barriers for entrepreneurship.

Secondly, the main contrast between the Russian and Hungarian cases is the methods and the sequence of implementation of the SLIP reforms. Here, it is worthwhile to note that indeed practice supported the theory with regard to the importance of the sequence of economic reforms. While in Hungary the policies were implemented roughly in the order which was prescribed by the SLIP package, Russian reforms lacked any logical sequence. Due to the interrelated character of policies under consideration, failures in implementation of one part of the reform agenda caused drawbacks in the implementation of other parts. Since in Russia all parts of SLIP were adopted often simultaneously, there were numerous structural weaknesses in every part of the institutional framework broadly understood. As a result not only the transformation and recovery in Russia lasted longer, but also numerous bottlenecks for long run development were created, which later on had - among other effects - negative repercussions for the entrenchment of informal economy.

Thirdly, the entrenchment of the informal sector in Russia can serve as an indicator of the overall failure of attempts during the Putin's presidency to create peculiar Russian model of capitalism which would work efficiently under quasi-oligopolistic arrangement with concentrated property structure, underdeveloped banking and recurring state involvement in economic affairs. In fact, the projected emancipation of state from business was completed only partially, whereby the Russian government remained still largely dependent on the oligarchic class. An express lack of disembedded administrative apparatus resulting from this arrangement translated into the lack of implementation capacity, further weakening of institutions and persistent corruption. A high share of informal economic activities hereby indicates the perceptions of the current situation by business community, for which the costs of operating officially remain too high. Therefore, the level of informal economy serves as

one of the best indicators of success or failure of regulatory quality, rule of law and economic institutional framework in a given country.

The results of the present research indicate that there is a regional and sectoral variation of informal economy, which gives room for further research. The present theoretical framework explains a macroeconomic tendency; nevertheless it does not contain an exclusive list of factors contributing to persistence of informal economy. Since the purpose of this research was to establish connections between the SLIP policies and informal economy, different cultural and sociological explanatory variables were outside the scope of investigation. For instance, one of the questions which is yet to be answered is what is the relative weight of factors contributing to the persistence of the informal sector. As it was shown, removal of price instability factor and the reform of taxes in the early 2000s did not lead to a decrease of the informal sector in Russia. At the same time, if the policies applied are valid and are the same for the whole country, what explains regional variation of informal economy, as it was the case in Hungary? The answers to these questions require additional and more extensive research. Therefore, in order to have a complete explanation of causes and effects of informal economy – if this is possible to achieve at all – further inquiries should be made in the areas outlined above.

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