

Short Reports

**INFLUENCE OF EXPENSES UPON
MAKING A DECISION ON UNDERTAKING
INFORMAL ACTIVITY**

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One of the reasons of informal economy is inefficient economic system, the totality of limiting frames, according to D. Nort, “rules of the game” that organize relations between people, and also methods of supporting these rules [1].

The role of institutes that consist of formal written rules and unwritten codes of behavior is in decreasing uncertainty via establishing a stable structure of relations between people. In an economy that operates efficiently, they don't exclude, but rather complement each other. At the same time institutes might limit and stimulate activity of business agents. Evaluation of efficiency of institutes should first of all consider reliability of state obligations, and secondly – level of expenses for using the rules. Thus, E. De Soto claims high price of obeying law to be the reason of prevalence of informal rules, he outlines two concepts within it: “price of access” to area of operation and “price of continuing” it [2].

“Price of access” includes expenses for passing administrative barriers that include costs for business or legal person registration, receiving patents, licenses, legal address, product certification, etc. However, as known, registration does not mean formalization of activity, as mechanisms of covert economy come in play: decrease in amount of total annual income in order decrease the sum of paid taxes, concealment of a part of revenue or distortion of listed number of staff, aimed to gain access to certain taxing regime, for example. At this point a businessman has to choose: pay the “price of continuing” his activity within the frames of law

or bear expenses of “illegality” that are related to regulating activity through informal rules.

Expenses of continuing activity in accordance with the law include:

1. Costs, defined by high rates of budget payments: taxes, dues, customs tariffs, etc. Apart from tax duties that serve as a significant obstacle on the way of profitable operation, we have to state existence of numerous half-legal collections, so-called “compulsory but made to appear as voluntary” assignments for different municipal needs.

2. Costs of operating within formal economy that come along with budget payments: price of accounting, legal consultations, audit, paying for specialist in logistics, costs for tracking the changing formal rules, and correction of activity due to the introduced changes.

3. Costs, related to an excessive attention of controlling authorities towards enterprises that operate within “formal area”. This phenomenon is defined by the fact that representatives of any controlling body are “bound to succeed” when they inspect a registered enterprise, since existing our legislation does not allow businessmen ability to protect themselves from mistakes. In fact, instability of formal business rules represents a greater risk than being caught in informal operation.

4. One among positive moments of operating legally is protection of violated laws in court, however, in practice businessmen often face illegal acting by judges, continuance and inefficiency of litigations.

5. Time and money costs, related to direct transactions, in other words, transactional costs (collecting information on a contractor's credibility, delays, related to bank payments, etc.)

6. Costs of liquidating a business, defined by the complicated and expensive procedure.

According to the provided information, let us introduce price of legality, defined by formula (1):

$$P_{leg} = \left[C_{reg} + \frac{N_{insp} (S_{br} + C_{idle})}{L_c} + N_{break} (C_{just} - S_{comp}) \right] + S_{tax}, \quad (1)$$

while P_{leg} is price of legality, paid by a businessman who accepts rules, set by the state;

C_{reg} is costs for registering activity;

N_{insp} is number of inspections by controlling bodies (tax police, fire department, sanitary-epidemiological service, police, etc.);

S_{br} is totality of bribes that a businessman has to pay due to conflicts in requirements of controlling bodies and complexity of tax legislation;

C_{idle} is costs of idleness, beared by a businessman due to inspections;

L_c is corruption level in a given country (corruption index);

N_{break} is number of violated contracts;

C_{just} is costs of protecting violated rights in court;

S_{comp} is sum of received compensations;

S_{tax} is tax burden, in other words, total sum of taxes, paid by a businessman.

Let us outline that corruption level, of course, increases the scale of informal economy, but we think that this index is:

– inversely proportional to sum of bribes and number of inspections due to a high level of competition at so-called market of informal services that allows one to cut costs within certain limits;

– directly proportional to expenses for court, as it becomes almost impossible to prove one's rightness via legal methods without additional

guaranteeing payments in terms of high corruption rate of legal instances;

– inversely proportional to costs for registration, as corruption defined bureaucratic delays, aimed to extort money.

Thus we can see that often “price of access” to legal area of activity and “price of continuing” it is excessive for business. However, during the process of functioning within informal environment businessmen also bear certain expenses – costs of illegality. Researchers [3, 4] outline the following types of them:

1. Serving informal schemes. It includes price for consulting on escaping taxes and other budget payments, allowance of additional staff, involved in accounting, logistics, costs of maintaining double financial report, costs of cashing money, etc.

2. Increased risks of maintaining informal operation: businessmen who operate informally, are constantly exposed to risk of being punished for lack of registration, license, unpaid taxes, etc. It is considered that representatives of informal economy spend 10 to 15% of their gross income for bribes and commissions, and law-abiding merchants spend no more than 1% for these purposes.

On the whole, however, businessmen evaluate risk of implementing strict sanctions lower than risk of target inspection by legal bodies, as there is always a possibility to “solve a problem” through established connections and relatively-low bribes. Routine nature of corruption relations allows one to decrease level of risk and uncertainty.

3. Costs, defined by periodically-missed profit due to maintaining informal operation and inefficient distribution of resources because of limiting circle of contractors, advertising abilities, decrease in business capitalization, etc.

4. Costs of obeying informal institutes: provision of business safety, including payments to controlling bodies and law enforcements as bribes for cancelling inspections and implementing sanctions, accelerated solution of problems, and also payments to informal (mafia-controlled) structures for solving problems, related to contract violations.

5. Costs of “crossing” legal sector of economy: taxes for goods and services, acquired in formal economy, and also inflation tax.

Formula (2) presents mathematical interpretation of the provided information

$$P_{illeg} = \left[\frac{N_{np} (S_{brilleg} + S_{pen})}{L_c} + N_{breakilleg} (C_{justilleg} - S_c) \right] + B, \quad (2)$$

while P_{illeg} is price of illegality, paid by a businessman for refusing to obey rules, set by the state; $S_{brilleg}$ is sum of bribes that a businessman has to pay for the “permission” to continue operation within the area of “informality”;

S_{pen} is penalties;

$N_{breakilleg}$ is number of violated contracts in informal economy;

$C_{justilleg}$ is costs for protection of violated rights in informal (criminal) instances;

B is unreceived profit.

Comparing formulas (1) and (2) we should outline that, sums of bribes, paid in informal sector of economy are several times larger than bribes, paid in formal conditions, the same notice is fair for the number of violated contracts and expenses for protection of violated rights. As a rule, price of legality is higher than price of illegality, since sum of registration and tax load is greater than difference between expenses in formal and informal economy. Let us underline that sum of the received compensations in informal economy might even exceed that in formal economy, as though “criminal” justice is much more expensive, it is more efficient since it implements strict punitive

measures. Price of legality can be lower only in case there are significant unreceived profits, related to operating within informal economy.

Thus, according to this multi-factorial correlation, we can try to define probability of transiting to informal economy from formal version of it for businessmen. On the one hand lays one ability to decrease his expenses of maintaining business significantly, but, on the other hand, there are high risks of doing business informally. Which scale is heavier depends on how a state will establish real functioning of civilized institutes, acceptable level of taxes, and decrease in bureaucratic pressure.

References

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