

LOCAL GOVERNMENT EFFECTIVENESS AND SOCIAL NORMS, IN INFORMAL EMPLOYMENT.(ELBASAN MUNICIPALITY.)

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Abstract

This paper analyses the role of local government effectiveness and social norms in the determination of informal employment. A theoretical model is developed, in which local governance affects worker productivity and in which non-compliance with local social norms constitutes a non-pecuniary cost to the worker. These effects, together with skill level, are assumed to influence the decision of the worker whether to seek employment in the formal or informal sector. The model is assessed empirically using data from Albania, where almost half of the urban labour force is employed informally. The empirical analysis supports the predictions of the model and suggests that informal employment is lower in regions with better governance, stronger social norms for compliance with tax and labour regulation, and higher average education.

1. Introduction

Wide-spread informal employment continues to be a salient feature of labour markets in developing countries. In their comprehensive study of informality in Latin America, Perry et al. (2007) estimate the share of the labour force employed informally to range from about 20 percent in Chile to about 80 percent in Paraguay. Despite economic growth, recent evidence suggests that informal employment has not declined over the past two decades (Freeman, 2009).

The defining characteristic of informal employment is usually that it is not regulated in any formal employment contract, and therefore is not subject to labour market regulations. To the worker, this of course implies being outside most of social security arrangements, while faced often with low compensation and poor working conditions (Jütting et al., 2008). For businesses, being informal constrains the ability to raise financial capital and to enforce complex contracts, which is likely to restrict their prospects of growing (Loayza, 1996).

To the economy as a whole, wide-spread informal employment means difficulties in collecting tax revenues for the provision of public goods and services. Recent empirical evidence even suggests that informality affects economic growth negatively, controlling for other country characteristics (Loayza et al., 2009).

A relatively large theoretical and empirical literature has sought to identify the determinants of informal employment, both in terms of worker and firm characteristics, on the one hand, and formal rules and regulations, on the other hand. But empirical evidence also suggests that two additional aspects seem to importantly matter for the degree of informality in a country. These are the manner in which governments choose to enforce regulations and the attitudes among citizens to oblige them. Friedman et al. (2000), for example, in a study including 67 countries, suggest that high taxes, per se, do not drive businesses underground. Instead, it is the discretion in the application of rules and the corresponding corruption that it generates that seems to make businesses escape the formal economy. Torgler and Schneider (2009), moreover, show in a study of 57 countries that the tax morale among

citizens plays a significant role in determining the relative size of the informal economy.

This paper adds to this branch of literature by assessing the role of government effectiveness and social norms in determining the size of the informal sector in Albanian municipalities. Government effectiveness is understood here as the extent to which the government supports and implements formal institutions and provides high-quality public goods and services. It corresponds closely to the definition given by Kaufmann et al. (2009) and Langbein and Knack (2010). Social norms, while being a broad and general concept, refer here specifically to collective attitudes towards obeying formal rules and regulations that are meant to govern the labour market and the taxation of income.

A simple theoretical model is outlined, incorporating these two concepts in the workers decision of whether to participate in the formal or informal sector. The model is evaluated empirically using Albanian data, specially at Elbasan, where the rate of informality in 2004 was 45,7%, and nowadays with a better local governance during these six years the informal unemployment is decrease.(35%) Among Albanias 12 municipalities, informality varies between 20 and 80 percent when measured as the share of the urban labour force lacking a signed labour card. This wide range of informality among municipalities suggests that labour and tax regulations, which are determined largely at the national level, are far from the only determinants of informality in a country. By using municipal data on public sector management and a range of other indicators, and keeping country-specific characteristics fixed, the effects of policy implementation and social norms are assessed. The empirical results support the predictions of the theoretical model. In particular, human capital level, quality of local governance, and strength of social norms are all related negatively to the size of the informal sector. The results stand up to a series of robustness checks, but given the cross-sectional nature of the data, limitations of the empirical assessment still need to be acknowledged.

2. Related literature

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This paper relates primarily to the literature on institutional determinants of informal economic activity. Institutional determinants refer here both to formal institutions, such as labour and tax regulations, and informal institutions, such as social norms of tax compliance (Casson et al., 2010). There is, on the one hand, a large literature on the determinants of informality (reviewed by Kucera and Xenogiani, 2009; Perry et al., 2007; and Schneider and Enste, 2000). There is also, on the other hand, a growing literature on how various notions of governance and social norms shape economic development and other aspects of society. Most such studies, however, focus on economic growth as the outcome of interest (e.g. Hall and Jones, 1999; Glaeser et al., 2004; and Huynh and Jacho-Chávez, 2009). Relatively few studies from these two branches of literature are concerned specifically with the role of government effectiveness or social norms in shaping the informal sector. The empirical evidence that exists is to a large extent at cross-country level and little work has been done at the sub-national or micro level. The remainder of this section briefly reviews some of these studies, by starting with cross-country evidence, followed by studies at the regional level.

Johnson et al. (1997; 1998) discuss how regulatory discretion seems to have caused businesses in transitioning economies to escape to the underground economy: "If the rules are fine on paper but officials have a great deal of discretion in their interpretation and implementation, this leads to a higher effective burden on businesses, more corruption, and a greater incentive to move to the unofficial economy" (Johnson et al., 1998, p. 387). Further empirical evidence on this is provided by Friedman et al. (2000), using a sample of 69 countries to assess the effect of tax rates and regulations versus corruption and weak legal environments on unofficial economic activity. Their central conclusion is that the unofficial economy tends to be larger, not where taxes are higher, but in countries where the regulatory burden is higher, corruption is more wide-spread, and where the rule of law is weaker. Loayza et al. (2005), in the same spirit, use a sample of about 70 countries to analyze the effect of business regulation and the quality of governance on economic growth and the size of the informal sector. They find that the level of business regulation is, on its own, correlated positively with informality. But when quality of governance is interacted with the level of regulation, regulation is instead negatively related with informality. Loayza et al. (2009) analyze a broader set of determinants of informality for a sample of about 85 countries. In line with the findings by Loayza et al. (2005), they find that informality is negatively related with law and order, business regulatory freedom, and with schooling achievement. As they restrict their focus to Latin America they note that "policy and institutional variables related to the quality of the state are the most important factors explaining the differences in informality".

Torgler and Schneider (2009) extend the empirical literature on institutional determinants of informality by adding tax morale to the set of explanatory factors for cross-country variation in informality. Besides showing that

various indicators of good governance (based on the Worldwide Governance Indicators; Kaufmann et al., 2003) relate negatively to the size of the shadow economy, they also show that the willingness among citizens to pay taxes is related negatively with the size of the shadow economy. They construct their indicator of tax morale using the Latinobarómetro, the World Values Survey, and the European Values Survey from various years between 1990 and 2000.

While the use of various indicators of quality of governance has been questioned (Andrews, 2008; Langbein and Knack, 2010), it is probably fair to conclude from the above studies that it is not only the design of formal rules and regulations that determines the size of the informal sector, but also the manner in which they are implemented and obeyed.

At sub-national level, there is about a handful of empirical studies concerned with regional variation in the size of the informal sector. Chaudhuri et al. (2006) study the development of the shadow economy in 14 major states of India over two decades. They find evidence that the expansion of the shadow economy has been less pronounced in states where the press is relatively free and independent (used as a proxy for a well-functioning democracy) and where the economy is more liberalized. Sharma (2009) also studies informality in India, by using a panel of about 130 industries in 16 states. He analyzes the effects of the removal of business entry barriers to the formal sector and finds that, while deregulation of industries has reduced the number of informal establishments in general, the decline has been larger in states with relatively "pro-employer" labour laws. The effects on informal employment are less clear. Torgler and Schneider (2007) use a panel of the 26 cantons of Switzerland to study the effect of regional tax morale on the size of the local shadow economy. They find a negative relationship between the two and that the degree of direct democratic participation seems to further reduce the willingness to participate in the shadow economy. Herwartz et al. (2009) make an effort at measuring the size of the shadow economy in 238 (NUTS2) regions in the European Union. While finding the determinants of informality is not their primary aim, they note that relatively poor regions are those with the largest shadow economies. Jonasson (2010), using Brazilian municipalities as unit of analysis, finds that informal employment is lower in municipalities with higher degree of government effectiveness, controlling for a series of other municipal characteristics. His findings suggest that three sets of indicators of government effectiveness are negatively related to informality: policy formulation, bureaucratic resources, and public goods and service provision.

At the micro level, few studies analyse the effect of institutional factors or social norms on the propensity of workers or businesses to participate in the informal sector. A recent exception is the study by Almeida and Carneiro (2009), who analyse how differences in enforcement of labour regulation across regions in Brazil affect regional informal employment and unemployment. They find evidence that stricter enforcement in a region, measured

as the aggregate amount of registration fines issued, leads to less informal employment but also to higher unemployment. Empirical studies at the micro level otherwise tend to be concerned primarily with worker characteristics as explanatory factors of informal employment. These studies generally conclude that the probability of working in the informal sector decreases with human capital endowment measured by years of education, job tenure, and experience (Funkhouser, 1996; Gong et al., 2004; Marcouiller et al., 1997). In terms of age, it tends to be the youngest and the oldest in the labour force who participate in the informal sector. Some evidence suggests that position in the household, household size, and the presence of children in the household affect sector choice. This probably captures a gender effect: women with children and married women tend to be more likely to participate in the informal sector (Amuedo-Dorantes, 2004). The reason could be that the informal sector offers a higher degree of flexibility in terms of work hours and work location (Maloney, 2004).

In sum, empirical evidence at the cross-country level suggests that corruption and low quality of governance, as well as and low tax morale, seem to cause informality to a greater extent than strict labour regulation and high taxes. Empirical evidence at the micro level provides strong evidence that worker-specific characteristics fundamentally affect the probability of working in the formal or informal sector. Less is known about the causes of regional variation in informality within countries. The fact that it varies considerably across regions suggests that region-specific characteristics could be at least, or even more, important determinants of informality than labour and tax regulations and other nation-wide formal institutions.

The Municipality of Elbasan .

The city of Elbasan, with its 2000-year history, has been and remains one of the most important cities in Albania. Located in the center of Albania, history has favored Elbasan as an important crossroad between north and south, east and west. Elbasan's location ensures good regional, national, and international connections in three directions: south via the road to Cerrik, east via the autostrada to the cities of Librazhd and Pogradec and to the Macedonian border, and west via the autostrada to port city of Durres or via the highway to Tirana, the capital of Albania. Elbasan is located in the Shkumbin River valley, surrounded by hills and mountains. To take advantage of this ideal geographic position, however, regional infrastructure must be developed. Such infrastructure would benefit the city of Elbasan by enhancing the mobility, social life, and economic activity of residents and the balance between communities throughout the region.

Elbasan is the urban, economic, and educational center of the Prefecture of Elbasan, which includes the cities of Peqin, Gramsh, and Librazhd and many smaller towns . Elbasan is approximately 70 km from the two key cities providing the main international access points in Albania: the capital, Tirana, with its international airport, and Durres, with its international port. In this, Elbasan holds a key advantage as an optimal nodal point in national ground and

rail traffic, especially in the transportation triangle Tirana-Durres-Elbasan. And this year in Elbasan with the help of the albanian government and the local government will begin the new road that will made Tirane-Elbasan only 35 km distance from each other, that means to be in Tirana in only 15 minutes, that means a lot of new opportunity and a great impact in the local development. Elbasan has benefited from its rich historical, cultural, educational, and economic heritage and its favorable geographic setting to become one of the most important cities in Albania. The Municipality of Elbasan, inspired by this history and potential, undertakes this strategy with the goal of growing as a competitive center of progress in the region and the country. In order to fully achieve its potential as a trade and social center, however, Elbasan must address certain problems and development issues. One such issue is the weak promotion of Elbasan's assets and the need to develop mechanisms to advertise the city's strengths and opportunities. Employment, in Elbasan, 2004 and how it change in nowadays , 2009, with the strong participation of the local government Unemployment remains a problem in Elbasan, despite the perception of greater employment opportunities held by many newcomers to the city. With the transition from Communism, a large contingent of the active work force lost their jobs, causing massive unemployment. An accurate assessment of the employment situation in Elbasan is difficult for several reasons: 1) the lack of complete data on employment at the Municipality of Elbasan; 2) the lack of unified information from other resources; 3) employment sectors that are still structuring; and 4) the level of informality in the local economy. However, official data and social/economic and business surveys demonstrate that it is difficult for job-seekers to find work. Nearly all surveyed families reported unemployment. In 2001, official unemployment in Elbasan was 37.6% according to Repoba 2001, making Elbasan one of the cities with the highest unemployment rate in the country . Over the last three years, 90% of the families surveyed report no change in the employment status of family members. Among positive factors, though, with regard to potential job creation are: 1) a young population (average age of 38) with a large contingent (2/3) of working age (65.1% of males and 63.4% of females) and 2) a wellqualified workforce due to the long-standing presence of industry and the university. The low number of new jobs created by the private sector also limits opportunities for employment. During 2004, the business survey indicated that new jobs with private firms remained few – on average, five positions for large businesses, two for small businesses, and one for unlicensed enterprises. Most of these “new” positions were due to the replacement of workers rather than the enlargement of businesses and the opening of new positions. Neither small businesses nor unlicensed enterprises serve as strong or secure generators of employment, despite their importance to the local economy. Formal employment in 2004 according to Social economic survey, accounts for only 54.3% of positions held by interviewees, the almost other half work informally .(45,7%). Thus, Elbasan's substantial informal, transitional economy, with its many manifestations, is

critical to a large part of population. It also represents one of the main issues, which limits the good functioning of the local economy. Table 3 gives more detail on the employment status of all of the members of working age (15-60) of surveyed families. Overall, the public and private sectors account for 10.8% and 12.6% of employment respectively, and another 5.8% of those surveyed reported owning and operating their own businesses. 6.18% reported occasional, or day, labor, reflecting the informality of the job market. The vast majority of occasional laborers are male and, in fact, they make up 12% of all employed men. In contrast, there are also 5.8% of those of workingage who retired before retirement age (up to 60 years). These people are predominantly female. The below

table also shows two categories of unemployed, with different gender characteristics. The unemployment rate among those seeking jobs is 18.4% and there is little difference between the sexes. Unemployment among women increases markedly among those who are unemployed and not looking for jobs. The large percentage of unemployed women or housewives in this category (26.3%) reflects a cultural mentality of transition. Greater unemployment among women is also the result of unequal opportunities for employment between sectors. The public sector offers more equal employment opportunities for women, while women are 2-3 times less likely than men to work in the private sector or run a business.

Table .1

Nr.	Status of employment	Unit	Male	Female	Total
1	Public sector	Count	122	155	277
		% within gender	9.68%	11.9%	10.8%
2	Private sector	Count	239	83	322
		% within gender	18.9%	6.40%	12.6%
3	Own business	Count	106	43	149
		% within gender	8.41%	3.32%	5.83%
4	Occasional labor	Count	152	6	158
		% within gender	12.0%	0.46%	6.18%
5	Retired	Count	38	111	149
		% within gender	3.02%	8.56%	5.83%
6	Unemployed, seeking job	Count	205	266	471
		% within gender	16.2%	20.5%	18.4%
7	Unemployed, not seeking job	Count	17	342	359
		% within gender	1.35%	26.3%	14.0%
8	Immigrant	Count	165	36	201
		% within gender	13.1%	2.78%	7.8%
9	Other	Count	14	16	30
		% within gender	1.11%	1.23%	1.17%
10	NA2	Count		202	238
440		% within gender	16.0%	18.3%	17.2%
	Total Count		1260	1296	2556
		% within gender	100%	100%	100%

Source: Social/Economic Survey (2004)

The performance of local government in Elbasan is an important indicator for the daily success of the city as well as for the potential of future development. Local government is closely tied to the creation of a positive climate for business and community development. The Municipality plays a key role through the process of decision-making and the coordination of stakeholders, in agreement with development needs and priorities. It reflects the development of cooperative relationships between local government, citizens, and the business community. The creation of effective local institutions was the first important step in connection with local government, as local government returned to a level of autonomy that was absent during the communist regime. The different levels of government now function according to the principle of subsidiarity (The World Bank, 2002) and on the basis of decentralization reform. With these reforms, the Municipality of Elbasan was charged with more and new

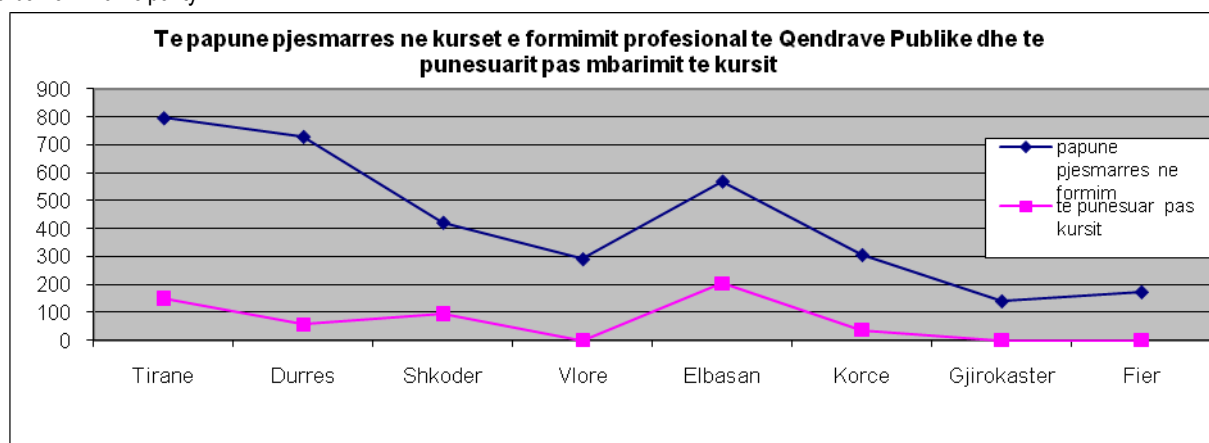
responsibilities in the area of development. The Municipality now has exclusive responsibility in local economic development, business stimulation, local infrastructure, public assistance, and social and cultural development. Addressing these responsibilities has brought a new reality to city administration and a better employment in these years. The experience of local institutions is relatively new. As a result, coordination between them in creating a favorable business environment is still developing, within financial and legal limits. Recognizing the importance of strengthening and increasing cooperation with the business sector, the Municipality of Elbasan has taken several important steps over the last few years to include the business sector in institutional decision-making. In 2000 and then, a strategic plan for economic development was completed, as well as a program for improvement of the business climate. And the tables below show better the work done and the co-

operation of the local government in Elbasan , comparing it with the others municipality in Albania, and it is seen clearly that the municipality of Elbasan is one of most effective in these years.(Source: INSTAT . 2009)

Tabela.2 Profesional formation in the public center in the different cities of Albania.

Rrethet	Gjithsej te regjistruar	Nga keto		Te papune pjesmarres ne formim	% e te Papuneve pjesmarres	Te certifikuar gjithsej	Te punesuar pas mbarimit te kursit
		Femra	Meshkuj				
Tirane	1608	913	695	797	50	1544	150
Durres	1645	854	791	730	44	1555	57
Shkoder	548	341	207	422	77	532	94
Vlore	1157	675	482	291	25	1051	0
Elbasan	1116	672	444	570	51	1116	203
Korce	672	367	305	306	46	633	37
Gjirokaster	677	456	221	140	21	677	0
Fier	329	131	198	173	53	256	0
Gjithsej	7752	4409	3343	3429	44	7364	541

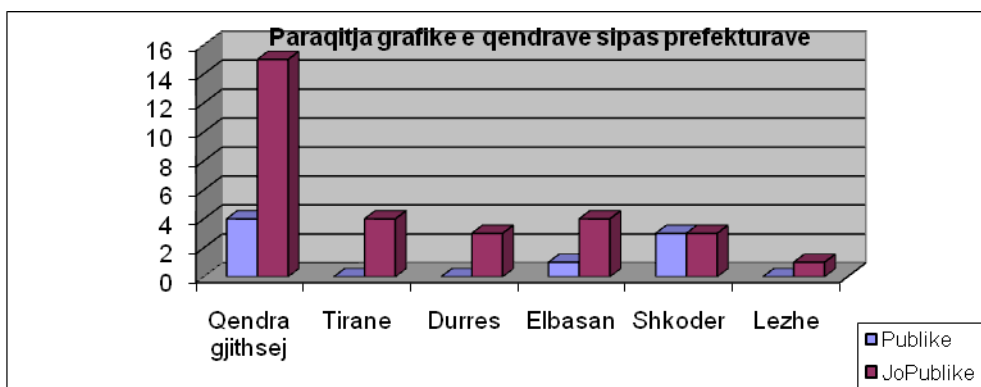
Table.3 The unemployement participants in the profesional formation of the public center before and after the course, for the albanian municipality.



Source : INSTAT 2009.

The tables and the graphs above shows , how these course of profesional formation financed by local government, help the participants that finish this course to find a job. As it is seen in the graphs Tirana and Elbasan are two of the municipality that have the highest number of the employment after the course. In the Elbasan municipality , is also seen , different from the other municipalities , a revelant numbers of different centers public and not public , financed and supported from the income of the municipality, that help the citiziens to do a better life, to learn a new skill (profession), and than with the help of the municipality to find a job. Also the graphs 4 and 5 , and 6 shows the best work done by our municipality in helping people to work more and to live better in their city, without emmigrate in the other country in and abroad .

Table.4 The centers for the youth in need, without school , without family,ect.



Source: INSTAT.2009

Table.5 The centers for the women in need, for the main municipality. (Source . INSTAT 2009)

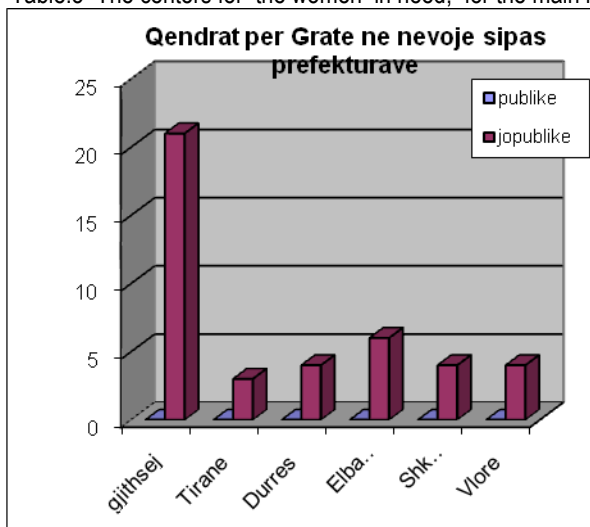
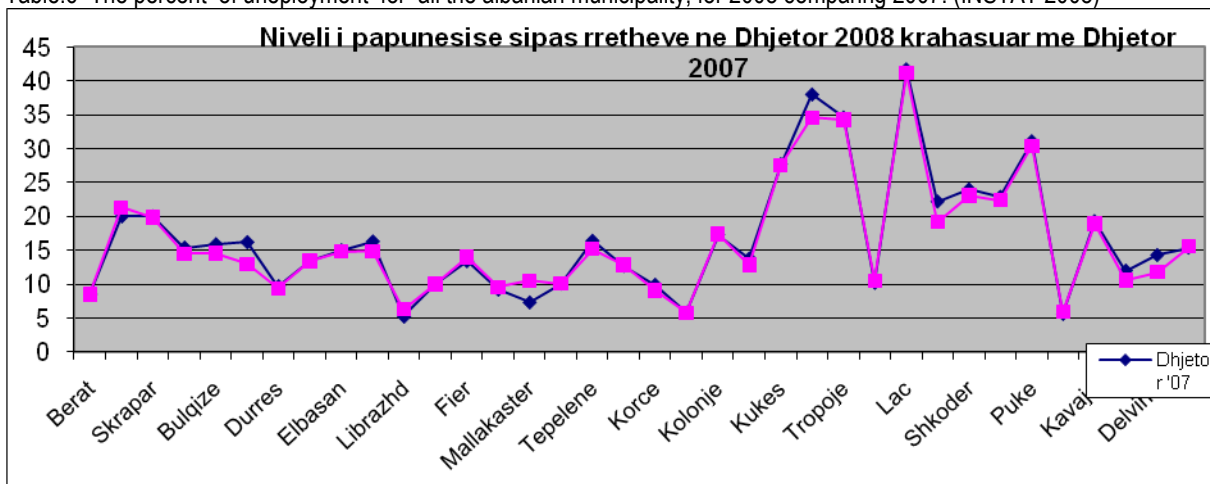


Table.6 The percent of unemployment for all the albanian municipality, for 2008 comparing 2007. (INSTAT 2008)



Conclusion

The aim of this paper is to assess the effects of implementation (by local governments) and obedience (by citizens) of rules and regulations on informal employment. Policy implementation has been referred to in this paper as government effectiveness and rule obedience as the strength of a certain social norm. A simple theoretical model was outlined to discuss how these factors may be directly related to worker decisions and informal employment. The empirical assessment of the model supports the main hypotheses: informality is higher where

education is lower, where governance is less effective, and where social norms on tax compliance are weaker. There is also some evidence that social norms have a stronger effect on employment outcome than the authorities' enforcement and implementation of formal institutions. These results complement previous studies by showing that regional factors, which are exogenous to the individual, affect individual employment outcomes. They also complement cross-country studies by showing that regional differences at sub-national level may cause informality to

vary just as much as between countries, despite the fact that the formal institutional framework is held constant. The ambition of the paper is not to provide specific policy advice on which actions to take in order to reduce informal employment. Nevertheless, a conclusion from the empirical results is that human capital investment is the principal means in increasing the chances of workers to find formal employment and strengthening the incentives to choose formal employment, the example of the municipality of Elbasan. But the results also suggest that the incentive structure may go beyond economic returns to formalisation. For the local government, the most challenging task – besides providing education, efficient bureaucracy, and

other public services to its citizens – might be to improve the quality of the “social contract” between the authorities and citizens. This implies making participation in the formal sector the norm rather than an exception. While such norms are likely to change only slowly over time, a government can seek ways to improve the sense of political participation and inclusion among its citizens. This includes transparency in the political decision process and in the spending of public resources, as well as recognizing the needs of the people outside the formal sector just as much as the needs of those who are already in it.

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