WAYS OUT OF INFORMAL ECONOMY

Bridging the Gap: Exploring Georgia's Informal Economy through Research and Data

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1. Introduction

The informal economy, often referred to as the “shadow,” “underground,” or “grey” economy, is a pervasive and complex phenomenon observed in countries worldwide. It encompasses economic activities that operate outside the purview of formal regulations, official oversight, and legal frameworks. Unlike the formal economy, which is characterized by registered businesses, regulated employment relationships, and transparent financial transactions, the informal economy is predominantly characterized by unregistered and unregulated activities, undeclared employment, and cash-based transactions.

The informal economy manifests itself in various forms, including street vending, small-scale subsistence agriculture, unregistered businesses, informal labor arrangements, and household production. It is driven by a range of factors, such as burdensome regulations, high levels of poverty, limited employment opportunities, inadequate access to financial services, and weak enforcement mechanisms. Individuals and businesses often turn to the informal economy as a survival strategy, seeking to generate income and meet basic needs in the absence of formal employment opportunities or due to barriers to entry into the formal sector.

While the informal economy plays a significant role in providing livelihoods and generating income for a substantial portion of the global population, it poses challenges and consequences that warrant attention. It often operates outside the protection of labor laws and social security systems, leaving workers vulnerable to exploitation, lack of benefits, and unsafe working conditions. Moreover, the informal economy hampers government revenue collection, undermines formal business sectors, impedes economic planning and development, and contributes to income inequality.

Understanding the informal economy, its causes, consequences, and potential solutions is crucial for policymakers, researchers, and stakeholders alike. Addressing this complex and multifaceted issue requires a nuanced approach that combines supportive policies, targeted interventions, and a comprehensive understanding of the social, economic, and cultural dynamics at play. Encouraging the shift from informal to formal economic activities presents numerous advantages, including increased tax revenues, improved social protection, enhanced productivity, and sustainable economic growth.

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economy have been conducted sporadically during various periods, which has made it challenging to consistently track its dynamics over the years.

In this policy brief, we delve into the concept of the informal economy, exploring its defining characteristics, causes, and the challenges it poses. This policy brief is also intended to serve as a comprehensive guide to the research and statistics available on informal economy in Georgia over the years. By shedding light on this often-overlooked aspect of economic activity, we aim to contribute to informed discussions and evidence-based policy development that fosters inclusive and sustainable economic growth in Georgia. We conclude with potential policy interventions and strategies that can facilitate the transition towards formal economy.

2. Terms, definitions and methodology

To delve into the complexities of the informal economy, it's crucial to understand the key terminologies and methodologies used in its estimation. The following section presents classification of different types of informal economy participants and commonly used methodologies for estimation of the share of informal economy.

2.1 Terms and definitions

The Non-Observed Economy (NOE) can be classified into various categories depending on the status of administrative registration and the scope of data collection methods such as administrative collection or enterprise surveys.

Firstly, if the producer is not covered by data collection methods and is not administratively registered, it could be an underground producer (N1), an illegal producer (N2), or an entity with no obligation to register (N3).

Secondly, if a producer is not in the scope of data collection but is administratively registered, it falls under the categories N4 and N5, representing registered legal persons and registered entrepreneurs not reached in the statistics, respectively.

The third category pertains to producers that are within the scope of data collection and are handled correctly, represented by N6, indicating producers misreporting their data.

The final category involves producers that are within the scope of data collection but are not handled correctly, termed N7, which includes deficiencies in the statistical system such as incorrect surveying or survey handling.

These categories are used in the National Accounts Method (NAM) to capture all non-observed economic activities and can be grouped into:

- Economic Underground (N1 + N6)
- Informal Economy, including own account production (N3 + N4 + N5)
- Statistical Underground (N7)
- Illegal Activities (N2)
In the context of Georgia, the National Statistics Office of Georgia (GEOSTAT) employs the same methodology, defining the informal economy as categories N3, N4, and N5. Consistent with this approach, this policy brief will also adopt this definition, focusing our analysis and discussions on the informal economy as it pertains to these categories (N3, N4, and N5) within the Georgian context.

2.2 Common methods

The methods for measuring the informal economy can be broadly categorized into direct and indirect approaches. Both these approaches have their unique strengths and limitations.

Direct Approaches

Direct ways to measure the shadow economy often involve surveys and data collection strategies. They include:

System of National Accounts Statistics: The unseen economy is divided into five sections: underground production, illegal production, informal sector production, household self-consumption, and statistical “underground”. The objective is to gauge the magnitude of these sections via data collection and adjustment methods.

Survey Technique Approach: This method uses representative surveys to collect data on
people's perceptions of, participation in, and opinions on the shadow economy.

Surveys of Company Managers: This technique estimates the shadow economy’s size by surveying managers about underreported business earnings and salaries.

Consumption-Income-Gap Estimation: This method determines the shadow economy’s size by comparing households’ declared income and actual consumption.

**Indirect Approaches**

Indirect, or ‘indicator’ approaches, are predominantly macroeconomic methods which use discrepancies and correlations in existing data sets to estimate the shadow economy size:

Discrepancy Between National Expenditure and Income: The difference between national income and expenditure provides an estimate of the shadow economy size.

Labor Force Discrepancy: Decreased official labor participation while the total remains the same may suggest a growing shadow economy.

Electricity Consumption: The growth disparity between electricity usage and official GDP estimates the shadow economy’s growth.

Transaction Approach: The equation Money*Velocity = Prices*Transactions considers both official and unofficial activities to estimate the shadow economy.

Currency Demand Approach (CDA): Increased demand for cash is seen as a sign of shadow economic growth as informal transactions typically use cash to avoid traces.

Multiple Indicators, Multiple Causes (MIMIC) approach: MIMIC leverages observable causes and effects of the shadow economy to estimate its size.

Due to its ability to capture the complex interaction of factors in the informal sector, MIMIC is widely used and facilitates meaningful cross-country comparisons. The next section will focus on using MIMIC to estimate the shadow economy in Georgia and other countries.

**3. Informal economy in the world and in Georgia**

The World Bank has provided comprehensive estimates of the size of the informal economy as a percentage of GDP for various countries, using the Multiple Indicators, Multiple Causes (MIMIC) approach. In this section, we will present a comparative analysis focusing on Georgia and its comparison with other countries, specifically neighboring countries in the region, including Armenia, Azerbaijan, Moldova, the Russian Federation, Turkey, and Ukraine.

From 1993 to 2018, Georgia consistently had one of the largest informal economies in the region as a percentage of GDP. The informal economy was at its peak in 1995, accounting for 69.3% of the country’s GDP. Over the following years, there was a general decline, with the informal economy representing 61.2% of GDP by 2018.
Comparatively, the size of Georgia’s informal economy as a percentage of GDP was larger than that of Armenia, which peaked at 49.1% in 1993 and gradually declined to 42.5% by 2018. Likewise, Georgia’s informal economy was larger than Moldova’s, which saw a peak of 46.2% in 1995 and a decrease to 39.8% by 2018.

Georgia’s informal economy was also larger than that of Russia and Turkey throughout the period. The Russian Federation’s informal economy as a percentage of GDP reached a high of 49.3% in 1997, decreasing to 42.1% by 2018. Meanwhile, Turkey’s informal economy hovered around the lower 30s as a percentage of GDP throughout the period.

Azerbaijan and Ukraine presented more comparable figures to Georgia. Azerbaijan’s informal economy, peaking at 62.3% in 1993, followed a trend similar to Georgia’s, reducing to 53.3% by 2018. Ukraine saw its informal economy peak at 54.3% in 1997 and reduce to 46.6% by 2018.

In summary, while there has been a general trend of decreasing size of the informal economy as a percentage of GDP across all these countries, Georgia’s informal economy has remained among the largest in the region over the studied period. This comparative analysis provides critical context for understanding the magnitude and importance of the informal economy in Georgia’s overall economic landscape.

![MIMIC estimates of informal economy](image)

*Figure 2. Share of informal economy in GDP by country*
4. Overview of informal economy in Georgia

The informal economy in Georgia has been a complex and evolving phenomenon over the years. While data collection and research about informal economy in Georgia have been somewhat sporadic since the country's independence, the National Statistics Office of Georgia has consistently assessed the share of the informal economy in the value added by various sectors.

![Graph showing the share of unobservable value added in total value added from 2010 to Q1 2023.](image)

**Figure 3. Share of unobservable value added in total value added in Georgia**

Based on the provided data detailing the share of unobservable value added in total value added from 2010 to Q1 2023, a series of important insights into the dynamics of Georgia's informal economy can be inferred.

There has been a visible trend towards formalization in the Georgian economy, with the overall share of unobservable value added in total value-added declining from 23.4% in 2010 to 11.9% in Q1 2023. This suggests a structural transformation in the economy, with increased regularization and formalization of economic activities.

However, this is not uniform across all sectors. While some sectors are becoming more formalized, others show the opposite trend. For instance, the Agriculture, Forestry, and Fishing sector has witnessed a consistent rise in the share of unobservable value added, increasing from 8.2% in 2010 to 14.7% in Q1 2023. This suggests that the informal economy has grown within this sector.

The Mining and Quarrying sector has also generally seen an increase in its informal activity, while the Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles sector experienced a significant decline from 58.9% in 2010 to 17.7% in Q1 2023.
Other sectors, such as Accommodation and Food Service Activities, have maintained high rates of informal activity, hovering around the 50% mark for the entire period.

In conclusion, while Georgia’s economy has been gradually formalizing over the past decade, variations across different sectors highlight the need for sector-specific policies and interventions to further facilitate this formalization process.

Due to otherwise fragmented statistics and research, for further analysis of the existing knowledge, it is helpful to outline three distinct periods to better understand their characteristics: Shevardnadze presidency (1992-2003), Saakashvili presidency (2004-2013), and Margvelashvili presidency (2013-2018). The sections below provide an overview of the characteristics and available data and research about informal economy in each of the three periods.


During the 1990s and early 2000s, Georgia faced significant challenges related to the shadow economy. In order to combat this issue, a Shadow Economy Scale-Down Program was later established under Saakashvili’s rule in order to reduce the levels of shadow economy at the time, mostly related to high corruption levels and lack of control over contraband entering the country.

According to the document describing the establishment of the program, one of the key factors contributing to the growth of the informal economy in Georgia was the existence of post-conflict zones in the country and the low level of control over economic borders. These conditions facilitated the inflow of contraband products into the domestic market, leading to unfair competition and forcing local entrepreneurs to evade taxes. Consequently, this lack of control contributed to the growth of corruption and the shadow economy.

Georgia’s transition from a command economy to a market economy was another challenge. Although large-scale privatization and economic reforms were initiated, some bureaucratic cadres with an old mentality remained, hindering the adoption of Western-style management principles. The remnants of the old system perpetuated corruption and inefficiency in state structures and the private sector alike.

Another significant challenge in combating the informal economy and corruption was the prevailing attitude towards corruption in society. Many businessmen were willing to pay bribes to avoid taxes, which not only fueled corruption but also perpetuated the existence of the shadow economy. Studies indicated that enterprises’ costs due to corruption were around 9 percent of their revenues.

The graph below depicts the estimated size of the informal economy, as reported by the National Statistics Office of Georgia.
The shadow economy was estimated to be most prevalent in the following sectors: HoReCa (Hotels, Restaurants, and Catering), trade, construction, transport, and industry. The respective shares of informal activity within the sectors are shown in the graph below.

Recognizing the seriousness of the issue, the Georgian government initiated various measures and programs to reduce the scale of the shadow economy and combat corruption. In 1998, the government approved a plan of measures to reduce the scale of the shadow economy, signaling its commitment to addressing the issue.

Various institutions and programs were established to analyze and propose anti-corruption measures, such as the Department of Legalization of the Shadow Economy and Anti-
Corruption Policy and the Georgian Anti-corruption Policy Coordinating Council. Important anti-corruption documents, like the "National Anti-Corruption Program," were developed with the involvement of government agencies, NGOs, and research institutions. The government adopted laws on controlling entrepreneurial activity and conflict of interest and corruption in public service. Additionally, the system for declaring incomes of individuals was introduced, and the state procurement system was reformed to increase transparency.

Despite these efforts, challenges persisted in the implementation of the measures. Structural reorganization and optimization of government institutions were slow, leading to duplication of functions between state bodies. The optimization of the budget expenditure structure and programmatic financing development were not fully realized, affecting the efficiency of budgetary resources. Enforcement of various regulations, such as the introduction of cash registers for cash settlement and proper accounting in certain sectors, faced hurdles. As a result, the informal economy persisted, particularly in sectors like industry, construction, transport, trade, hotels, and restaurants.

In a paper exploring economic practices and social dynamics in Soviet and post-Soviet Georgia, Rekhviashvili contrasts two viewpoints: the "formalist" and "substantivist" interpretations of informal economies.

Formalist Interpretation: This perspective sees informal economic activities as separate from formal markets, assuming individuals act rationally to maximize profit. It underestimates cultural and social factors.

Substantivist Interpretation: This viewpoint emphasizes cultural norms, trust, and social networks in shaping economic behavior. It highlights how informal practices are deeply embedded in society and impact economic decisions.

The text delves into Georgian society, showing how honor, family, and trust influence economic exchanges. It explains that the transition to a market economy faced resistance due to the clash between traditional practices and modernization.

The substantivist approach suggests recognizing cultural significance and supporting gradual marketization with social safety nets. This understanding allows for more effective policies during economic transitions (Rekhviashvili, 2017).

4.2 Saakashvili presidency (2004-2013)

In the late 2000s, Georgia underwent significant tax reform aimed at improving the state’s tax system and bolstering its economy. The main goal of this reform was to create a more business-friendly environment, attract investment, and simplify the tax structure for both individuals and corporations. The tax reform was a crucial component of Georgia’s economic development strategy during that time.

One of the key aspects of the tax reform in Georgia was the reduction of tax rates. The state government implemented substantial cuts in both personal income tax and corporate tax rates. Lowering these rates was intended to stimulate economic growth, encourage entrepreneurial activity, and attract businesses to set up or expand operations within the state.
Additionally, the tax reform sought to streamline the tax code and eliminate various deductions and loopholes. The aim was to simplify the tax filing process for individuals and businesses, making it more efficient and reducing the compliance burden. By simplifying the tax code, the state intended to improve tax collection and reduce the incidence of tax evasion, thus contributing to the transition from informal economy.

The outcomes following the tax reform have been explored in a research paper by Torosyan and Filer (Torosyan and Filer, 2014). According to the paper, prior to the reform, the size of the shadow economic activity in Georgia was estimated to be the highest in the sample of Transition Economies (TEs), with an average of approximately 68.8 percent of the official GDP, based on the dynamic multiple indicator/multiple cause (MIMIC) method.

The study reveals that the level of income underreporting decreased in the years following the reform. Notably, households headed by farmers experienced the most significant reduction in underreporting, followed by households where the head did not report any working status. In contrast, employed and self-employed households exhibited minimal changes in income reporting after the reform. These results suggest that the reform, which included adopting a low flat tax rate, did contribute to increased income reporting, but much of the effect may have been driven by enhanced tax enforcement efforts rather than the changes in tax rates alone. Overall, the study provides valuable empirical evidence on the relationship between tax reforms and shadow economic activity, shedding light on the complexities of this dynamic in the Georgian context.

However, some research has highlighted the shortcomings of these reforms in formalizing the labor of some workers, notably street vendors and drivers. Rekhviashvili’s analysis challenges traditional assumptions about informal economic activities and institutional reforms.

According to a paper based on fieldwork carried out in 2012 and 2013, while implementing policies, the Georgian government decided to remove small traders from public spaces, in order to facilitate the commercialization of urban land and property. The rising rental prices made it difficult for small traders to remain in these spaces, leading them to favor informal trade. As a result, informal practices emerged as adaptive responses to the unintended consequences of market-oriented reforms, leading to worsened social and economic vulnerabilities for these actors (Rekhviashvili, 2015).

4.3 Margvelashvili presidency (2013-2018) and onward

Since the Georgian Dream party assumed power in 2012, the Georgian economy has experienced a series of market regulations and reforms. Some of these initiatives might contribute to the growth of the informal economy in the country.

One significant regulation introduced by the Georgian Dream party was the establishment of the Pension Agency, which required an additional tax of 2% from both the employee’s and employer’s side to fund pensions. While aimed at securing retirement benefits for workers, this measure may have inadvertently created an incentive for businesses and workers to operate
in the informal economy to avoid paying these extra taxes.

The National Statistics Office of Georgia publishes data on informal employment, categorized by demographics, from the labor force survey conducted between 2020 and 2022. However, it’s essential to note that data from prior years is not directly comparable due to modifications in the methodology of data collection. Additionally, data from 2023 is yet to be analyzed.

Upon reviewing the available data, it is evident that, on average, there is a downward trend in informal economy regardless of gender and rural-urban divide. (see the figure 5)

In 2020, the total informal economy in Georgia was estimated to be 31.7% of the entire economic output. This means that nearly one-third of the country’s economic activities were conducted in the informal sector, indicating a significant presence of unregulated and untaxed economic transactions.

When examining the data by gender, it is evident that both male and female participation in the informal economy decreased from 2020 to 2022. In 2020, 36.4% of male workers were engaged in informal activities, while 26.2% of female workers were part of the informal sector. In 2021, these percentages declined to 34.2% for males and 22.5% for females, showing a reduction in the proportion of both male and female workers involved in informal economic activities.

Furthermore, the data highlights the difference between the urban and rural areas in terms of informal economic participation. In 2020, the informal economy in urban regions accounted for 30.2% of economic activity, while in rural areas, it was much higher at 35.6%. By 2021, both urban and rural areas saw a decrease in informal economic participation, with the urban informal economy estimated to be 26.8% and the rural informal economy at 33.7%.

These trends in the informal economy suggest that efforts may have been made to formalize economic activities in Georgia, leading to a reduction in the share of informal economic transactions. While there have been no significant policy changes in the recent years, the repercussions of the policies introduced earlier, such as tax benefits to individual entrepreneurs, as well as checks carried out by the Revenue Office of Georgia, have lingering effects on the long-term decreasing trend in informal economy.
in Georgia. However, it is crucial to continue monitoring these figures to assess the effectiveness of policies and to understand any shifts in the dynamics of the informal economy in Georgia.

Additionally, the National Statistics Office of Georgia has conducted sectoral research and outlined the sectors where informal economy is most prevalent in recent years. These include tourism, education, healthcare, entertainment, transportation and storage sectors. Unfortunately, since these sectors are different from those which were researched in 2003, a dynamic comparison of the data is not viable.

Recently, a case study (TBSC consulting, 2023) has been made specifically into the banking sector. While informal shadow banking has been present for many years in Georgia, the National Bank of Georgia has been regulating this sphere by regulating microfinance organizations and other shadow banking parties.

In 2023, within the framework of USAID Economic Governance Program, TBSC Consulting estimated the share of informal shadow banking, which refers to unobserved transactions between individuals, as well as between individuals and non-financial institutions. In the context of Georgia, this includes lending between friends and family members, as well as lending by non-financial institutions. Overall, the share of informal shadow banking is low (estimated at 5.5% in 2021), although there has been an increase amplified by the pandemic.

**Share of informal shadow banking in Georgia (GeoStat, NAPR, NBG)**

- B2B = business-to-business
- B2P = business-to-peer
- P2B = peer-to-business
- P2P = peer-to-peer

![Figure 7. Share of informal shadow banking in Georgia](image-url)
5. Conclusions and recommendations

The analysis of the informal economy in Georgia reveals that this sector plays a significant role in the national economy, while also posing substantial challenges. Cultural factors, such as trust, play a substantial role in the persistence of the informal economy. For instance, in Georgia, a neighborhood culture fosters informal economic relationships, as many services like babysitting or cleaning are sought among relatives and friends. Despite this, there has been a general trend towards formalization across different sectors over the years, yet the informal economy persists and continues to shape economic realities in the country. Considering the complexities of the informal economy, the following recommendations aim to facilitate a comprehensive approach towards its formalization:

Easing the Formalization Process

Reducing administrative and procedural barriers to formalization can make it more appealing for informal enterprises to register their businesses. Georgia had a significant breakthrough in the late 2000s when registering a business became a low-cost and quick process. In the modern world, switching to online platforms for an even easier access to business registration (an example being Estonia’s e-Business registration platform) could be the next step in the country’s efforts to formalize the economy.

Social Protection Programs

Expanding access to social protection programs can be an effective way to discourage informal employment. We have witnessed the effect of such programs during the COVID-19 pandemic in Georgia, when those formally employed could get benefits due to the employment risks imposed by the lockdowns. Easy access to healthcare, pensions, and other social programs through formal employment can serve as an incentive to avoid engaging in informal economic activities.

Access to Finance

Improving access to affordable credit and financial services is critical for encouraging the formalization of businesses. This question is particularly acute for Georgia, where individuals and businesses often complain about high
interest rates. The government should work with financial institutions to develop microfinance programs and loan products tailored to the needs of small businesses, facilitating their transition into the formal economy.

Awareness and Education

Promoting awareness and education about the benefits of formalization can influence individual and business decisions. While the Revenue Office of Georgia has instructional videos for various procedures, such as filing a financial declaration, work could be done to make those videos widely spread (as opposed to providing these videos to those who are proactively searching for them). This can be achieved through public campaigns, training programs, and educational initiatives that emphasize the advantages of operating within the formal economy, such as increased access to credit and legal protections.

Law Enforcement

Enhanced law enforcement, particularly for non-registered enterprises, can deter activities within the informal economy. While the Revenue Office of Georgia conducts regular randomized checks into registered companies, it has a challenge in checking persons who operate without registration. The methodology can be improved to enable the Revenue Office to check on a broader range of economic actors.

Improve Data Collection and Analysis

Continuous improvement of data collection methods and regular analysis of the informal economy by GeoStat can provide valuable insights for policymakers. Moreover, monitoring and evaluating the effectiveness of policies aimed at reducing the informal economy are crucial for making necessary adjustments and ensuring that the strategies implemented are having the desired impact.

In conclusion, there have been significant improvements in addressing the informal economy in Georgia over the years. While the progress might have stagnated somewhat in the recent years, the positive repercussions of the earlier reforms still linger on. Looking ahead, the transition towards a more formalized and sustainable economic landscape can be supported through further easing the formalization process, carrying out awareness campaigns, intensifying law enforcement efforts, and carrying out data collection and analysis.
6. References


President of Georgia. (2003). About the program to reduce the scale of the shadow economy. Registrative Herald of Georgia.


## 7. Annex

### Table 1. Share of unobservable value added in total value added in Georgia

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