

# ON INFORMAL UNDERGROUND FINANCE

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## Abstract

The paper starts from the observation that the financial sector has an informal, unofficial and unregulated segment, less visible, but which still has its importance. The specialized literature refers to what we call the informal financial sector using a multitude of terms: Informal Credit Market, Informal Financial Sector, Unorganized Money, Non-Institutional Credit, Black Money, Indigenous Banking Sector, Parallel Money, Underground Money Markets, etc. A score of issues and considerations will be presented in the category of "underground" informal finance and its implications in economic practice. At the end of the paper, some identified features (whether they are illegal or/and not allowed socially, clients are speculative, a violent attitude in the event of incapacity to pay of client default, predatory fees, etc.) will be subject the debate to clarify the difficulty of evaluation and analysis in relation to the importance for the informal sector.

**Key words:** financial market, financial policies, informal financial sector, lending market, monetary system banking system

**JEL Classification:** G23, G41, H26

## Introduction

Worldwide/throughout the world, both for economic (economic) and social (human and citizen) reasons, but also for political reasons (weak political institutions that lead to corruption and defective relations between governors and citizens, non-compliance with legal regulations which causes large tax evasion), the question of the informal economy is at the forefront of attention. The issue of the informal economy and the underground finances, both at the scientific level and on the level of the appropriate economic policy, is a stringent one.

At EU level, the Administrative Co-operation Directive is in place, according to which Member States exchange information on all forms of financial income. This regulation was extended by an agreement to combat tax evasion that would bring European Union standards at the level of world regulations in the period 2017-2018, to a standard agreed by the Organization for Economic Co-operation and Development (OECD), which provides for automatic exchange of information between countries and jurisdictions so that it is easier to identify those who escape the tax by moving money abroad. The EU's aim is to ensure that member countries exchange information as they are committed to doing with the United States under the Foreign Account Tax Compliance Act.

Consequently, addressing a subject of scientific research aimed at defining underground finances, identifying the mechanism of occurrence and establishing relationships between underground finances and the informal financial system, namely the informal economy, as a basis for assessing the possibilities, ways and results of public policy interventions mainly financial policies) in the management of the problem, the underground financial system appears to be opportune.

The study addresses a component of this complicated and current theme, the theme of the informal economy. In particular, it refers to a component of informal finances, namely their "underground" structure, a subject that can lead to a scientific research approach, even a multidisciplinary research approach.

This analysis considers several considerations and a score of underground informal finances to define conceptually and establish the place of underground finance in the informal economy. Romania's economy, especially after 1989, is an emerging economy in a process of transformation and economic and financial structuring that knows the influences of underground informal finances and does not have a formula for their management. Informal finances are a vulnerability of this economy. Fighting tax evasion, corruption, black money is a continuing concern for governments that translates into complex strategies, associating macroeconomic policies and specific policies.

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The overall objective of the analysis is to delimit conceptually and methodologically the category of underground informal finances within the informal financial sector. Thus, the specific objectives of the analysis concern:

- O1 establishing the theoretical foundation of the concept of "underground informal finance";
- O2 assessment of the implications in the economic activity.

For the "underground" component, we started from observing reality and identifying characteristics (for example, being illegal or / and not allowed socially), then followed a first conceptualization just needed to assess the implications in reality and eliminate the measurement difficulties the size of the underground sector. We mention that we were only interested in microeconomic processes. We did not analyze the sources of macroeconomic financing, but only the microeconomic ones.

## Description of the Problem

### The informal financial sector - a component of the informal economy

Through this analysis, we propose conceptual clarification of the "underground" component of informal finances. Terminology is not consecrated and, of course, can be improved. It is a phenomenon whose importance causes the challenge to support a conceptual point of view and to delimit it, trying to eliminate the ambiguity of the notions currently used.

The purpose of the paper is not to review the notions, nor to criticize the conceptions made so far by theoreticians, but to establish a consistent understanding of the issues discussed later in this research.

The concept of informal economy has been introduced in the literature since 1972 by the International Labor Organization, but the literature does not indicate a unitary definition of the "underground" component. This definition refers mainly to 'black' work, which is always illegal and clandestine. Other unusual and undeclared production activities or services may be included here.

In fact, from the beginning, first in 1955, the term was used in connection with work, more specifically with the generation of jobs in the economies of developing countries by W. Arthur Lewis<sup>31</sup> through the model that bears his name Dual Sector Model, showing that the labor force surplus in the traditional agricultural sector is being transferred to the modern industrial sector, whose growth, over time, absorbs the surplus labor, promotes industrialization and stimulates sustained development. And those who do not find formal, legal employment in the industrial sector become participants in the informal economy.

At the International Labor Conference, on Decent Work and the Informal Economy, in 2002 the term "informal economy" was used to replace the term "informal sector" and means "all economic activities that are - in law or in practice - are insufficiently regulated by formal agreements" (International Labor Organization, 2002)<sup>32</sup>.

An examination of the economic implications of the shift of economic activity in the observed sector, registered to the unregistered, hidden and uncontrolled sector of the economy, is carried out by Feige (2007)<sup>33</sup>. He demonstrates that such a change not only reduces the government's ability to collect revenue but can also influence the nation's IT systems and can therefore lead to wrong political decisions. The paper analyzes alternative means of estimating the size of various unseen economies and examines their consequences in both socialist and market-oriented economies.

*Unnoticed economy* is the widest compared to other concepts, as it includes: informal production, illegal production, underground production, own final production and unregistered production. It is the total of economic activities that are obscured by statistical observations.

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<sup>31</sup> Laureate of the Nobel Prize for Economics in 1979

<sup>32</sup> Resolution and conclusions concerning decent work and the informal economy, adopted on 19 June 2002, ILC, 90th Session, Geneva, 2002, <http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/pr-25res.pdf>

<sup>33</sup> Edgar L. Feige, "The Underground Economies: Tax Evasion and Information Distortion." University of Wisconsin, Madison, 2007 p. 73

Activities of *the unseen economy* are, according to the National Accounts System 93 (SCN 93) and the European System of Accounts 95 (ESA 95), the following specialized concepts and terminology are known: illegal, underground (or hidden), informal. National accounts meet the definition of non-registered economy, which includes non-registered production activities either by administrative authorities or in statistical data sources. This situation occurs when: the activity performed is illegal, there is no legal obligation to register, the non-registration is void (ie it is a deliberate action, the main reason being the tax evasion). National accounts also operate with the notion of under-traded economy, which refers to reporting lower values than reality (sub-reporting). Data provided by economic agents is not consistent, and component reporting costs are higher than results. The final result is the undervaluation of the profit of the economic agents. Non-registration and sub-reporting can be identified in the underground economy / hidden in both formal and informal sectors. Illegal economy includes: the production of goods and services the sale, distribution or possession of which is prohibited by law or the production of lawfully-lawful activities when they become unlawful because they have been carried out by unauthorized producers (eg unauthorized producers of alcohol, unlicensed medicines, non-accredited healthcare providers, etc.).

*The gray economy* consists of different types of small businesses that seem legal, but which practically violate the law to a great extent (in terms of tax payments, for example, no fiscal receipt is issued at each sale, income is not recorded, no tax is paid; in the case of employment contracts, for example, an employment contract is drawn up for 2 hours and the activity corresponds to the 8-hour program, the full payment of the contributions to the insurance system and the payment of the salary tax etc.).

The scope of *the underground or hidden economy* - hidden from an economic perspective - is the legal production activities but is deliberately hidden from the public authorities for reasons such as: non-payment of income taxes, value added tax or other taxes, non-payment social security contributions; avoiding administrative procedures, etc. From the point of view of statistical measurement, the notion of "hidden" should be interpreted as refusing to fill in questionnaires that collect data for statistical surveys or other administrative documents and for the purpose of deliberate subtraction. The underground economy comprises the unregistered and under-traded economy.

*The black economy* involves illegal types of activity (production and trade in drugs, prostitution, illegal production and arms trafficking, black market operations, etc.). This includes clandestine manufacturing workshops (in the textile, leather, footwear and apparel industry), services of various types (pseudo / para medical, guessed coffee, gambling cards). Their emergence in some countries is due to the availability of cheap labor or to illegal migrant workers.

A comprehensive definition of the underground economy is given by Pestieau (2005), ie "all economic activities that are carried out outside criminal, social or fiscal laws or which escape the inventory of national accounts"<sup>34</sup>.

There is often a considerable overlap of concepts and the possibility of easily changing the terms used to become ambiguous and unclear. With the growth and modernization of the economy, the informal economy also grows, and the attempts to measure and sizzle it struggle with the difficulty of defining it. What can be said is the existence and evidence of this segment; also, the fact that this type of economic activity is ubiquitous, exist in market economies and economies with centralized planning, both in the developing ones and in the developed ones.

The informal economy does not exist and does not manifest itself separately from the formal economy, but relates to it, sometimes it produces it and makes a significant contribution to the creation of GDP. In this economy there are results that are disseminated in the global economy, namely, distributed, used labor force, income is obtained and consumed. The informal economy distributes products and services, so it concludes transactions in monetary or non-monetary form, creates or influences markets, changes prices and behaviors. In conclusion, it has effects on the markets, on the balance in the real economy, on the state budget, on the trade balance, on the monetary equilibrium.

It has been shown in the first part of the section that there are multiple meanings that can be

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<sup>34</sup>Pierre Pestieau "The Welfare State in the European Union - Economic and Social Perspectives", Oxford University Press, USA, 2005, p 49

assigned to the concept of informal and informal economy and that interpretation in different ways depends on the size and characteristics of economic activity.

In Schneider (2002) we find a clarification of the boundaries between activities involving monetary transactions and those involving non-monetary transactions as shown in the following table:

**Table 1**

**Taxonomy of types of underground economic activities<sup>35</sup>**

Type of activity	Monetary Transactions		Non-Monetary Transactions	
Illegal activities	Trade in stolen goods, trafficking and drug manufacture, prostitution, gambling, smuggling and fraud.		Troc of drugs, stolen goods, smuggling, etc. Production or cultivation of drugs for their own use. Theft for own use.	
	Tax evasion	Tax avoidance	Tax evasion	Avoidance of taxes
Legal Activities	Unreported income from wage-earners and assets from undeclared work related to services and legal products	Reductions granted to employees, benefits	Troc of services and products / legal goods	Marginal services and products / legal goods Activities provided for personal or for assistance purposes neighbors

Source: Schneider, Friedrich, "Size and measurement of the informal economy in 110 countries around the world, July 2002, p. 4

Thereby, we can observe underground financial activities (payments, receipts), both legal and illegal. It is obvious that they are caused by financial imbalance and instability at different levels: individual, microeconomic and macroeconomic.

Based on the definitions in the above-mentioned literature, we examine some criteria for the existence of the "underground" component of the informal structure of the financial system:

- *The criterion of institutionality* refers to the degree to which the structures of economic / financial activity are regulated by the state. Underground informal finances (FIS) are not institutional - they violate the criterion, they are an informal component of the financial system.
- *The criterion of legality* refers to the extent to which it complies with the legal provisions regarding the organization, the object of activity, the way of functioning, the way of attracting the resources. FIS are not legal - they violate the criterion, they are an illegal component of the financial system
- *The transparency criterion* refers to the degree to which it is registered, according to the regulations in force to be monitored and controlled by the responsible public authorities. FIS violates the criterion, I am an unregistered component of the financial system.
- *The criterion of administrative compliance* refers to the degree to which it is reported to public institutions. FIS violates the criterion, I am an unrecognized component of the financial system.
- *The criterion of observability* refers to the extent to which underground financial activity is accessible from the informational point of view, to the publicly competent structures. FIS can be observed, although it is a less visible component of the financial system.

An analysis of the reasons leading to the appearance and maintenance of the FIS reveals the following general causes:

- high tax burden (avoidance of taxes and social contributions, sometimes even of taxes, especially the tax burden on labor is the one that determines the work of "black", but it also influences the "debt", because the informally employed persons do not qualify for obtaining a bank loan, not having a contract of employment).
- the state institutions are of poor quality (the confidence and loyalty to the state and its institutions

<sup>35</sup>The structure of the table is taken from Lippert and Walker (1997, p. 5) with personal observations, as Schneider notes in the cited paper.

is diminishing, fiscal morality is deteriorating, the psychological contract works in the negative sense - voluntary compliance with the tax obligations is avoided, tax evasion is being pursued voluntarily).

Knowledge, the correct and effective application of the fiscal code and other financial-banking regulations play a crucial role in the hidden economy, namely underground financial co-penetration. We can appreciate that bureaucracy and corruption favor FIS development. The costs of creating a business, the length of a loan, the duration and the value of the tax, the insolvency processes, are also factors that favor the development of this sector.

- economic cyclicality is an element that determines the size of the "underground" structure;
- many ambiguous legal regulations, especially on the labor market;

Based on the above-mentioned observations, we propose a list of the causes that can generate the "underground" structure of informal finances in the following table:

**Table 2**

**Mechanism of production / causes of underground "underground" substructure of finance**

<b>Nr. crt.</b>	<b>General Causes</b>	<b>Financial sector specific causes</b>
<b>1</b>	formal	failure of the central bank
<b>2</b>	managers	weak fiscal control
<b>3</b>	structural	organization of cartels and trade unions
<b>4</b>	conjunctural/circumstantial	globalization

*Source: bibliographic processing of authors*

Formal causes - incomplete, ambiguous or inconsistent normalization determine the behavior of the economic actor, namely illegal behavior (the law is defeated), paralegal (exploited the letter of law) or metalegal (exploited the spirit of the law).

Managerial Causes - Lack of Governance Skills reflected in Financial and Tax Arrears.

The structural causes, namely the non-realization and the non-observance of the private property, lead to bureaucracy and corruption at the level of the legal financial institutions for obtaining financing, which leads to the preference for other available forms of credit.

Conjunctural causes: eg: globalization - opportunities in the field of illegal activities (chivalry, pyramid games, speculation, gambling).

The specific causes of finances mainly relate to the government's inability to observe and manage these activities.

Among the FIS effects we can list:

- Formal spending of money generated in underground activities. It is a potentially positive effect.
- Effects on quality of life are of the opposite direction, because they do not create the premises of a healthy and active life.
- Stimulate unfair competition among businesses, illicit trade in alcohol, tobacco, fuel, smuggling and illicit trade.
- Reducing the quantity and quality of public goods and services (eg infrastructure, education, health, etc.).
- Distorting certain official indicators (eg unemployment rate, the evolution of excise duties in relation to illegal trade).
- At the individual level, an increase in welfare, even slow, leads to a decrease in the use of funding from the underground system

As regards measures to combat the underground nature of the financial system, it can be concluded that systemic solutions can be more effective than punitive measures:

- Decline in taxation (taxes and reduced contributions, taxes effectively spent).

- Reducing declarative / administrative regulations and obligations.
- Reducing corruption and bureaucracy, increasing the efficiency of the public sector.
- Treating taxpayers as partners in their relations with tax authorities.
- Financial education of individuals on the personal budget, the purpose of taxation and taxation, calculation of interest on credits, calculus of time to savings, etc.
- Encouraging electronic payments without cash.

## **Case Study on Informal Commercial Lending**

In this section, we present the results of an empirical research on the use of informal commercial credit. The study was based on the premise that the sale of products on debt is an old practice and maintained in the activity of small traders, regardless of the degree of development of the economy.

### **Methodology and Data Sources**

#### **Methodological Aspects**

Between June and August 2017, we approached 27 retail stores and their representatives for research.

#### **a) Volume and structure of the research population**

The study was conducted on a sample of 108 people with the following features:

Country of origin: rural (100%), aged 20-80 (97), of which 14% employed, 67% pensioners and 19% non-occupation. Those interviewed were 38% of women and 62% of men.

#### **b) The method of choosing the participants**

Two methods were used:

- 1) Simple random sampling (randomly selected customers of the participating firms).
- 2) Opportunity-based sampling (decision-makers, or their representatives from 27 trading companies, from 3 counties (Satu Mare, Iasi, Ilfov) were elected).

#### **c) Research methodology**

The methodology I used in this exploratory-descriptive, investigation, and description of "credit on the notebook" as a form of manifestation of the informal "underground" financial system focused on both quantitative and qualitative aspects. In the first part, we used the sociological survey by applying a questionnaire. The questionnaire was administered individually between June and August 2017.

The questionnaire was built from 3 simple, closed questions, with 2 variants of an answer and an open question:

- Q1. Are you accustomed to buying the "notebook"? R1. YES NO
- Q2. Up to what value? R2.  $\leq 100$  lei /  $> 100$  lei
- Q3. What is the pace of payments? R3. Weekly / Monthly
- Q4. Why do you call "notebook"?

The questionnaire was applied to 108 people, of which 27 representatives of the "creditor" and 81 beneficiaries of the "credit".

Instruction for completing the questionnaire aimed at self-esteem and direct, honest answers to Q4, with the possibility of developing the answer. Completing the questionnaire lasted about 10 minutes.

#### **d) Results Obtained**

Participants' response rate was 100%. The results show that in 90% of the reputable stores sell on

"debt", "on the notebook". The remaining 10% no longer continues this practice for fear of the consequences of controls.

The informal commercial lending operation has the following steps:

- From the store, the customer chooses whatever goods he wants. If he does not have money on him or does not have enough available money, he enters in the notebook with the following information: name and surname, date, products (briefly listed, sometimes this field is not filled in, and in some notebooks does not exist).

- Because the payment is not actually made, no tax receipt is issued, the merchant does not pass the merchandise through the accounting and does not pay income tax / profit tax.

- The customer pays the merchandise when it is available at the sale price that also includes the sales add-on of the seller, but does not pay interest on the debited amount.

- When the client - the debtor pays, the balance in the accounting is established, the statements are drawn up correctly and the money is paid to the budget (in some cases).

What the trader assumes: the risk of tax control that can cause very large fines and the risk of not getting the given goods.

Customers - debtors have no risk or additional cost. They are low-income people with fixed earnings on salary, allowances, or pensions. Debt value fluctuates between 25-75% of revenue and closes once a year or a year and a half.

In order to avoid "tax evasion", even for a short, technical time, the sale could be done on the basis of a tax invoice with the payment on time, namely when the debtor comes out of the "notebook" would turn into a supplier credit for the consumer.

## Conclusions

We find the existence of several functions of the "underground" structure of the financial sector, as follows:

1. The Shock Absorption Function - We can talk about the absorption function of both economic shocks by amortizing the shocks that occur either in the goods and services market or in the labor market, the money-market and the institutional shocks, which are, in most cases, the cause of economic shocks. In fact, the two types of shocks are exploited to provide substantial and unclaimed profits.

2. The function of covering economic "gaps" - The underground structure is interested in economic needs where formal finances are not open or needing an insufficiently motivating profit rate for them. Most of the time, they exploit resources and opportunities that are ignored or folly incomplete from the formal economy, thus becoming complementary to formal structures. (which we are going to reflect on).

3. Calculation of cost-of-opportunity costs of economic decisions - Calculates a kind of shadow prices that represent for any economic subject the cost of the real economic decision.

4. Signaling function on resource allocation, economic behavior, relative prices - Sends signals on economic and especially financial resources: their structure, degree and quality of use; on adverse effects on economic behavior; on the relatively real price, different from the official one.

The effects of the "underground" structure of finance:

1. Creating parallel markets

2. Changes in consumption and saving behavior, respectively the misappropriation of money

3. Undermining formal finance

4. Reducing fiscal revenues through non-payment of budgetary obligations

Finally conclusion:

✓Underground finances are "inevitable,,"

✓The underground finance component can not be liquidated

- ✓The underground economy is an obstacle to the country's economic growth and, implicitly, to the standard of living
- ✓It must be known for use by appropriate government management.

## **Future Directions to Be Approached**

- ✓Analysis of the relationship with the formal financial sector (competition or complementarity)
- ✓The informal financial sector - a specific approach for Romania
- ✓Assessing the possibilities of estimating the size of the sector in Romania

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## Presentation of the results of the questionnaire on informal commercial crediting

Question	Number participants	Response options	
<b>Q1, Q2, Q3, Q4</b>			
<b>Q1</b>		Yes	No
"Are you accustomed to selling on the notebook?"	<b>27</b>	24	3
		89%	11%
"Are you accustomed to buying on the notebook?"	<b>81</b>	68	13
		84%	16%
	108	85%	15%
<b>Q2</b>		<= 100	>100
"What is the sales limit on the notebook / month?"	<b>27</b>	24	17
		89%	63%
"What is the limit of purchase per notebook / month?"	<b>81</b>	56	63
		69%	78%
	108	74%	74%
<b>Q3</b>		weekly	Lunar
"What is the rhythm of the proceeds?"	<b>27</b>	5	19
		19%	70%
"What is the rhythm of payments?"	<b>81</b>	15	53
		19%	65%
	108	19%	67%
<b>Q4</b>			
"Why do you call/use "notebook"?"	<b>27</b>	'People are in need here in our county. They are old people alone and until the pension comes to eat. "	
		'Because people have no money and I keep too much my best merchandise on the shelf."	
		' In this period are weddings and so I think to help them, they will only pay for what they consume after everything is over"	
		'It is charity, people are so upset. I think I'll help them, they'll pay after everything's over and just what they're doing, the rest I get back. "	
		'If I do not give them, they give X .and I stay with my lips swollen / ruined merchandise /my proud / etc."	
	<b>81</b>	'That's how we get used to, and it's easier to handle, that little money we have."	
		'We do not get to go from one month to the next and if we have many medicines we have to take on debt"	
		'Only when the children come home, then there are more hands to work!"	
		'They allow this loan. There are people in fear of God, like us. Do not fool each other "	
		'Need and not pride."	

When asked if the lent amount higher and lower than 100 lei, some checked both.

We counted:

12 common responses, 12 under or equal to 100, and 5 just over 100.