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Introduction

1.1. The informal sector in focus

An analysis of the informal sector is the core of this thesis. The informal sector appears in many forms. For example, 'the builder's need to build in places or in ways that he knows from the very start are forbidden, but thinks that the local authorities will certainly not have the building demolished, once it has been completed, since this type of punishment is held to be intolerable 'social waste' in the light of the present housing shortage' (Del Boca and Forte, 1982:195). Another example is the labor market position of an employee who involuntarily or voluntarily works without a labor contract. In the involuntarily case, the result is indirect evasion of personal income tax and the loss of social benefit of the employee her/himself, as well as the direct tax evasion by the employer. In the voluntary case, there is a direct evasion of personal income tax by the employee her/himself. The informal sector appears also in street vending, where people try to make a living by selling a variety of goods, ranging from second-hand clothes, books or tools to consumables like cigarettes, chewing gums and bananas. Final examples are the illegal trafficking of humans (e.g., females and children), weapons or drugs and money laundering.

Given these many examples, it is not surprising that economists are interested to study the informal sector. Its significance is frequently estimated at a level of about 20-30% of GDP (cf. chapter 2). The goal of this thesis is to contribute to our understanding of the informal sector and individuals' motivations to participate in it.

1.2. The informal sector in perspective

'The informal sector has usually faced a negatively or openly hostile policy environment. The impact of macro-economic policy is frequently negative, while open hostility is often the case at the micro level. Nevertheless, there has been recent movement toward developing and applying positive policies in support of informal sector activity' (Lubell, 1991:114). The concern, put forward by Lubell, has been especially apparent during periods of recession. These are the periods when the informal sector is observed most.

Nevertheless, there are clear differences in situations across countries that sparked the interest of policy makers and researchers in the informal sector. In developed countries, a major cause of concern was the increasing budget deficits. Therefore, research on the informal sector was mostly promoted to study and eventually decrease tax evasion, in order to obtain higher tax revenues. In developing countries, besides the study of tax evasion, the informal sector received special attention with respect to the labor market in general and the position of workers in it. In communist countries, the study of the informal sector (or second-economies) was motivated by its particular features such as the consumer shortages, political dissatisfaction and the gap between reality and ideology. In transition countries, the analysis of the informal sector was stimulated by the events of the economic and institutional crisis after the collapse of communism. The consequences of economic crisis involve a severe decline in output, a rapid increase of the unemployment rate and an increasing budget deficit. Institutional crisis involves a gap between the destruction of old institutions and the construction of new ones, accompanied by inefficient enforcement mechanisms. This crisis was enforced by the persistence of old social norms and a slow if any adaptation to the new system.

While research on the informal sector in developed and developing countries originated in the 1970s (cf. chapter 2), this research could only start in the last decade in transition countries. Although studies in other countries have shown that the informal sector has a significant impact in the economy, it was neglected in the first years of transition. There have been some disputes about whether this neglect was due to the perceived unimportance of the informal sector or it was purposely pursued by governments due to its tremendous effect as an absorber

of poverty and social chaos. However, a recent rise in the interest of researchers and policy makers is notable.

This thesis represents a demonstration of this growing interest. Its main focus is the study of the informal sector in transition countries. The first and straightforward motivation is the scarcity of research in this field. In addition, the complexity of factors involved in the transformation process of these countries makes the study of such a significant phenomenon not only a challenge but also a necessity. As reported in chapter 2, the magnitude of the informal sector in transition countries is significantly larger than in developed countries. Therefore, the consequences are larger. They are not only economic, but also social, institutional and political. It is time that the analysis of the informal sector is not only based on development economics but also on institutional economics. In other words, if one wants to study the informal sector in these countries, one needs to take account of the specific institutional characteristics in a systematic way.

A specific country in transition was chosen for this study, to wit, Albania. Albania is a particularly interesting country to study in this respect. It was the last country in Eastern Europe that opened itself up to democratic changes. While other Eastern European countries had in one way or another introduced slight changes with respect to private property as well as some moderate openness to international exchange of interests (already from the mid 50s), Albania, up to the beginning of transition, was in all aspects a completely isolated country. Therefore, when Albania entered the process of transition, it was struck by a deep crisis. In addition, for a long time Albania has been one of the poorest countries in Europe. This situation created suitable conditions for the informal sector to be the prevalent economy in Albania. It appeared everywhere. It initially started as an emergency exit from the numerous problems of the formal sector, but later became an inevitable part of the society. Therefore, the informal sector in Albania emerged and developed in a unique way, demonstrating both the positive and negative impacts on a country as a whole. The study in this thesis is aimed at contributing to the long-running controversy over the pros and cons of the informal sector.

As mentioned above, the informal sector has many aspects, which makes it impossible to analyze them all in one study. Although this thesis elaborates the informal sector in general,

its main focus is on the study of tax evasion. The main reasons for analyzing this aspect of the informal sector are the direct links it has to large budget deficits and hence to lower investments in public goods, and the opportunity it creates to study the decision-making process of (non)complying with taxes on the individual level. In addition, the study of tax evasion gives an indirect indication of individuals' involvement in the informal labor market. The study of non-compliance in transition economies is likely to yield the most revealing view of the effective prevailing incentive structure, of the critical strategic behavior induced by that structure, and thus of the outcomes of policy changes (Feige, 1997). Because individual tax compliance is the main focus of this thesis, and the role of institutions in this individual decision is considered to be of crucial importance, the research is predominantly micro-economic. The individual's decision whether or not to evade taxes and the way this is affected is the central core.

Two empirical methods are used to study the individual's compliance decision. One is the experimental method. Although it has sporadically been used to study tax evasion before, this method appears in studies of tax evasion in developed countries only. To our knowledge, experimental research of tax evasion in transition countries is still missing. This is one motivation to use this method. A second motivation is that it provides an opportunity to test existing hypotheses on tax evasion directly. Finally, it is seen as an opportunity to obtain comparative results from two types of countries with respect to individuals' attitudes towards tax compliance, while controlling for the numerous differences between countries (for more details, cf. chapter 4). The two countries used are Albania (a country in transition) and the Netherlands (a developed country). While the reasons for choosing Albania were discussed above, the choice of the Netherlands is based on the simple fact that it is a developed country with a highly democratic institutional system. In addition, its size is comparable to Albania. Finally, the facilities and experience of running experiments in the Netherlands are well known.

The second method used in this thesis is a large field survey based on written questionnaires and personal contacts. Due to financial and time restrictions, this method is only applied in Albania. This method is often used in countries in transition. An important motivation of using it is that it provides a large data set to test existing hypotheses on tax

evasion. Compared to experimental data, this set contains more information about 'real world' evasion.

By combining experimental and field survey results in this thesis, it is hoped that our analysis can provide greater understanding of individuals' motivations to evade taxes than either method in isolation can. A synthesis of the results of the two methods is presented in chapter 7.

1.3. An outline of this research

Chapter 2 discusses the existing literature on the informal sector in developed, developing and transition countries. Although it tries to include research on countries in transition, due to the scarce literature on these countries, most of the studies discussed, refer to the informal sector in developed and developing countries. These studies focus on a variety of issues: the attitudes to the informal sector, the theories about it, empirical methods used when study it, and the policy implications derived. Despite the unevenness in contributions to the literature, it is stressed throughout this chapter that the distinction between studies of the informal sector in developed countries and studies on less developed countries is of key importance. Maintaining this structure throughout the chapter, we describe the distinct criteria used to define the informal sector based on its various appearances. In addition, we discuss in detail the continuous dispute whether the existence of the informal sector has positive or negative consequences for the society as a whole. In order to provide some background for this dispute, various theories and empirical evidence related to the informal sector and tax evasion – including the motives to go informal- are presented. The picture is made complete by summarizing the main empirical methods that have attempted successfully or unsuccessfully to quantify and analyze the informal sector and tax evasion.

Chapter 3 provides background information about Albania. This chapter is divided in two main parts. The first part presents a general political and economic overview. Besides the general profile, it focuses more specifically on those political, economic, social and institutional aspects that are related to the informal sector in this country. This is followed by a brief description of one of the extreme appearances of the informal sector in Albania: financial pyramid schemes. Recognizing the reliability problem of statistics in Albania, the second part presents one of the few studies on the informal sector in this country. This study

is concerned with an early field research of street vendors in Tirana, conducted by the Albanian Center for Economic Research (ACER) in 1996. Following the theoretical discussion -presented in chapter 2- about the significance of the informal sector in general, this chapter concludes by supplementing this debate with some illustrative evidence from the Albanian experience.

Chapter 4 presents one of the empirical approaches of this thesis towards the study of tax evasion. This approach is based on laboratory experiments in Albania (a country in transition) and the Netherlands (a developed country). This comparative experimental study of tax evasion provides the answer to one of the main research questions of this thesis: Is there any difference in the individual decision making process with respect to tax compliance in these two types of countries? Another important element is added to this approach, which is a distinction not only across countries but also across subject pools within a country. Because tax evasion may vary across subject pools within a country as well as across countries, we decided to gather data from various subject pools in each country. This will help to clarify the following issue: if there are differences in behavior across countries, are these due to overall country differences or subject pools' differences? In addition, a novel feature of our experiments is the endogeneity of the choice of income. This makes it possible for individuals to distinguish between a registered and an unregistered income, which in turn is expected to affect their decision to comply –or not comply- with taxes. Finally, this chapter provides an answer to another important research question of this thesis: Are there any country differences, and if so, what are they attributable to?

Chapters 5 and 6 present the second empirical approach of this thesis. More specifically, chapter 5 describes the methodology of the field survey of households in Tirana, the capital of Albania. This chapter discusses the selection of this method used –a combination of written questionnaires and personal contacts- in comparison with some other survey methods. In addition, it describes in detail some important elements of the survey, like the main characteristics of the sampling population, the sample size and the method that determined it, the set-up of the questionnaire and the pilot work. Finally, the validity and reliability of the measurement procedures and the representativeness of the results of the survey are assessed.

Chapter 6 analyzes the data obtained in the field survey described in chapter 5. While chapter 4 analyzes experimental data, this chapter analyzes data from the field, attempting to

supplement the experimental evidence on the determinants of individuals' decisions about whether or not to evade taxes. The data cover information on evasion of personal and business taxes. This chapter constructs three major variables that represent evasion of three types of taxes. In addition, using factor analysis, it groups attitudinal statements raised in the questionnaire in order to get a grip on the impact of formal and informal institutions on the decision whether or not to comply with taxes. Several hypotheses are tested based on two main regression models that try to explain tax evasion with respect to the personal background information and the formal and informal institutions (attitudinal factors). Two main research questions are addressed. First, what are the determining factors in the decision to evade taxes? Second, how does personal background information affect formal and informal institutions, and how do the latter ones affect individuals' attitudes towards taxes?

Chapter 7 closes with a summary of the main findings and conclusions of this thesis, and attempts to link the experimental and survey results.

