

Tax evasion and Public Choice

In Gërxhani, K. and R. Wintrobe (forthcoming), 'Understanding Tax Evasion: Combining the Public Choice and New Institutional Perspectives.' *Handbook of Comparative Economics*, edited by Elodie Douarin and Oleh Havrylyshyn, we argue that the standard economic theory of tax evasion, which focuses on penalties and deterrence, cannot adequately explain why most people in advanced countries like Canada or the United States pay their taxes, and it cannot explain differences in tax evasion across countries. The recent literature on "tax morale" and "conditional cooperation" provides an important step forward. We add to this literature by focusing on the idea that citizens see their taxes as a payment for government services or "political exchange" (public choice). We complement the public choice theory by incorporating insights from new institutionalism and the tax morale literature. We add to that literature by providing a precise definition of trust and we show the relation between concepts like trust, social capital, solidarity, reputation, and so forth. By focusing on "trust-based political exchange" we argue that tax evasion is related to the degree to which citizens trust the government to be honest and to provide services promised, and the degree to which they believe their fellow citizens pay their taxes. This is tested using two hypotheses, relating individual tax evasion to the extent to which citizens support the government and believe it is not corrupt, and to which they believe others are paying taxes, respectively. The empirical data support the theoretical hypotheses.

Tax Evasion and well-being across countries

In Ferrer-i-Carbonell, A. and K. Gërxhani (2016), 'Tax Evasion and Well-being: A Study of the Social and Institutional Context in Central and Eastern Europe.' *European Journal of Political Economy* 45: 149-159, we examine the relationship between tax evasion and individuals' well-being by using a subjective question on life satisfaction in fourteen Central and Eastern European countries. The paper focuses on the role of institutions and social capital in molding this relationship. The results indicate that evading taxes is negatively associated with individuals' life satisfaction. This negative relationship seems to be shaped by a positive perception of formal tax-related institutions and a high level of formal social capital. A similar analysis run for two generational groups, distinguished in terms of whether having had working experience during communism, yields further interesting results: while associational engagement (i.e. formal social capital) has a crucial role to the younger generation in the way they experience the relationship between evading tax and how satisfied they are with their life, for the older generation it is their social networks (i.e. informal social capital) that shape this relationship.

Informal sector and education

In Gërxhani, K. and H. van de Werfhorst (2013), 'The Effect of Education on Informal Sector Participation in a Post-communist Country.' *European Sociological Review* 29(3): 464-476, we examine participation in the informal economy in Albania, a post-communist country in transition. In particular, this study focuses on the effect of education while considering other individual, social, and institutional factors. Two

factors that can be central in the educational effect on informal sector participation are considered. The human capital factor, referring to the income-related returns of education, may lead to less participation due to lower financial incentives to do so. The other factor, referring more to the role of education in forming moral attitudes and values, may also lead to less participation but primarily through broad and civic norms affected by education. Using survey data, we find a strong negative relationship between education and informal sector participation. The role of education in shaping broad civic attitudes explains relatively more of this relationship than the human capital factor. Importantly, the effect of education is independent of income, which suggests that education shapes moral values independent of whether these values are developed to legitimize one's advantaged position in society. These findings provide a somewhat optimistic view of how to deal with the social inequality caused by participation in the informal sector.

Tax Evasion and well-being

In Ferrer-i-Carbonell, A. and K. Gërkhani (2011), 'Financial Satisfaction and (In)formal Sector in a Transition Country.' *Social Indicators Research* 102(2): 315-331, we examine the relationship between working in the formal or informal sector and self-reported individual financial satisfaction in a country in transition. This is done by allowing for individual heterogeneity in terms of perceived financial insecurity and tax morale. The empirical analysis uses a dataset for Albania, a country in transition. The method applied is the 'self-administered questionnaire', which combines personal contacts with written questionnaire. The results indicate that, for most individuals, working in the informal sector has negative effects on their self-reported financial satisfaction. For some individuals, however, this effect is positive. The characteristic defining these two groups of individuals is their attitude towards the perceived financial insecurity related to not paying taxes. These findings have important implications, in particular for transition countries with large informal sectors. Given the involuntary participation in the informal sector in these countries, the majority of individuals working in this sector will remain financially dissatisfied as long as they have no other social safety net.

Clientelism

In Gërkhani, K. and A. Schram (2009), 'Clientelism and Polarized Voting: Empirical Evidence.' *Public Choice* 141(3): 305-317, we argue that one must take country-specific institutional features into account when analyzing former communist countries' transformation process to new political institutions. We do so for post-communist Albania, where the regional and cultural polarization that has existed for centuries has evolved to clientelism in the new democracy. We show how clientelistic parties give rise to very particular voting patterns. These reveal major differences across regions not only in party choice but also in voters' responses to government policies. These responses depend on the party in government and on the region concerned. This is in sharp contrast with results obtained when applying the same model to a large number of more advanced democracies with similar electoral institutions. A proper evaluation of democratization in Albania thus requires looking beyond the formal institutions governing elections and taking clientelism and its effect on voter behavior into account.

Social capital

In Fidrmuc, J. and K. Gërzhani (2008), 'Mind the Gap: Social capital, East and West!' *Journal of Comparative Economics* 36: 264-286, we argue that social capital in Central and Eastern Europe lags behind that in Western European countries. We analyze the determinants of individual stock of social capital – measured by civic participation and access to social networks – and find that this gap persists when we account for individual characteristics and endowments of respondents. However, the gap disappears completely after we include aggregate measures of economic development and quality of institutions. Informal institutions such as the prevalence of corruption in post-communist countries appear particularly important. With the enlargement of the European Union, the gap in social capital should gradually disappear as the new member states catch up (economically and institutionally) with the old ones.

Gender and tax evasion

In Gërzhani, K. (2007), 'Explaining Gender Differences in Tax Evasion: The Case of Tirana, Albania.' *Feminist Economics* 13(2): 119-155, I argue that recently, a considerable amount of research has focused on the evidence of gender differences in corruption. Research conducted on another predatory activity, tax evasion, similarly shows strong differences between women's and men's behaviors. This paper tests this finding in a transition country using a unique data set collected from a field survey of households in Tirana, Albania in 2000. Acknowledging that scholars generally explain gender differences in economic behavior either as biological or by social/psychological role theory, this paper examines a broader range of explanations for gender differences in tax evasion. Taking new institutional theory as a starting point to explain the differences in men's and women's tax behaviors, this paper discusses the relative importance of education, income, age, and number of children, among other factors. Finally, it explores the explanations provided by feminist theory and to what extent these can be integrated into the new institutional theoretical framework.

Tax evasion surveys

In Gërzhani, K. (2007), "'Did you pay your taxes?' How (Not) to Conduct Tax Evasion Surveys in Transition Countries.' *Social Indicators Research* 80(3): 555-581, I argue that gathering large-scale data on tax evasion is an undisputable challenge in and of itself. Doing so in a country in transition from a communist to a democratic system is even more difficult. This paper discusses the challenges and presents a case study to show how they can be dealt with effectively. One important implication of the paper is that such a sample survey can be successful if it combines a careful sample design, research method and questionnaire design, and explicitly takes country-specific institutional and cultural features into account.

Tax evasion across countries

In Gërzhani, K. and A. Schram (2006), 'Tax Evasion and Income Source: A Comparative Experimental Study.' *Journal of Economic Psychology* 27(3): 402-422, we

compare tax evasive behavior in a country in transition from communism to that in a developed economy by running an experiment across distinct social groups in Albania and the Netherlands. Aside from the tax compliance decision, subjects choose a source of income, where one type enables subsequent tax evasion. We show that they take the possibility of evasion into account when deciding on the income source. This yields potential allocative inefficiency in the labor market. In addition, Dutch subjects evade more than the Albanians. We argue that the different levels of tax evasion outside of the laboratory in the two types of countries can be attributed to distinct formal tax institutions.

Informal sector and institutions

In Gërxhani, K. (2006). 'Politico - Economic Institutions and the Informal Sector in Albania, Chapter 6, pp. 81-95.' In Bezemer, D.J. (ed.) *On Eagle's Wings. Ten Years of Market Reform in Albania*, New York: NovaScience Publishers, I study the role of the informal sector in transition from a centrally planned economy to a market economy and the importance of institutions in the evolution of the informal sector. The Albanian case is used to demonstrate some of the characteristics of this transition.

Tax evasion and institutional clash

In Gërxhani, K. (2004), 'Tax Evasion in Transition: Outcome of an Institutional Clash? Testing Feige's Conjecture in Albania.' *European Economic Review* 48(4): 729-745, I provide an institutional analysis of tax evasion in transition countries. I do so based on a unique field survey of households that was conducted in Tirana, Albania in 2000. A response rate of 89.3% yielded 1.340 valid questionnaires, allowing me to test conjecture that more tax evasion will be observed, when formal and informal institutions clash. Respondents' attitudes towards formal and informal institutions were obtained by applying factor analysis to their responses to a series of attitudinal questions. The theoretical importance of the interaction between formal and informal institutions in determining tax evasion finds empirical support in the data.

Informal sector in (less) developed countries

In Gërxhani, K. (2004), 'The Informal Sector in Developed and Less Developed Countries: A Literature Survey.' *Public Choice* 120(3-4): 267-300, I aim: (1) to provide a general overview of the contributions to the literature on the informal sector, with a special focus on the public choice approach; and (2) to compare these contributions across two institutionally different types of countries: developed and less developed (developing and transition) countries. The paper focuses on the criteria used to define the informal sector, the relationship between the formal and informal economy, tax evasion, and public choice analysis. It is stressed throughout this paper that the distinction between the two types of countries is of key importance.

Informal sector and tax evasion

In Gërxhani, K. (2002). *The Informal Sector in Transition: Tax Evasion in an Institutional Vacuum*, Ph.D. thesis, University of Amsterdam, Tinbergen Institute

Research Series, no. 265, Amsterdam: University of Amsterdam; published by thesis publishers, Amsterdam, I discuss the informal sector mainly focusing on the study of tax evasion. Individuals' decision whether or not to evade taxes is the core of the studies presented here. The role of institutions in this individual decision is considered to be of crucial importance. As a natural consequence, the research is predominantly micro-economic. Two empirical methods are used to study the compliance decision. The first is the experimental method and the second consists of a large field survey based on written questionnaires and personal contacts. Focusing on two cases, Albania (a country in transition) and the Netherlands (a developed country), an important outcome is that there are significant country and group differences with respect to tax compliance. This supports one of the main arguments in this thesis, which is that the informal sector in a developed country differs in many significant ways from the informal sector in a country in transition. The distinct relationship between formal and informal institutions is argued to be an important element in these country differences. Given that differences in institutions in Albania and the Netherlands are controlled for in the experiments and tax evasion outside of the laboratory is higher in Albania, this book provides evidence that the different levels of tax evasion in the two countries are not attributable to different tax norms and attitudes, but to different formal institutions (e.g., tax institutions) and their 'informal use' by individuals.

Clan culture

In Gërzhani, K. and A. Schram (2000), 'Albanian Political-Economics: Consequences of a Clan Culture.' *Journal for Institutional Innovation, Development and Transition* 4: 5-14, we study the politico-economic interaction in a country in transition from a communist regime to a democratic, free market system, to wit, Albania. It is argued that the politico-economic system there is characterized by the existence of clans. Both the communists and the first democratically chosen government applied policies that favored specific clans. Moreover, a popularity function estimation shows that voters related to different clans react in a distinct way to party policies.