

Ethnic divisions, trust, and the size of the informal sector

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Abstract

This paper investigates the relationship between ethnic fractionalization and the size of the informal, or hidden, economy. Recent experimental and empirical research links, in turn, ethnicity and trust, and trust and tax compliance. In addition, recent empirical studies have identified an unwillingness to contribute to public goods benefiting other ethnic groups. Combining these insights, we argue that increasing ethnic fractionalization decreases voluntary tax compliance, and we present empirical evidence at the macro level in a cross-section of more than 50 countries that more ethnically fractionalized societies have significantly larger informal sectors.

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1. Introduction

Tax compliance and administration are central issues in public finance. For developing economies, difficulties in tax collection remain a major obstacle for economic development. Tax evasion and large informal sectors can force governments and tax agencies to increase tax rates on activities less prone to evasion, resulting in increased distortions that can have adverse effects on investment and growth and, additionally, non-compliance can result in effective tax systems being less equitable than those legislated. These problems of non-compliance are present also in the developed world; for example, European countries are currently considering how to

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finance extensive welfare state programs in the face of adverse demographic changes, and the presence of large scale tax evasion will make this even harder.¹

This paper provides the first cross-country empirical investigation of two explanations for the size of the informal sector that have received much attention in the literature on tax compliance and administration, particularly regarding developing countries:² (i) the degree of voluntary tax compliance, and (ii) the size of the rural, or agricultural, economy. While the latter is straightforwardly tested using available data, I draw on recent experimental and empirical research in economics, political science and social psychology to formulate the hypothesis that the degree of voluntary tax compliance (and the size of the informal sector) depends on the degree of ethnic fractionalization in society: Ethnic fractionalization (i) decreases the level of trust, which decreases tax compliance, and (ii) increases the unwillingness to contribute to financing public goods to the extent that these (primarily) benefit other ethnic groups.

This approach might give some insight into why developing nations, some of which (especially in Africa) are characterized by a high degree of ethnic heterogeneity, have larger informal sectors. While ethnic heterogeneity could be one of many reasons many developing countries have problems securing (voluntary) support for taxation, it is also very relevant for the discussion concerning the financing of Europe's extensive welfare state programs, given that the historically very homogenous European countries are currently experiencing increasing ethnic heterogeneity due to immigration and, further, that an integrated European Union itself will be an area with a high degree of ethnic, linguistic and religious fractionalization.

While there is by now a substantial theoretical literature on tax compliance and the size of the informal sector, comparative empirical evidence (for obvious reasons) is more scarce. In the first cross-country study of the informal sector, [Friedman et al. \(2000\)](#) find that the size of the informal sector increases in the level of corruption, measured in a variety of ways. They do not, however, consider the effect of societal heterogeneity on the informal sector and generally control only for two explanatory variables at a time.

A small, recent group of papers address issues related to the analysis presented here. [Slemrod \(1998, 2003\)](#) suggests, without testing it empirically, that voluntary tax compliance is linked to social capital and trust.³ [Scholz and Lubell \(1998b\)](#) find, linking survey data on attitudes with micro data on tax compliance for the U.S., that trust in others increases tax compliance. [La Porta et al. \(1997\)](#) consider trust in large organizations, instrumenting a survey measure of tax compliance as a proxy for trust by the degree of ethnolinguistic fractionalization, without discussing their finding.⁴

This paper provides a framework for why ethnic fractionalization, through trust, matters for tax compliance. The resulting hypothesis is tested using as the dependent variable actual estimates of the size of the informal sector, rather than the qualitative survey measure employed by [La Porta et al. \(1997\)](#). Finally, the empirical analysis employs a wider set of control variables in a larger sample.

¹ See [Slemrod and Yitzhaki \(2002\)](#) for a thorough discussion of the importance of tax administration issues for tax policy.

² See, for example, [Goode \(1952\)](#) and [Kaldor \(1963\)](#); [Burgess and Stern \(1993\)](#) provide a recent overview.

³ Social capital, like trust, is influenced by ethnic heterogeneity; see [Knack and Keefer \(1997\)](#) and [Alesina and La Ferrara \(2000\)](#). Cross-country measures of trust have been carried out in the *World Value Surveys*, but these so far cover only a limited number of countries.

⁴ The survey measure is from the World Competitiveness Yearbook and asks a group of respondents to rate qualitatively the severity of tax evasion in their country.

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