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Labor market institutions, taxation and the underground economy

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Abstract

The paper aims at qualifying the links between labor market institutions, taxation, tax monitoring, and underground economic activity. The proposed model is a continuous time matching model with one commodity roduced either overground or underground. Underground economic activity arises because of partial compliance with regulations and tax contributions imposed by the government. Vacancies and workers search are directed at a specific labor market. Workers are heterogenous in the subjective cost they face when operating in the irregular sector. Analytical and numerical investigations suggest that interactions between regular and irregular activities can affect standard results of policy interventions. In that respect, the paper supports the view that policies aiming at increasing individuals benefits of participating in the regular sector are more desirable than a deterrence policy.

1. Introduction

Underground economic activity is a feature shared by all OECD countries.[1] However, the debate about accurate estimation procedures and definitions is still quite open.[2] The underground sector can include both legal and illegal, and both paid and unpaid activities.[3]

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[1] See Schneider and Enste (2000) for an extensive review of existing estimates.

[2] See for instance the contributions of Tanzi (1999), Thomas (1999) and Feinstein (1999) in a special feature of the *Economic Journal*.

[3] See for instance Thomas (1992) for a detailed description and an exhaustive listing of currently used definitions.

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In this paper, the underground sector is assumed to cover only legal production. In addition, tax evasion and non-compliance with economic legislation are assumed to be the main primary activities involved in it.[4] Henceforth, the underground sector is called the informal or irregular sector interchangeably.

The issue of irregular economic activity has gained a constantly increasing share of attention within public policy communities.[5] Their major concern has been to qualify the underground economy phenomenon in order to determine possible policy interventions able to curb it.[6] The reduction of informal activities is usually motivated by budgetary considerations. However, it is also recognized that the existence of an underground economy is likely to affect economic policies outcomes as it makes official indicators unreliable.[7]

This paper develops a theoretical model that allows to assess the influence of various economic institutions upon the size of the irregular sector, while taking interactions between the regular and the irregular sectors into account. The framework also contributes towards the definition of policy interventions able to reduce participation in the irregular sector while controlling for aggregate efficiency and employment.

Two types of economic institutions are considered in this paper: fiscal and labor market institutions.

The link between informality and fiscal institutions usually refers to tax evasion. A vast literature on the issue has developed since the seminal paper of Allingman and Sandmo (1972).[8] The problem, seen from the taxpayer's point of view, has been mostly treated by applying portfolio theory of choice under risk.[9] Other theoretical contributions adopt the view that opportunities for evasion differ among occupations,[10] and that these differences may affect agent's labor supply decisions.[11] The relation between tax rates and tax evasion appears to rely very much on the assumption made about individuals attitude vis-à-vis risk bearing.[12] Another major attempt of this strand of the literature has been to identify an optimal design of fiscal policy in terms of either tax revenues or social welfare. As far as tax proceeds are concerned, theoretical investigations have concentrated on the determination of the most effective policy instrument in containing income underreport. On the one hand, the imposition of relatively high penalty rates (or equivalent tax adjustments) is thought to be more desirable than that of relatively high enforcement effort. The

[4] We discuss further in the paper the possibility to relax this assumption in order to include tax avoidance activities like do-it-yourself work and neighbor help.

[5] For instance, since 1990, the European Commission has funded various studies dealing with the issue. See Barthelemy et al. (1990) and Deloitte and Touche (1997).

[6] See European Commission (1998).

[7] See for instance Schneider (2001) and Schneider and Enste (2000).

[8] See Andreoni et al. (1998) for an extensive survey.

[9] See Cowell (1990) for a detailed survey of this literature.

[10] An early example of a two-sector model of tax evasion is that analyzed by Watson (1985).

[11] See, for example, Pestieau and Possen (1992).

[12] For instance, Jung et al. (1994) show that tax rates and tax evasion are positively related to each other only if individuals preferences exhibit increasing relative risk aversion.