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Tax evasion in transition: Outcome of an institutional clash? Testing Feige's conjecture in Albania[☆]

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Abstract

A field survey of households was conducted in Tirana, Albania in 2000. A response rate of 89.3% yielded 1.340 valid questionnaires, allowing me to test Feige's (In: Nelson, J.M., Tilley, C., Walker, L. (Eds.), *Transforming Post-communist Political Economics*. National Academy Press, Washington, DC, p. 21) 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.

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1. Introduction

Studies in developed and developing countries have shown that the underground economy has a significant impact on the economy as a whole (Loyaza, 1996; Bhattacharyya, 1999; Giles, 1999a; Tanzi, 1999; Schneider and Enste, 2003). Nevertheless, this phenomenon was neglected in previously socialist countries, in the first years of transition. There has been some discussion about whether this neglect was due to a perceived unimportance of the underground economy or it was conveniently

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disregarded by governments due to its tremendous effect as an absorber of poverty and social chaos (Kesner-Skreb, 1997). However this may be, a recent rise in the interest of researchers and policy makers is noticeable.

This paper represents a demonstration of this growing interest. Its main goal is to provide an institutional analysis of tax evasion in transition countries. Based on a unique data set collected in Albania, the paper tests Feige's conjecture, that a clash between formal and informal institutions is a major cause for the rise and persistence of underground economies (Feige, 1997). The results support this hypothesis.

Three choices underlie this goal and the empirical test chosen. In the following, I will briefly motivate these choices by discussing: (1) why the focus is on tax evasion; (2) why transition countries in general and Albania in particular are interesting for this study; and (3) how institutional economics can increase our understanding of the underground economy.

The underground economy has many aspects, including tax evasion, unregistered labor, and illegal activities, for example. This makes it impossible to analyze all aspects in one study. This paper focuses on tax evasion for obvious macro-economic reasons: There is a direct link between tax compliance on the one hand and budget deficits and investments in public goods on the other. In other words, effective tax collection is a precondition for collective good provision and economic growth,¹ which may be especially important in transition countries. Moreover, a study of tax evasion allows one to study the decision-making process with respect to underground activities at the individual level. It also gives an indirect indication of individuals' involvement in the unregistered labor market. Finally, "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, p. 25).

As reported in Schneider and Enste (2003), the magnitude of the underground economy in transition countries is significantly larger than in developed countries (on average 20% and 12%, respectively). This is one reason why I focus on a transition economy. Another is related to the scarcity of empirical research on underground activities in transition countries compared to developed countries (Gërxxhani, 2003). Although this literature has been growing in the last decade, it is mainly based on macro-economic data. Using electric consumption methods, for example, Kaufmann and Kaliberda (1996), Lacko (1996) and Eilat and Zinnes (2002) estimate the underground economy in transition countries. Even though these studies have increased our knowledge of the level of underground activities in transition countries, one should recognize the importance of (empirical) micro-economic research for an understanding of the reasons why these activities are undertaken. "... surveys can provide detailed information about the structure of the shadow economy" (Schneider and Enste, 2003, p. 15). This paper recognizes this gap in the existing literature and provides such a micro-economic study.

A specific country in transition is chosen for this study, to wit, Albania. Albania is an interesting country to study in this respect. It is the last country in Eastern Europe

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