

***Filling Institutional Voids: Market Self Organisation,
Informal Sector or Organised Crime***

A CRCE Colloquium

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The Informal Economy

Chairman: Philip Hanson

Discussion Leaders: Arnis Sauka –

The Recent Shadow Economy Index for the Baltic countries

Tomasz Mickiewicz –

To Pay or not To Pay: Which Business People Want to Pay Taxes in Latvia?

Session 1 (PowerPoint presentation)

Arnis Sauka: When I present this paper to PhD students, I generally demonstrate this as a country example of a multi-dimensional approach. My major is in entrepreneurship, and frankly speaking I do not know much about macro methods, about economics, statistics, econometrics and so forth. I am much more engaged in qualitative research, whereas Tomasz Mickiewicz's background is finance. We both attempted to measure the shadow economy using our own methods, but neither of us succeeded. Somehow we met and began to talk, and this was probably the reason that this presentation became possible. The Shadow Economy Index draws on a survey of entrepreneurs; and this is my part of the job. I could design the questionnaire for my range of entrepreneurs and I collect the data. Whereas Tomasz could bring this to the macro level with this data. He admitted that he never actually trusted or did data collection in this way; he always used statistical data and other data sources. But he was able to bring this to the GDP level, because we measured the shadow economy as a share of GDP. So as you can see, a multi-dimensional approach is sometimes helpful.

These are the two aims: to measure the shadow economy in Latvia, Lithuania and Estonia, and to explore the main reasons and inflation factors behind such activity – why entrepreneurs in these three countries are involved in the shadow economy. The definition of the shadow economy that we use is in line with the OECD, the World Bank and Professor Schneider in his study. We do not deal with the black economy – such as drug dealing, prostitution and so on – for the reason that exploring the black economy requires different methods, and is more the work of police than researchers.

Briefly I used three key methods to measure the shadow economy. Micro methods: these are different indicators and then we have this mimic that presents a latent variable method, as used by Professor Schneider; and the third is the use of direct methods. All, of course, have their shortcomings, and if somebody says that his is the best and we can measure the shadow economy 100% accurately, then I think that person is lying. Clearly, (this is emphasised by the OECD), the first two methods – the micro method and mimic – have three key shortcomings. The main shortcoming is that they draw on very simplified assumptions, and because of this their conclusions are not considered completely stable. Just to give an example, we talked to Professor Schneider when he was in Riga, and they realized that one assumption was slightly wrong, so they changed it and the Latvian shadow economy decreased by 8% of GDP. That's a lot of money – so imagine if other assumptions were wrong too. It's a tricky thing. What is good about those methods though is that they can be cheaply implemented, and you can cover the whole world.

In implementing the shadow index Tomasz and I used a direct approach, and it does require fewer assumptions, which is trickier I believe. We argued that entrepreneurs know, and are willing to share, how much of the shadow economy there is in economics. I will explain how we control for these answers.

We conduct surveys, and have done so since 2010. Each year we ask about the level of the shadow economy and the reasons for being involved in the shadow economy over the two previous years. We use a random sample and panel data, which means that overall we interview 1500 entrepreneurs every year, but if some is missing then we would add other entrepreneurs to the sample. Since this is a very sensitive topic, we try to use various methods to get as accurate data as possible. First, we phrase the important questions indirectly and we ask whether such companies as yours or those in the industry are involved in the shadow economy, and we ask how much. The reason that we can presume entrepreneurs are talking about their own company and not the industry, is from my PhD dissertation. I did a survey of one hundred and thirty three interviews with managers in Latvia, when conducting my PhD thesis in 2005. I was not sure then that I could call people and ask about their involvement in the shadow economy. So I undertook exhaustive data collection and interviewed these people face-to-face. Imagine having one hundred and thirty three face-to-face interviews, some lasting four hour. There were two that lasted for six hours, and afterwards I actually got job offers! In six hours, three hours were spent discussing other subjects to gain trust. We talked about the shadow economy for one hour, and for the rest of the time we discussed the job offer. One thing that I learnt from these interviews was that although I was equipped with all the possible papers, I was only doing research. Of course I was also very young, and maybe that was why people trusted me. I did not look like someone from the revenue service or the police, who could use the data against them. I made sure that I had all the papers from my university and so on, thus demonstrating that I was really conducting research and was a genuine PhD student, and that the data would be anonymous and so on. Only one person asked for my business card, which I did not possess, so I showed a letter instead. They could really talk about the shadow economy. I realized that this was because it is tolerated as normal behaviour, so it is easy to discuss on the telephone in the Baltic countries. I am not sure whether this would work in Sweden, Finland, Germany or the U.K. In Latvia it worked, as demonstrated by this survey.

I repeated the survey in 2006 for some extra data for my PhD. I reminded these entrepreneurs at the end of the interview, that the year before they had said for various reasons that they were underreporting the salary by twenty-five percent for instance. I said “*you*” are underreporting, not “companies such as yours” or “firms in your industry”. I asked whether this had changed, increased or decreased. I realized that they were actually talking about their companies not the industry as such, because they know their own companies the best. We also used overlapping years, so if answers seemed incorrect or inconsistent then we do not use them for data analysis. If somebody said that underreporting in each category is zero, then we look at some controls to see how this correlates; to see how entrepreneurs tolerate or do not tolerate misreporting in other controls. If this seems to be wrong then we again exclude it. So as far as possible, we try to allow for these misleading answers.

Unregistered business income, hidden employees and unregistered wages are the main estimates that we combine in order to derive this shadow economy index as a proportion of GDP. We also thought that it was instinctive to look at the level of bribery, including the bribery of government officials. This is of more interest for a policy-level discussion than for research.

The conclusions are as follows: the shadow economy as a percentage of GDP in Latvia was almost double the amount than in Lithuania and Estonia in 2009 and 2010, but this has decreased substantially. It is difficult to explain why, but we have drawn two explanations. One is that Latvia was kicked the hardest by economic crisis as it was indeed. We know that the macroeconomic condition in the country was very bad in 2009 and 2010, and when the economy recovers, of course the shadow economy returns to normal. Another thing was that many policy incentives were introduced in 2010 in order to tackle the shadow economy. I myself was a consultant to one of the groups headed by the Ministry of Finance, and they really worked hard on the main components, the main drivers of the shadow economy. So this could be another reason. But all in all not only do we see a decrease of the shadow economy in Latvia but also in the other Baltic countries. It shows the macro conditions, but it also shows that the dynamics – if not the amounts – are similar to what Professor Schneider observes. So this gives us some more confidence in our results.

These are the components of the shadow economy in each of the Baltic countries. So you can see that unregistered wages and unreported business income form the biggest share of the shadow economy in Latvia, whereas if I were a policymaker in Estonia I would do everything I could to fight the issue, because this is a clear way to decrease the shadow economy there. To conclude, you can see here that the level of unreported income – these are profits, the level of unreported profits – is something which drives the decrease of the shadow economy. In Latvia, we can also see some decrease in the level of unreported employees, although not a very significant one. We can also see that the level of unreported salaries is still a big problem in our three countries. Perhaps it is due to this research, which is the “top news” every May when presented to journalists or perhaps for other reasons, policymakers today are very keen to tackle this underreporting of salaries.

Tomasz Mickiewicz: I want to say is an extension of what Arnis has said. Arnis was in London a while ago when we met and started to work together. Where my talk takes off is from a question that Arnis asked at some point during the presentation: what is behind these attitudes?

What makes businessmen and businesswomen in Latvia disinclined to pay taxes? This is our question. Why is this an important question? There are a few reasons why. One is that this means there is some entrepreneurial effort allocated to unproductive activities. If you are not paying taxes, then you are investing some effort to conceal it. That is an unproductive effort. Another reason is the erosion of the tax base. The transaction costs would be much lower if you have lower taxes than if you have higher taxes and some of these are not collected. A significant case is Greece. We found that Greece had exactly the worst scenario – where you have a government trying to collect a lot of taxes but not being able to. You have a dual business sector where you have legitimate taxes competing with businesses that do not pay taxes. If you look at this question from the point of view of economic efficiency, then this is obviously an extremely inefficient system, because instead of a level playing field, you have serious distortions to competition. So basically you create a vicious circle. I will elaborate later on this point, but basically you have a government that is not collecting revenue. It assumes that it should have more revenue, so it increases taxes and then there is more avoidance and even more distortion – and that can become quite dysfunctional. Unless you are on the other side – by which I mean that most of your economy is in the shadow economy – then you may be fine.

So what are the individual and corporate level incentives to avoid taxes? In this paper we did not measure this directly, but we focused instead on tax morals. By this we mean attitudes – we wanted to understand attitudes because they drive behaviour and also because they are easier to establish. Again, if you have time like Arnis you can talk to entrepreneurs and if you can get their trust you can get more from it, but in these short surveys it was not really possible to reach this level of understanding. So by the term ‘tax moral’ I intend to represent the sense of a moral obligation to pay taxes. In other words it is an ethical belief about tax evasion – what kind of ethical significance we attach to people who pay taxes. The measure is not our measure, but is a strong one because it is standardised. It is taken from a World Bank survey, and our question is “is it justifiable to cheat on tax if one has an opportunity?” Then you have a scale from “always” to “never”. So this is the World Bank measure that we adopted. The model we used, I am sorry to say, is not simplistic. Because what we found is basically that there is a combination of standard rational choice economics reasoning and sociological reasoning. We found it difficult to reduce the explanation to one discipline or one class of disciplines. The standard rational choice reasoning basically relates to belief about punishment, again there is some small print here to which I will return. But the two key issues are likelihood of being caught, and severity of punishment, and then you weigh the two and you get the expected cost of not paying taxes. Now the sociological branch is basically what other people are doing around you. You are influenced by other people, so do you have other people around you who are doing it or not. But also – and I think this is interesting because we can also see it in the prevalence of organized crime – it links a lot to what your beliefs are about government. Do you have trust in government? Do you have trust that your government is spending the money well? Do you have trust in your tax authority being fair? And these are strong drivers, as you will see, of tax attitudes.

There is also another dimension to this; and that is how well you identify with your community. This basically means how much you care about your community; because paying taxes is ultimately an act of solidarity with your community. This degree of identification or alienation is another important factor in this. There are some standard controls, but I am not going to talk

about that – although I can provide the references. We have not submitted the paper yet, so we are happy to have criticism and comments.

We used two hundred and seventy-nine owners or managers of companies; they were fairly small companies but there was a whole range. The table that I have included on the slide does not represent a large sample, but what you can see from it is that trust in government is a very significant factor. If you want an illustration, the best example comes from one of the interviews that Arnis did with the entrepreneurs. One told Arnis that he had a female employee who was not reported as employed, and therefore he did not pay any social security for her. He also told Arnis that he did not believe that the government would do a good job of spending this social security anyway. This employee was about to have a baby, and he was going to pay her private benefits for one year, because he wanted her back, and he believed that he will do a better job than the state would. I do not approve or disapprove of this behaviour, but reporting what is behind this question: whether you trust that your government will spend the money well.

Now what is the implication of this? The implication is that the tax payment is not simply a case of maximising the technique of catching the people that evade it. This works to some extent, but it is far more complex. It links a lot to the question of legitimacy on various dimensions. If you have a government that comes across as spending them well, people are more likely to pay taxes; if you do not, the reverse is true. Again, the perceived fairness of the tax administration also plays a role. On the subject of community belonging – if you have an ethnic group that does not fully identify with your country then there is a likelihood that they would be less inclined to pay. There could be an issue of ethnic Russians versus ethnic Latvians in Latvia but I do not think that we actually found anything significant from an ethnic perspective in our study, as long as we controlled for other factors. Now the economic story – I stress the sociology mostly because I am not a sociologist – the economic rational choice story is there as well, but there is an interesting twist. What really matters is not how likely you are to be caught, but how severe the punishment is. So it is a kind of indication that the Anglo-Saxon model – effectively that you do not control people much, but when they are caught they are really punished – is more functional. The reason behind this is simple: that there is a standard framework of risk avoidance. It is not an expectation value that bothers me, it is the distribution of outcomes, how strongly I would be hit. And this came out clearly in our results. This may not be that exciting, but I do not think that people have thought that clearly about it in this context.

There are five conclusions. The first is that the shadow economy is detrimental to entrepreneurship, for reasons that I have tried to highlight at the very beginning. This is why trying to identify the factors that raise tax morality is critical. Again, you should ask the question not in the context of the general population but in the context of businesses, because this is what is relevant here. This is where the focus on entrepreneurs comes from, and what became clear during our research is that we could not explain it using just one perspective. You really need a multidisciplinary perspective, because there are norms and values that go beyond rational choice. Further, institutional trust is critical. The sense of belonging to the polity is critical, and then again poor and corrupt administration may contribute to a vicious circle of noncompliance. So you have contagion effects. When there are more people around you, there is a tipping point; and the competitive aspect works there too – if enough people around you cheat on taxes you are either out of business or you also cheat. There is no third way. And then – and this is the

sociological aspect – once you have this situation for a long time, the behaviour becomes embedded and this enables you to talk openly to an interviewer, because this is a social norm. It becomes embedded, and then it becomes difficult to change even if you change the policy parameters.

There is a chance that we have exaggerated this a little bit. It is an open question just how much inertia we have when it comes to social attitudes and norms at this level. The numbers that Arnis has on his slide show that within a couple of years of crisis there was a significant change. In my opinion therefore the jury is still out. It is difficult to quantify the real weighting of rational choice incentives and social norms. I think they are both there, but it is difficult to say the extent to which they matter.

Silvana Malle: I have two points. The assumption in both papers and generally in this matter is that paying tax is good or that it is moral. There is a vast literature on this, but since Tomasz, you raise this issue in your conclusion, that in this time of crisis, attitudes can change. In my experience it is not only in times of crisis that attitudes can change. What I have noticed myself, not going through the literature but going through the press and government – announcements, promises, threats and so on – is that tax needs to increase and people need to pay. An organization to which I belonged – the OECD – is really becoming threatening on tax. So I think that there is a problem in this (whether you want to discuss it here or not). Is the attitude towards tax legitimate?

Many people analyse and discuss this issue, and the difficulty here is that if you want to have a state you need to pay tax. If the question goes beyond that, if the state no longer provides securities and defences, then it becomes all sorts of things. It becomes a sort of saving, also for criminal banks or very often friends of politicians. When do states become that, why should I pay for that? So the whole attitude towards paying taxes depends very often on what the state of governance is becoming. The second point is about this community feeling; the feeling of belonging to a community, which I found very interesting. Apart from there being problems in identifying this feeling of belonging to a community, I can gather something there: if this community is small, than if it is ‘the state.’ I was wondering whether you were going to work on that, because I think that it would be extremely interesting.

Krassen Stanchev: Some colleagues in Bulgaria who are studying democracy are bringing the shadow economy into our purviews. And in my work with them I started using contact-intensive measures, and this methodology is a significant correction. Of course Professor Schneider’s statistical methods are also a significant correction.

Bulgaria did this exercise I think around 1999 or 2000, and the average result for those years was that it would be thirty or fifty percent cheaper to operate in the shadow economy. So if you have for example a tradition in which the in-family redistribution is roughly twenty percent of the income of the family, and you have the government collecting twenty percent tax revenue, plus twenty plus percent social security taxes, then at some point you are forced to decide whether you support your family, your parents, your kids, *or* if you will give money to the government. So my question here would be what is moral? If the collective setting of tax revenues is moral then that is okay, but if we take it to the individual level then we could be of

the opinion that we have to support our parents and our kids, and not so much the government or people that we do not know.

My last point is about the efficiency of the government. You have government expenditure statistics, you have government debt statistics, and it is very clear when you observe the government's behaviour, and if you link it to tax compliance behaviour, you will see what is the objective situation.

Matej Kovac: I have two questions. There is a significant proportion of the shadow economy related to wages – not all work is being declared and so on. My feeling is that this percentage is higher in the Baltic States than in our country, despite the fact that we have much higher and more progressive taxes. The other dissimilarity is that we have to look at the sample. I presented more than a hundred and fifty interviews, and I asked people what offers they received from other potential employers, and I found out that actually the crisis in Croatia did not affect, it did not decrease, the amount of offers. This was the case in 2010, in 2009, when I first interviewed people, and also this year. In 2009, as you know, very few candidates for jobs had offers from other employers.

Another issue that arose from Tomasz's talk is that I read somewhere – on the topic of crime or capital punishment or some such thing – that the severity of punishment is not such a strong deterrent as the likelihood of being caught. Here you showed us the opposite.

Arnis Sauka: I completely agree that before you do anything with the tax system or with punishment or whatever, the government does need to understand the reasons why entrepreneurs are actually evading taxes. I did not have time to say that we also directly asked for the opinions of entrepreneurs. We asked them to tell us why entrepreneurs in Latvia, Lithuania and Estonia are evading taxes. We received lot of interesting information from this exercise, and two things are particularly worth mentioning. The first is that it was not the size or the amount that people objected to, but you can ask any entrepreneur in any country almost, and nobody likes taxes – that is why we call them taxes. But in the Baltic countries – especially in Latvia, particularly when the shadow economy was very high – entrepreneurs really hated inconsistency in tax policies. An entrepreneur friend of mine, when asked to explain this, told me 'are you kidding, I could tell you what is going on in my company'. He is a manufacturer with a big rubber factory, and he said because of this inconsistency in tax policy he does not invest in his manufacturing premise unless he knows that the investment will give a return in six months. So what can you invest in that will pay off in six months? He does this because he does not trust that the rules will be the same six months later; and if you invest one million, two million, five million euros, and then the rules or the taxes change by three or five percent, that is a lot.

Secondly, we were also a bit provocative. We asked whether it is important to have highly competitive, innovative and value-added products and processes in order to be competitive in the market, or whether you could be more competitive simply by evading taxes. And guess what? In Latvia people were more inclined to say that actually we can be more competitive simply by evading taxes – we do not need to make more innovative products. We can reduce our costs by not paying taxes. My brother has a car rental company, and he says that they do all the transactions without considering value-added tax. This is how the business is built. If somebody

unexpectedly wants the receipt – which happens – then the prices are different, which is worth mentioning.

On the second question – I do not know what the contacting method is unfortunately. But I would be very happy to see this survey of entrepreneurs of the shadow economy in Bulgaria. I would be very happy to see it because I have not come across it before. When it comes to [Balmo – some academic], actually [Balmo] advocates that there are benefits to tax evasion as well. I know this for sure because whilst I was doing my doctoral thesis on productive, unproductive and destructive entrepreneurship I actually drew a lot on his concepts. Most other authors advocate that nothing is black and white when it comes to evading taxes. I argued this in my dissertation. When we are talking about what is “unproductive,” we are not talking about tax evasion. “Unproductive” is output. And if I had a board here I could draw a table of metrics introduced by [Wickland] and [Davidson]. They looked at the behaviour and performance of different types of newly-established companies in Sweden. In that study they graded venture-level benefits and society-level benefits, as well as short-term benefits and long-term benefits. And there were some rubber companies – what they called rubber companies – who were not beneficial at the society level, and they did not even earn profits so it was even minus at the social and venture level, as well as in terms of short-term and long-term benefits. So obviously according to [Balmo] these could be unproductive entrepreneurs. But then there were also plus-plus; those whom create profits but also contribute to society at the venture level. So these would be productive entrepreneurs. But then according to [Wickland] and [Davidson] there are many entrepreneurs that create venture-level profits but are not beneficial to society; and in fact in some cases those that do not profit but in fact create some spillovers in society. So the discussion is not so straightforward.

About this comparability perspective I completely agree. I was actually about to launch a bigger topic – I discussed it in the European Council of Small Businesses and Entrepreneurship. If it had not been for this invitation to become the Vice Rector of Research then I would have already launched this project. We were thinking about complementing this method – or maybe some other techniques to collect data in other countries – with case studies and also with expert interviews, just to get a more in-depth perspective. Because although we can say something about the extent of the shadow economy and where this comes from, we would still like to explore some questions, including the questions that you raised, in more depth.

So on the question about institutional trust... a question which Tomek raised. Trust in government was extremely low in 2009 / 2010, particularly in Latvia when the shadow economy was so high. Interestingly enough, even though the trust is slightly increasing, I think that eighty-five percent of the population was unsatisfied or very unsatisfied with government in different aspects in 2009 or 2010; and then by 2012 I think it was maybe eighty percent. So nothing has really changed! But the shadow economy according to our data has decreased substantially. So maybe it is not that much about institutional trust. What actually struck me a bit was that it seems like although the macro conditions in Latvia have actually recovered to some extent – we have GDP growth and so on – it seems like the shadow economy has decreased not because of institutional trust or because of change in informal institutions, but because of the changes in formal institutions. What governments did, for instance to reduce the shadow economy in a company's employee wages, is that they really targeted some policy

incentives, they changed laws and regulations, and they actually increased punishment in these areas. So this was not changing attitudes, this was saying that you will really be hit if you do this, by law, and this is how we will control it. And this makes me again think about another paper that I also wrote with Tomek, and it raises some questions about whether we are on the right track. We cannot explore this with the data we already have; we need more data to make it more sure but obviously there is something here.