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# **Tackling the informal economy in South East Europe: an institutional approach**

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# **Tackling the informal economy in South East Europe: an institutional approach**

## **Abstract**

Analysing a 2013 survey of the informal economy in six South-East European nations, this paper reveals how such tax non-compliance arises when the codified laws and regulations of a society's formal institutions are not aligned with the norms, values and beliefs of citizens (its informal institutions). Tackling the informal economy is therefore shown to require a re-aligning of a society's formal and informal institutions. This necessitates not only changing citizens' norms, values and beliefs using for example tax education campaigns, but also changing the formal institutions to improve trust in government. The wider theoretical and policy implications are then discussed.

**Keywords:** informal sector; envelope wages; tax evasion; institutional analysis; South-Eastern Europe.

## **Introduction**

In the past few years, a burgeoning literature has drawn attention to the growth of the informal economy in South-East European countries and how employers and citizens alike are turning to the informal economy as survival strategy (Baric and Williams 2013, Dzhekova and Williams 2014; Dzhekova et al. 2014; Franic and Williams 2014; Gaspareniene et al. 2014; Hudson et al. 2012; Kapelyushnikov et al. 2012; Remeikiene et al. 2014; Williams 2010). Indeed, new theorisations have sought to explain this state of affairs. As Williams (2013) highlights, a 'modernisation' school has sought explanations in the lack of economic development and modernisation of governance, a 'neo-liberal' school has explained the informal economy as resulting from high taxes, state corruption and too much state interference in the workings of the free market, and a 'political economy' school has conversely laid the blame on inadequate state intervention and the lack of protection of

workers. Although these all provide valuable indications of the structural characteristics that can lead to larger informal economies, the problem they all confront is that they fail to explain why some individuals facing the same structural conditions participate in the informal economy and others do not; in other words, they fail to take agency into account.

In this paper therefore, the aim is to advance understanding by evaluating a new way of explaining and tackling the informal economy with particular reference to Southeast European countries that are member states of the European Union, namely Bulgaria, Croatia, Cyprus, Greece, Romania and Slovenia. Drawing inspiration from institutional theory (Baumol and Blinder 2008; Helmke and Levitsky 2004; North 1990), we here evaluate whether the informal economy can be explained as resulting from the asymmetry between the codified laws and regulations of a society's formal institutions and the socially shared unwritten rules of its informal institutions. From this perspective, the greater is the gap between the norms, values and beliefs of citizens regarding tax compliance (individual morality) and the codified laws and regulations of formal institutions (state morality), the higher is the prevalence of the informal economy. Of course, this does not mean that the various structural characteristics (e.g., the lack of social protection) identified in previous explanations are unimportant. In this institutional asymmetry thesis however, they are seen less as free-standing causal explanations and more as structural conditions which might result in the advent of institutional asymmetry.

To advance and evaluate this institutional asymmetry theory, this paper evaluates its validity when studying a prominent type of work in the informal economy in Southeast European countries, namely the practice where employers pay their employees an official declared salary and an additional undeclared ('envelope') wage in order to fraudulently reduce their tax and social security payments and thus labour costs. In the next section therefore, we briefly review the previous literature on envelope wages and propose a set of

propositions regarding firstly, the relationship between the prevalence of envelope wage payments and the degree of institutional asymmetry and secondly, what needs to be done to reduce this institutional asymmetry. The third section then introduces the data set used to evaluate these propositions, namely a 2013 survey involving 1,962 face-to-face interviews with formal employees in six South-East European countries that are EU member states (Bulgaria, Croatia, Cyprus, Greece, Romania and Slovenia). In the fourth section, the results regarding the relationship between the prevalence of envelope wages and institutional asymmetry are reported followed in the fifth section by a discussion of how this institutional incongruence, and thus participation in the informal economy, might be reduced. The final section then draws conclusions on the theoretical and policy implications of the findings. The outcome will be the advancement of both a new way of explaining the informal economy in South-East Europe as well as a new policy approach for tackling the informal economy.

### **Explaining the informal economy: an institutional perspective**

In the latter half of the twentieth century, a dualistic depiction prevailed that the formal and informal economies were separate and discrete, and thus an employment relationship was widely viewed as either formal or informal (Geertz 1963; Lewis 1959). The possibility that a job could be both informal and formal was not considered. Formal employment was paid work declared to the state for tax, social security and labour law purposes, while informal employment was in every respect the same except that it was wholly hidden from or unregistered by, the state for tax, social security and/or labour law purposes (European Commission 2007; ILO 2002; OECD 2012). This dualistic depiction of employment as either formal or informal however, has begun to be transcended over the past few decades (e.g., Bignami et al 2013; Williams 2009). Exemplifying this is a burgeoning literature that displays how formal employers sometimes under-declare the salaries of formal employees by paying

them both an official declared salary as well as an additional undeclared salary, or what is termed an ‘envelope wage’, which is hidden from, or unregistered by, the state for tax and social security purposes (Karpuskiene 2007; Meriküll and Staehr 2010; Neef 2002; OECD 2003; Round et al. 2008; Sedlenieks 2003; Williams 2009; 2014c; Woolfson 2007; Žabko and Rajevska 2007).

The way in which this illegitimate wage practice operates is that when an employer appoints an employee, they agree an official formal wage and this is detailed in a formal written contract. However, they also at the same time reach a verbal unwritten agreement that an additional envelope wage will be paid which will not be declared to the authorities for tax and social security purposes (Chavdarova 2014; Williams 2009; Woolfson 2007). Envelope wages are therefore the result of fake labour contracts where, technically, either the level of salary or the number of working hours, or the job description stated is different to the one verbally agreed upon. Unless the employee accepts these conditions, then generally they will not get the job and salary. Such conditions might include firstly, that the employee will not take their full statutory entitlement to annual leave, secondly, that they will work longer hours than is stated in their formal contract (which often means that they will work more than the maximum hours in the working hours directive or that they end up being paid less than the minimum hourly wage), and/or thirdly, that they will undertake a different job in terms of tasks and responsibilities to that specified in their formal contract (Williams 2014a). This verbal contract supersedes the formal written contract of employment and thus constitutes the unwritten ‘psychological contract’ regarding their conditions of employment (Rousseau 1995).

In this paper, it is proposed that institutionalist theory provides a useful lens for understanding and explaining this type of informal wage practice (Baumol and Blinder 2008; Helmke and Levitsky 2004; North 1990) and for understanding the existence of different

historically developed perceptions of formal – informal relations in different (types) of societies. From an institutional perspective, every society has codified laws and regulations (i.e., formal institutions) that define the legal rules of the game. Every society also has informal institutions which are the ‘socially shared rules, usually unwritten, that are created, communicated and enforced outside of officially sanctioned channels’ (Helmke and Levitsky 2004, 727). Drawing upon this, the proposition in this paper is that when these formal and informal institutions are in alignment, and consequently state morality is in symmetry with individual morality, then the informal economy will be largely absent because the socially shared norms, values and beliefs of the population will be aligned with the formal rules. However, when the formal and informal institutions are not in symmetry, such as when there is a lack of trust in government and the rule of law, one will witness the prevalence of informal economic practices which are embedded in the unwritten socially shared rules of the society but do not conform to the formal rules of the game.

Take, for example, the payment of envelope wages. This exemplifies how when there is non-alignment of the formal and informal institutions, an informal practice emerges where individual employers and employees do not adhere to the formal rules of the game (i.e., the codified laws and regulations of formal institutions) but instead adopt unwritten socially shared rules agreed verbally to pay an additional envelope wage in order to evade the full tax and social security payments owed. This is the case not only at the level of individual employers and employees but also at a societal-level. When the formal codified laws and regulations of a country are not aligned with the socially shared norms, values and beliefs of the population, then the likelihood is that the propensity to pay envelope wage will be greater.

To evaluate this proposition, some measure of the degree of institutional asymmetry at an individual- and societal-level is required. When studying the informal economy which refers to non-compliance with the formal rules regarding tax and social security payments,

this can be measured by analysing the level of ‘tax morality’ of a person or population, which is their intrinsic motivation to pay taxes owed (McKerchar et al 2013; Torgler 2011; Torgler and Schneider 2007). Measuring the degree of institutional asymmetry using the level of tax morality therefore, the following hypothesis can be tested:

Institutional incongruence hypothesis (H1): the prevalence of informality will be greater in populations expressing lower levels of tax morality.

In previous studies of who engages in the practice of paying envelope wages, the finding in the context of the European Union has been that smaller businesses and those operating in the construction sector are more likely to pay envelope wages, and that men, younger persons and the lower paid are more likely to receive envelope wages (Williams and Padmore 2013). If the above hypothesis is correct, then the finding will be that these populations will also have lower tax morality. Similarly, and at a societal level, previous studies in a European context have revealed that the prevalence of envelope wages is higher in East-Central and Southern European nations than in West European and Nordic nations (Williams 2009). Again, if the above proposition is correct, then the finding will be that those countries with a higher prevalence of envelope wage payments will have a lower level of tax morality. This can be tested by evaluating whether cross-national variations in the propensity to pay envelope wages are associated with cross-national variations in the level of tax morality.

When explaining the informal economy however, it is important not only to test this new institutional asymmetry explanation but also the other previous explanations. These are important to evaluate not only in their own right as free-standing explanations for the informal economy but also, and from an institutional asymmetry perspective, as detailing the characteristics of formal institutions that improve or worsen the level of tax morality. As



Williams (2014b) has highlighted, such explanations can be grouped into three major schools of thought.

Firstly, a 'modernisation' school of thought has argued that the informal economy becomes less prevalent with economic development and the modernisation of government (Geertz 1963; Lewis 1959). Applying this to the study of the propensity to make envelope wage payments, this perspective would thus view envelope wage payments as more prevalent in less developed economies, measured in terms of GNP per capita, and countries in which there is a lack of modernisation of the state bureaucracy. To test this, the following hypothesis can be evaluated:

Modernity hypothesis (H2): the prevalence of informality is greater in poorer economies with unmodernised state bureaucracies.

Secondly, a 'neo-liberal' school of thought has claimed that the informal economy results from high taxes and state interference in the free market and thus that reducing taxes and the level of state interference in work and welfare arrangements is the way forward (De Soto 1989; 2001; London and Hart 2004; Nwabuzor 2005; Schneider and Williams 2013). Viewed through this lens, envelope wage payments will be more prevalent in those South-East European nations with higher taxes and levels of state interference in work and welfare systems. To evaluate this therefore, the following hypothesis can be evaluated:

Neo-liberal hypothesis (H3): the prevalence of informality is greater in economies with higher tax rates and levels of state interference in the free market.

Third and finally, a ‘political economy’ school of thought, in stark contrast to the neo-liberal school of thought, claims that the informal economy directly results from inadequate levels of state intervention in work and welfare arrangements, which leaves workers less than fully protected and thus dependent on the informal economy as a survival strategy in the absence of other means of livelihood and support (Davis 2006; Gallin 2001; ILO 2014; Slavnic 2010; Taiwo 2013). Consequently, envelope wages will be lower where expenditure on labour market interventions to protect vulnerable groups and social protection expenditure is higher. To evaluate this, the following hypothesis can be evaluated:

Political economy hypothesis (H4): the prevalence of informality is greater in economies with lower tax rates, levels of social protection and public sector intervention in labour markets.

Until now, the only studies to have explicitly evaluated these competing explanations used simple bivariate correlations comparing cross-national variations in the prevalence of the informal economy and cross-national variations in the structural conditions (e.g., tax rates, social protection expenditure) pinpointed as influential in these competing schools of thought (European Commission 2013; Eurofound 2013; Williams 2013; 2014b,c). These have revealed support for the modernisation and political economy explanations but little or no support for the neo-liberal school of thought. These simplistic analytical methods however, mean that there has been no evaluation of whether these associations remain significant when other variables are introduced and held constant. Neither, and importantly, has there been any evaluation of the relationship between the prevalence of the informal economy and the degree of institutional asymmetry, which the present paper argues is central to explaining the propensity to participate in the informal economy. To fill these gaps therefore, an analysis of

the varying prevalence of envelope wage payments in six South-East European countries that are member states of the European Union is now reported and logistic regression analysis used to evaluate this new institutional asymmetry explanation as well as the structural conditions associated with greater levels of informality.

## **Methodology**

To evaluate these propositions regarding the informal economy, data from special Eurobarometer survey no. 402 is reported which involved 5,567 face-to-face interviews conducted in 2013 in the six South-East European nations that are member states of the European Union and this included in this Eurobarometer survey, namely Bulgaria, Croatia, Cyprus, Greece, Slovenia and Romania. Although these are all EU member states, and thus not representative of South-East Europe as a whole (which also includes Albania, Bosnia and Herzegovina, Croatia, Republic of Macedonia, Montenegro, Serbia, Moldova and Turkey), this survey nevertheless provides the first insight into the link in South-East Europe between the under-reporting of employees' salaries and the tax morality of its citizens. In all six countries, a multi-stage random (probability) sampling methodology was used to ensure that each country, as well as each level of sample, was representative in proportion to its population size with regards to the variables of gender, age, region and locality size. Here in consequence, and for univariate analyses, the sample weighting scheme is used to obtain meaningful descriptive results, as is recommended in not only the wider literature (Sharon and Liu 1994; Solon et al 2013; Winship and Radbill 1994) but also the Eurobarometer methodology. For the multivariate analysis nevertheless, and given that the majority of literature suggests that such weighting schemes should not be used (Pfefferman 1994; Sharon and Liu 1994; Solon et al 2013; Winship and Radbill 1994), we have selected not to do so.

The face-to-face interview schedule firstly, asks attitudinal questions about the informal economy followed by questions about whether the participants had purchased goods and services in the informal economy, whether they had received envelope wage payments from their employer (if they reported that they were employed) and finally, whether they had supplied work in the informal economy in the prior 12 months. In this paper, and given the focus on envelope wages, we concentrate largely on these questions. Firstly, the 1,962 participants in these six South-East European nations who reported that they were employees were asked whether they had received an envelope wage payment from their employer in the year prior to the survey, secondly, whether this envelope wage payment was for their regular employment, for overtime hours, or both and, third and finally, to estimate the percentage of their gross yearly income from their employment which is received as an envelope wage payment.

To evaluate the hypotheses, the dependent variable is whether the employees are paid envelope wages by their employer. This is based on their answer to the question: ‘Sometimes employers prefer to pay all or part of the salary or the remuneration (for extra work, overtime hours or the part above a legal minimum) in cash and without declaring it to tax or social security authorities. Has your employer paid you any of your income in the last 12 months in this way?’. To test H1 regarding the association between the prevalence of envelope wages and level of tax morality, we here construct a tax morality index for each survey participant and country. To do this, employees’ responses are analysed to a set of attitudinal questions about how acceptable they view six non-compliant tax behaviours using a 10-point scale (where 1 means ‘absolutely unacceptable’ and 10 means ‘absolutely acceptable’), namely: someone receives welfare payments without entitlement; a firm is hired by another firm and does not report earnings; a firm hires a private person and all or part of their salary is not declared; a firm is hired by a household and does not report earnings; someone evades taxes

by not or only partially declaring income; and a person hired by a household does not declare earnings when it should be declared. The tax morality index is their mean score across these six attitudinal questions.

To test hypotheses H2-4, the association between cross-national variations in the prevalence of envelope wage payments and various country-level structural conditions are analysed. To evaluate the modernisation hypothesis (H2), the indicators used are:

- GDP per capita in purchasing power standards (Eurostat 2014a), and
- European Quality of Government Index – this covers not only perceptions and experiences with public sector corruption, but also the extent to which citizens believe various public sector services are impartially allocated and of good quality. The index is standardised with a mean of zero, with higher scores marking a higher quality of government (Charron et al. 2014).

To test the tax tenet of the neo-liberal hypothesis (H3), the country-level structural variables previous studies have employed when evaluating this tenets in relation to the informal economy (European Commission 2013; Williams 2013) is evaluated, namely the:

- Implicit tax rate (ITR) on labour, which approximates to the average effective tax burden on labour, and is the sum of all direct and indirect taxes and employees' and employers' social contributions levied on employed labour income divided by the total compensation of employees (Eurostat 2014b), and
- Current taxes on income, wealth, etc, which covers all compulsory, unrequited payments, in cash or in kind, levied periodically by general government and by the rest of the world on the income and wealth of institutional units, and some periodic taxes assessed neither on income nor wealth (Eurostat 2014c)

To test the contrasting perspectives of the neo-liberal (H3) and political economy (H4) hypotheses regarding state intervention meanwhile, the country-level structural conditions analysed, akin to previous studies on the informal economy in Europe (European Commission 2013; Eurofound 2013; Williams 2013), are:

- Public expenditure on labour market interventions aimed at correcting disequilibria. This covers all public interventions in the labour market aimed at reaching its efficient functioning and correcting disequilibria which explicitly target groups with difficulties in the labour market, namely: the unemployed; those employed but at risk of involuntary job loss; and people who are currently inactive in the labour market but would like to work (Eurostat 2014d), and
- Social protection expenditure contain: social benefits, which consist of transfers, in cash or in kind, to households and individuals to relieve them of the burden of a defined set of risks or needs; administration costs, which represent the costs charged to the scheme for its management and administration; other expenditure, which consists of miscellaneous expenditure by social protection schemes (payment of property income and other). It is calculated in current prices as a percentage of GDP (Eurostat 2014e).

To analyse the institutional incongruence hypothesis (H1), and given the nonparametric nature of the data, firstly, a two-sample Wilcoxon rank-sum (Mann-Whitney) test evaluates whether the median tax morality score of those paid envelope wages significantly differs to the median score of those not paid envelope wages, whilst secondly, a Spearman's bivariate correlation is used to evaluate whether a statistically significant relationship exists between cross-national variations in tax morality and cross-national variations in envelope wages. To evaluate whether H1 remains valid whilst holding constant a range of individual-level socio-

demographic, occupational and socio-economic characteristics (in Table 1 below), as well as various country-level structural conditions, a logistic regression analysis is used.

To evaluate the three hypotheses (H2-4) regarding the country-level structural conditions associated with a higher prevalence of envelope wages meanwhile, and given the significant correlation between these country-level structural conditions, a logistic regression analysis utilising the hierarchical nature of the data (individuals within countries) is employed, adding each structural condition in turn to the individual-level variables to evaluate whether they are significantly associated with the prevalence of envelope wages.

## **Findings**

Of the 5,567 face-to-face interviews conducted in 2013 across these six South-East European countries that are member states of the European Union, 1,962 were with formal employees, of whom one in 14 (7 per cent) reported that they had received envelope wages from their employer in the 12 months prior to the survey, amounting on average to 30 percent of their gross annual salary. Moreover, and as shown in Table 1, a higher proportion of employees receive envelope wages in these South-East European countries than in Western Europe and Nordic nations, and also receive a greater proportion of their gross salary illegitimately.

However, the prevalence of envelope wages varies across businesses and employee groups across these South-East European countries. As Table 1 displays, although employees working in all sizes of business report that they have been paid envelope wages, the propensity to pay envelope wages is higher in smaller businesses. Indeed, one in eight employees in businesses employing less than five employees are paid envelope wages. This is without doubt a consequence of the lack of presence of dedicated HRM staff and formal HRM practices in such businesses (Barrett and Mayson 2007; Benmore and Palmer 1996), meaning

that employers are able to introduce unwritten verbal contracts that contravene the employees' formal written contract.

INSERT TABLE 1 ABOUT HERE

Examining the employee groups more likely to receive envelope wages, this practice is more prevalent amongst manual workers (10 per cent). So too are younger people more likely to be paid envelope wages, which is a group amongst whom unemployment is much higher (European Commission 2013), as are those who have difficulties paying the household bills most of the time with less years in formal education and those with fewer years in formal education. The intimation therefore, is that employers target weaker and more vulnerable employees, who may as a result of their situation see the formal rules of the game as being for the benefit of others rather than them, resulting in them having less allegiance to the formal rules.

To test H1 which asserts that envelope wages will be more prevalent in populations with lower levels of tax morality, the final column of Table 1 reports the tax morality for different groups of employees. This reveals that some employee groups have a lower tax morality than others. Older workers display a higher tax morality than younger workers. Similarly, managers have a higher tax morality than manual and other white collar workers, women adhere to the formal rules more than men, and those with more years in formal education and with fewer difficulties in paying the bills have a higher tax morality than those with fewer years in education and greater difficulties paying the bills. Analysing whether a statistically significant association exists between the level of tax morality of individuals and the propensity to receive envelope wages, a Wilcoxon Rank Sum test displays that those receiving envelope wages have a significantly lower tax morality with a median of 2.50 compared with those not receiving envelope wages whose median tax morality is 1.67 (where



1=totally unacceptable and 10=totally acceptable across six tax non-compliance behaviours). This therefore, validates H1 which asserts that envelope wages will be greater in populations expressing lower levels of tax morality.

Turning to the cross-national variations in the prevalence of envelope wages, it is again the case that envelope wages are not evenly distributed across these six South-East European countries. Some 8 per cent of employees receive envelope wages in Croatia and 7 per cent in Greece and Romania but 6 per cent in Bulgaria, 4 per cent in Slovenia and just 2 per cent in Cyprus. Similarly, the level of tax morality is not the same across these nations. The level of tax morality (i.e., the adherence of the population to the codified laws and regulations of formal institutions) is highest in Cyprus and Greece followed by Croatia and Slovenia, whilst there is the lowest adherence to the formal rules of the game in Bulgaria. Therefore, Table 1 shows that Bulgaria, the country with the lowest adherence to the formal rules, does not have the highest percentage of people receiving envelope wages and also that there are differences between the level of tax morality for countries with the same percentage of employees receiving envelope wages (e.g., Greece and Romania). Differences in the share of gross salary received as envelope wages are also revealed. The share of gross salary received in envelope is highest in Cyprus (50 per cent) and smallest in Romania (9 per cent). Thus, even if Cyprus has the highest tax morality and the smallest number of people receiving envelope wages across these six South-East European countries, those receiving envelope wages in this country receive the biggest share of their income in this way.

Consequently, to further evaluate whether the cross-national variations in the prevalence of envelope wages are associated with cross-national variations in the level of tax morality, a Spearman's bivariate analysis is conducted. This reveals a statistically significant association ( $p < 0.01$ \*\*\*). The direction of the association is that the lower is the tax morality in a country the greater is the prevalence of envelope wages. Therefore, H1 is again

supported. Interestingly, this is further reinforced when comparing the descriptive results on EU regions. Table 1, that is, displays that the prevalence of envelope wages is lower in Western Europe and the Nordic nations, and the level of tax morality higher, than in South-East Europe.

To determine whether this association between the prevalence of envelope wages and tax morality remains significant when other characteristics are taken into account and held constant, Table 2 reports the results of a logistic regression analysis. Model 1 tests whether this association continues to be significant when purely individual-level characteristics are added, and models 2-8 when various country-level variables are included. The first row in models 1-8 displays that the prevalence of envelope wages remains strongly associated with lower levels of tax morality across all models, whether individual-level characteristics alone are analysed, or country-level structural conditions are added. A strong association thus exists between tax morality and the prevalence of envelope wages. As tax morality improves, and thus institutional asymmetry decreases, the prevalence of envelope wages declines. As such, this further validates the institutional incongruence hypothesis (H1).

INSERT TABLE 2 HERE

Model 1 also examines the types of business and employee groups in which envelope wages are more prevalent when other individual-level factors are held constant. Smaller firms are significantly more likely to pay envelope wages. Similarly, the likelihood of receiving envelope wages decreases significantly with age. Strong evidence also exists that envelope wages are more prevalent among those who have difficulties most of the time in paying their household bills and among those with few years in formal education. Turning to the cross-national variations meanwhile, Model 2 again reveals that the cross-national variations in the propensity to pay envelope wages remains significant, with Romania, Croatia and Bulgaria

significantly more likely to receive envelope wages than those in the reference country of Greece, even when individual-level factors are taken into account.

Models 3-8 in Table 2 meanwhile, test the hypotheses H2-4 regarding how to explain these significant cross-national variations. Each country-level variable refers to a particular country-level structural condition that the competing perspectives use to explain the cross-national variations in envelope wages. Given that the pairwise regressions reveal that these country-level variables are strongly correlated with each other, they are here each treated in separate models, providing alternative explanations for the greater prevalence of envelope wages.

Starting with the modernity perspective (H2), model 3 provides good evidence that the prevalence of envelope wages is higher in countries with lower levels of GDP per capita and model 4 provides good evidence that envelope wages are more likely in countries with lower qualities of government. These models thus support H2 that envelope wages are more prevalent in countries with lower levels of economic development and less modernised state bureaucracies. To evaluate the neo-liberal explanation (H3), model 5 reveals a lack of significance of the relationship between envelope wages and the implicit tax rate (ITR) on labour. This therefore, refutes the neo-liberal tenet that higher tax rates lead to a greater propensity to pay envelope wages. To test this further, model 6 looks at another indicator of tax rates, namely current tax on income. Here, strong evidence is provided of an association. However, this is in the opposite direction to that suggested by the neo-liberal explanation. This displays strong evidence that envelope wages are less prevalent in countries with higher levels of current tax on income. This therefore begins to reinforce the political economy hypothesis (H4). Similarly, and turning to the tenet regarding the influence of state intervention in H3 and H4, model 7 again provides strong evidence that envelope wages are more likely in countries with smaller public expenditure on labour market intervention and

model 8 good evidence that the propensity to pay envelope wages is higher in countries with smaller levels of social protection expenditure. All these models, therefore, provide support for the political economy hypothesis (H4) and evidence to refute the neo-liberal explanation (H3).

Given that three hypotheses are “positively” confirmed, namely the institutional asymmetry thesis, the modernization thesis and the political economy thesis, it is important to briefly analyse their role and weight in explaining envelope wages. As explained at the outset of this paper, the modernization and political economy theses as free-standing explanations do not explain why some individuals facing the same structural conditions participate in informal practices and others do not; they fail to take agency into account. The institutional asymmetry thesis, however, does this. As Table 2 displays moreover, there is a strong association between envelope wages and tax morality, which remains strongly significant across all models, thus reinforcing the proposition that institutional asymmetry is key to explaining the prevalence envelope wages.

Meanwhile, to compare which structural conditions better predict the propensity to pay envelope wages, one can analyse which have higher values of pseudo R-squared (Freese and Long 2006). Examining models 3-8, the finding is that although there are small differences in the values of pseudo R-squared ranging between 0.1175 and 0.1319, it is the structural conditions associated with the political economy thesis (i.e., public expenditure on labour market interventions and social protection expenditure levels) that predict better the prevalence of paying envelope wages than the structural conditions associated with modernisation theory (i.e., GDP and government quality). As such, and comparing the three positively confirmed theses, the institutional asymmetry thesis is seen to be key to explaining the variations in the propensity of populations to pay envelope wages, which remains strongly correlated across all models. Meanwhile, and examining the structural conditions, it is those

associated with the political economy thesis (i.e., public expenditure on labour market interventions and social protection expenditure levels) and only then those associated with the modernisation thesis (i.e., GDP and government quality) which better predict the propensity to pay envelope wages.

## **Discussion**

This analysis therefore reveals a strong association between the propensity to pay envelope wages and the degree of institutional asymmetry as measured by tax morality. The prevalence of envelope wages is greater amongst those whose beliefs regarding tax compliance are more at odds with the formal rules, and this remains strongly significant even when other individual- and country-level variables are introduced and held constant. Consequently, the greater is the degree of asymmetry between formal and informal institutions, the more likely is such an informal wage practice both at an individual- and country-level.

To tackle the informal economy therefore, the degree of institutional incongruence needs to be reduced. This necessitates a somewhat different policy approach towards the informal economy than South-East European country governments have until now pursued. Conventionally, as portrayed in Table 3, governments have employed direct controls to ensure that the cost of being caught and punished is greater than the pay-off from participation in the informal economy. This has been achieved by increasing the actual and perceived risks and costs associated with participation by firstly, raising the penalties and secondly, increasing the actual or perceived likelihood of detection (see Allingham and Sandmo 1972; Williams 2014a). More recently however, recognition that ‘carrots’ are more effective than ‘sticks’ at eliciting behaviour change has led to greater attention being paid to making work in the formal economy easier and more beneficial both for businesses and individual tax-payers. This has employed measures ranging from simplifying compliance for businesses to the use of

demand-side incentives to encourage citizens to source goods and services from the formal rather than informal economy (Williams 2014a). The above findings however, suggest that this direct controls approach to enforce compliant behaviour is not the way forward.

INSERT TABLE 3 ABOUT HERE

The informal economy in these South-East European countries, as shown here, results from employers and employees not adhering to the written codified laws and regulations and the prevalence of informality increases as the degree of institutional incongruence increases. What is thus required is a focus on reducing the degree of institutional incongruence. To achieve this, and drawing inspiration from the organisational level where there has been a shift from 'hard' to 'soft' HRM, and from bureaucratic to post-bureaucratic management (Legge 1995; Thompson and Alvesson 2005; Watson 2003), a similar shift is advocated at the societal level. Until now, a 'hard' approach has been adopted, seeking the compliance of employers and employees using tight rules, prescribed procedures, close supervision and monitoring and centralised structures within the context of a low trust, low commitment and adversarial culture in which a 'cops and robbers' approach is adopted. Here however, a societal-level 'soft' approach is advocated in which a high trust, high commitment culture is sought that aligns the values of employers and employees with the formal institutions so as to generate self-regulated control.

To achieve this, it is not only individual morality which needs to change. Given that there is distrust in government and the rule of law across these South-East European nations as displayed by their tax morality, there is also a need to change the formal institutions. To alter the norms, values and beliefs of citizens across South-East European societies that lead employers and employees to flout the codified laws and regulations and participate in the informal economy, at least three policy initiatives can be pursued. Firstly, tax education is

required targeted at both employers and employees so as to re-align their values with the formal rules and encourage greater self-regulation. Taxes, after all, are the prices South-East European citizens pay for the public goods and services they receive. Until now however, it has been rare in South-East European societies for governments to inform their citizens explicitly of the public goods and services that they receive in return for the taxes they pay (Saeed and Shah 2011). For example, signs indicating ‘your taxes paid for this’ in hospitals and outside schools is one way forward in this regard. Secondly, advertising campaigns (targeting the groups identified above with low tax morality such as those who have difficulties paying bills) can be used, which can inform employees and employers of the costs and risks of informality and/or benefits of formality (OECD 2013). And third and finally, normative appeals can be used (Lill and Nurmela 2009).

To improve the psychological (social) contract between government and citizens, and reduce institutional asymmetry however, it is not simply the informal institutions that need to change. Formal institutions also need to alter. This requires change on two levels. On the one hand, the tax morality of citizens will not improve if a low level of trust in government and a perception of public sector corruption persists, as is the case in many South-East European nations (European Commission 2014a,b). As model 4 in Table 2 reveals, a modernisation of governance is thus necessary. This requires at least three institutional reforms. Firstly, there is a need to improve procedural justice, which refers to the tax authority treating citizens in a respectful, impartial and responsible manner and thus shifting away from a ‘cops and robbers’ approach and towards a service-oriented approach (Leventhal 1980; Murphy 2005). Secondly, there is a need to enhance procedural fairness which refers to citizens believing that they pay their fair share compared with others (Molero and Pujol 2012) and third and finally, there is a need to improve redistributive justice which relates to whether citizens believe they receive the goods and services they deserve given the taxes they pay (Kirchgässner 2010). On the

other hand, and as models 3-8 in Table 2 display, governments also need to pursue wider economic and social developments associated with lower levels of informality. These models clearly reveal how countries with more modernised governance, higher tax rates, higher expenditure on social protection and more intervention in labour markets to protect vulnerable groups, have lower levels of informality.

## **Conclusions**

This paper has advanced a new way of explaining and tackling the informal economy. Drawing upon institutional theory, it has revealed that when there is asymmetry between formal and informal institutions and the norms, values and beliefs of citizens are at odds with the codified laws and regulations, informal economic practices such as envelope wage payments emerge which are fraudulent in terms of the formal written rules but are embedded in unwritten socially shared rules. The greater is the degree of institutional incongruence, the greater is the propensity for such practices. Using logistic regression analysis, this has been here revealed to be the case for both the individuals engaged in such activity and for the countries with a higher prevalence of informality.

To reduce the prevalence of the informal economy in consequence, it has been argued that a policy shift is required away from direct controls that detect and punish informality and towards eliciting a high trust high commitment culture where the values of citizens are aligned with the formal institutions regarding the benefits of tax compliance. This requires changes not only in the informal institutions, using tax education, awareness raising campaigns and normative appeals, but also alterations in the formal institutions so as to enhance trust in government by pursuing firstly, greater procedural fairness, procedural justice and redistributive justice and secondly, higher tax rates, higher expenditure on social protection and more intervention in labour markets to protect vulnerable groups.



Whether this institutional approach remains relevant when explaining and tackling the informal economy more widely and also in other nations and global regions now requires evaluation. If this paper stimulates such research, then it will have fulfilled one of its intentions. If it also results in greater awareness amongst Southeast European governments that the informal economy is strongly associated with institutional asymmetry and greater exploration and evaluation of policy measures for tackling this lack of alignment, rather than merely detect and punish informality, then the broader intention of this paper will have been achieved.

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**Table 1.** Distribution of envelope wages in South-East European EU member states: by business size, employee group and country

N=1,962	% of employees receiving envelope wages in last 12 months	% of gross salary received as envelope wage (median)	% of all employees receiving envelope wages	% of all employees	Tax morality index (where 1 = totally unacceptable and 10 = totally acceptable)
Western Europe	1	10	--	--	2.19
Nordic Nations	1	3	--	--	1.92
<i>Southeast Europe</i>	7	30	100	100	2.24
Firm size:					
1 - 4 employees	13	50	24	14	2.11
5 - 9	10	30	18	13	2.46
10 - 19	9	20	20	17	2.49
20 - 99	7	30	29	32	2.20
100 or more	3	35	9	24	1.99
Occupation:					
Managers	2	40	6	19	2.24
Other white collars	3	30	12	26	2.12
Manual workers	10	30	82	55	2.30
Gender:					
Man	8	25	64	53	2.22
Woman	5	35	36	47	2.25
Age:					
15-24	12	20	17	10	2.37
25-39	8	30	53	46	2.28
40-54	5	30	27	36	2.18
55+	3	10	3	8	2.11
Age formal education ended:					
<15	9	1	6	5	2.18
16-19	8	30	59	51	2.21
20+	5	35	35	44	2.29
Difficulties paying bills:					
Most of the time	10	30	28	18	2.19
From time to time	7	40	42	39	2.34
Almost never/never	5	10	30	43	2.13
Country:					
Croatia	8	35	11	9	2.15
Greece	7	10	15	15	1.96
Romania	7	9	53	50	2.29
Bulgaria	6	30	18	20	2.46
Slovenia	4	20	2	4	2.20
Cyprus	2	50	1	2	1.52



**Table 2.** Logistic regressions of the prevalence of envelope wage payments in South-East European EU member states

	Model 1			Model 2			Model 3			Model 4		
	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )
Tax morality (Centred)	0.289	0.063 ***	1.335	0.245	0.065 ***	1.278	0.257	0.065 ***	1.293	0.263	0.064 ***	1.301
Gender (Female)												
Male	0.322	0.229	1.380	0.376	0.233	1.457	0.363	0.230	1.438	0.347	0.230	1.415
Age (Centred age: 39)	-0.027	0.012 **	0.974	-0.028	0.012 **	0.973	-0.029	0.012 **	0.971	-0.028	0.012 **	0.972
Formal education (15 and under)												
16-19	1.657	0.764 **	5.244	1.452	0.776 *	4.272	1.566	0.780 **	4.788	1.567	0.775 **	4.791
20+	1.481	0.799 *	4.399	1.350	0.814 *	3.856	1.406	0.816 *	4.081	1.363	0.812 *	3.906
Difficulties paying bills last year (Most of the time)												
From time to time	-0.722	0.258 ***	0.486	-0.897	0.268 ***	0.408	-0.788	0.261 ***	0.455	-0.759	0.260 ***	0.468
Almost never/never	-1.308	0.318 ***	0.270	-1.634	0.342 ***	0.195	-1.307	0.318 ***	0.271	-1.277	0.318 ***	0.279
Occupation (Managers)												
Other white collars	-0.297	0.404	0.743	-0.183	0.409	0.833	-0.270	0.405	0.763	-0.298	0.405	0.742
Manual workers	0.428	0.371	1.534	0.431	0.380	1.539	0.400	0.375	1.492	0.373	0.376	1.452
Firm size (1-4 employees)												
5 – 9	-0.001	0.379	0.999	-0.088	0.387	0.916	-0.093	0.384	0.911	-0.070	0.382	0.932
10 – 19	-0.165	0.374	0.848	-0.368	0.386	0.692	-0.348	0.383	0.706	-0.308	0.380	0.735
20 – 99	-0.128	0.337	0.879	-0.411	0.353	0.663	-0.343	0.349	0.710	-0.290	0.344	0.749
100 or more	-0.832	0.415 **	0.435	-1.148	0.427 ***	0.317	-0.922	0.417 **	0.398	-0.889	0.417 **	0.411
Country (Greece)												
Cyprus				-0.464	0.607	0.629						
Slovenia				0.730	0.485	2.074						
Bulgaria				0.724	0.427 *	2.063						
Romania				1.281	0.438 ***	3.602						
Croatia				0.969	0.423 **	2.636						
GDP per capita in PPS 2013 (Centred)							-0.021	0.009 **	0.979			
European Quality of Government Index 2013 (Centred)										-0.473	0.201 **	0.623
Constant	-3.744	0.881 ***	0.024	-3.937	0.934 ***	0.020	-3.390	0.905 ***	0.034	-3.356	0.903 ***	0.035
N		1493			1493			1493			1493	
Pseudo R <sup>2</sup>		0.1158			0.1388			0.1248			0.1247	
Log likelihood		-300.6339			-292.8155			-297.5988			-297.6032	
$\chi^2$		78.77			94.40			84.84			84.83	
p>		0.0000			0.0000			0.0000			0.0000	

Notes: All coefficients are compared to the benchmark category, shown in brackets. Indicators were centred to the mean obtained using weighting scheme. Significance level at \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Running the Model 2 by grouping countries with similar political-economic and historical backgrounds, namely Croatia-Slovenia, Bulgaria-Romania and Greece-Cyprus shows that compared with Romania – Bulgaria, only the employees in Greece-Cyprus are significantly less likely to receive envelope wages. All the other covariates keep the significance and the sign of association, except for gender which shows a significantly weak association with envelope wage propensity (\*p<1).

**Table 2.** Logistic regressions of the prevalence of envelope wage payments in South-East European EU member states- continued

	Model 5			Model 6			Model 7			Model 8		
	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )	$\beta$	se( $\beta$ )	Exp( $\beta$ )
Tax morality (Centred)	0.279	0.064 ***	1.322	0.238	0.065 ***	1.268	0.264	0.064 ***	1.302	0.259	0.064 ***	1.296
Gender (Female)												
Male	0.337	0.229	1.400	0.401	0.232 *	1.494	0.338	0.230	1.401	0.353	0.230	1.424
Age (Centred age: 39)	-0.028	0.012 **	0.973	-0.030	0.012 ***	0.970	-0.028	0.012 **	0.973	-0.029	0.012 **	0.971
Formal education (15 and under)												
16-19	1.631	0.770 **	5.110	1.525	0.785 *	4.595	1.528	0.774 **	4.608	1.556	0.778 **	4.742
20+	1.490	0.805 *	4.439	1.437	0.820 *	4.210	1.342	0.811 *	3.828	1.433	0.813 *	4.192
Difficulties paying bills last year (Most of the time)												
From time to time	-0.748	0.260 ***	0.473	-0.867	0.265 ***	0.420	-0.784	0.261 ***	0.456	-0.830	0.263 ***	0.436
Almost never/never	-1.310	0.317 ***	0.270	-1.463	0.321 ***	0.232	-1.362	0.320 ***	0.256	-1.445	0.322 ***	0.236
Occupation (Managers)												
Other white collars	-0.282	0.405	0.755	-0.191	0.406	0.826	-0.293	0.406	0.746	-0.255	0.405	0.775
Manual workers	0.433	0.372	1.542	0.452	0.375	1.572	0.363	0.377	1.438	0.411	0.375	1.509
Firm size (1-4 employees)												
5 – 9	-0.039	0.382	0.961	-0.118	0.386	0.889	-0.081	0.382	0.922	-0.096	0.383	0.909
10 – 19	-0.229	0.379	0.796	-0.422	0.385	0.656	-0.312	0.379	0.732	-0.336	0.381	0.715
20 – 99	-0.213	0.345	0.808	-0.446	0.351	0.640	-0.315	0.344	0.730	-0.349	0.346	0.705
100 or more	-0.865	0.416 **	0.421	-1.068	0.421 **	0.344	-0.932	0.418 **	0.394	-0.975	0.418 **	0.377
Implicit tax rate on labour 2012 (Centred)	-0.027	0.026	0.973									
Current taxes on income, wealth, etc. 2013 (Centred)				-0.211	0.067 ***	0.810						
Public expenditure on labour market interventions 2011 (Centred)							-1.219	0.455 ***	0.295			
Social protection expenditure 2011 (Centred)										-0.071	0.028 **	0.931
Constant	-3.682	0.888 ***	0.025	-3.310	0.910 ***	0.037	-3.220	0.908 ***	0.040	-3.325	0.906 ***	0.036
N		1493			1493			1493			1493	
Pseudo R <sup>2</sup>		0.1175			0.1319			0.1269			0.1261	
Log likelihood		-300.0516			-295.1569			-296.8673			-297.1409	
$\chi^2$		79.93			89.72			86.30			85.75	
p>		0.0000			0.0000			0.0000			0.0000	

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Notes: All coefficients are compared to the benchmark category, shown in brackets. Indicators were centred to the mean obtained using weighting scheme.

**Table 3:** Approaches towards tackling the informal economy

Approach	Method	Examples of measures
Direct controls: deterrents	Improve detection	Data matching and sharing Workplace inspections
	Raise penalties	Increase penalties for evasion
	Raise perception of risk	Advertise penalties Advertise effectiveness of detection procedures
Direct controls: incentives	Formalise businesses	Simplify compliance Direct and indirect tax incentives Supply chain responsibility Support and advice to businesses, especially start-ups
	Formalise citizens	Supply-side incentives (e.g. society-wide amnesties; voluntary disclosure; smoothing transition to formalization)  Demand-side incentives (e.g. service vouchers; targeted direct taxes; targeted indirect taxes)
Indirect controls: aligning state and individual morality	Change informal institutions	Tax education Awareness raising Normative appeals
	Change formal institutions	Change processes of formal institutions by improving perceptions of tax fairness, procedural fairness and redistributive justice  Change products of formal institutions by improving social transfers, social protection expenditure and labour market interventions to protect vulnerable groups