

Informal Taxation*

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Abstract

Informal cash and in-kind payments are an important yet frequently overlooked source of local public finance in many developing countries. We use microdata from ten developing countries to establish stylized facts on the magnitude, form, and distributional implications of this type of “informal taxation.” We find that informal taxation is prevalent in a wide range of countries, particularly in rural areas, and includes substantial payments in the form of labor. The wealthy pay more in informal taxes in absolute terms but less in percentage terms, and the informal tax system as a whole appears more regressive than the formal tax system. Failing to take informal taxation into account results in underestimates of the tax burdens faced by households and the level of revenue decentralization in developing countries. We propose a simple model of information and enforcement constraints that parsimoniously explains the patterns observed in the data.

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1 Introduction

A key function of government is the finance and provision of local public goods. In many developing countries, formal direct taxation of households is limited, comprising only 18% of total tax revenues on average compared with 45% in developed countries (Gordon and Li 2005).¹ Agricultural sectors are often entirely exempt from taxation, and local taxation is generally quite constrained (Burgess and Stern 1993, Bird 1990). These facts would suggest that local public goods are primarily financed outside the local community, either through direct provision or intergovernmental grants.

Substantial anecdotal evidence, however, suggests that local residents in many communities throughout the developing world do contribute substantially – outside the formal tax system – to the construction and maintenance of local public goods (e.g., Ostrom 1991, Wilson 1992, Beard 2007). People pay in both money and labor to these projects, with often complex social arrangements determining how much each household should pay and what penalties apply for those who free ride. Many countries even have specific vocabulary to describe these systems, such as *gotong royong* in Indonesia and *harambee* in Kenya.

We refer to these mechanisms of financing of local public goods as “informal taxation” in a direct parallel to the informal insurance literature (e.g. Townsend 1994): it is a system that operates outside the formal sector but accomplishes the same function as local taxation in the financing of local public goods.² We use the term taxation because, as we discuss, these mechanisms are coordinated by community public officials and do not appear to be purely voluntary.³

In this paper, we develop some of the first systematic micro-evidence on the magnitude, distributional implications, and forms of informal taxation, using a micro dataset we assembled consisting of survey data from ten developing countries throughout the world. We then develop a simple framework for thinking about informal taxation that, with very few assumptions, matches the styl-

¹These figures refer to personal income taxation and are calculated from Table 1 of Gordon and Li 2005.

²This is not to be confused with bribe payments, which are occasionally also referred to as informal taxation. To the best of our knowledge, the system of financing local public goods through these types of payments was first described as informal taxation by Prud'homme 1992, who, in his study of local public goods provision in Zaire, defined informal taxation to include any "nonformal means utilized to finance the provision of public goods and services."

³The involvement of public officials distinguishes informal taxation from, for example, provision of local public goods by charities or other non-governmental organizations. Here we use the term "not purely voluntary" to indicate that there are negative consequences for refusal to participate.

ized facts we observe in the data. In the concluding section of the paper, we discuss the broader implications of our findings for public finance and policy in developing countries.

The first stylized fact we document is that informal taxation is a widespread phenomenon, and it can form a substantial share of local revenue. The share of households making informal tax payments is 20% or higher in all but one country in our sample and exceeds 50% in several countries. Participation rates are always higher in rural areas than in urban areas. Across our sampled countries, informal taxes generally comprise a small share of household expenditure (0.85% in the modal country) and a modest share of total taxes paid by households (15.7% in the modal country). However, informal taxes can still be an important source of local public finance. In our Indonesia sample, for example, including informal taxation almost triples the estimates of the amount of revenue under local control.

The second stylized fact we document is that, within individual communities, informal taxation is redistributive but regressive. In all countries in our sample, we find that wealthier households in a community are more likely to participate in informal taxation schemes than poorer households. The elasticity of total payment with respect to household expenditure is positive but less than one in all countries, indicating that informal taxes rise with expenditure, but the average informal tax rate (i.e., informal taxes divided by total expenditure) falls with expenditure. Informal taxation is therefore regressive, but still provides redistribution if the local public good it finances is valued equally across the income distribution. Informal taxes are more regressive than formal taxes, both within communities and when examined in aggregate at the national level.

The third stylized fact we document is that the form of payment differs from a traditional tax; in particular, in-kind labor payments play a substantial role in informal taxation. Moreover, both the participation gradient and the elasticity of payments with respect to household expenditure are smaller for labor payments than for money payments, so that labor payments are relatively more important for poorer households. All three stylized facts we observe are remarkably consistent across countries.

Given these facts, we propose a simple model of informal taxation. Although informal taxation may appear suboptimal, we argue that it can in fact arise as the solution of a constrained optimal

tax problem. In our model, communities in developing countries wish to finance a public good in a social welfare maximizing way. Communities face an enforcement constraint (how severe a punishment they can levy for non-compliance) and two information constraints: a hidden income constraint (how easy it is for high ability types to pretend to be low ability types,) and a shirking constraint (how easy it is for those supposed to be working on public projects to shirk).

We model formal and informal taxation as having different constraint parameters. In the informal system, enforcement happens through social sanctions rather than through courts. This means that the informal tax system can use information that is observable but not legally verifiable, so informal taxation mechanisms effectively have better information than the formal tax system. On the other hand, by foregoing formal legal proceedings, the informal system must use less severe punishments – i.e., social sanctions instead of jail time – which limits the progressivity of the informal taxation system. The choice between formal and informal taxes therefore represents a trade-off between enforcement and information.

The model requires few assumptions and parsimoniously explains the observed stylized facts. Informal taxes are likely to be preferred to formal taxes if evasion costs are low or if the community can effectively levy social sanctions. We should therefore expect to see informal taxation in poorer countries and in rural areas. Informal taxation should have a positive income gradient but will not necessarily be progressive. Finally, labor payments can be used as a screening device, since unobservably high ability types face a higher cost of in-kind labor payments relative to monetary payments. This rationalizes the high observed prevalence of labor payments in the data and the fact that labor payments have a lower income elasticity than monetary payments.

We argue that the empirical evidence is more consistent with this model than with alternative explanations of altruism, user fees, and collective action. Informal tax payments do not appear to be purely voluntary: community organizations and leaders play important roles in determining the magnitude of each household's payment, and there are negative consequences for non-payment. While it does appear in some cases that households are more likely to pay for goods from which they benefit, a pure user fee model would not predict the income gradients observed in the data. Finally, the evidence suggests that informal taxation is redistributive; these mechanisms to not

appear to be designed solely to overcome a collective action problem.

While our framework predicts that informal taxation is more likely to be prevalent in developing countries, these types of systems may arise whenever there are limits to formal taxation and such mechanisms are feasible. When Vermont's school finance redistribution law made financing schools through higher local taxes more expensive, some communities responded by explicitly pressuring households and businesses to make "voluntary" contributions to schools (Winerip 2003). School fund leaders in Manchester, for example, published lists of individuals and businesses that made their payments and encouraged residents to call or visit non-contributer neighbors (Tomsho 2001). Residents described a variety of sanctions levied on non-contributors, ranging from specific punishments ("if there is a restaurant that didn't pay, I know that I'm not going to eat there") to more intangible social sanctions ("it's hard to look at those people in the same way").⁴ Although our empirical analysis focuses on developing countries, the model developed here is conceptually applicable to socially enforced extra-governmental provision of public goods more generally.

The paper proceeds as follows. Section 2 provides an overview of the existing literature and Section 3 describes the data. Section 4 presents the stylized facts. Section 5 develops our model of informal taxation, and Section 6 considers specific empirical evidence that distinguishes our model from other potential theories. Section 7 discusses the implications of our findings and concludes.

2 Existing Evidence on Informal Taxation

Qualitative evidence from a variety of settings suggests that informal taxation is a common form of local finance for the construction and maintenance of public goods such as roads, schools, and water systems throughout the developing world (e.g., Ostrom 1991), although formal empirical evidence on informal taxation remains fairly limited. A range of studies have documented the presence of informal taxation in various countries in Latin America, Africa, and Asia.⁵

⁴Similar extragovernmental mechanisms were observed in California when Proposition 13 limited local property taxes (Brunner and Sonstelie 2003). Labor and money contributions to fire departments, libraries, and recreational services have also been shown to increase in response to fiscal limitations (e.g., Ferris 1984, Bice and Hoyt 2000).

⁵A non-exhaustive list of countries includes Cameroon (Njoh 2003), China (Eckaus 2003), India (Rao 2004), Indonesia (Rao 2004, Beard 2007), Kenya (Mbithi and Rasmusson 1977, Thomas 1987, Barkan and Holmquist 1989, Miguel and Gugerty 2005, Ngau 1987), Nigeria (Barkan, McNulty and Ayeni 1991), Pakistan (Khwaja 2007), Peru

In many of these countries, informal tax systems appear to form a very important component of community development. In Indonesia, for example, the concepts of *gotong royong* (mutual assistance) and *swadaya* (self-help) have become deeply institutionalized within local communities: residents are expected to make labor and monetary payments toward development projects. Rao (2004) estimates that 37% of the cost of village public goods he examines in Indonesia are contributed by the community. In Kenya, *harambee* (pull together) projects accounted for 11.4% of national development expenditure between 1967 and 1973, and *harambee*-financed spending on particular sectors, such as education, matched or exceeded government expenditure (Mbithi and Rasmusson 1977).

Several patterns emerge from the range of anecdotes and studies of informal taxation. First, payments do not appear to be chosen by households individually. Rather, expected payments are generally coordinated by community leaders or a project committee. Households may be expected to provide a given monetary payment, as in the case of school fees in Kenya (Miguel and Gugerty 2005), or provide a certain number of days of labor (Roseman 1996, Ostrom 1991). In some cases, individuals may have a choice between paying in labor or in money (Njoh 2003).

Second, many of these studies document the existence of non-contributors and describe a range of punishments that may be imposed on such individuals. Miguel and Gugerty (2005) provide several anecdotal examples of social sanctions in the context of school financing in western Kenya.⁶ A common sanction is the public announcement of the names of parents who are late with fees; other forms of sanctions include "sending letters to the homes of parents late with fees, asking local church leaders to encourage payment during sermons, and making personal visits to the individual homes of debtors accompanied by the local Chief" (Miguel and Gugerty 2005). Other examples of punishments include fines (Ostrom 1991) and the denial of access to communal resources, such as the use of a cattledip (Thomas 1987). It is possible that punishments could also include exclusion from community credit or risk-sharing arrangements, as in the informal insurance and microfinance literatures.

(Larrabure 1966), and Zaire (Prud'homme 1992).

⁶The paper argues that limited ability to impose social sanctions in ethnically diverse communities leads to lower financing of local public goods.

Our own direct experience with informal taxation in a village in Central Java, Indonesia, echoes many of these themes. In 2002, a village where one of the authors was staying received 29 drums of raw asphalt from the district government. In order to make use of the raw asphalt to resurface a road, the village needed to raise funds for additional materials (e.g., finely crushed gravel, coarse gravel, sand) as well as labor. To solve this problem, the village head called a meeting in the neighborhood where the road would be built. At that meeting, the village head, neighborhood head and an informal community leader (a local school teacher), went around the room "assigning" payments to each household. These payments increased with income: poorer households would be asked to pay a small amount (usually a few days of labor), whereas wealthier households were asked to pay in money, with the wealthiest households asked to pay the most. The meeting did not specify what sanctions would be for non-payment; however, given that payments were assigned in a public meeting, one can presume that there would have been social pressure applied to those who failed to meet their assigned payment level.

To the best of our knowledge, quantitative work on the distribution of informal tax burdens has focused on two countries: Indonesia and Kenya. Beard (2007) finds that Indonesian households with more assets or more education pay more in labor and money toward informal taxation; those with high household expenditure pay less. Note that these effects are not unconditional: regressions include all of these factors as independent variables. In surveys of particular communities in Kenya, Thomas (1987) finds that labor payments are widespread and that the rich are more likely to make cash payments than the poor, and Barkan and Holmquist (1989) find that participation in projects and payments in labor tend to follow an inverse U-shape with respect to landholding and that payments in cash are increasing in landholding.

An open question is whether or not informal tax mechanisms appear similar across the broad range of countries in which they are observed. In the next sections of the paper, we provide systematic cross-country evidence to document several stylized facts about informal taxation.

3 Data

We compiled microdata from around the world to create a micro dataset that covers the phenomenon of informal taxation in as many countries as possible. We examined over 100 household surveys, including (but not limited to) every publicly available World Bank Living Standards Measurement Study (LSMS) survey.⁷ To be included in our sample, a survey needed to elicit information specifically about payment towards the provision of local public goods. A typical example of such a question is: "In the last 12 months did you personally or any other member of the household participate in any of the following ... participate in the collective construction of community works (roads, schools etc.)."⁸ Our sample includes every household survey that met this criterion. We did not include surveys that asked only about labor sharing agreements among neighbors or contributions to local social organizations. We do not include cases in which the labor was clearly paid for, such as paid public works days.⁹

In addition to these pre-existing datasets, we designed a special survey module on informal taxation for the Health and Education Service Survey in Indonesia. This survey module included detailed questions on labor and monetary payments as well as questions on the decision-making process and enforcement of informal taxation not available on the other surveys in the sample. The Indonesia survey was conducted by Gadjah Mada University and The World Bank as a baseline survey for a poverty-alleviation program. The survey took place in 5 provinces from June-September 2007, and covered a total of 12,000 households in over 2,300 villages. More details about the survey can be found in Olken, Onishi, and Wong (2008).

The types of community works mentioned on these surveys include roads, water and sanitation systems, schools, health centers, dams and irrigation systems, electricity systems, and cleaning of public roads and areas.¹⁰ While we refer to these goods as local public goods, they may be excludable in some cases. We return to this issue in Section 6.

⁷The review of surveys was conducted in the summer of 2006.

⁸Guatemala, National Survey of Living Conditions, 2000.

⁹It is still possible that in some cases those paying labor are partially compensated by being provided food or other benefits not observed in our data.

¹⁰The Indonesia survey also includes payments towards religious places. All results remain very similar if we exclude those who only made these types of payments.

The resulting sample consists of household surveys from 10 countries: Albania, Ethiopia, Guatemala, Indonesia, Nigeria, Nicaragua, Panama, the Philippines, Vietnam and Zambia.¹¹ The sample is geographically diverse, including countries from Europe, Latin America, Africa and Asia. Table 1 provides an overview of our sample of household surveys. The surveys were conducted between 1997 and 2007, and sample sizes range from 1,500 to 75,000. The surveys are nationally representative with the exceptions of Ethiopia, Indonesia, and the Philippines, which were conducted in rural areas only. Indonesia and the Philippines focus on a poorer-than-average selection of rural areas, since both surveys were conducted as baseline surveys for poverty alleviation programs. As shown in the table, all surveys contain information on in-kind labor payments toward public goods; monetary payments and quantity data are available for subsets of countries. Note that the recall period varies across surveys: while most surveys ask about payments over the past year, one survey (Philippines) asks only about the previous six months and two surveys (Nicaragua and Zambia) ask about the previous 5 years (see Appendix A for more details).

Summary statistics for each survey are given in Table 2. The summary statistics (as well as per-capita GDP from the World Development Indicators) indicate the breadth of countries covered by our data. For example, per-capita GDP in the surveyed countries ranges from a low of PP\$774 in Zambia to a high of PP\$6129 in Panama, and mean years of education for the household head ranges from a low of 2.5 in Ethiopia to a high of 9.6 in Albania.

We include survey data from all available countries in our empirical analysis in order to paint as complete a picture as possible of the informal taxation phenomenon. One caveat, however, is worth noting explicitly. To the best of our knowledge, public labor contributions are legally mandated in Vietnam. If an individual cannot fulfill his required contribution, he must find a replacement worker or make a monetary payment equivalent to hiring a replacement at local labor costs.¹² The

¹¹Two countries had multiple surveys: Vietnam and Indonesia. In Vietnam, surveys were conducted in 1998 and 2002; we use the 2002 data which has five times the sample size of the 1998 data. In Indonesia, in addition to our 2007 survey, the 2000 Indonesia Family Life Survey (IFLS) asks about informal taxation, but only measures routine cleaning activities. We therefore use our constructed survey module for Indonesia which has more comprehensive questions about informal tax payments. A potential concern with our sample of countries is that relevant survey questions are more likely to be included in countries where the phenomenon is prevalent. As discussed in Section 2, anecdotal evidence indicates that informal taxation is common in many other countries that are similar to our sampled countries.

¹²Specifically, as of the year 2000, each citizen (men 18-45 yrs old, women 18-35) is required to participate in public service work, for 10 days per year. If one cannot participate, the individual needs to find some replacement worker

payments observed in Vietnam may therefore be a formal tax rather than an informal tax; we discuss this in more detail below.

4 Stylized Facts and Implications

This section presents several stylized facts about informal taxation. We focus on the following questions that are relevant when thinking about any tax: where is it most prevalent? how large is it? who pays it? and how is it collected? The first subsection summarizes the prevalence and magnitude of informal taxation and compares the magnitude of informal taxation to formal tax payments made by households and to formal government expenditure. In the second subsection, we examine the distributional implications of informal tax payments and discuss the progressivity of informal taxation relative to formal taxation. The third subsection discusses how these taxes are collected and explores a feature of informal taxation that sharply distinguishes it from conventional taxation: payments are often in labor rather than money. The final subsection provides a brief discussion of the implications of these findings for public finance in developing countries.

4.1 Prevalence and Magnitude of Informal Taxation

4.1.1 Descriptive statistics on prevalence and magnitude

We begin by presenting descriptive statistics to examine the most basic question about informal taxation: prevalence. Table 3 presents three sets of descriptive statistics: the share of households making informal taxation payments (Panel A), the share of households making in-kind labor payments vs. payments in money and materials (Panel B), and the average amounts of those payments (Panel C) for each country in our sample.¹³

or submit a financial contribution either to the commune/ward people's committee or to the individual's employing institution/enterprise. This payment is once per year (per individual), and the required amount is set equivalent to the hiring of replacements at local labor costs. The law specifies different degrees of formal punishments depending the type of violations: for example, avoidance for the first time gets a warning and fine. We thank Trang Nguyen for providing this information.

¹³As noted above, the recall period differs across surveys. We report annualized amounts for quantities but do not adjust the participation data. To facilitate interpretation, the surveys in this and subsequent tables are sorted by survey recall period. Also, in some surveys, respondents may have been asked only about labor payments or only about payments for construction projects. For those surveys (noted in the table), the listed participation rates for "overall participation" can be thought of as lower bounds on true participation rates.

We find that informal taxation is prevalent in all surveyed countries (Panel A). With the exception of Albania, participation rates are 20% or higher in all surveyed countries. More than 50% of surveyed households participated in informal taxation in Ethiopia, Indonesia, and Vietnam. Informal taxation is more prevalent in rural areas in every country in our sample for which we have data on both. Across the sample, participation rates are between 27% (Vietnam) and 183% (Guatemala) higher in rural areas than in urban areas.

Panel B reveals that in-kind payments in the form of labor are common in all surveyed countries. The share of households paying in labor is higher than the share of households paying in money in 3 of the 5 countries for which we have data on both labor and monetary payments (Indonesia, Nicaragua, and Zambia). In the other two countries (Panama and Vietnam), labor payments are still quite common, with 19 and 24 percent of households making payments in labor, respectively. The gap between urban and rural is smaller for monetary payments than for labor payments in all cases.

Panel C shows the magnitude of informal tax payments for all countries for which quantity data are available. The figures shown represent annualized labor payments (in days) and annualized monetary payments (in 2000 PPP US dollars). Average labor payments vary from 0.2 days per year in Albania to 14.1 days per year in Ethiopia. Although cross-country comparisons must be made with caution, the data in Panel C of Table 3 suggest that labor payments are substantially higher in poorer countries. Specifically, for the five countries for which we have data on payments in days, the correlation between the average number of days of labor paid per year and PPP GDP per capita is -0.88 .¹⁴ Although there are only 5 countries in this sample, the strength of the correlation is noteworthy.

4.1.2 Informal taxes and formal taxes paid by households

To better gauge the magnitude of informal taxation, we compare it to two types of benchmarks. In this subsection, we examine the burden it imposes on households by comparing informal tax payments to total household expenditures and to total taxes paid by households. These benchmarks

¹⁴This strong correlation is robust even if we drop the lowest (Albania) or highest (Ethiopia) country in terms of labor payment.

are available for the same households for whom we have data on informal taxation payments, ensuring consistent samples for comparison. In the next subsection, we compare informal taxation to government budgets.

In order to make these comparisons, we monetize the labor payments made by households to construct a measure of total informal tax payments. To do so, we predict the wage for all working household members based on their education, age, gender, and urban/rural status, and value the labor contributions at the average wage for all working household members.¹⁵ This method values the marginal and average wage of the household equally. This assumption is consistent with Benjamin (1992) who shows that household composition does not affect own-farm labor supply for agricultural households in Indonesia, suggesting that labor markets for these households are competitive and complete. Since predicted wages vary across households, the magnitude of informal taxation is measured as the social cost of production.¹⁶ We use an equivalence scale adjusted household expenditure measure for each country.¹⁷

Data on total tax payments comes from two sources. Direct formal taxes paid by households are calculated as the sum of all direct tax payments observed in the data, and include items such as land and buildings taxes and personal income taxes. Indirect formal taxes (VAT) are imputed from

¹⁵To predict wages, we first we approximate household income per worker as annual household expenditure divided by the number of workers. We then divide by the number of working days in a year, which we define as 250, to get a measure of the household daily wage rate. We then regress the household daily wage rate on each individual's education, age, and age² interacted with a female dummy, an urban dummy, and a female \times urban dummy. We repeat this prediction separately for each country. We use the predicted daily wage rate, rather than the household daily wage rate, so that when we regress contributions on household expenditures below, we will not be using expenditures on both the left hand and right hand sides of the same regression.

¹⁶Note that this is not necessarily the same as the value of the output produced, particularly if labor payments are made by individuals whose wage rates exceed the unskilled wage rate. Note also that this measure may be biased if labor contributions are made by those with the lowest opportunity cost of time, making the average household wage an overestimate. On the hand, it is possible that some people who are listed as "working" do not work a full 250 work days per year, which would lead us to underestimate their true wage rate, or that those who contribute are prime-age males with a higher marginal product than the average in the household. We discuss specifications using labor measured in days rather than monetized days below.

¹⁷Following Deaton 1997, we define equivalent expenditure as

$$\frac{\text{household expenditure}}{(\text{adults} + \alpha_1 \text{children} + \alpha_2 \text{infants})^\theta}$$

Infants are defined as those aged 0-4; children are defined as those aged 5 to 14. Combining Deaton 1997's estimates of total child costs and Olken 2005's estimates of household economies of scale, we set $\alpha_1 = 0.6$ and $\alpha_2 = 0.5$ and $\theta = 0.85$. As an alternative, we have verified that all empirical results are qualitatively similar if we use log total household expenditure and a set of household size dummies instead of log equivalent expenditure.

consumption data and VAT and excise rates for each country. We do not include expenditures on food in our VAT estimates, since most households in developing countries are unlikely to pay VAT on most food consumption in practice. Total formal taxes are the sum of direct and imputed indirect taxes. Further details on the calculation of direct and indirect taxes are given in Appendix A.

Using this data, we calculate informal taxes as a share of total household expenditure and informal taxes as a share of total household taxes (informal + direct formal + indirect formal).¹⁸ Table 4 presents the mean and median of these variables for each country in the dataset. Since some households may live in areas where informal taxation does not occur, Panels A and C present the means and medians for all households, and Panels B and D present the means and medians for all households that have non-zero informal tax payments.

Overall, informal taxation appears to comprise a small share of household expenditure, although there is substantial heterogeneity across countries. Mean informal taxation payments range from a low of 0.04% of household expenditure in Albania to a high of 3.7% in Ethiopia. Conditional on making any informal tax payments, shares range from 0.06% (Albania) to 6.8% (Ethiopia).

Informal taxes are a moderate share of total taxes paid by households: mean shares are 0.5% in Albania, 7% in the Philippines, 16% in Vietnam, 17% in Indonesia, and 27% in Ethiopia. As a share of total tax payments, informal taxes are therefore comparable in magnitude to local or state taxes in the United States.

4.1.3 Informal taxes and formal government expenditure

To understand how important informal taxation is to local public finance, we compare informal taxation to government budgets. We focus on Indonesia, where for the 2001 budget year we have data on both district expenditures and village expenditures for the districts and villages in our

¹⁸Income data from developing country household surveys is often unreliable, so we follow the standard convention of using household expenditures as a proxy for household income throughout the paper. Since household expenditure includes direct and indirect taxes, it is conceptually a "pre-tax" measure. To be consistent, one might also want to add back income lost as a result of informal tax payments. Since our measure of the household wage rate is likely to be noisy, we do not make this adjustment.

survey area.¹⁹ We inflate these 2001 budgets using the overall Indonesian CPI to be comparable to our 2007 data on informal taxation, and report all amounts in 2000 PPP dollars. We calculate the mean per-household level of informal taxes and formal taxes from the household survey, as well as the mean per-household level of village and district revenues and village and district expenditures for our sample area; results are given in Table 5.²⁰

We find that informal taxes are large relative to village budgets. Average annual per household village budgets are 43.67 dollars per year, whereas our household survey suggests that per household informal taxes are 49.86 dollars per year. Moreover, the official village budget actually already includes 13.09 dollars per year in "on-the-books" informal tax payments. If we subtract the 13.09 dollars per year in informal tax payments from the village budget to avoid double-counting, then informal taxes – at 49.86 per year – are 1.2 times as large as all other sources of revenue in the village budget (30.59 dollars per year). The inclusion of informal taxation in the village budget indicates that these local governments view informal taxation explicitly as a source of government revenue, and the magnitudes demonstrate that informal taxation is one of the primary ways through which local public goods are financed by these villages.

We next compare informal taxation to district budgets. Since Indonesia's decentralization began in 2001, Indonesian districts have primary responsibility for virtually all local public goods, including local infrastructure, water, health, and education. The budget is divided into routine expenditures (mostly civil servant salaries) and development expenditures (mostly capital expenditures).²¹ These district budgets also include the intergovernmental transfers to villages, so these budgets should be viewed as a superset of the village budgets. Informal taxation payments are 7% as large as total district budgets, and 22% as large as district spending on development expenditures. This implies that a non-trivial share of all spending on local public goods occurs through

¹⁹District budget data in Indonesia is available annually through 2005. Village budgets, however, are only collected once every decade in the census of villages (PODES); the most recent data comes from the 2002-2003 census of villages, which asked about village budgets during 2001. We therefore use 2001 district budget data as well to ensure comparability with the village data.

²⁰Note that the village budgets were available for 19 of the 20 districts in our household survey area. We have therefore calculated all statistics in the Table on the same set of 19 districts to ensure maximum comparability. Note also that the household survey sample only includes subdistricts that are no more than 70% urban, so it potentially excludes the very urban central areas of a few districts.

²¹Note that informal taxation payments are not reported in district budgets, so double-counting is not an issue in this setting.

the informal taxation mechanism.

Third, we compare informal taxes with the other taxes that are under the control of local government: formal taxes and fees collected by the village and district governments. Table 5 shows that, other than informal taxation, sources of formal tax revenue under direct control of local governments are extremely limited, as most revenue comes from intergovernmental grants from the national government (which administers the VAT and other taxes). Informal taxation is 12 times larger than total village formal taxes, and almost triple total district level formal taxes and fees. Informal taxes are therefore – by far – the largest source of finance that is under local control.

The above figures present estimates of informal taxes in which labor payments are monetized as described in the previous section. We have also constructed estimates of informal taxes in which labor payments are monetized using the local unskilled wage rate.²² The resulting estimates of per household informal taxes decline only slightly, from 49.86 to 44.30 dollars per year. This adjustment does not substantively affect any of our conclusions about the importance of informal taxes as a local revenue source.

4.2 Distributional Implications of Informal Taxation

This section examines the distributional implications of informal taxation by looking at the relationship between informal taxation payments and household expenditure. We begin by examining the distribution of informal taxation payments within communities, which tells us how the burden for financing a given level of public goods is borne across high and low income individuals in those communities. Since informal taxation payments are determined at the community level, this within-community analysis is the level of analysis one needs for developing models of informal taxation. We then turn to compare the aggregate burden of informal and formal taxation across the income distribution.

²²The local unskilled wage rate is calculated using survey information provided by the village head. We sum the daily wage of a male laborer in the month of the interview in the village/ward with the average value per day of goods provided for consumption while working (if applicable). We then divided by the number of hours worked by laborers on an average day and multiplied by 6 to get the value of labor for a "normal" work day at the village level.

4.2.1 Informal taxation within communities

To examine the distribution of informal taxation within communities, we first examine the participation margin – i.e., who makes informal taxation payments. We estimate the following conditional logit specification via maximum likelihood:

$$\mathbf{P} \left(PAY_{hc} = 1 \mid \sum_{h=1}^{H_c} PAY_{hc} = T_c \right) = \frac{\exp \left[\sum_{h=1}^{H_c} PAY_{hc} (\gamma LN (EQUIVEXP)_{hc}) \right]}{\sum_{\mathbf{d}_c \in S_c} \exp \left[\sum_{h=1}^{H_c} d_{hc} (\gamma EQUIVEXP_{hc}) \right]} \quad (1)$$

where h represents a household, c represents a community, PAY is a dummy for whether the household made any payments, $LN (EQUIVEXP)$ is a measure of log household expenditure per equivalent adult, T_c is the number of respondents in community c who reported any payments, and S_c is the set of all possible vectors $\mathbf{d}_c = \{d_{1c}, \dots, d_{H_c c}\}$ such that $\sum_{h=1}^{H_c} d_{hc} = T_c$.²³ The key coefficient of interest is γ , which is the elasticity of the probability of making payments with respect to equivalent household expenditure. Robust standard errors in this and subsequent regressions are adjusted for clustering at the community level.

The results are presented in Panel A of Table 6. Each cell in the table reports the coefficient on log equivalent household expenditure (γ) from a separate regression of the form in equation (1).²⁴ The estimated overall participation-expenditure gradient is statistically significantly positive in 6 of the 10 countries in our sample and is never negative and statistically significant. The modal elasticity among all 10 countries in the sample is about 0.2. This demonstrates that the probability of payment is increasing with household expenditure within communities, and this pattern is generally consistent throughout the the countries in our sample.

We next examine the relationship between the quantity of payments and expenditure, for countries for which data on the quantity of payments are available. Given the large number of observations with no payments, we estimate this relationship as a fixed-effects Poisson quasi-MLE regression with robust standard errors (Hausman, Hall and Griliches 1984, Wooldridge 1999; see

²³Note that for the Philippines, Albania, Ethiopia, Guatemala, and Nigeria, the PAY variable refers to in-kind labor payments only. For all other countries, the PAY variable captures both monetary and in-kind payments.

²⁴As discussed above, we obtain similar results in this and subsequent specifications if we regress contributions on log household expenditure and add as controls dummies for household size (not shown).

also Wooldridge 2002). This estimates, by MLE, equations such that

$$\mathbf{E}(PAYMENTAMOUNT_{hc}) = \alpha_c \exp(\chi LN(EXP)_{hc}) \quad (2)$$

where α_c is a community fixed-effect, and *PAYMENTAMOUNT* is the quantity of total payments (in local currency). Given the Poisson QMLE specification, the resulting coefficients χ can also be interpreted as elasticities.

To calculate *PAYMENTAMOUNT*, we monetize labor payments using the imputed average household wage as described above.²⁵ By allowing the wage to vary with household income, we incorporate the fact that providing a day of labor is more costly for those with high income.

The results are shown in Panel B of Table 6 for all countries for which have data on the quantity of informal taxes. The results show that total payments are increasing in expenditure in all countries for which we have quantity data, and the coefficients are statistically significant in all countries. The estimated elasticities of informal taxation payments with respect to equivalent expenditure are 0.40 in the Philippines, 0.33 in Albania, 0.13 in Ethiopia, 0.39 in Indonesia, and 0.08 in Vietnam. The fact that these elasticities are strictly and statistically significantly less than 1 indicates that while payments increase with expenditure, the share of household expenditures devoted to informal tax payments (i.e., the average tax rate) is declining with expenditure.²⁶ As shown in Panel C of Table 6, payments are also increasing in expenditure, even conditional on making a positive informal tax payment, so the effects are driven by the intensive margin as well as the extensive margin.

Together, the results in Table 6 tell a consistent story across all the countries in our data: within

²⁵As an alternative, we have considered a specification in which we examine days, rather than monetizing by the wage rate (results not reported). As one would expect, the coefficients examining just days are smaller than in the monetized days specification, although the gradient remains positive and significant in Albania and Indonesia and positive and insignificant in the Philippines and Ethiopia. The coefficient for Vietnam is negative and significant, which may reflect features of the mandatory labor payment system.

²⁶Note that monetizing labor payments at a common rate, rather than at the predicted household wage rate as we do, would make informal taxation appear even more regressive. One might be concerned that measurement error in household expenditure data could cause the estimates to be less than one even if informal taxation is truly progressive. However, applying the classical measurement error attenuation bias formula to our estimates shows that measurement error would have to account for more than 60% of the total variation in observed household expenditures in all countries in order for this to be the case.

communities, the wealthy pay more in informal taxes than the poor on an absolute level, though they pay less as a share of their total resources.

4.2.2 Comparing formal and informal taxation

We next compare informal taxes to formal direct and indirect tax payments by households. We consider payments both within communities, as above, and also in aggregate across the entire economy, to capture the fact that informal taxation is more prevalent in rural communities, which tend to be poorer on average.

The results are presented in Table 7. For comparison purposes, Panels A and B show the results for informal taxes. Panel A of Table 7 shows results with community fixed effects (equivalent to Panel B of Table 6), and Panel B of Table 7 shows results without community fixed effects. The estimates for direct formal taxes are shown in Panel C and D (with and without community fixed effects, respectively), and the analogous estimates for total direct and indirect formal taxes are shown in Panels E and F.²⁷

The results in Table 7 show that in all countries we examine, the estimated elasticities of formal taxes with respect to household expenditure are greater than the estimated elasticities for informal taxes. This is true both within communities and in aggregate over the entire sample. For example, the overall elasticity of formal direct taxes with respect to household consumption (i.e., without including community fixed effects) from Panel D of Table 8 is 1.647 in the Philippines, 1.437 in Albania, and 1.299 in Indonesia, so that formal direct taxes are progressive in these countries. By comparison, the analogous overall elasticity of informal taxes with respect to household consumption (i.e., without including community fixed effects) from Panel B of Table 8 is 0.196 in the Philippines, 0.391 in Albania, and 0.439 in Indonesia, so informal taxes are on average regressive in these countries.²⁸ Informal taxes are levied by local governments, whereas VAT and formal direct taxes tend to be levied by state or national governments, so these are not necessarily taxes levied by the

²⁷Note that since formal indirect taxes are imputed by applying VAT rates to different categories of consumption (see Data Appendix), measurement error will bias the coefficients on formal indirect taxes towards 1. In that sense the most meaningful comparisons are between informal taxes and formal direct taxes, both of which are estimated completely independently of household consumption.

²⁸In interpreting these results, recall that the Ethiopia sample is rural and the Indonesia and Philippines samples focus on poorer, rural areas. These results are therefore not necessarily representative of the entire country.

same level of government; nevertheless, the difference in progressivity is dramatic.

Figure 1 illustrates these differences graphically, plotting informal taxes, direct formal taxes and total formal taxes (i.e., direct + indirect), all expressed as percentages of total household expenditure. For each country, we plot the results of a non-parametric Fan regression of each variable against log equivalent household expenditure. The solid lines in Figure 1 show informal taxes, the dashed lines shows direct formal taxes, and the dotted line shows total formal taxes. For comparison, we also plot a histogram of log equivalent household expenditure. To keep the graphs readable, we have excluded the bottom 0.5% and top 0.5% of the household expenditure distribution. The most striking fact about these graphs is that the formal tax system is progressive in most countries whereas the informal tax system is regressive. Including informal taxation therefore makes the total tax burden look more regressive than previously thought.

4.3 Monetary vs. In-Kind Payments

A notable feature of informal taxation is that payments are often made in labor. In particular, for most households, informal taxation payments are in-kind labor payments, rather than payments in money (Table 3). While measuring a household's true opportunity cost of time is difficult, the findings certainly suggest that at least some households are making inefficient payments in labor. We discuss possible explanations for the prevalence of labor payments below. To better understand this phenomenon, it is useful to understand in more detail which types of households pay in labor versus money.

To do so, we re-estimate equations (1) and (2) separately for each type of payment, focusing on the countries for where we have data on both monetary and in-kind labor payments. In this analysis, to be consistent with the previous tables, we continue to examine the value of labor payments, where they are valued at the household's predicted average wage rate, though using days instead of monetized labor contributions in these tables makes the reported estimates for labor smaller and accentuates the difference between labor and money more than shown in the tables here.

The results for the participation margin – does the household pay any labor or any money – are

presented in Table 8, and the results on the quantity paid are presented in Table 9. The results in both Table 8 and Table 9 show a very clear pattern: for almost all countries in the sample, monetary payments increase more quickly with overall household expenditure than in-kind labor payments. This is true both on the participation margin (Table 8) and, for the two countries where we have quantity data, on the quantity margin as well (Table 9). For example, looking within communities in Indonesia, the elasticity of labor payments with respect to household expenditure is 0.26, but the elasticity of monetary payments with respect to household expenditure is 1.45 (see Panel A of Table 9). Overall, the findings suggest that within communities, participation in both labor and money increases with income, with a much higher income elasticity for money than for labor. This implies that monetary contributions are particularly concentrated at higher income levels, a fact we return to in the theoretical framework below.

4.4 Implications

These stylized facts have several implications for public finance in developing countries. A substantial share of households in many developing countries participate in extragovernmental mechanisms for the finance of local public goods. To the extent that these payments are thought of as a tax, estimates of formal taxes may understate the true tax burden faced by households. Failing to take informal taxation into account will also lead to underestimates of the size of the public sector and the level of decentralization. In particular, informal taxation can be the dominant source of revenue for local communities and may be a non-trivial component of national spending on public capital improvements in developing countries.

We find that informal taxation is redistributive but regressive, and this pattern is observed in almost all of our sample countries. Formal taxes appear to be more progressive than informal taxes in all of our sample countries. Estimates of formal taxes alone may therefore result in overestimates of the overall progressivity of the tax system.

Finally, a notable feature of informal taxation is that in-kind labor payments are an important source of finance and are made even by households with relatively high household expenditure. While measuring a household's true opportunity cost of time is difficult, the findings certainly

suggest that at least some households are making inefficient payments in labor. We discuss possible explanations for the prevalence of labor payments below.

5 A Model of Informal Taxation

The stylized facts we observe are remarkably consistent across countries. This section develops a simple framework for thinking about informal taxation that does not require non-standard preferences, government corruption, or market failures in labor or credit markets, but instead treats informal taxation as one possible solution to an optimal tax problem, with asymmetric information and screening. We discuss alternative models in Section 6.

In our model, local governments face a standard problem: financing local public goods in a social welfare maximizing way under asymmetric information. As in standard taxation models, governments face information constraints about true earnings ability, since by paying some cost individuals can hide income from the government. Our model adds two additional constraints: governments may face constraints on their ability to enforce the desired tax schedule, and they may also face constraints on labor taxes, since individuals can shirk on required labor payments. These information and enforcement constraints limit the degree to which the government can achieve redistribution in financing the public good.

We model formal and informal taxes as having different constraint parameters arising from differences in their tax technologies. In the informal system, enforcement happens through social sanctions rather than through courts. This means that the informal system must use less severe punishments than the formal system, i.e., social sanctions instead of jail time. However, the informal tax system can use information that does not meet the burden of proof required in court (i.e., information that is observable but not verifiable), so it effectively has better information than the formal tax system.²⁹

We demonstrate that informal taxation may be the optimal solution to the government's con-

²⁹ Another possible constraint on redistribution is exit from the local community. Exit would affect both formal and informal taxes in the same way, so for simplicity, we do not consider the issue of exit here. In practice, mobility is often low in developing countries (Bardhan 2002). Abramitzky (2008) explores the issue of exit as a constraint on redistribution in a different context, that of Israeli kibbutzim.

strained maximization problem and show that the model’s predictions are consistent with the observed patterns of informal tax prevalence. We also show that the predictions of the model match the stylized facts on the distribution and form of informal tax payments.

Modeling these payments as the equilibrium of a screening mechanism differs from the literature on voluntary contributions to public goods, which often models contributions driven by a personal desire to affect the level of the public good (e.g., Olson 1965), a warm-glow from donations (e.g., Andreoni 1990), or to signal wealth to others (e.g., Glazer and Konrad 1996). Others have modeled private provision of public goods in a collective action framework; see for example Bergstrom et al. (1986) and Bagnoli and Lipman (1989). To the best of our knowledge, little work has focused on formally modeling informal tax mechanisms specifically. An exception is Wilson (1992), who argues that cooperation in a repeated prisoner’s dilemma game may be sustainable in the context of *harambee* programs in Kenya.

This section proceeds as follows. We begin in section 5.1 by setting up the general social planner’s maximization problem with enforcement and information constraints as a two-type screening model. We introduce informal and formal taxation in the context of this model by varying the enforcement and information constraints. Section 5.2 discusses the implications of the model for the empirics of informal taxation.

5.1 Model

5.1.1 Setup

Suppose that there are N individuals. A fraction α of the individuals have wage w_H and a fraction $1 - \alpha$ have wage w_L where $w_L < w_H$. We assume that w is private information. We assume that each individual has an endowment of time 1 which they spend working. For simplicity, we model all behavioral responses as coming through the decision to hide income rather than through changes in labor supply. Each individual’s wealth is therefore equal to his wage rate. There are no savings, so individuals consume their entire wealth after paying any taxes.

Each individual i can potentially consume two goods, the private good (w_i) and the public good (g). If the public good is provided, all individuals consume it and $g = 1$; if it is not provided, then

$g = 0$. We assume that utility over the private good is concave and that the utility from the private and public good are separable, i.e.

$$U = u(w_i) + \theta g$$

where u is concave and θ indicates the value the individual receives from consuming the public good. We assume that u has the property that the coefficient of relative risk aversion is greater than 1 (i.e., $\frac{-wu''(w)}{u'(w)} > 1$).³⁰

The public good costs G to produce, and once produced is both non-rival and non-excludable. G is determined exogenously.³¹ For the public good to be provided, total government revenue R must be greater than or equal to G . We assume that providing the public good is efficient, so that the first-best involves providing the public good.

We assume that the goal of the government is to finance the public good in a way that maximizes social welfare. Taxes cannot be negative; in other words, redistribution occurs only through progressive payments toward the public good.³²

Taxes can potentially be paid in two forms: money and labor. Define τ_H and τ_L as the monetary payments from the high and low type. Define λ_H and λ_L as the labor payments from the high and low type, defined as a share of each type's total time budget. After-tax income for type i is then $w_i(1 - \lambda_i) - \tau_i$.

We assume that λ_i is publicly valued at the low type wage rate w_L , i.e., λ is always used for low-skill tasks. This implies that labor by the high type is inefficient, since it is valued at the opportunity cost w_H by the high type but valued only at w_L in the government budget constraint.

³⁰This assumption guarantees a single-crossing property which is necessary to allow screening using labor taxes (λ), discussed in more detail below. To see this, note that

$$\frac{\partial^2 U}{\partial \lambda \partial w} = -wu''(w) - u'(w)$$

If $\frac{-wu''(w)}{u'(w)} > 1$, then $\frac{\partial^2 U}{\partial \lambda \partial w} > 0$, so that the marginal utility cost of an extra hour worked is strictly increasing in wealth.

³¹We focus here on the decisions made by local government trying to raised a fixed amount of revenue to finance a public good, abstracting from intergovernmental transfers and endogenous public good size.

³²In a system where a large share of payments take the form of in-kind unskilled labor, positive net transfers (i.e., net receipt of unskilled labor) could be difficult to implement. In addition, we can observe only payments (either zero or positive) to the public good in the data. General transfer payments, if any, may occur through a different mechanism. In this respect, we can think of informal taxation as somewhat analagous to a property tax system (a tax levied to finance a set of goods) that may exist in addition to a traditional income tax and transfer system.

We assume that the social planner faces three types of constraints in designing the optimal allocation. First, there is the *enforcement constraint*: if a given type fails to pay his required taxes, the planner can impose a utility punishment up to a maximum of P . This punishment P enters the planner's problem as an IR constraint. Second, there is the *hidden income constraint*: by paying a utility cost D , a high type can hide his income and pretend to be a low type. Third, there is the *shirking constraint*: by paying a utility cost S , the type who is supposed to do the higher amount of work in labor can shirk and actually do only the lowest amount of labor required of any type (denoted $\underline{\lambda}$).³³ The hidden income and shirking constraints enter the planner's problem as IC constraints. Together, the triplet of costs, (P, D, S) , is what we refer to as the technology of the tax system. We will model informal vs. formal taxation as having different tax system technologies.

5.1.2 Planner's problem and characteristics of the solution

Faced with a given tax technology (P, D, S) , the social planner's problem is to maximize social welfare subject to the enforcement (IR), hidden income (IC) and shirking (IC) constraints, i.e., he solves:

$$\max_{(\tau_i, \lambda_i)} \alpha (u(w_H(1 - \lambda_H) - \tau_H)) + (1 - \alpha) (u(w_L(1 - \lambda_L) - \tau_L)) + \theta \quad (3)$$

subject to the enforcement constraints (IR):

$$u(w_H) - P \leq u(w_H(1 - \lambda_H) - \tau_H) \quad (\text{EC}_H)$$

$$u(w_L) - P \leq u(w_L(1 - \lambda_L) - \tau_L) \quad (\text{EC}_L)$$

hidden income constraints (IC):

$$u(w_H(1 - \lambda_L) - \tau_L) - D \leq u(w_H(1 - \lambda_H) - \tau_H) \quad (\text{HI}_H)$$

$$u(w_L(1 - \lambda_H) - \tau_H) - D \leq u(w_L(1 - \lambda_L) - \tau_L) \quad (\text{HI}_L)$$

³³Note that hiding income allows the high type to pretend to be the low type and pay the labor and money taxes required by the low type, whereas shirking allows each type to do the minimum amount of required labor without affecting the monetary taxes.

shirking constraints (IC):

$$u(w_H(1 - \underline{\lambda}) - \tau_H) - S \leq u(w_H(1 - \lambda_H) - \tau_H) \quad (\text{SC}_H)$$

$$u(w_L(1 - \underline{\lambda}) - \tau_L) - S \leq u(w_L(1 - \lambda_L) - \tau_L) \quad (\text{SC}_L)$$

the government budget constraint:

$$\alpha(\tau_H + w_L\lambda_H) + (1 - \alpha)(\tau_L + w_L\lambda_L) = \frac{G}{N}$$

and non-negativity constraints:

$$\tau_i \geq 0, \lambda_i \geq 0 \quad \forall i$$

Note that in the first best (when no constraints bind), the planner will set taxes so that the after-tax marginal utilities are equal for the two types; if the non-negativity constraint binds, the optimum in the first-best will be to set $\tau_L^* = 0$ and $\tau_H^* = \frac{G}{\alpha N}$.

Several comments are worth making about the general solution to this problem. We first examine the form of tax payments of each type and then discuss the distributional implications.

Remark 1 *The high type will always pay in money, not in labor.*

Proof. All proofs are given in Appendix B. ■

The fact that the high type always pays in money, not labor, is the equivalent of the "no distortion at the top" result from the optimal tax literature (Mirrlees 1971).

The shirking constraint determines the degree to which labor can be used as a screening device and therefore the form of payment of the low type:

Remark 2 *As the utility cost of shirking (S) increases, the low type's taxes will weakly shift towards taxes in labor, i.e., $\frac{\partial \left(\frac{w_L \lambda_L}{w_L \lambda_L + \tau_L} \right)}{\partial S} \geq 0$, with the inequality strict whenever EC_H does not bind and $\tau_L > 0$.*

Since an hour of the low type's labor is publicly valued at the low type's outside wage rate, having the low type pay in labor does not affect the government budget constraint. It does, however, allow for more screening by affecting the high type's hidden income constraint, since it would now cost the high type more in foregone income if he were to deviate to the low type's tax package and pay labor instead of money. As long as EC_H is slack (in other words, as long as it is possible to increase the tax payment of the high type without violating his IR constraint), then shifting the low type toward labor will allow the planner to improve social welfare.

If the shirking constraint for the low type does bind (from Remark 1, we know that $\underline{\lambda} = 0$ at the optimum), then there are limits to the degree to which labor can be used as a screening device. In this case, τ_L could be positive, and the inability to screen using labor could reduce the overall progressivity of the tax system or make it no longer optimal to provide the public good.

We next examine the distribution of payments:

Remark 3 *As long as the planner has some information (either $D > 0$ or $S > 0$) and $P > u(w_H) - u(w_H - \frac{G}{N})$, then if the public good is provided, total payments will be strictly increasing in household expenditure, i.e., it will always be the case that $\tau_H + w_H\lambda_H > \tau_L + w_L\lambda_L$.*

Thus as long as the government has any information and sufficient ability to enforce, the tax system will be redistributive – i.e., the high type will pay more in taxes than the low type.³⁴ This result comes directly from the fact that the planner is maximizing social welfare and the marginal utility of income is higher for the low type. The difference in tax payments between the two types is weakly increasing in the wage gap between the two types.

The fact that the high type pays more does not necessarily imply that the tax system will be progressive – i.e., it does not imply that the high type will pay more in taxes as a share of income than the low type. In fact, whether the tax system is progressive or regressive is theoretically ambiguous and depends on the parameters of the model.

It is also important to note that while the utility costs (P, D, S) represent a social loss, none of these costs should be borne in equilibrium. Efficiency costs relative to the first best instead

³⁴We monetize labor payments by the high type using the high type's wage rate, since this measure is most relevant for considering the distribution of tax burdens.

take two forms. First, the public good may not be provided whereas it will always be provided in the first best. This may occur if the government cannot satisfy the enforcement and information constraints and still meet its budget constraint or if redistribution is limited enough that providing the public good actually reduces social welfare. Second, in a multiple type case, it may be optimal for the government to require inefficient labor payments from individuals whose wage rate exceeds the unskilled wage rate, since those labor payments serve as a screening device for higher wage types. We discuss extensions to the multiple type case in more detail below.

5.1.3 Formal vs. informal taxes

We model formal and informal taxation as having different technology triplets. Formal taxes are thus represented by the triplet (P_F, D_F, S_F) whereas informal taxes are represented by the triplet (P_I, D_I, S_I) . We assume that $P_F \geq P_I$ – i.e., the punishments that can be imposed by the courts, conditional on detecting non-compliance, are at least as great as the punishments that can be imposed informally through social sanctions.³⁵ By using the formal legal system, the social planner can in theory levy an unlimited punishment if the individual does not meet his required payments (for example, through imprisonment); in the informal tax system, there are likely to be limits on the sanctions that can be imposed for non-payment. We can think of the costs of evading income (D) or evading labor taxes (S) as inversely related to the information the community needs to impose punishment. A conviction in the formal legal system is likely to require a higher level of proof than a community needs to impose informal punishments, which implies that $D_F \leq D_I$ and $S_F \leq S_I$. The choice between formal and informal taxation thus entails a trade-off between enforcement (P) and information (D and S). In the limiting case ($P_F \rightarrow \infty, D_I \rightarrow \infty$), formal taxes are limited by the IC constraints (hidden income and shirking) whereas informal taxes are limited

³⁵Note that social sanctions must be levied by individual community members, not by the social planner directly. However, we can think of the social planner as coordinating the community on a particular equilibrium by choosing the schedule of social sanctions to be implemented by the community. If each individual in the community's cost of enforcing a social sanction on someone else is less than the cost of receiving a social sanction themselves, there is an equilibrium where everyone in the community enforces the social sanction on non tax payers, as well as enforces the social sanction on anyone who deviates and does not enforce a social sanction when they are supposed to do so. Perroni and Scharf (2007) note that *any* tax schedule must ultimately be sustained by the collective willingness of the group to enforce the schedule, and Fehr and Gächter (2000) discuss the willingness of individuals to punish free riders even if such punishments are costly.

by IR constraints (punishments).³⁶

5.2 The informal tax framework and the stylized facts

5.2.1 The choice between formal and informal taxes

This framework suggests that informal taxation is likely to result in a social welfare improvement relative to formal taxation when: (1) the ability of the community to levy social sanctions (P_I) is high; (2) there is more available information about incomes informally than formally ($D_F < D_I$); and (3) the ability to monitor labor payments informally is greater than the ability to monitor formally ($S_F < S_I$).

The prevalence of informal taxation throughout our sample of developing countries, particularly in rural areas, is consistent with the existing evidence that informal insurance and credit markets may function more effectively in rural areas, where information is better and villagers are better able to levy informal sanctions for default (Townsend 1995, Besley and Coate 1995, Banerjee and Newman 1998, Ghatak 1999). The ability to verify income legally may also be more difficult in developing countries, since many individuals work in or can easily shift into the informal sector.³⁷ Unsurprisingly, informal taxation mechanisms are not generally observed in developed countries, where it is harder to hide income and where social sanctions may be less effective.³⁸

Labor payments are also likely to be hard to verify legally. This suggests that even if D is the same across the two systems, informal taxation may be preferable since the community can more easily make use of labor payments as a screening device through the informal system.

Note that labor taxes are sometimes implemented through the formal tax schedule. Systems of corvée labor, for example, were common at one time in Europe and elsewhere, and mandatory labor taxes still exist in some countries, such as Vietnam. It may be that in at least some of these contexts, local landlords or officials did not have to meet the burden of proof required by a court

³⁶Depending on the constraints, it may be possible that the government will optimally choose some formal and some informal taxes.

³⁷Similarly, while landholding may be legally verifiable in theory, land taxes in developing countries have also proven difficult to implement in practice (Burgess and Stern 1993).

³⁸As noted in the introduction, however, such systems can arise even in countries like the United States in situations in which formal taxation is limited.

in order to punish non-compliers, resulting in a high D_F .³⁹

5.2.2 The distribution and form of informal taxes

The informal tax model makes a number of predictions about the distribution and form of informal tax payments. As discussed above, the framework suggests that informal tax payments should be increasing with household expenditures. In fact, the elasticity of total payment with respect to household expenditure is positive in all countries (shown in Table 7), consistent with the prediction of the model. Moreover, in the simple two-type case, it will be optimal for the public good to be financed solely by the high types if income inequality is sufficiently high and the planner has the ability to satisfy the high type's IR and hidden income IC constraints. The data is also consistent with this prediction: we observe significantly positive participation gradients in the majority of sample countries (shown in Table 7).

In our simple framework, we have focused on the local government making a choice between formal and informal taxes. In practice, the optimal solution may involve the government levying both types of taxes. The observation that formal direct taxes are generally more progressive than informal taxes could result from local governments levying formal taxes until D binds. While such a formal tax system could be progressive, once D binds, a marginal expansion of the formal tax system could then only be achieved by a (very regressive) poll tax. The local government might instead choose to expand financing through informal taxes, where some degree of redistribution can be achieved by making use of the higher information (D and S) available informally. The fact that formal direct taxes tend to be very small, even in comparison to informal taxes (Figure 1) is consistent with the idea that local governments are constrained in their ability to levy formal taxes, i.e., D may be binding.⁴⁰

Our framework also rationalizes the prevalence of labor payments in the data. In the first best case, the government will be indifferent between having the low type pay in labor versus money. In

³⁹A number of studies have documented substantial absenteeism in sectors such as health and education in developing countries (e.g., Banerjee and Duflo 2006), which suggests that the effectiveness of formal public works projects may be constrained by shirking as well.

⁴⁰By contrast, indirect formal taxes (VAT) are large, but these tend to be levied by state and national governments and could be administratively difficult to administer at the local level.

this framework, the government will always prefer to have the low type pay in labor if the shirking constraint does not bind, since doing so allows the government to extract greater payments from those with (unobservably) higher income. If the shirking constraint does bind, the low type may make payments in both money and labor, consistent with what we observe in the data (Table 3, Panel B). Conversely, high types should pay in money rather than in labor, which is what we observe in almost all countries (Table 8; Table 9).

5.3 Extensions to multiple types

This section discusses two extensions of the model. First, we consider the case where the low type's wage is above the unskilled wage rate, so that having the low type pay in labor imposes social costs. Second, we consider what happens when we introduce more than two types into the model. Together, these two extensions allow the model to closely match all of the stylized facts demonstrated above.

First, consider the case when both the high and low wages are above the unskilled wage rate. Specifically, suppose that a fraction α of the population earns wage w_H and a fraction $1 - \alpha$ earns wage w_M , where $w_H > w_M$. The labor payments of each type are valued by the government at wage rate w_L , where $w_L < w_M$. The enforcement, hidden income and shirking constraints are the same as above, with the difference that the low skilled type is now receiving wage w_M and paying taxes $\lambda_M w_M + \tau_M$. In this case, the general pattern of the equilibrium – with the high type paying more in total and the high type never paying labor taxes – still hold, i.e.:

Remark 4 *Even if $w_M > w_L$, $\lambda_H = 0$ and $\tau_H > \tau_M + w_M \lambda_M$ under conditions analogous to those given in Remarks 1 and 3.*

The key difference if $w_M > w_L$ is that using labor as a screening device now has real social costs, so it affects the attractiveness of using labor as a screening device. At the same time, however, changing the payment mix for the low type without affecting the government budget constraint results in an increased total tax payment for the low type. Nevertheless, we show with a numerical example (provided in Appendix B) that it is still possible to obtain similar equilibria, i.e.:

Remark 5 *Even if $w_M > w_L$, it is still possible to obtain an equilibrium where the high type pays only in money and the low type pays only in labor.*

The model thus provides a potential explanation for labor payments made by those with an opportunity cost above the unskilled wage rate, despite the fact that these in-kind payments are inefficient.

Second, we examine the case when there are three types in the model. With three types, we can simultaneously consider participation gradients (i.e., does the household pay anything at all) and the quantity paid conditional on participating. With a numerical example (provided in Appendix B) we can show the following possibility result:

Remark 6 *If there are multiple types and if the cost of hiding income increases with the amount of income hidden, it is possible to get both a positive participation gradient and a positive income gradient conditional on participating.*

The example in the appendix provides parameter values for which the pattern outlined in the above remark will hold at the optimal solution. Moreover, in this numerical example, it is also optimal for the middle type, whose wage rate is greater than the unskilled wage rate, to pay in the form of labor, since these payments serve as a screening device. We have thus provided an example that encompasses many of the stylized facts: a positive participation gradient, a positive income gradient conditional on paying, prevalent labor payments, a steeper gradient on money payments than on labor payments, and labor payments by those whose incomes are greater than the unskilled wage rate.

6 Alternative Explanations

In this section we discuss other explanations for these methods of local public goods finance. In particular, we focus on three alternatives: voluntary contributions, user fees, and collective action. The first possibility we consider is that observed informal tax payments are voluntary contributions, motivated by altruism or warm glow preferences (e.g., Andreoni 1990). However,

the inclusion of informal taxes in Indonesian village budgets indicates that governments view these payments as a fundamental component of the local budget, rather than as charitable contributions which supplement government expenditures. In addition, there is substantial evidence that these payments are not purely voluntary. Many of the studies discussed in Section 2, for example, specifically describe the punishments that are imposed on those who do not meet their expected obligations.

To investigate more systematically the process through which informal tax payments are determined and enforced, we asked both households and village heads in the Indonesia survey to describe who makes decisions regarding household contributions and what the consequences are for households who do not participate.

The first question we asked was who makes decisions about which households participate in such mechanisms (Table 10). Although respondents were allowed to give multiple responses, only 8% of individual respondents and village heads reported that households make these decisions for themselves. The majority of respondents indicated that decisions are made by community leaders or at community meetings. We observe a similar pattern when respondents are asked who makes decisions about how much each household is expected to pay: only 20% of households and 15% of village heads report that households make these decisions for themselves. These consistent responses from individual households and from village heads suggest that these payments are not voluntary contributions decided by individuals, but rather part of a system determined at the community level.

We then ask respondents about the consequences for not making the determined level of payment. Although we believe that informal taxation may be enforced at least partially by intangible social sanctions, we explicitly limited this question to concrete measures of sanctions (i.e., we did not include response options of the form "I would feel uncomfortable in the neighborhood"). A substantial number of respondents indicated that they would be expected to make up the contribution in another way, either by payment at a different time or in a different form. Most strikingly, 17% of individual respondents and 21% of village heads indicated that non-participating house-

holds would be expected to pay a fine.⁴¹ Conditional on some type of sanction being levied, 66% of households stated that the sanction was determined by either the village head or at a village meeting. Taken together, these findings suggest informal tax payments are not analogous to charitable contributions: informal tax payments are an important component of government budgets, payment schedules are set by the leader or group, not by the individual, and there are consequences imposed for non-contribution.

A second alternative hypothesis is that these payments represent pre-paid user fees. A user fee model would suggest that those who do not pay should be excluded from the public good; however, virtually none of the individuals or village heads in the Indonesia sample described not being allowed to use the result of the activity as a possible consequence of non-participation. In addition, a user fee model would not necessarily generate a positive correlation between household expenditure and payments, unless demand for the goods was correlated with household income. To examine this, we examine whether households are more likely to pay for goods for which they benefit and whether this could explain the observed positive participation gradient of informal tax payments. We focus on the two types of goods for which we can clearly separate users from non-users: we examine whether households who have their own private well are less likely to contribute to water projects, and whether those with school-age children are more likely to contribute to schools.⁴²

For 3 of the 5 countries for which we have disaggregated data on project type, we do see some evidence of user fees: those who are likely to need public water are more likely to pay for water projects and those with children are more likely to pay for schools (Table 11).⁴³ However, with the exception of Zambia, we do not observe a positive expenditure gradient on participation for schools or water projects, even in regressions where we do not control for having children or not

⁴¹It is worth noting that a smaller share of respondents and village heads report that they can replace their required labor payment with the labor of another individual. If D is high enough that the government does not need labor as a screening device, allowing replacement labor could be efficient. Otherwise, allowing individuals to replace labor undermines labor as a screening device.

⁴²Note that the within-community sample sizes are not large enough for us to construct meaningful overlapping samples. Therefore, the results for project type should be interpreted as illustrating the distribution of payments for the sample of communities for which the share of households making payments to that project type are strictly between zero and one.

⁴³It is difficult to interpret the coefficient on children in the household since we also include equivalent scale expenditure. We use this specification because we are primarily interested in the difference in the relationship between payment and having children in the household across the school and water regressions rather in the level of the coefficient.

having access to private water. This suggests that while these goods may be financed partially through user fees, these goods are not explaining the overall positive correlation we found above between participation rates and household expenditure. While these goods may have a user fee components, other goods, such as roads, health centers, and sanitation systems, may not.⁴⁴

The final possibility we consider is that informal taxation is not a system of optimal taxation but rather simply a mechanism to overcome a collective action problem. In this model, all residents of the community benefit from the public good but free riding prevents the good from being provided. The goal of the government is to overcome this collective action problem by levying sanctions on those who do not participate. This model differs from our framework in that the government's goal here is to maximize the participation rate, not to achieve redistribution. This model predicts a positive participation gradient with respect to income, since wealthier households will be more willing to make a payment in order to avoid a social sanction. However, it does not predict that payments should rise with income conditional on participating, which is what we observe in almost all of our sample countries.

Another limitation of all of these alternative models is that they cannot, in isolation, fully explain the observed pattern of labor payments. Each of these models predicts that households should make payments in labor only if it is efficient to do so. These models do not explain why labor payments are so prevalent over a large range of the income distribution, nor do they explain why a given household might make both labor and monetary payments. Explaining the patterns observed in the data under any of these models therefore requires introducing failures in the labor market.

7 Conclusion

Informal taxation systems appear to play an important role in local public finance in developing countries. We present some of the first systematic, cross-country evidence on the prevalence,

⁴⁴Moreover, the point estimates on log expenditure per equivalent adult do not change substantially depending on whether we include variables for having children in the household and having a private water source. This suggests that even for these types of goods, differences in demand for the goods are not driving the participation gradient.

magnitude, distributional implications, and forms of informal taxation. We find that informal taxation is prevalent, with 20% or more of households participating in informal taxation schemes in all but one surveyed country, and more than 50% of households participating in several countries. Informal taxes exceed formal direct tax payments by most households and can form a substantial share of households' total tax burdens. In Indonesia, where we can compare informal taxes to local budgets, we find that informal taxation represents the largest source of public finance under local control and comprises a substantial share of all development expenditures.

We propose a simple optimal tax framework that helps to explain many of the stylized facts about informal taxation we observe in the data. We depart from the first best case by introducing constraints on enforcement (the government may face limits in enforcing its tax schedule) and constraints on information (individuals can hide income and shirk when working on public labor projects). The choice between formal and informal taxation represents a trade-off between the two types of constraints. The model parsimoniously explains the patterns of informal tax prevalence, the positive income gradient on informal tax payments, and the widespread use of labor payments, even when such payments appear to be inefficient.

Our findings have a number of implications for thinking about public finance in developing countries and for development policy. First, a substantial share of households in many developing countries participate in extragovernmental mechanisms for the finance of local public goods. Policies such as the imposition of formal taxes, paid public works programs, and intergovernmental grants may therefore affect households and communities both directly as well as indirectly, through their effects on informal taxation mechanisms. To the best of our knowledge, this type of crowd-out has not traditionally been considered in the analysis of public programs in developing countries.

Second, to the extent that these payments are thought of as a tax, estimates of formal taxes may understate the true tax burden faced by households. In particular, the conventional wisdom that poor households and households in rural areas do not generally pay taxes other than VAT may be misleading. The potential efficiency costs of these taxes have not, to the best of our knowledge, been considered; in our framework, efficiency costs arise from possible failure to provide the public good and inefficient payments in labor.

Third, failing to take informal taxation into account will lead to underestimates of the size of the public sector and the level of decentralization. In particular, informal taxation can be the dominant source of revenue for local communities and may be a non-trivial component of national spending on public capital improvements in developing countries. While there has been an increasing push toward decentralization in developing countries, such reforms have generally led to greater decentralization of expenditures than of revenue collection (Bardhan 2002). Since informal taxes are collected at the community level, these findings indicate that a larger share of local public goods is financed locally than the formal budget figures would suggest. In addition, informal taxation generally pays for particular types of goods, so formal tax figures will distort estimates of the mix as well as the level of government expenditures.

Finally, informal taxation is redistributive but regressive, and this pattern is observed in almost all of our sample countries. Formal taxes appear to be more progressive than informal taxes, so failing to take informal taxation into account will result in overestimates of the overall progressivity of the tax system. It also suggests that a marginal expansion of the formal tax system through expansion of the VAT, used to allow communities to reduce informal taxes, could substantially increase the overall progressivity of the tax system. However, it is important to keep in mind that most of these formal taxes are not raised by the local community, and determining the appropriate community-specific intergovernmental transfers is challenging. This is a primary reason why local public goods in developed countries are often financed through local taxation.

The findings also have important implications for development policy. Many government programs, such as community-driven development programs championed by the World Bank and others, encourage local co-financing of public goods. Given that financing through informal taxation is more regressive than financing through the overall tax system, there would need to be other benefits of local co-financing to make this co-financing optimal. For example, requiring local co-financing might help reveal information about the local willingness to pay for local public goods, or it could improve project sustainability by encouraging ongoing maintenance of local public goods. Alternatively, as discussed above, it is possible that additional central financing of public goods might crowd out these types of locally-financed public goods, altering both the level and type of

public goods provided. There could also be other consequences of formal versus informal financing on community institutions and social networks. Understanding how central government policies interact with informal taxation is an important direction for future research.

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A Appendix A: Data

[TO BE ADDED]

B Appendix B: Proofs

Proof of Remark 1. Suppose that, at the optimum payment level, $\lambda_H > 0$.

(i) Suppose SC_L does not bind.

Let the payment of the high type change to the new levels $\lambda_H^* = \lambda_H - \epsilon$ and $\tau_H^* = \tau_H + w_L \epsilon$, for some small $\epsilon > 0$. At these new payment levels, the shirking constraint for both types would still hold.

For HI_H :

$$u(w_H(1 - \lambda_L) - \tau_L) - D \leq u(w_H(1 - \lambda_H) - \tau_H) \leq u(w_H(1 - \lambda_H) - \tau_H + (w_H - w_L)\epsilon) = u(w_H(1 - \lambda_H^*) - \tau_H^*) \implies HI_H \text{ still holds for } \lambda_H^* \text{ and } \tau_H^*.$$

For EC_H : $u(w_H) - P \leq u(w_H(1 - \lambda_H) - \tau_H) \leq u(w_H(1 - \lambda_H^*) - \tau_H^*) \implies EC_H$ still holds for λ_H^* and τ_H^* .

HI_L , EC_L , the government budget constraint and the low type's utility are unaffected by the changes in the high type's payments.

The high type's utility now becomes:

$u(w_H(1 - \lambda_H^*) - \tau_H^*) = u(w_H(1 - \lambda_H) - \tau_H + \epsilon(w_H - w_L)) > u(w_H(1 - \lambda_H) - \tau_H)$. Thus, the high type can be made strictly better off without violating any of the constraints.

(ii) Suppose SC_L binds.

This implies $\lambda_L > 0$. Let the payments of the two types change such that, for some small $\epsilon > 0$, $\lambda_L^* = \lambda_L - \epsilon$, $\lambda_H^* = \lambda_H - \epsilon$, $\tau_L^* = \tau_L + w_L \epsilon$ and $\tau_H^* = \tau_H + w_L \epsilon$.

Decreasing λ_L and λ_H by ϵ and increasing τ_L by ϵ would not change the low type's income or the SC_L constraint. So SC_L will still hold.

We next check that SC_H is still satisfied at the new payment levels.

At the previous allocation, $S \geq u(w_H(1 - \lambda_L) - \tau_H) - u(w_H(1 - \lambda_H) - \tau_H)$. At the new allocation, income in both utility terms is increased by $\epsilon(w_H - w_L) > 0$. Since the utility function is concave, this change will decrease the right-hand side of the inequality, so SC_H will still be satisfied.

As above, HI_H , EC_H , HI_L , and EC_L will continue to hold at the new payment levels. The government budget constraint and the low type's utility are unaffected by the changes in payments.

As before, the high type's utility now becomes:

$u(w_H(1 - \lambda_H^*) - \tau_H^*) = u(w_H(1 - \lambda_H) - \tau_H + \epsilon(w_H - w_L)) > u(w_H(1 - \lambda_H) - \tau_H)$, so the high type can be made strictly better off without violating any of the constraints.

Thus, in both (i) and (ii), $\forall \lambda_H > 0$, social welfare can be increased without violating any of the constraints \implies at the optimum level of payments, $\lambda_H = 0$. ■

Proof of Remark 2. Notice that the non-negativity constraint and the fact that $\lambda_H = 0$ at the optimum (Remark 1) imply $\underline{\lambda} = 0$ and SC_H is slack.

Assume that there exists an allocation $\lambda_L \geq 0$, $\tau_L > 0$, $\tau_H \geq 0$ such that the constraints are satisfied and the public good is provided. Thus, $S \geq u(w_L - \tau_L) - u(w_L(1 - \lambda_L) - \tau_L)$.

Let $S^* = S + \Delta S$, $\Delta S > 0$. Thus, $S^* > u(w_L - \tau_L) - u(w_L(1 - \lambda_L) - \tau_L)$ and SC_L is slack.

For some small $\epsilon > 0$, let $\tau_L^* = \tau_L - w_L \epsilon$ and $\lambda_L^* = \lambda_L + \epsilon$. At these new payment levels SC_H and SC_L would still be satisfied.

Since $u(w_L(1 - \lambda_L^*) - \tau_L^*) = u(w_L(1 - \lambda_L) - \tau_L)$, HI_L and EC_L are unchanged. EC_H is also unchanged.

However,

$u(w_H(1 - \lambda_L^*) - \tau_L^*) - D = u(w_H(1 - \lambda_L) - \tau_L - \epsilon(w_H - w_L)) - D < u(w_H(1 - \lambda_L) - \tau_L) \leq u(w_H(1 - \lambda_H) - \tau_H) \implies HI_H$ is slack $\forall D \geq 0$. Thus, HI_H would be satisfied for higher values of τ_H . This is because it would now cost the high type more in foregone income if he were to deviate to the low type's tax package.

Since $u(w_H(1 - \lambda_H) - \tau_H) > u(w_L(1 - \lambda_L^*) - \tau_L^*)$ and the utility function is concave,

$u'(w_H(1 - \lambda_H) - \tau_H) < u'(w_L(1 - \lambda_L^*) - \tau_L^*)$.

Therefore, if EC_H is not binding at τ_H , $\exists \delta > 0$ such that increasing τ_H by δ/α and decreasing τ_L by $\delta/(1 - \alpha)$ will still satisfy HI_H and improve social welfare. If EC_H binds at τ_H , then the change in the low type's tax mix (and the resulting slackness of HI_H) does not allow for a change in τ_H . Therefore, the total tax payments and the utilities of the two types will be unaffected.

Hence, as S^* increases, it is weakly optimal to decrease τ_L . Therefore, $\exists S_0 > 0$ such that $\forall S \geq S_0$ setting $\tau_L = 0$ can weakly increase social welfare. In this case, it is weakly better for the low type to pay only in labor and not in money, if his optimal total tax payment is positive. ■

Proof of Remark 3. First assume the social planner maximizes social welfare when $\tau_H + w_H\lambda_H < \tau_L + w_L\lambda_L$. Now consider the allocation $\tau_H = \tau_L = \frac{G}{N}$. If the constraints for the low type were satisfied at the previous allocation, they will still be satisfied at the new allocation. HI_H and SC_H will be satisfied for $D = 0$ and $S = 0$, and EC_H will be satisfied as long as $P \geq u(w_H) - u(w_H - \frac{G}{N})$. Since $w_H > w_L$ and the utility function is concave, the new allocation will result in a social welfare improvement.

Now assume the social planner maximizes social welfare when $\tau_H + w_H\lambda_H = \tau_L + w_L\lambda_L$.

(i) Suppose $S = 0$.

From Remark 1, we know that $\lambda_H = 0$ and therefore $\underline{\lambda} = 0$. $S = 0$ and the government budget constraint then imply that $\lambda_L = 0$ and $\tau_H = \tau_L = \frac{G}{N}$. At this allocation, HI_H will be satisfied at $D = 0$ and is therefore slack $\forall D > 0$. If the condition given in the remark holds (i.e., $P > u(w_H) - u(w_H - \frac{G}{N})$), then EC_H will also be slack.

Then $\exists \epsilon > 0$ such that HI_H and EC_H are still satisfied for $\tau_H^* = \tau_H + \epsilon/\alpha$ and $\tau_L^* = \tau_L - \epsilon/(1 - \alpha)$. This change in τ_H and τ_L leaves the government budget constraint unchanged. If the constraints for the low type were satisfied at (τ_H, τ_L) , they will still be satisfied at (τ_H^*, τ_L^*) .

Since the utility function is concave, $u'(w_H - \frac{G}{N}) < u'(w_L - \frac{G}{N})$. Therefore, increasing τ_H by ϵ/α and decreasing τ_L by $\epsilon/(1 - \alpha)$ will improve social welfare.

(ii) Suppose $D = 0$.

From Remark 1, we know that $\lambda_H = 0$ and therefore $\underline{\lambda} = 0$, so SC_H is slack. If $D = 0$, HI_H can be rewritten as

$$u(w_H - \tau_H) \geq u(w_H(1 - \lambda_L) - \tau_L)$$

HI_H will be slack for the allocation given $(\tau_H = \tau_L + w_L\lambda_L)$ as long as $\lambda_L > 0$. As above, if $P > u(w_H) - u(w_H - \frac{G}{N})$, then EC_H will also be slack.

If the allocation given has $\lambda_L > 0$, then we can achieve a social welfare improvement by increasing τ_H and reducing τ_L as in case (i) above.

Now suppose the allocation given has $\lambda_L = 0$. SC_L will then be binding at $S = 0$ and slack for $\forall S > 0$. Then, $\exists \eta > 0$ such that we can set $\lambda_L^* = \eta$ and $\tau_L^* = \tau_L - w_L\eta$ and SC_L will still

be satisfied. This change does not affect the total tax payment of the low type, the government budget constraint or HI_L . We can then achieve a social welfare improvement by increasing τ_H and reducing τ_L as in case (i) above. ■

Proof of Remark 4. We denote the low type's income and tax payments by the subscript M , to differentiate them from the notation for the unskilled wage rate at which government values labor, w_L . The fact that at the optimum level of payments $\lambda_H = 0$ can be shown using a proof similar to the one used for Remark 1 with the additional condition that if SC_M does not bind, then it must be the case that $D > u(w_M(1 - \lambda_H) - \tau_H) - u(w_M(1 - \lambda_M) - \tau_M)$ in order for HI_M to be satisfied.

To show that the tax payments are strictly increasing in income, the proof is similar to the one used to prove Remark 3. ■

Example 1 Let $U(y_i, g) = \ln(y_i) + \theta g$, where $y_i = w_i(1 - \lambda_i) - \tau_i$. We take $w_H = 9$, $w_M = 4$, $w_L = 3.5$, $\alpha = 1/3$, $P = 1$, $D = \ln(10/7)$, $S = \ln(3/2)$, $G/N = 2$ and $\theta = 2$.

In the first best, when no constraints bind, the optimal solution would involve $\tau_H = 16/3$ and $\tau_M = 1/3$. The social planner would not use any labor taxes since both individuals' labor is publicly valued at a lower rate than their outside wage.

If we introduce the enforcement, hidden income and shirking constraints, then the hidden income constraint for the high type would not be satisfied at the first-best values of τ_H and τ_M . Thus, labor would have to be used as a screening device to make the low type's tax mix less attractive to the high type. By requiring the low type to pay some taxes in labor, the high type's utility cost of switching to the low type's tax mix is increased since the high type values his labor at a higher wage rate than the government. However, the introduction of labor payments also increases the low type's total tax payment, since his labor is also valued at a lower rate than his outside wage. Thus, P , D and S must be high enough so that the constraints hold even after these changes in the tax mix.

In this example, after switching the low type's payment to labor instead of money, the hidden income constraint for the high type will be satisfied with equality. Solving the constrained maximization numerically, at the optimal level, $\tau_H^* = 4.26$, $\lambda_H^* = 0$ and $\tau_M^* = 0$, $\lambda_M^* \simeq 0.25$. The total tax payment for the low type increases to $w_M \lambda_M \simeq 1$, reflecting the need to use the low type's payment as a screening device. One can check, for example, that welfare under this scenario is greater than, for example, setting $\tau_H = \tau_L$, or setting $\lambda_L = 0$ and setting τ_H and τ_L such HI_H binds.

Note that we can always guarantee that it will continue to be optimal to provide the public good by setting θ high enough.

Example 2 As in the previous example, let $U(y_i, g) = \ln(y_i) + \theta g$, where $y_i = w_i(1 - \lambda_i) - \tau_i$. Assume there are three types of individuals in the community: high-skilled, medium-skilled and low-skilled, each representing a share $\alpha = 1/3$ of the population. We take $w_H = 11$, $w_M = 5$, $w_L = 4.5$, $G/N = 2$ and $\theta = 2$. Let D_{ij} denote the utility cost for individual of type i to hide income and pretend to be of type j . Assume the punishment and utility cost of shirking P and S are identical for all types. We let $P = 1$, $S = \ln(3/2)$, $D_{HM} = D_{MH} = \ln(1.45)$, $D_{HL} = D_{LH} = \ln(1.9)$, $D_{ML} = D_{LM} = \ln(1.3)$. Notice that the cost of hiding income is increasing with the amount hidden in such a way that switching to the medium type's tax rates is always more attractive for the high type than switching to the low type's tax rates.

In the first best case, when no constraints bind, the optimal allocation involves $\tau_H = 6$, $\tau_M = 0$, $\tau_L = 0$ and no labor payments. This allocation reflects the large difference in income between the

high type and the other two types. However, at this allocation, the hidden income constraint would not hold for the high type, who would have an incentive to switch to be the medium type's schedule. Therefore, the constrained maximization problem will use labor payments as a method of making the medium type's payment less attractive to the high type. (In this example, the large gap between the high and medium wages makes increasing the medium type's labor payments preferable to increasing his monetary payments.)

Solving the constrained maximization problem numerically yields $\tau_H = 5$, $\tau_M = 0$, $\lambda_M = 0.214$, $\tau_L = 0$ and $\lambda_L = 0$. In this example, we obtain a case in which the lowest type is not required to pay anything, the medium-skilled type is required to supply labor, and the high-skilled type only pays in money.

Note that we can always guarantee that it will continue to be optimal to provide the public good by setting θ high enough.

Figure 1: Comparison of formal and informal taxes

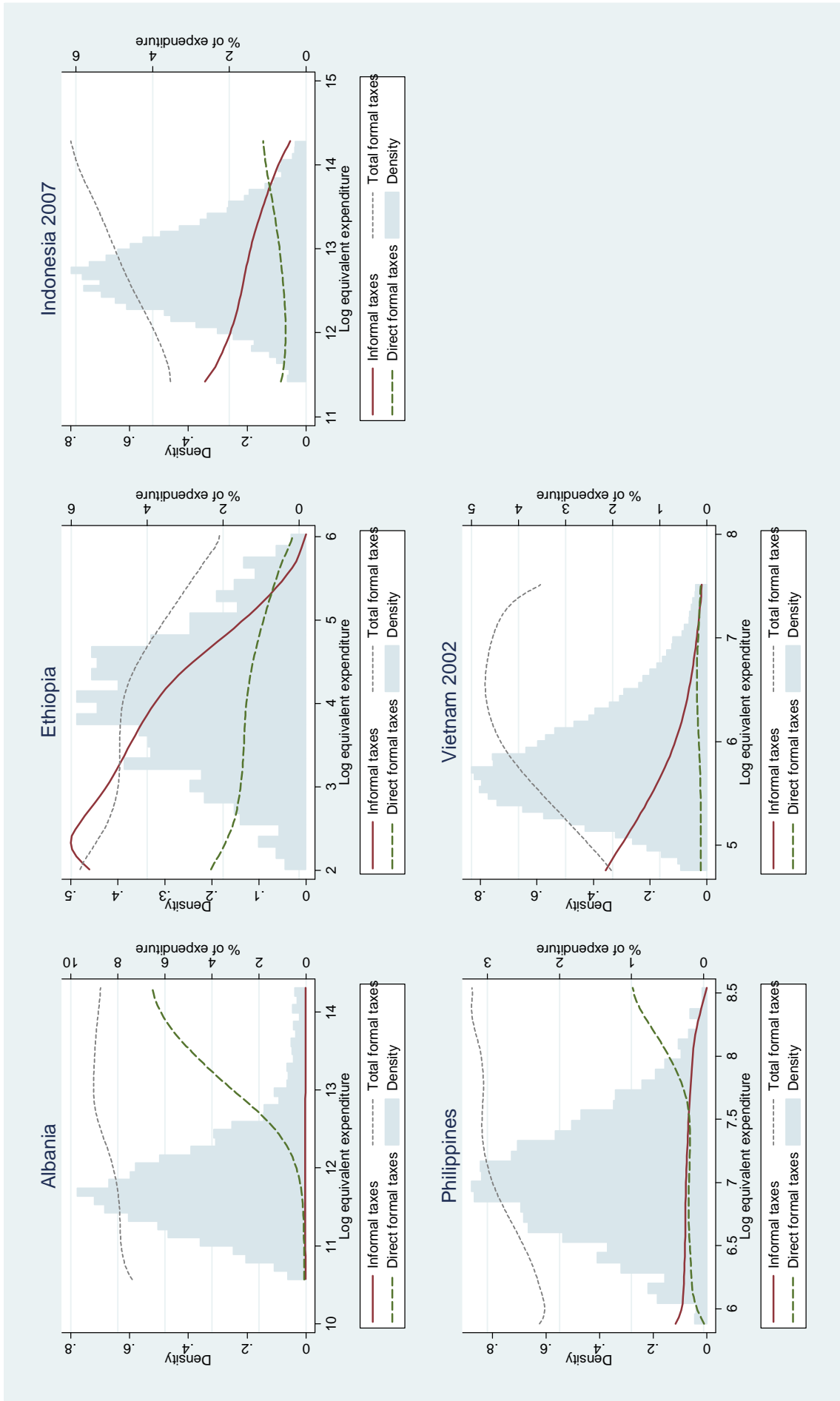


Table 1: Data sources

Database Name	Year	Sample	Sample size (number of households)	Recall period	Labor			Money		
					Payment indicator	Quantity	Payment indicator	Quantity		
Albania Living standards measurement survey	2005	Nationally representative	3,840	1 year	X	X	X	X		
Ethiopia Ethiopian rural household survey	1997	Only rural area	1,482	1 year	X	X	X	X		
Guatemala National survey of living conditions	2000	Nationally representative	7,276	1 year	X	X	X	X		
Indonesia Health and education service survey	2007	20 rural, poorer districts in 5 provinces	11,676	1 year	X	X	X	X	X	
Nicaragua Living standards measurement study survey	1998	Nationally representative	4,209	5 years	X	X	X	X		
Nigeria Nigeria living standards survey	2004	Nationally representative	19,159	1 year	X	X	X	X		
Panama Living standards survey	2003	Nationally representative	6,363	1 year	X	X	X	X		
Philippines Living condition Survey	2003	Only rural area, focus on poorer areas	2,398	6 months	X	X	X	X		
Vietnam Household living standards survey	2002	Nationally representative	29,426	1 year	X	X	X	X	X	
Zambia Living condition monitoring survey	1998	Nationally representative	16,788	5 years	X	X	X	X		

Notes: The Nigeria survey does not specify a recall period. The instructions to the interviewer specify a recall period of 1 year for the previous question on the survey; we therefore take the recall period as 1 year. Please see the Data Appendix for further details.

Table 2: Summary statistics

	Albania	Ethiopia	Guatemala	Indonesia	Nicaragua	Nigeria	Panama	Philippines	Vietnam	Zambia
Household size	4.4	7.3	5.2	3.8	5.5	4.8	4.0	5.1	4.4	5.4
Number of workers per household	1.6	1.6	2.1	1.7	1.7	1.5	1.4	1.9	2.5	1.9
Expenditure per capita (in PPP \$)	2272	554	2338	1112	2850	489	3514	938	1368	744
GDP per capita (in 2000 PPP\$)*	4731	814	4048	3423	2910	941	6129	4250	2274	774
% of Urban household	47	0	43	0	57	45	64	0	24	36
Age (Household head)	52	47	44	47	45	48	48	47	48	41
Years of education (Household head)	9.6	2.5	4.1	6.6	4.3	5.1	8.3	5.7	7.0	6.6

Notes: Each cell presents the mean of the variable in the row in the dataset listed in the column. When GDP is not available for the survey year, we used the most recent data.

Table 3: Summary of informal tax payments

		Philippines	Albania	Ethiopia	Guatemala	Indonesia	Panama	Nigeria	Vietnam	Nicaragua	Zambia
Recall Period		6 months	1 year	1 year	1 year	1 year	1 year	1 year	1 year	5 years	5 years
Panel A	Any payment	All	0.33	0.09	0.51	0.37	0.76	0.32	0.59	0.2	0.23
		Rural	0.33	0.12	0.51	0.51	0.76	0.48	0.62	0.26	0.27
		Urban		0.07	0.18	0.18		0.24	0.49	0.16	0.15
Panel B	Any labor payment	All	0.33	0.09	0.51	0.37	0.76	0.19	0.24	0.15	0.18
		Rural	0.33	0.12	0.51	0.51	0.76	0.34	0.28	0.22	0.23
		Urban		0.07	0.18	0.18		0.11	0.13	0.09	0.08
Panel B	Any money payment	All						0.22	0.5	0.08	0.08
		Rural						0.3	0.51	0.07	0.07
		Urban						0.18	0.45	0.08	0.09
Panel B	Both money and labor payments	All						0.09	0.15	0.02	0.03
		Rural									
		Urban									

Notes: Each cell presents the mean of the variable listed in the row in the dataset listed in the column. Some surveys only contained information about labor payments; for these surveys, participation rates given in Panel A will be identical to participation rates for “any labor payment” given in Panel B.

Table 3: Summary of informal tax payments (continued)

	Philippines	Albania	Ethiopia	Guatemala	Indonesia	Panama	Nigeria	Vietnam	Nicaragua	Zambia
Amount of labor payment (in days)	All	1.1 (4.2)	0.2 (0.6)	14.1 (28.3)	5.7 (13.2)			3.1 (7.3)		
	Rural	1.1 (4.2)	0.2 (0.6)	14.1 (28.3)	5.7 (13.2)			3.5 (7.7)		
	Urban		0.1 (0.6)					1.6 (5.6)		
Conditional amount of labor payment (in days)	All	3.3 (6.8)	1.8 (1.2)	27.6 (34.6)	7.5 (14.7)			12.8 (9.8)		
	Rural	3.3 (6.8)	1.6 (1.0)	27.6 (34.6)	7.5 (14.7)			12.8 (9.7)		
	Urban		2.1 (1.3)					12.9 (10.1)		
Amount of money payment (in 2000 PPP US\$)	All				8.9 (167.4)			13.5 (19.8)		
	Rural				8.9 (167.4)			13.2 (18.4)		
	Urban							14.5 (23.6)		
Conditional amount of money payment (in 2000 PPP US\$)	All				32.5 (318.2)			27.2 (20.4)		
	Rural				32.5 (318.2)			25.8 (18.3)		
	Urban							32.0 (25.8)		

Panel C

Notes: For reference in interpreting the monetary amounts in Panel C, the average annual per capita expenditure in these samples (in PPP\$) is 1112 for Indonesia and 1368 for Vietnam.

Table 4: Informal Taxation, Expenditure, and Formal Taxation

	Philippines	Albania	Ethiopia	Indonesia	Vietnam
<i>Panel A: Informal tax as a share of HH expenditure</i>					
Mean	0.0023	0.0004	0.0377	0.0143	0.0085
Median	0	0	0.0032	0.0035	0.0029
<i>Panel B: Informal tax as a share of HH expenditure (conditional on informal tax > 0)</i>					
Mean	0.0066	0.0037	0.0681	0.0183	0.0141
Median	0.003	0.0025	0.0263	0.0063	0.0075
<i>Panel C: Informal tax as a share of HH Total Formal + Informal Tax payments</i>					
Mean	0.0694	0.0048	0.268	0.1656	0.157
Median	0	0	0.0677	0.0779	0.0659
<i>Panel D: Informal tax as a share of HH Total Formal + Informal Tax payments (conditional on informal tax > 0)</i>					
Mean	0.2036	0.0457	0.4922	0.2115	0.2607
Median	0.1379	0.0335	0.4933	0.1287	0.1982

Table 5: Comparison to other local budgets in Indonesia

Per household value of:	Mean	Informal taxes as percent of.....
<i>From Indonesia household survey:</i>		
Informal taxes	49.86	.
Direct formal taxes	29.16	171%
Indirect formal taxes	158.88	31%
<i>From village budget data:</i>		
Total annual village budget:	43.67	114%
Total village development expenses:	23.87	209%
Total village routine expenses:	15.29	326%
Village revenue from inter-governmental transfers:		
Village revenue from local formal taxes/fees:	19.48	256%
Village revenue from on-books informal taxation	4.25	1173%
Village revenue from other sources:	13.09	381%
	6.86	727%
<i>From district budget data:</i>		
Total annual district budget	696.65	7%
Total district development expenses:	231.85	22%
Total district routine expenses:	464.80	11%
District revenue from inter-governmental transfers and other sources:		
District revenue from local formal taxes/fees:	721.66	7%
District revenue from other sources:	17.50	285%
	28.49	175%

Notes: All data comes from Indonesia. Village and district budgets are from 2001, and are inflated to 2007 Rupiah using the Indonesian CPI. Village budget data are from the 2003 Census of Villages; District budget data are from the World Bank. All are the per-household amounts for the 19 districts where we have complete data from the household survey, the village budget data, and the district budget data. All amounts are reported in 2000 PPP US\$, as in the previous tables, which translates to US\$1 = Rp. 3571. Note that districts have small budget surpluses in 2001; this was the first year of decentralization, so districts likely were still adjusting to their new roles.

Table 6: Informal taxation vs. household expenditure

	Philippines	Albania	Ethiopia	Guatemala	Indonesia	Panama	Nigeria	Vietnam	Nicaragua	Zambia
<i>Panel A: Participation margin, with community fixed effects (conditional logit model)</i>										
Any payment	-0.018 (0.117)	0.456*** (0.097)	0.159 (0.159)	0.160 (0.100)	0.196** (0.087)	0.427*** (0.065)	0.107* (0.056)	0.439*** (0.060)	-0.094 (0.122)	0.111*** (0.042)
Observations	2200	2487	1165	5074	6188	5963	9036	24521	2669	10271
<i>Panel B: Total payments, with community fixed effects (Poisson model)</i>										
Total payments	0.395* (0.213)	0.334*** (0.053)	0.127*** (0.054)		0.387*** (0.041)			0.080*** (0.025)		
Observations	2143	1784	1062		10840			26899		
<i>Panel C: Total payments, with community fixed effects, conditional on payments > 0 (Poisson model)</i>										
Total payments	0.229* (0.117)	0.122*** (0.043)	0.111** (0.049)		0.364*** (0.041)			0.001 (0.021)		
Observations	655	254	587		9053			17310		

Notes: Each cell reports the estimates from a separate regression, with robust standard errors clustered at the village level in parentheses. Panel A reports results from conditional logit estimates, where the dependent variable is a dummy for making any informal tax payments, the independent variable is log household expenditure per equivalent adult, and the conditioning variable is the village. Panel B reports results from conditional Poisson QMLE models, where the dependent variable is the quantity of informal tax payments (where labor payments are converted to monetary units at the household's predicted wage rate), the independent variable is log household expenditure per equivalent adult, and the conditioning variable is the village. Panel C reports results from an analogous model to Panel B but without conditioning on the village.

Table 7: Formal taxes vs. household expenditure: quantities

	Philippines	Albania	Ethiopia	Indonesia	Vietnam
<i>Panel A: Informal taxes, with community fixed effects</i>					
Total payments	0.395* (0.213)	0.334*** (0.053)	0.127*** (0.054)	0.387*** (0.041)	0.080*** (0.025)
Observations	2143	1784	1062	10840	26899
<i>Panel B: Informal taxes, without community fixed effects</i>					
Total payments	0.196 (0.144)	0.391*** (0.058)	0.119 (0.112)	0.439*** (0.048)	-0.107* (0.059)
Observations	2200	2923	1062	11015	28858
<i>Panel C: Direct formal taxes, with community fixed effects</i>					
Total payments	1.526*** (0.198)	1.433*** (0.083)	0.418*** (0.133)	1.372*** (0.075)	0.691*** (0.114)
Observations	2073	3358	1197	11591	20407
<i>Panel D: Direct formal taxes, without community fixed effects</i>					
Total payments	1.647*** (0.196)	1.437*** (0.063)	0.587** (0.257)	1.299*** (0.095)	0.932*** (0.062)
Observations	2259	3838	1197	11674	29422
<i>Panel E: Total (direct + indirect) formal taxes, with community fixed effects</i>					
Total payments	0.901*** (0.104)	1.009*** (0.006)	0.798*** (0.056)	1.102*** (0.022)	1.289*** (0.038)
Observations	2259	3838	1197	11674	29422
<i>Panel F: Total (direct + indirect) formal taxes, without community fixed effects</i>					
Total payments	0.962*** (0.087)	1.009*** (0.013)	0.728*** (0.156)	1.094*** (0.024)	0.976*** (0.023)
Observations	2259	3838	1197	11674	29422

Notes: Each cell reports the estimates from a separate regression, with robust standard errors clustered at the village level in parentheses. All results are from conditional Poisson QMLE models (Panels A, C, and E) and Poisson QMLE models (Panels B, D, and F), where the dependent variable is given in the table, the independent variable is log household expenditure per equivalent adult, and the conditioning variable (for Panels A, C, and E) is the village.

Table 8: Labor and money payments: participation margin

	Indonesia	Panama	Vietnam	Nicaragua	Zambia
<i>Panel A: With community fixed effects</i>					
Labor payment	0.190** (0.085)	0.137 (0.090)	0.003 (0.093)	-0.099 (0.130)	0.065 (0.044)
Observations	6433	5782	14753	2225	8902
Money payment	0.720*** (0.077)	0.634*** (0.067)	0.560*** (0.059)	-0.057 (0.150)	0.167*** (0.059)
Observations	7313	5716	23780	1405	6701
<i>Panel B: Without community fixed effects</i>					
Labor payment	0.176*** (0.066)	-0.653*** (0.077)	-0.900*** (0.072)	-0.635*** (0.096)	-0.148*** (0.040)
Observations	11648	6363	29422	4040	16415
Money payment	0.869*** (0.067)	0.097* (0.057)	0.096** (0.045)	0.155 (0.102)	0.163*** (0.049)
Observations	11648	6363	29422	4040	16415

Notes: See Notes to Table 6.

Table 9: Labor and money payments: quantities

	Indonesia	Vietnam
<i>Panel A: With community fixed effects</i>		
Labor payment	0.260*** (0.039)	-0.018 (0.036)
Observations	10840	15826
Money payment	1.446*** (0.208)	0.220*** (0.026)
Observations	7632	25429
<i>Panel B: With community fixed effects, conditional on payments > 0</i>		
Labor payment	0.234*** (0.039)	-0.05 (0.033)
Observations	9053	10855
Money payment	1.490*** (0.222)	0.073*** (0.024)
Observations	6370	15997
<i>Panel C: Without community fixed effects</i>		
Labor payment	0.305*** (0.046)	-0.373*** (0.107)
Observations	11015	28858
Money payment	1.545*** (0.191)	0.207*** (0.034)
Observations	11648	29422

Notes: See Notes to Table 6.

Table 10: Decisions about informal tax payments

	Respondent	
	Individual	Village Head
<i>1. Who makes decisions about which households participate?</i>		
Village/hamlet/neighborhood head	84.2	79.0
Village/hamlet/neighborhood meeting	49.5	54.6
Each household decides for themselves	8.0	8.1
<i>2. Who determines how much is expected from each household?</i>		
Village/hamlet/neighborhood head	69.1	56.0
Village/hamlet/neighborhood meeting	51.1	60.1
Each household decides for themselves	20.4	14.7
<i>3. What is the sanction imposed on a household if they do not participate? (Note: the word used for "sanction" has the connotation of a specific punishment and does <u>not</u> include informal social sanctions.)</i>		
Replace at another time	10.6	12.7
Give materials/food	11.1	19.5
Replace with other person	5.2	9.0
Pay another person to replace you	2.0	5.6
Pay a fine	17.0	20.8
Not allowed to use result of activity	0.1	0.7
Excluded from local activities	0.4	1.2
No specified official sanction (could still be informal social sanctions)	62.3	53.3
<i>4. If applicable, who determines this sanction?</i>		
Village/hamlet/neighborhood head	66.3	36.0
Village/hamlet/neighborhood meeting	66.7	61.7
Each household decides for themselves	22.3	21.0

Notes: All data comes from Indonesia. Multiple responses were allowed for each question. The full set of choices given for questions 1, 2, and 4 were: village head, hamlet head, neighborhood head, village meeting, hamlet meeting, neighborhood meeting, each household decides for themselves, religious leaders, other informal leaders, and other. For question 4, the choice of no sanction / not applicable was also given. The full set of choices given for question 3 was: replace at another time, give materials/food, replace with another person, pay another person to replace you, pay a fine, not allowed to use result of activity, excluded from local activities, other, and no sanction.

Table 11: User fees

	Indonesia	Nicaragua	Nigeria	Panama	Zambia	Philippines
<i>Panel A: School Contributions</i>						
Children in the HH	0.476** (0.199)	0.617*** (0.173)	0.172 (0.113)	2.106*** (0.228)	0.827*** (0.112)	1.094* (0.626)
No private water	-0.121 (0.346)	0.186 (0.263)		-0.37 (0.359)	0.464* (0.248)	-0.204 (0.538)
Log expenditure per equivalent adult	0.351 (0.234)	-0.09 (0.122)	0.0246 (0.098)	-0.204** (0.102)	0.130*** (0.049)	0.362 (0.362)
Observations	1308	1743	2860	4767	8389	384
<i>Panel B: Water Contributions</i>						
Children in the HH	0.322** (0.152)	0.436 (0.393)		0.365*** (0.112)	0.183 (0.167)	-1.077 (1.145)
No private water	0.112 (0.239)	3.382*** (0.484)		1.190* (0.623)	1.438*** (0.375)	-0.653 (1.032)
Log expenditure per equivalent adult	0.248 (0.168)	-0.167 (0.258)	-0.088 (0.221)	0.048 (0.135)	0.132 (0.089)	-0.191 (2.030)
Observations	1397	1076	1076	3282	4096	102

Notes: Each column reports results from estimating Poisson QMLE regressions, as in Panel A of Table 6, except that the dependent variable is restricted to participation in contributions for schools (Panel A) or participation in contributions for water systems (Panel B). The first column for each country includes a dummy variable for missing water source.