

## **Non-technical summary**

on the paper "Did the flat tax reduce informal employment in Albania? prepared by Mara, I, Narazani, E. And Permeti, E.

This paper provides empirical evidence on the individual behaviour in a transition economy towards labor supply and participation in the formal/informal labour market under different tax regimes.

A discrete choice model is used to estimate the labour supply decision which incorporates the informal employment option. More precisely, this model focuses on the labour responses, both at participation and hours of work decision, in the formal and informal labour market, counting for the option of tax evasion. Different studies have emphasized diversities between labor supply responses on the extensive margin (participation) and intensive margin (hours worked). The literature consistently suggests that, for the low-income earners, the response at extensive margin is probably more important than the response at the intensive margin. However, a crucial drawback of these studies is that they ignore the attractiveness that the irregular labor market may inspire to individuals especially when the implicit tax rate, at the low end of the earnings distribution, is very large. Consequently, in contrast to these studies this research brings an innovative approach where the inclusion of informal employment, both at intensive and extensive margin, makes the difference and we can build a more realistic scenario of informality in the labour market.

We find that the flat tax implemented since July 2007 has not contributed to the reduction of labour informality. In spite, has been the wage increase in the formal labour market that has played an important role in inducing individuals to move from the informal to the formal labour market. The rationale behind these results is that higher average tax rates are imposed by the new flat tax regime for the whole sample. The flat tax regime of 10% is certainly the lowest applied in the world but as our results demonstrate, it leads to higher average taxes compared to the former progressive one, save the labour income remain unchanged. Furthermore, the responses in informal labour market are mainly driven by the behaviour of middle-high income earners. The gender dimension, shows that women compared to men tend to have a similar response toward participation in the formal labour market, but in a smaller magnitude.

These results guide to the conclusion that a kind of progressivity should be back in the taxation system without affecting the attractiveness of the simplicity that a flat tax entails. Furthermore, the main findings suggest that social norms and increase

of opportunities in the formal labour market are important factors for combating the informal employment and consequently tax evasion.

This paper's intention was to investigate whether the application of a low flat tax in a transition economy, with a high level of informal market, provides a stimulus to increase the formal sector and regular employment in Albania. The results reject it. The flat tax system didn't provide a stimulus to increase the formal sector and regular employment but instead, financial incentives, e.g. raises of wages are important tools for combating informal employment especially in a transition economy as in Albania, where the culture of paying taxes is still hybrid. In addition, fiscal reforms, whenever implemented without supportive instruments, e.g. instruments that enforce compliance and incentivize the shift from informal to formal labour market, are destined to be insufficient.