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Occasional Paper

CHUNG-HUA INSTITUTION FOR ECONOMIC RESEARCH

75 Chang-Hsing St., Taipei, Taiwan

Republic of China

This paper is intended to provide economic information and stimulate further research. Any opinions expressed within are solely those of the authors and not those of the Chung-Hua Institution for Economic Research.

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The Informal Sector and Public Policy in Taiwan

Jiann-Chyuan Wang

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The Informal Sector and Public Policy in Taiwan

Jiann-Chyuan Wang*[1]

I. INTRODUCTION

Recently, the phenomenon of the informal economy has received increasing attention among the economists and politicians in many countries. Many names are applied to this area of activity such as the underground, hidden, subterranean, black, irregular or shadow economy. The economy is underground due to the violation of tax laws, licensing requirements, labor standards, and other government regulations.

Because of tax immorality, there will be underground transactions as long as there exists a tax burden on economic activities. Some businesses, which are not completely underground but which seek to evade taxes by understating the volume of their sales, also cause a massive loss of revenue to the government. In addition, based on social-economic or political reasons, governments impose restrictions on certain economic activities forcing the underground businesses to keep their activities secret from the government. For instance, underground laborers are quite often not afforded the benefits of regulations regarding minimum wage levels, maximum working hours, and those related to job security. Also, the monetary authority's tightening policies force the firms to turn to informal credit suppliers for financial help. Furthermore, trafficking of marijuana and cocaine, illegal gambling, and other profit-oriented crimes are also part of the informal economy.

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1. The impacts of informal activities on policy measures

Since underground transactions are not reported to the government, they are not directly reflected in official statistics on the economy. As a consequence, this statistical illusion affects several macro-economic variables.

(1) Overestimation of the unemployment rate

Since the illegal labor force is excluded from official labor statistics, the unemployment rate will thus be overestimated. Under such circumstances, the more the hidden economy flourishes, the more likely it is that the unemployment rate will be seriously overestimated.

(2) The overrating of the inflation rate

The inflation rate may be overrated by the existence of the informal economy. In addition, the price inflation rate will be further aggravated if the monetary authority loosens its restraints on the money supply according to the biased indicators.

(3) Underestimation of the economic growth rate

Since official statistics do not take the informal activities into account, the rate of economic growth may be seriously underrated. And as a result, the government's economic policy will approach an overheated but stable economy with a biased measure in hand.

(4) The rising tax burden

The scale of the public sector will be increased by an increase in the size of the hidden economy. As a consequence, the burden of taxpayers will be increased and income distribution will be made worse.

2. The impacts of informal activities on the economy

In the presence of a hidden economy, macro-economic variables will either underrated or

overrated. Hence, economic policy measures might be of a wrong magnitude or even be in the wrong direction, if they are based on the mistaken indicators of the state of the economy. Consequently, the public sector will be forced to expand to deal with the enlarging economy which includes both the legal and underground sectors. The expanding public sector might seek to finance its budget by collecting more taxes from the legal economic sectors resulting in a rising burden on the taxpayers. The higher the tax rate, the larger are the expected benefits from tax evasion. As a consequence, more and more activities will be lured into the underground economy. As long as the profitability of the hidden economy is higher than the after-tax profitability of the legal economy, the resources are going to be moved from the high-productivity legal sector to the low-productivity hidden economy leading to resource mis-allocation and a fall in economic welfare.

After introducing the basic concept and the impacts of the underground economy, we will extend our coverage to the informal economy in Taiwan.

II. THE INFORMAL ECONOMY IN TAIWAN

In 1982, a delegate at a provincial meeting said that Taiwan has every underground activity except an underground railway. Chian (1981) estimates that the hidden economy comprises at least 31.28% of officially measured GNP in Taiwan. Tsai (1981) comes up with a corresponding figure of 14.41%. These papers point out that the existence of Taiwan's hidden economy is obvious and is a big concern of the government these days. The informal sector of the Taiwanese economy is predominantly comprised of underground investment houses and informal credit suppliers. Tax evasion, violation of license requirements and so on are also rampant. Since other activities contribute an insignificant amount to Taiwan's informal economy, we will focus only on the activities described above and explore the determinants of them respectively.

1. Underground investment houses

In the last few years, the rapid growth of the money supply and the low interest rate have provided surplus liquidity in the private sector. However, the limited number of productive investment channels has caused the ample supply of funds to flow into the property and stock markets through deposit-taking companies with speculative purposes. According to an unofficial estimate, there are more than two hundred such companies although the exact number of underground investment houses and the money they control is not really known. It is estimated that some 30-40 firms control well over NT$lOO billion (US$3.86 billion). The investors, well over two million, have been attracted by interest rates as high as 7% - 8% a month. Since many of the houses' fortunes are closely tied to Taiwan's high-flying stock and real-estate markets, the big capital gains that they have earned have enable them to cover the high interest temporarily. Besides, the small investors who strongly demand investment opportunities are willing to put their money in investment houses instead of legal banks so that they can earn much higher interest resulting in the large size of these deposit-taking companies. However, these underground investment houses enhance speculative fever fuelling inflation and widening income gaps. Accordingly, the authority considers the houses a threat to the financial system as well as investors. Because the houses are not regulated and investors are not protected under the law.

2. Informal credit suppliers

There have been and still are three principal sectors in the financial capital market in Taiwan: the first consists of relatives and friends who privately advance financial capital to the owner of business; another source is private money lenders who make loans to businessman; finally, there are formal credit institutions that make loans to business. In the early 1950s, the formal institutions probably provided only a small amount of financial capital while the other two provided the majority of capital to businesses in Taiwan. Although the formal credit market has become increasingly important these days, the rampant informal credit market still plays an important role in Taiwan. In 1980, the loans which are made by the informal credit market are

linked to 70.94% of the total amount of economic crime in Taipei. There are two major reasons for the informal credit market. They are:

(1) The dualism of Taiwan's financial system

As described above, Taiwan's financial system can be roughly classified into two categories: one is the banking system and the official money market, the other one is the informal money market. The banking system includes commercial banks, saving banks, banks for special purposes and trust and investment companies. However, most of Taiwan's banks are government-run and suffer from excessive regulation. The loan officers are held responsible for the loans they make; hence, they become conservative. This conservatism means they seldom lend to small and medium sized enterprises (hereafter referred to as S-M enterprises) but only to large and credit worthy customers. Consequently, the difficulties in obtaining loans from formal institutions force the S-M enterprises to turn to the informal credit market for financial capital.

(2) The unhealthy financial statement of local enterprises

Hsueh (1989) discovered that there are about three quarters of a million business establishments in Taiwan, of these, 98.5% can be classified as S-M enterprises, which do not have a sound financial structure and/or an accounting system. Their unreliable financial statements usually are not acceptable to banks and other financial institutions when trying to obtain a loan. Moreover, the bank's play-it-safe philosophy has made it even harder for S-M enterprises to obtain a loan from formal institutions. Under such circumstances, they have little choice but to raise funds through the informal sector at a higher interest rate. On the other hand, most of the official financial institutions have a history of preference and loan to government-run enterprises instead of civilian S-M enterprises. The sources of funds obtained by government-run and civilian enterprises are shown in Table 1 & 2 respectively.

3. Tax evasion

Chen (1987) estimates that the amount of business profit taxes evaded by firms was about

NT$350million in 1983. In the same year, the amount of total evaded tax accounted for 52.77% of total taxable income. This huge amount of escaped tax receipts has received wide attention by the government. There are several ways which to evade taxes according to a report by the Ministry of Finance (MOF) and they are as follows: Regarding business profit taxes, S-M enterprises make transactions without issuing invoices to under-report real revenue. In Taiwan, there has been a long-existing fact that many enterprises register their transactions on two different accounting statements. One is referred to as the "internal financial statement" which is for internal use only and the other one is called the "external financial statement" which is reported to the tax-collecting authority. The real profit on the external financial statement is, of course, much lower than that on the internal financial statement to reduce the companies' tax burden. As for personal income tax, people usually under-report their taxable income to avoid progressive taxes. What makes people evade or avoid taxes? First of all, the progressive individual income tax schemes induce people to resort to dishonesty to maintain their standard of laving. Furthermore, the more people that cheat on taxes, the fewer chances they have of being caught. Since this cheating behavior is more or less tolerated by the social moral standard, more people are attracted to committing the same crime which results in a high state tax evasion rate. Second, there is a lighter penalty for tax evasion crimes than in USA or japan. In terms of "absolute amount", Taiwan's penalty for tax evasion is much lower than that of Japan. This and the fact that the chance of being caught of tax evasion is very low leads people to continue to evade taxes. Third, the dishonest accounting system of S-M enterprises' and the suspicious integrity of C.P.A. (Certified Public Accountants) in Taiwan also allow these enterprises to escape taxes more openly and easily.

4. Unregistered firms (licensing requirement violations)

There were around twenty-five thousand unregistered firms in Taiwan in 1986. Approximately one out of every four firms in Taipei, which is the largest city in Taiwan, is not registered. The productivity of these unregistered firms account for 3.08% of Taiwan's gross national product in 1981. As most people already recognize, the restrictive barriers of entry for new firms and the

complicated procedures for applying for licenses have been the major reasons that discourage firms from obtaining legal licenses. Moreover, in license requirement violation cases, the authorities can only force the illegal firms to close their businesses and cannot give them a monetary fine if they get caught. Although there is a NT$3,000 penalty for violating the zoning law, the amount is relatively low as compared with Michigan state's five thousand US dollar fine for the same violation.

III. GOVERNMENT'S POLICIES IN DEALING WITH THE HIDDEN ECONOMY IN TAIWAN

Some people claim that the underground economy, offers, at least for certain people, the closest thing available to free choice of activity. However, there are several defects of the informal economy. First, the loss in government revenue definitely increases the tax burden on the formal sector, forcing more legal activities to go underground. The bad crowds out the good resulting in an the adverse selection. Second, because the indicators on the state of the economy are biased, the authorities' economic policy may be partially offset or even in a wrong direction. Third, the declining tax morality and other aspects that are related to the underground economy also deserve attention. Since the informal sector has so many negative impacts on the economy, how the governments deal with it and what tools are needed demands further discussion. The aim of this section is to look at the present and future policies that have been proposed by the government in Taiwan to scale down the informal economy. As we did in the last section, we will separate the underground economy into four sectors and discuss each one separately.

1. Underground investment houses

Most of Taiwan's bank reform laws were passed in July, 1989. The bill included provisions that forbid informal institutions to take money as deposits, which set legal boundaries on the island's rampant underground investment houses for the first time. However, the authority realized that the collapse of large unregulated investment houses could trigger a financial crisis

and that investors could lose the chance to redeem their deposits. Therefore, the authorities chose not to break up the big deposit-taking companies even though they have been given the power to do so. Right before the new bank law was passed, small deposit-taking companies fell down one by one. The bigger ones either suspended deposit taking or reduce the returns offered to just 2% a month to survive through the panic period. The ideal solution, though, Would be for bigger companies to turn to the newly expanded banking sector and go into banking themselves. Although no clear-cut alternative has emerged so far, one needs to be found to stop the damage that the underground investment houses have done to Taiwan's economy. The high-flying stock and real-estate markets are just two examples of this damage:

2. Informal credit suppliers

The new banking law also allows new private commercial banks to be established. However, there is a lot of controversy over the stipulations of the new law. The controversy has focused on the restrictive requirements for the establishment of a new bank, including NT$lOO billion capitalization, no more than 15% of a bank's equity can be controlled by any single family or business group, strict standards on banking staff experience, no branches for at least three years and so on. Despite the huge amount required for capitalization, and the strict requirements regarding the bank's staff, many enterprises are still pursuing to start a bank. With the new banking law, most industrialists and economists have hope that it will bring fresh competition to Taiwan's lethargic banking sector and open the door for S-M enterprises to obtain loans, especially as Taiwan proceeds to restructure its economy going from labor-intensive to capital-intensive and technology-based businesses. Financial support for S-M enterprises is in urgent need. The banks in Taiwan have the freedom to set their own rate now that the government has removed the interest rate ceiling. However, the banks are still look to the Central Bank of China to set interest rates, as they have done in the past. The liberalization of interest rates should induce funds to return to the banking system; the banking sector can then loan this new financial capital out to S-M enterprises. The optimal allocation of financial capital will be reached based on the laws of supply and demand, which can break up the informal

financial institutions. This ideal solution is under the assumption that banks can set interest rates on their own. In addition, in response to difficulties in obtaining loans, the government has set up a public owned bank that specializes in loaning money to S-M enterprises, known as the Taiwan Medium and Small Business Bank.[1] The difficulties of S-M enterprises in obtaining loans can be further eased when the "real" liberalization of the banking system in Taiwan is put into effect.

3. Tax evasion

Since the current tax law creates loopholes and allows individuals and enterprises to evade taxes, several suggestions have been made to the Ministry of Finance (MOF): First, imposing a lump-sum penalty on tax evasion instead of the current proportional penalty, the severe punishment could discourage people from cheating on their taxes. Second, stopping the differences in the reporting of income which is based on the size of the business. According to the current tax law, stores with sales of less than NT$2OO,OOO per month do not have to show invoices. Hence the authority has no idea of the exact amount of sales that the stores made, the tax bases will then be destroyed. The MOF should establish a more restrictive standard for "small scale" business, and insist that they should issue invoices to provide for a sound tax system. Third, improving the current accounting systems used by businesses and improving the credibility of the C.P.A.'s in Taiwan are needed to restructure the system. In 1987, 81% of the enterprises' tax returns were filed by C.P.A.s in Taipei. Therefore, the credibility and quality of C. P. A.s are more than important, they are fundamental. Under such circumstances, a higher standard is needed for a C.P.A. to obtain a license. This is a must. In addition, a severe penalty, like the suspension of their licenses, should be imposed if a C.P.A. gives a false opinion, or a recklessly misleading information on an accounting statement.

[1] Under government regulation, medium and small business bank has to lend at least 70 % of loans to S-M enterprises.

4. Unregistered firms (A violation of the licensing requirement)

The current complicated procedure in applying for a license results in the licensing requirement violation of many firm. Facilitation of the process of licensing and strengthening supervision afterward should encourage more firms to obtain licenses. Furthermore, heavier penalties would increase the cost of licensing violations whereby deterring firms from violating the law.

IV. CONCLUDING REMARKS

Since the existence of a hidden economy has many negative impacts on the economy, the growth of the informal sector has received increasing attention among politicians and economists in Taiwan. To know the determinants and development of the underground economy is important for the government in order to find solutions to deal with it.

Limited channels for investment causes the supply of idle funds to flow into underground investment houses. As most people recognize, the difficulties in obtaining loans for S-M enterprises force them to turn to informal credit suppliers. While the unsound tax system creates loopholes that enable people to evade taxes. The "real" liberalization of interest rates and the banking system is the best way to handle the first two problems mentioned, while lump-sum penalties, improving the tax structure and the quality and credibility of C.P.A.s should deter people from evading taxes. However, the implications of growth in the informal economic sector go far beyond the loss of government revenue, there is a decline in civic morality, a widening gap in income distribution, a fall in economic welfare and other non-desirable aspects to the underground economy which also deserve further attention.

Table 1. Sources of borrowings of government - run enterprises

Unit : million new Taiwan dollars

Year	Formal financial institutions		Borrowings from private sector						Total
			non-profit organization		cross-borrowings between enterprises		subtotal		
	amount	percentage	amount	percentage	amount	percentage	amount	percentage	
1964	5,592	99.45	-	0.00	31	0.55	31	0.55	5,623
1965	5,717	99.17	-	0.00	48	0.83	48	0.83	5,765
1966	6,215	99.27	-	0.00	46	0.73	46	0.73	6,261
1967	7,300	99.25	-	0.00	55	0.75	55	0.75	7,355
1968	7,899	94.83	-	0.00	431	5.17	431	5.17	8,330
1969	9,828	94.89	-	0.00	529	5.11	529	5.11	10,357
1970	12,261	98.24	-	0.00	220	1.76	220	1.76	12,481
1971	16,263	98.31	-	0.00	280	1.69	280	1.69	16,543
1972	18,354	98.82	-	0.00	219	1.18	219	1.18	18,573
1973	22,719	98.47	-	0.00	353	1.53	353	1.53	23,072
1974	40,287	99.85	-	0.00	62	0.15	62	0.15	40,349
1975	58,415	99.87	-	0.00	76	0.13	76	0.13	58,491
1976	68,108	99.80	-	0.00	136	0.20	136	0.20	68,244
1977	79,965	99.82	-	0.00	141	0.18	141	0.18	80,106
1978	89,917	99.87	-	0.00	121	0.13	121	0.13	90,038
1979	119,195	99.84	-	0.00	190	0.16	190	0.16	119,385
1980	174,769	97.85	-	1.12	1,829	1.02	3,838	2.15	178,607
1981	210,581	96.81	-	2.91	607	0.28	6,939	3.19	217,520
1982	247,236	95.25	-	4.36	1,024	0.39	12,341	4.75	259,577
1983	249,118	95.53	-	3.69	2,036	0.78	11,651	4.47	260,769
1984	233,432	96.20	-	2.29	3,659	1.51	9,224	3.80	242,656
1985	217,103	96.47	-	2.02	3,410	1.52	7,953	3.53	225,056
1986	214,126	96.93	-	1.66	3,106	1.41	6,784	3.07	220,910
average		98.03		0.79		1.18		1.97	

Source: The Central Bank of China, Financial Statistics Monthly, Taiwan District, R.O.C. (in Chinese)

Table 2. Sources of borrowings of civilian enterprises

Unit : million new Taiwan dollars

Year	Formal financial institutions		Borrowings from private sector						Total
			non-profit organization		cross-borrowings between enterprises		subtotal		
	amount	percentage	amount	percentage	amount	percentage	amount	percentage	
1964	8,116	51.89	7,175	45.88	349	2.23	7,524	48.11	15,640
1965	11,223	55.84	8,515	42.37	359	1.79	8,874	44.16	20,097
1966	14,674	54.34	11,962	44.30	369	1.37	12,331	45.66	27,005
1967	18,187	57.10	13,045	40.96	620	1.95	13,665	42.90	31,852
1968	29,122	65.01	12,776	28.52	2,895	6.46	15,671	34.99	44,793
1969	37,762	66.39	15,957	28.06	3,157	5.55	19,114	33.61	56,876
1970	36,625	62.42	18,587	31.68	3,460	5.90	22,047	37.58	58,672
1971	47,155	65.89	20,883	29.18	3,531	4.93	24,414	34.11	71,569
1972	76,784	68.31	30,952	27.54	4,671	4.16	35,623	31.69	112,407
1973	119,013	78.28	27,077	17.81	5,944	3.91	33,021	21.72	152,034
1974	135,024	69.91	54,998	28.47	3,128	1.62	58,126	30.09	193,150
1975	159,628	72.47	56,772	25.78	3,858	1.75	60,630	27.53	220,258
1976	184,128	67.68	80,986	29.77	6,928	2.55	87,914	32.32	272,042
1977	204,821	67.66	89,049	29.42	8,838	2.92	97,887	32.34	302,708
1978	242,781	63.13	133,158	34.63	8,625	2.24	141,783	36.87	384,564
1979	302,957	61.38	179,509	36.37	11,132	2.26	190,641	38.62	493,598
1980	379,492	63.77	198,875	33.42	16,761	2.82	215,636	36.23	595,128
1981	452,134	58.47	302,457	39.12	18,636	2.41	321,093	41.53	773,227
1982	473,970	60.47	289,810	36.98	19,973	2.55	309,783	39.53	783,753
1983	567,650	64.02	294,356	33.20	24,646	2.78	319,002	35.98	886,652
1984	645,811	65.76	303,917	30.95	32,303	3.29	336,220	34.24	982,031
1985	669,707	62.34	355,321	33.07	49,304	4.59	404,625	37.66	1,074,332
1986	775,568	55.23	585,436	41.69	43,338	3.09	628,774	44.77	1,404,342
average		63.38		33.44		3.18		36.62	

Source: same as Table 1.

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