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Informal Economies and Taxation: Compliance, Fairness Perceptions, and State Legitimacy

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ABSTRACT

The relationship between informal economies and taxation presents critical challenges for tax compliance, perceptions of fairness, and the legitimacy of the state. This study examines how the prevalence of informal economic activity shapes individuals' willingness to comply with tax obligations and influences broader governance outcomes. Drawing on compliance theories, the paper highlights the interplay between economic incentives, enforcement mechanisms, and tax morale in determining compliance behavior. It further explores how procedural and distributive fairness perceptions particularly regarding transparency, equity in tax burdens, and accountability affect citizens' trust in government and their intrinsic motivation to pay taxes. The analysis demonstrates that in contexts with large informal economies, weak administrative capacity and limited provision of public goods often undermine tax compliance and reinforce perceptions of illegitimacy. Informal taxation systems and alternative governance structures may emerge, sometimes substituting for state functions but often exacerbating inequality and coercion. Evidence suggests that voluntary compliance is more sustainable when tax systems are perceived as fair, inclusive, and responsive to citizens' needs. The study concludes that strengthening state legitimacy in such contexts requires a combination of tailored enforcement strategies, improved public service delivery, and inclusive policy frameworks that integrate informal actors into the tax system. Enhancing transparency, accountability, and participatory governance is essential for fostering tax morale and building a sustainable fiscal social contract between citizens and the state.

Keywords: Informal Economy, Tax Compliance, State Legitimacy, Tax Morale, and Fiscal Fairness.

INTRODUCTION

Taxation interacts with the informal economy in notable ways that impact compliance, fairness perceptions, and ultimately, the legitimacy of the state [1]. Compliance theories postulate that, under certain conditions, individuals accept that not fulfilling a legal obligation may be justified. Both economic factors and perceptions of the fairness of legislation influence compliance decisions [2]. Two additional interrelated channels emerge: the recourse to informal credit and labor markets and the limited enforcement options available to tax authorities. Such considerations raise questions about state legitimacy, a concept encompassing the extent to which a government's authority is accepted and recognized [3]. When a sizable portion of the economy does not contribute to tax revenues, government capacities to deliver public goods or services may diminish, thereby adversely affecting expectations regarding the benefits derived from taxation. A large informal economy can thus foster the perception that tax administration is discretionary and arbitrary [1].

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Conceptual Framework

Defining informal economies is complex, but broad conceptual frameworks capture salient characteristics and variation [1]. The term refers to economic activities that occur beyond the formal structures and laws governing businesses and individuals, such as labor law compliance, tax payment, and regulation adherence. Earnings from informal activities may be integrated into individuals' recorded family income or activity [2]. These economies are ubiquitous, accounting for over 50 percent of employment in nearly 60 countries. Globally, about 70 percent of self-employed workers operate in the informal economy [3]. Businesses and workers operate informally for diverse reasons, including lack of choice, opportunity, and exposure to specific risks. Diversity of informal activity limits generalization about compliance with tax regulations, yet certain considerations apply widely [4].

Defining the Informal Economy

The informal economy is "the production of goods and services, the provision of protection, security, and financial services and other activities that take place outside the legal framework" [1]. It is characterized by a range of activities that are not authorized by the state. The three main characteristics of the informal economy are: [1] The activities are generally small in scale; [2] The activities are unregistered and, hence, inferior in quality; and 3) The arrangements are informal, short-term, and usually for survival. (An et al., 2015, p. 108) Many people work across both formal and informal economies [3]. In a model of two formal and one informal sectors, people may sometimes leave and sometimes return to work in the informal sector. Individual decisions about whether to work informally are conditioned by income support through unemployment insurance [4]. Taking advantage of a large survey dataset covering almost an entire country's population over time, the model matches well to the data.

Taxation and state legitimacy

Taxation is an institution that enables persistent governance during the entire political life cycle. The case study of Sierra Leone illustrates how taxes help to maintain effective state control [4]. Regime longevity of authoritarian states correlates positively with having revenue streams such as natural resources, because ordinary citizens cannot monitor the finances of elites whose pay is not dependent on taxes. In a democracy, states need to act on behalf of constituents who are involved in tax systems [5]. Therefore, taxation through the formal economy is regarded as a main pathway for governance, and the absence of an operating tax system disqualifies a political entity from being defined as a "state". The international trade of expropriation of the natural resources fostered low tax states and informal domination [6]. Taxation norms also contribute to evaluate regime persistence. Surveys indicate that populations have low trust in governments, which has been interpreted as an opportunity for popular uprising. In turn, low corruption in tax systems is associated with a higher estimated likelihood of regime change regarding undemocratic states [7]. Public goods are collectively determined and informal economies are not exempt from financing public services, which provides a "public good" type of redistribution. Outside the formal economy, addressing bureaucratic compliance and taxation is hampered by the lack of formal channels that could justify linking low formal activity with tax levies, which underlines the importance of understanding informal governance [8].

Compliance Theories in Taxation

Both informal and formal economic activities can be subject to taxation. Tax compliance is defined as the extent to which a taxpayer grants permission for tax authorities to use some portions of their income, whereas evasion comes into play when economic agents intentionally distort their income figures to minimize tax payments [2]. Individuals may comply with taxation despite easy opportunities for tax evasion, and most European countries rank high on both formal and compliance indicators [3]. In Switzerland, for example, citizens willingly pay taxes even when evasion is easy, because they value the public goods and services public spending generates. Nevertheless, tax payments are less stable and tax morale is considerably lower in the more informal sector of the economy. In economic and institutional terms, low tax compliance leads to a black economy that hinders the provision of public goods and services [3]. Tax authorities can increase compliance through a combination of enforcement and voluntary measures. In short, tax compliance necessitates a certain view or perception of the tax system, while evasion occurs when the taxpayer's perceived tax value falls below the actual tax payment. Understanding compliance and evasion within the informal sector is thus crucial, especially in developing countries with significant informal economies [4]. Such understanding provides insights into citizens' preferences for public funding, their compliance evaluation of the formal sector, and the type of income generally declared for tax purposes. The competitive economy often coexists with the informal sector. Individuals sometimes do not purchase the public goods that tax financing offers, and some states deliver poor services despite advocacy and promotion of equitable taxation [5]. The characteristics of the informal sector determine the choice between income generation in the formal sector, which entails formalization of secured income and increased taxation, and informal generation of greater income but lesser private or family welfare. Citizens' willingness to pay taxes varies accordingly [7].

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Compliance in Informal Economies

In compliance with the tax compliance literature, tax compliance is defined as the degree to which taxpayers obey tax laws and regulations, whilst tax evasion is viewed as the failure to fulfil legal obligations regarding tax liabilities [2]. As informal economies are not governed by the same laws and rules as formal economies [3], taxpayers in these economies may not feel obligated to fulfil tax compliance requirements. Furthermore, individuals in informal economies may view tax compliance in informal sectors as illegitimate, leading to the perception that the government does not have a legitimate claim to tax their income bases. Accordingly, informal and unlicensed sellers do not pay taxes on informal income streams while viewing such tax evasion as acceptable and legitimate behavior [1]. Taxpayers residing in capitalist informal economies and remote rural areas may develop a critical attitude regarding the legitimacy of paying taxes to central authorities, viewing it as legitimating government legitimacy [2]. Enterprises operating in the informal economy are usually unable to gain access to formal credit. Improving the capacity of state-licensed microcredit institutions and promoting the public bank alternative can help redirect informal credit and encourage compliance under a licensing regime [1].

Motivations for Compliance and Evasion

To entice informal entrepreneurs into formality, governments must understand better how they evade taxes and why they actively choose to evade these obligations [3]. Different factors drive tax compliance and non-compliance in informal economies [4]. Some comply, voluntarily paying tax even when hidden from the tax authorities, while others attempt to escape detection [5]. Some evade tax on goods sold in the informal economy; in some cases, the compliance decision relates to whether earnings come from the informal or formal economic sector [5]. Other influences remain very local, with compliance differing even at street level [6].

Enforcement Mechanisms and their Effects

States might deploy several enforcement mechanisms when attempting to influence compliance in the informal economy. External enforcement mechanisms, defined as coercive actions against tax evasion, are standard across different enforcement regimes [2]. Internal compliance mechanisms, characterized as the spirit of voluntary payment on the part of the taxpayer, differ according to the predominant type of enforcement regime [1]. Informal economies are often associated with high non-compliance, yet under certain circumstances micro and small firms may comply with various forms of taxation. An analysis of compliance motivations and the nature of enforcement indicate that [2] compliance and evasion derive from distinct motivations and [3] the enforcement regime has a significant influence on compliance behaviour across micro and small firms. Positive inducements constitute an internal enforcement mechanism under voluntary compliance and play a key role in informing the trade-off between compliance and evasion [3]. Normative tax compliance models alongside the understanding of enforcement regimes clarify how formalisation enhances monitoring and accountability factors that are readily manipulable when both micro and small firms operate informally [5].

Informality, Taxation, and Informal Credit and Labor Markets

Informal economies persist in most developing countries despite tax collection reforms. Their resilience is attributed to regulatory gaps, weak administrative capacity, social networks, and heavy entry costs associated with formalization [6]. Registration remains attractive for businesses seeking growth and market access. In developing cities, a sizable share of the population engages exclusively in informal employment due to prohibitive costs or overpowering regulations that make entry into the formal economy impossible [1]. Mandatory formalisation often generates widespread evasion under limited administrative capacity. Informal taxation, including levies imposed by the state or non-state actors such as traditional authorities, organised groups, or violent gangs afflicts many low-income countries and can significantly surpass formal payments [6]. Informal taxes tend to be regressive, despite wealthier households paying a larger amount in absolute terms. Coercive enforcement, which can encompass harassment, extortion, or social sanctions barring access to essential resources, poses a severe economic threat [7]. However, in the absence of an effective or accountable state, informal revenue collection frequently finances public goods roads, schools, water systems or supplements service-sector salaries [5].

Fairness Perceptions in Tax Policy

Fairness perceptions about tax policy are often described in terms of two dimensions: procedural fairness (or the fairness of the tax process) and distributive fairness (or the fairness of the tax burden and revenue redistribution). Procedural fairness relates closely to the degree of taxpayer trust in government authorities [6]. The perception of equitable tax treatment among different social classes and the availability of channels for public complaints or grievances are key components of procedural fairness [7]. Distributive fairness relates to perceptions of equity in tax burden and distribution of taxes among the people [6]. An overly heavy tax burden is considered one of the major obstacles in developing countries; excessive tax levies and unfair share allocation of the economic pie can lead to social unrest [3]. When taxpayers believe that the tax burden is allocated unequally, they would much rather not pay taxes. Transparency, accountability, and public involvement in the fiscal policy-making process can

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help increase perceived distributive justice [4]. Tax compliance is influenced by the procedural fairness of tax administration and the equality of tax burden levied by the tax authority; these determinants can significantly influence tax morale [5].

Procedural Fairness and Trust in Government

Taxpayers' perceptions of fairness in tax policy and tax administration are essential determinants of state legitimacy. Citizens in the Global South frequently express concerns about taxation policy, rate, and enforcement because they believe that tax systems ignore the needs of the poor, fail to provide essential public services, or grant preferential treatment to the wealthy[7]. Fairness perceptions of tax policy and tax administration greatly influence tax morale, people's intrinsic desire to pay taxes independent of the risk of detection or punishment as well as satisfaction with government, governmental trust, and overall legitimacy of the state 8. Informal economy participants can have significantly different fairness perceptions and legitimacy beliefs than those working in the formal economy [5]. Consequently, fairness concerns in post-collection taxation centered on procedural, distributive, and intrinsic justice assume greater importance when the informal economy is extensive, when informals generate a significant share of economic activity or tax base, and when the legitimacy of the public sector or state is low[6]. The significant share of individuals and firms remaining in the informal economy precludes reliance on the formal framework employed in many states, and underscores the need to adapt previous findings about taxation, compliance, and state legitimacy to a situation where no substantial or regular payments are made to government[4].

Equality of Tax Burden and Perceived Distributive Justice

Informal arrangements are often a norm rather than an exception, and equity of the tax burden might have a more significant impact on state legitimacy for activities outside the formal economy [8]. A study investigating Sierra Leonean taxpayers' attitudes toward tax obligations indicates that, while taxes perceived as excessive generate resentment against state authorities, taxes imposed by local chiefs and other similar sources do not provoke the same reaction despite being regarded as similarly exorbitant [7]. Formal state taxes are viewed as more appropriate in terms of compliance with regulations and equity of the burden; although the system is portrayed as fundamentally flawed, it is not perceived as systematically oppressive or unfeasible[4]. Taxpayers consider the regime overly complex, generate expectations of accountability, and delimit priorities in terms of the need for assistance [6]. A comparison of high- and low-income households in Japan shows that equalization of income and wealth, contributions according to ability, and provision of public goods with little cost are regarded as the most crucial elements to a fair tax system, generating perceptions that the current system does not adequately satisfy these requirements [3]. Social norms for redistribution influence these perceptions, and while individuals with high social capital consider taxes as fairly paid, those with a high school education feel that taxes on their incomes are too heavy [9].

Transparency, Accountability, and Tax Morale

Tax morale defined as the intrinsic motivation to pay taxes is a crucial determinant of compliance behavior across a wide range of political and economic contexts [7]. Individuals with high tax morale view tax payments favorably and accordingly honor their obligation to remit them. It is therefore not surprising that tax morale lies at the center of debates concerning the legitimacy of tax systems and the social contract between citizens and the state [10]. The literature identifies three core dimensions of tax morale: horizontal equity (equality of tax burden); vertical equity (fairness of the tax system in relation to various social strata); and the fairness of tax administration itself [9]. Paying taxes is considered legitimate when taxpayers are treated with respect and fairness, that certified government authorities and procedures apply equally to all, and legitimate expectations regarding the supply of public goods and services are met [8]. The respect and trust generated through these fairness and goodwill considerations contribute to a rise in overall tax morale, which ultimately reinforces compliance [6]. Tax morale is shaped by perceptions of the state, where positive perceptions of distribution and administration enhance compliance motivation, while negative perceptions have the opposite effect [7]. Taxpayer perceptions of tax administrations and the perceived quality of the associated fiscal contract remain significant even in informal economies the tax base for which are negligible or absent, since compliance motivation is still rooted in broader socio-political aspects of the relationship between citizens and the formal institutions of government. It remains to be verified whether compliance in informal economies is also motivated by tax morale within those economies [11]. Individuals active in informal markets nevertheless share an interest in the nature and extent of tax engagement by formal enterprises within their country, as they are presumably keenly aware of the limits of public goods and services generated via tax revenue [9]. Governance is a multi-faceted concept, often categorized as input legitimacy (governmental processes), throughput legitimacy (governmental outputs), or output legitimacy (impacts on societal welfare). Legitimacy requires compliance and citizens' willingness to statutory rules and orders, including rules related to tax [6].

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State Legitimacy and Tax Administration

Tax legitimacy exerts a significant influence over state capacity, public-service provision, and citizens' compliance with taxes [10]. Three channels mediate the ties between state legitimacy and tax administration. First, the informal economy reduces the availability of public goods and services and diminishes social expectations concerning their provision [1]. Second, informal workers' access to state business licenses or permits relies on non-fiscal services, thereby constraining states' capacity to impose taxes or fees on informal actors. Third, efforts to formally integrate informal actors often entail a shift from indirect (e.g., public-works jobs) to direct (e.g., income) taxation, raising concerns about fair access to services and equity in the tax system [13].

The Role of Tax Legitimacy in Governance Outcomes

Tax compliance and evasion are vital determinants of tax revenue within informal economies. Conventional compliance and enforcement theories often apply, yet the unique context of informal economies modifies their predictive ability [10]. Citizens engaged in informal activities remain subject to formal taxes on declared incomes from other forms of work, and both tax policy and compliance responses in formal sectors substantially influence attitudes toward taxation within informal economies [12]. Tax legitimacy thus emerges as pivotal, shaping taxation perceptions and subsequent governance outcomes. Legitimacy resides at the nexus between contentment with public goods and services, and equity in tax burdens. Informal actors typically expect less from state provision, and thus the perceived legitimacy of tax regimes designed to encompass them may diminish [11]. Various design considerations therefore influence both the establishment of legitimacy-seeking tax mechanisms targeting informal economies and the minimization of legitimacy-eroding consequences [9].

Public Goods, Services, and Expectations in Informal Economies

In many developing countries, those employed in the informal economy perceive little connection between the taxes they pay and the benefits they receive from the state. This detachment is tied to the expectations associated with the payment of taxes and the receipt of public goods and services [7]. The provision of such goods and services does not usually happen on a fully market basis; people expect that the government should address their needs adequately, and only under these conditions would they be willing to pay taxes. Informal wages would usually be regarded as "informal" when, under the expected conditions of provision of goods and services, the persons concerned are yet not willing to pay taxes at all [1]. The informal economy enables people to evade state machinery, including the nexus involving tax and accountability [5]. The expectations regarding the provision of public goods and services determine how far taxation goes, what materials are transformed into tangible products but remain undocumented, and when they'll start providing public goods and services in turn, in a way that maintains secrecy and does not allow for a tax account to be opened [6]. Publication of accounts would then open the door to taxation and render those operating in the informal economy immediately liable [4].

Institutional Design for Legitimacy-enhancing Taxation

Tax policy and administration affect the legitimacy of the state through citizens' perceptions of the system's fairness [12]. Individuals determine whether the state is operating fairly based on their perceptions of the measures put in place to create and enforce tax rules [6]. Heightened perceptions of state legitimacy concerning tax policy contribute to the effective, willing collection of taxes by the state, which is crucial for governance in an informal economy where an absence of trust and reliance on the state to provide services are conspicuous [5]. A citizen's perception of a government institution's fairness is an indicator of legitimation. Individuals interpret fairness based on the procedures followed to establish tax measures and the equitability of the resulting burden. In an informal economy characterised by a large proportion of self-employment, taxpayers tend to favour procedures centred on tax simplicity and burden equality [6]. Taxpayer perceptions of the fairness of tax policy procedures and distributive justice govern the acceptance of specific tax instruments.

Policy Implications and Reform Pathways

Various insights regarding policy implications emerged from research documents exploring tax compliance in the informal economy [1]. Tax authorities often find it difficult to enforce perceived unfair policies, even on grossly tax-evading businesses. Depending on informal actors' evolving needs, partial compliance may serve as a gateway to increasing the tax base. A menu of options specifically designed for the informal economy might foster the perception of inclusion and legitimacy, ensuring the voluntary acceptance of the continued provision of public goods and services expected from such a reciprocal engagement [3]. Compliance could thus serve as the vehicle through which public attitudes towards taxes, governments, and state capacity evolve positively. Strengthening collective markets and representation is crucial, as the architecture of many developing economies tends toward monopolistic relationships that offer little mutual gain [10]. Strategies for engagement should adapt to local conditions. Where the informal economy operates outside collective arrangements, sending formal delegation representatives to informal actors might encourage the exploration of options that formal institutions perceive as infeasible [9]. Engagement must also preserve politically advantageous openness: uninvolved sector actors should

not be perceived as closing ranks at the expense of others. Building up local facilitators through cooperative action and noticeable benefits may in such cases prove exceedingly important [8]. If businesses share resources with an intermediary, only collective action generates sufficiently strong incentives for return. Partial concessions might induce participation where collective action is stymied [7].

Integrating Informal Actors into Tax Systems

Worldwide policies promote the incorporation of informal actors into tax systems [1]. Informal earnings often evade taxation alongside stricter regulations and are widely used socio-economic risk management strategies that indirectly promote compliance via collective action [2]. Factors that determine the complexity of tax systems for the informal sector also affect compliance from formal entrepreneurs; these include the perceived relative equity and efficiency of taxes and government spending across economic levels. Multiyear regression analysis correlates anti-evasion measures attracting firms into the informal sector with increased governmental demands in the remaining formal sector [3]. Formal and informal actors mutually benefit by integrating informal firms into tax and other systems, maximizing the sharing-permit rate. Such integrated arrangements become even more attractive when tax and spending system upgrades lower the vantage-point return consistently over time, in cases of demand movement where present customers migrate over time or through voluntary fluidity-gaining programs [4]. The ability to finance suppression of corporate-agenda tax-independence costs via the systemic storage of public endorsements also broadens the feasible-entry margin [5].

Tailored Enforcement and Voluntary Compliance Strategies

Ensuring compliance with tax regulations is particularly challenging for activities based in the informal economy. The lack of registration and inadequate records of transactions constrain the establishment of information and operational audit trails [5]. Consequently, much of the information typically available to the government or tax authorities on the activities undertaken by taxpayers is not accessible for informal activities [5]. The widespread perception that informal activities also do not generate income for their practitioners adds to the reluctance of tax authorities to issue tax schedules or devise controversy-generating enforcement or compliance campaigns. The absence of a tax schedule or compliance enforcement measures may inadvertently create a perception of the informal economy as a legitimate activity from which no tax is legitimately due [1]. Tailoring enforcement and compliance strategies to address these contextual issues can help identify pathways for formalising informal economy activities, integrating the activities into the tax base, and increasing revenue without generating taxpayer push-back for collecting an extra tax perceived as illegitimate by the public [12]. Various broad strategies have been proposed to enhance voluntary compliance with the tax regime across the economy as a whole, many of which could be tailored and directed at the informal economy [9]. Addressing the well-recognised issues of legitimacy, fairness, and conduct integrity associated with tax regulations for informal economy activities would also have the secondary effect of generating appreciation for the economic value of formalising informal sector activities and increasing fiscal transparency throughout the economy [7].

Reducing Perceived Unfairness through Policy Design

Taxpayers perceive formal state taxes to be more fairly applied and collected and more evenly distributed among the population than illegal levies, despite believing formal taxes are often unfair [12]. Formal and informal taxes are generally regressive, as most are flat-rate levies. Enforcement mechanisms, such as harassment or social ostracism, are more associated with informal, non-statutory levies [6]. Reducing perceived unfairness through policy design involves implementing institutional features such as oversight, sunset clauses, and earmarking mechanisms to make economic reform more acceptable to the public. These design features can influence political support for tax reform by reducing uncertainty and addressing distributional concerns, especially among groups with low trust in the government [13]. Public safety is a key area where these effects are significant, though their applicability to other goods remains uncertain. Overall, simple institutional adjustments can help mitigate opposition to taxation, but they are not sufficient to generate overwhelming support [12].

Methodological Considerations in Studying Informality and Taxation

Research on taxation of the informal economy remains scant. Informal economies encompass a broad range of activities with diverse links to state institutions and vary greatly in size and nature across countries. Consequently, informal sector research is plagued by measurement problems [8]. Given the political nature of taxation, the challenge is compounded by the paramount need to avoid “ceteris paribus” assumptions in the study of tax matters, a central tenet of classical and neoclassical economics. Research on tax compliance and tax policy in fragile states illustrates these difficulties [7]. Longitudinal data and appropriate causal inference methodologies, including propensity score matching or synthetic control estimators, are paramount. Solid surveys can support tax morale inquiries [1].

Data Sources and Measurement

Identifying unregistered businesses is generally easier than detecting the under-reporting of wages, turnover, or profits [12]. To assess policy approaches targeting informal enterprise, a survey was conducted in 2015 among 1,384 small firms in Croatia, Bulgaria, and FYR Macedonia, whose informal work levels are particularly high. Using face-to-face interviews, the research began with non-sensitive questions about the business environment before addressing compliance issues and subsequently informal employment practices [13].

Causal Inference and Comparative Analysis

The estimation of tax compliance rates requires a balance between accuracy and realism, and a set of appropriate conditions to ensure credible results [11]. Available studies that rely on either panel or longitudinal data do not seem to meet these conditions. In what follows, an alternative approach is suggested that leverages the comparative analysis of countries based on their scores on the informal economy as reported by Schneider [10]. This method satisfies the necessary conditions for a reasonable causal inference. Between and within countries, the analysis evaluates whether changes in the level of informal economy have had significant and measurable impacts on taxation compliance. In addition, the country-level analysis assesses whether a clear, negative correlation emerges between the size of the informal economy and economies' tax compliance rates in line with the predictions of the theory of compliance outlined in [1]. The analysis capitalizes on the possibility of exploring these issues since Schneider has provided a time series of cross-country data on the evolution of the size of the informal economy over the period 1999–2022. This time frame encompasses the direct and indirect effects of the 2008 financial crisis and many other global or regional events, including the Arab Spring in the MENA region, which offer rich variations in changes in the size of the informal economy across countries and years. The results confirm the key predictions of the theoretical framework [14].

Ethical Considerations in Taxation Research

The study of taxation raises a number of ethical issues for researchers that merit reflection. Taxation is often portrayed as a moral obligation or social contract a form of participation in society, the exercise of citizenship, or an expression of solidarity [1]. In democratic societies, taxation entails civic duties. Well-designed tax policy aligns taxpayer citizenship and decision-making, thereby involving taxpayers as citizens in relationships with government. Assumptions of compliance, evasion, and legitimacy reflect angles of legal and moral categorization associated with law and taxation at the societal level [9]. Understanding the informal economy, a second-order construct, necessitates studying the ground level where taxpayers differ in formal or informal status. Distinctions require a third-order construct. Hence, teachings emphasize precisely delineating the societal mechanism, observables, and definition of invariance in the taxation-formation problem [10]. Tax and legitimacy signify the research topic. Study of taxation may be confidential and non-transparent, yet a balance between access and confidentiality can often be achieved [11]. Taxation co-evolves with legitimacy at four levels of abstraction. Expectations of citizen deliverables shape taxpayer motivation for compliance and define taxation-formation questions at the first level [12,13]. Expected deliverables also govern legitimacy at the second level. Additionally, arrangements involving informal settlement and process of state conversion from informal to formal raise further orchestrations in informal settlements and at the third level of taxability [14]. Finally, the physics of engineering constrains observables mapped onto citizen deliverables, with potential yet opaque conversion from taxation-formation metric to second- or third-space arrangements of citizen deliverables and legitimacy. Perceptions of tax legitimacy and therefore structure of the research are further determined to complete the description [15, 16].

CONCLUSION

The persistence of informal economies poses a fundamental challenge to effective taxation, equitable resource distribution, and the legitimacy of the state. This study has shown that tax compliance within informal contexts cannot be understood solely through enforcement mechanisms; rather, it is deeply rooted in perceptions of fairness, trust in government, and the perceived value of public goods and services. Where citizens view tax systems as inequitable, opaque, or disconnected from tangible benefits, compliance declines and informality becomes both a survival strategy and a rational response. Fairness perceptions encompassing procedural justice, equitable burden-sharing, and transparency emerge as central to shaping tax morale and willingness to comply. In many developing contexts, weak state capacity and limited service delivery further erode legitimacy, creating a cycle in which low compliance reduces revenue, thereby constraining the state's ability to improve governance outcomes. Informal taxation systems may partially fill this gap, but they often reinforce regressive practices and undermine formal institutions. Policy responses must therefore move beyond coercive enforcement toward legitimacy-enhancing strategies. Integrating informal actors into tax systems through simplified regimes, partial compliance pathways, and incentives can foster gradual formalization. At the same time, strengthening public service delivery, ensuring accountability, and promoting citizen engagement are essential to rebuilding trust. Tailored approaches that reflect local realities, combined with robust data systems and inclusive governance

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structures, can help bridge the divide between formal and informal economies. Ultimately, sustainable taxation in the presence of large informal sectors depends on rebuilding the fiscal social contract one grounded in fairness, reciprocity, and mutual accountability thereby reinforcing both compliance and state legitimacy.

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