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Friedrich Schneider and Dominik H. Enste

Excerpt

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# 1 *The shadow economy: a challenge for economic and social policy*

In the 1980s, the causes, effects, and problems generated by increasing shadow economic activities were extensively and controversially discussed in many countries, especially in the OECD. In the 1990s, attention was being drawn to the shadow economy because of dramatically rising unemployment (e.g., in the European Union) and the problems of financing public expenditure, as well as the rising anxiety and disappointment about economic and social policies. Public discussion of illicit work, tax evasion, and all the other activities in the shadow economy have grown increasingly pointed even beyond the turn of the millennium. Broad initiatives on behalf of the EU Commission and EU Parliament, as well as at state level, show that politicians have finally felt the need to act as well.<sup>1</sup>

Politicians are in a dilemma. While the fact that the wealthy are evading taxes leads to widespread public indignation, illicit workers are often much less criticised, although some politicians argue that they are behaving antisocially and are a source of growing unemployment and social injustice. This opinion is broadly shared in regard to social fraud, illegal employment, and extensive tax evasion. But what about part-time illicit work in the evening ('moonlighting'), which, for example, about half of the population in Germany would tolerate, or even take advantage of, if they had the opportunity to do so?<sup>2</sup> Can more sanctions and controls, combined with more regulation, be the ultimate solution to combat illicit work? What is the right way to deal with undeclared work?

In the popular scientific media and in newsprint, this discussion naturally does not go into detail. Here, judgement on the nature of the

All translations from German are by the authors.

<sup>1</sup> See, e.g., EU Commission (1998; 2007); EU Parliament (2000); Feld and Larsen (2012).

<sup>2</sup> See Enste (2001: 158 f.).

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shadow economy fluctuates between two extremes: either the shadow economy is blamed for many problems of economic policy, such as unemployment, high public debt, and the recession, or it is regarded as a legitimate free space in an economic system that is characterised by high taxes and too much regulation. New data on the size of the shadow economy is often used by certain pressure and interest groups which focus on only a few unilateral issues concerning illicit work. In the social sciences, articles and papers dealing with the shadow economy often focus on one single aspect only, mostly on the difficulties and challenges involved in measuring its size. In addition, the basis of the analysis of the causes and consequences of the increasing shadow economy is often quite narrow and does not take the results and insights of other social sciences into account. Therefore, a comprehensive overview and scientific analysis of this complex phenomenon is necessary. This book is an attempt to provide this analysis and to fill the gap.

The main focus of interest in the shadow economy is concentrated on three areas, which will be analysed in more detail here.<sup>3</sup>

(a) In *economic and social politics*, the driving force for dealing with illicit work is the fact that these illegal and semi-legal activities are undesirable for official institutions. A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the 'exit option' rather than the 'voice option'.<sup>4</sup> If the growth of the shadow economy is caused by a rise in the overall tax and social security burden, together with 'institutional sclerosis' (Olson (1985)), then the 'consecutive flight' into the underground may erode the tax and social security bases. The result can be a vicious circle of further increase in the budget deficit or tax rates, additional growth of the shadow economy, and gradual weakening of the economic and social foundation of collective arrangements.

In addition, the effects of the shadow economy on the official economy must be considered because illicit work can be a source of allocation distortions, since resources and production factors are not used in the most efficient way. On the one hand, a growing shadow economy may attract (domestic and foreign) workers away from the official labour market and create competition for official firms. On the other

<sup>3</sup> See also Weck, Pommerehne, and Frey (1984); Gaertner and Wenig (1985); Petry and Wied-Nebbeling (1987); Feige (1989); and Thomas (1992).

<sup>4</sup> See Chapter 9.

hand, at least two-thirds of the income earned in the shadow economy is spent in the official economy, thereby having a positive and stimulating effect on the official economy.<sup>5</sup>

Furthermore, a prospering shadow economy may cause severe difficulties for politicians because official indicators, for example, on unemployment, labour force, income, GDP, and consumption are distorted. Policy based on erroneous indicators is likely to be ineffective, or worse. Therefore, the reciprocal effects between the shadow and the official economies have to be considered when planning measures of economic policy, especially fiscal policy. If underground activities occur in an economy, the tax revenue might reach the negatively sloped part of the Laffer curve, where higher tax rates result in a lower tax yield.<sup>6</sup>

(b) In *social sciences*, the shadow economy is first and foremost a challenge for economic theory and economic policy. In economic and social science, answers have to be found for questions like: Why are people working illicitly? Why are transactions made in the shadow economy? What are the effects resulting from this behaviour? Currently, theoretical approaches in different social sciences exist that concentrate on single aspects of this complex phenomenon. But, since a coherent, integrative, and interdisciplinary approach for the analysis of the causes is missing, the development of a systematic, basic 'model' is necessary.

In empirical studies, the problems of measuring the size and development of the shadow economy by different methods have to be examined. The theoretically derived causes and consequences of shadow economic activities have to be investigated empirically. Feedback effects on the official economy as well as interactions between the two sectors have to be considered and measured. Schneider, Buehn, and Montenegro (2010) have used a quite new method, the multiple indicators and multiple causes (MIMIC) model, to quantify the extent of the shadow economy. This method also allows for a comparison of the size of shadow economies of many countries.<sup>7</sup>

<sup>5</sup> This figure has been derived from polls of the German and Austrian populations about the effects of the shadow economy. For further information, see Schneider (1998b). Moreover, the results of these polls show that two-thirds of the value added produced in the shadow economy would not be taken up in the official economy if the shadow economy did not exist.

<sup>6</sup> See section 6.7.

<sup>7</sup> See Cowell (1990); Thomas (1992); Pozo (1996); Spiro (1997); Lippert and Walker (1997); and Schneider and Enste (2000a; b).

(c) The most difficult task for *economic policy researchers* is to convey the often not very much appreciated results of scientific analysis to politicians, and then to convince them that the findings are relevant and correct. Here, we try to make suggestions for economic policy measures that are based on the analysis of the relationships between causes and effects of the shadow economy. They go beyond the guidelines laid down by the EU Commission in their pan-European employment strategy for combating illicit work and the most recent initiative of the International Labour Organization.<sup>8</sup> The latter's guidelines demand an exchange of 'good practice models' and coordination at the EU level to combat illicit work, for example, by stricter controls and harsher sanctions. Unfortunately, these propositions are not new and they often do not go beyond trying to cure the symptoms. Instead, reforms of the tax system and the social security system are necessary, which could improve the dynamics of the official economy and make the official institutions more competitive within the different (national and international) institutional arrangements.

The discussion about adequate economic policy is often influenced by ideologies. One comes across every position, from a forced denial of the phenomenon of a 'shadow economy' to imaginative exaggerations of its size and impact. The starting point for debate is the fact that there are differences in estimates of the size of the shadow economy. Clearly, such estimates are vital for reliable analysis. Unfortunately, as a result, research efforts are concentrated on questions like: Which is the best method to estimate the extent of the shadow economy? How large is the shadow-economy labour force and how is it changing over time?

The collection of information about underground (or criminal) activities and the frequency with which these activities occur, as well as their magnitude, is crucial for making effective and efficient decisions. But it is very difficult to obtain accurate statistics about shadow economy activities, since the individuals engaged in these activities do not wish to be identified. Hence, the estimation of shadow economy activities can be seen as a scientific passion for knowing the unknown. An extensive literature on single aspects of the hidden economy exists, including a comprehensive survey.<sup>9</sup> But there is still disagreement about the definition, the

<sup>8</sup> See, e.g., International Labour Organization (2010).

<sup>9</sup> The literature on the 'shadow', 'underground', 'informal', 'second', 'cash', or 'parallel', economy is increasing rapidly. Various topics on how to measure it, its

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estimation methods, and the ‘right’ estimation of the shadow economy. Much controversy arises in discussion about these issues.<sup>10</sup>

Nevertheless, there are strong indications of a growth of the shadow economy on a global scale. The size, the causes, and the consequences vary in each country, but some comparisons can be made that are of interest to social scientists and the public in general, and helpful to politicians who will need to deal with this phenomenon sooner or later. Therefore, we will not restrict ourselves only to document the size of the shadow economy and its labour force in 151 countries from 1996 to 2007. An analysis of the cause and effects is also carried out. After defining the shadow economy (Chapter 2) and discussing the different estimation methods (Chapter 3), we will present our extensive data (Chapter 4) on the shadow economy and its labour force (Chapter 5). After this empirical part of the book, the theoretical fundamentals are elaborated. Besides presenting the economic theory to analyse the relationships between the causes and effects of the shadow economy, we introduce a social sciences approach that adds socio-psychological and sociological components to the economic considerations (Chapter 6). On this basis, the causes of the increase of the shadow economy will be analysed, and different economic policy measures will be discussed in the context of illicit work (Chapter 7). The analysis of the effects of the shadow economy on the resource allocation, income distribution, and stabilisation policy, as well as on the official economy in general (Chapter 8), provides the foundation for propositions of economic policy for the treatment of illicit work as an economic and social challenge (Chapter 9). We will propose a ‘two-pillar strategy’, with two approaches for dealing with the phenomenon: (1) reducing the attractiveness of evading taxes and regulations (‘exit option’) and (2) improving the ways of voting and influencing the formal institutions (‘voice option’). The book concludes with a summary and an outlook (Chapter 10).

causes, and its effect on the official economy are analysed. See, e.g., the first publications by Tanzi (1982); Frey and Pommerehne (1984); and Feige (1989); survey-type publications by Thomas (1992); Loayza (1996); Pozo (1996); Lippert and Walker (1997); Schneider (1994a; b; 1997b; 1998a); Johnson, Kaufmann, and Shleifer (1997); and Johnson, Kaufmann, and Zoido-Lobatón (1998a); and, for an overall survey of the global evidence of its size, Schneider and Enste (2000a; b).

<sup>10</sup> For an early and broad discussion see, e.g., Dixon (1999), ‘Controversy: on the hidden economy’, including the different opinions of Tanzi (1999), Thomas (1999), and Giles (1999a; b).

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## 2 | *Defining the 'shadow economy'*

When examining the phenomenon of the 'shadow economy', the definition of the term is of the utmost importance. Many scientific controversies and political discussions arise because of differing or unsatisfactory definitions.<sup>1</sup> To analyse the causes and, above all, to estimate and evaluate the consequences of the growing shadow economy, it is necessary to clarify the term in each context.

Since the term 'shadow economy' comprises numerous economic activities, it is difficult to provide a formal definition. For example, one has to distinguish between goods and services produced and consumed within the household, 'soft' forms of illicit work ('moonlighting'), and illegal employment and social fraud, as well as criminal economic activities.<sup>2</sup> In the context of the European Economic and Monetary Union, the definition has to be made comparable and more or less uniform. The shadow economy has been identified as a very problematic area within the European National Accounts. A harmonisation of terms is needed and should be attained by integrating the shadow economy into the gross national product (GNP). Although this is generally regarded as necessary,<sup>3</sup> a global definition has not yet been found.<sup>4</sup>

An overview of different ways to define the shadow economy will be given here for general guidance.<sup>5</sup> The objective is to make the definition

<sup>1</sup> The following is a small selection of the terms that are used either synonymously or for different areas by the respective author: 'underground economy', 'illicit work', 'informal sector', 'irregular sector', 'leisure economy', 'alternative economy', 'black economy', 'hidden economy', 'unofficial economy', 'parallel economy', 'shadow economy', 'unobserved economy', 'unrecorded economy'. See, among others, Thomas (1992: 125).

<sup>2</sup> This chapter is partly taken from Enste (2002). <sup>3</sup> See Strom, et al. (1999).

<sup>4</sup> See Bhattacharyya (1999); Dixon (1999); Giles (1999b); Tanzi (1999); and Thomas (1999).

<sup>5</sup> See also Cassel and Caspers (1984); Gretschmann (1983; 1984); Schrage (1984); and Thomas (1992).

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transparent for the following analysis, without laying claim to a homogeneous definition. It has to be noted that considerable differences exist between developing, transitional, and OECD countries concerning the activities of their respective shadow economies. The following overview is a general approach, but concentrates particularly on those areas of the unofficial economy that are important for OECD countries.

## 2.1 Informal economic activity and national income accounts

In general, the shadow economy can be seen as an 'emigration from the established ways of working' (Stützel (1980): 453; own translation) or, as the German Council of Economic Experts defines it, it is 'a decision against the official norms and formal institutions for economic activity' (SVR (1980): 145, subsection 296). Cassel and Caspers (1984) as well as Mückl (1986) try to give a more systematic definition of the term, which, by now, has gained broad acceptance in the literature,<sup>6</sup> even though it omits the purely financial transactions. The concept of the National Income Accounts is taken as a systematisation criterion.<sup>7</sup>

The separation of the economy (dual economy) into an official (first economy) and an unofficial sector (second economy; informal economic activities) offers an initial guide towards a categorisation of the shadow economy (see Figure 2.1). This classification depends on the respective national propositions concerning the economic activity to be included. However, there is no unique set of propositions governing the construction of the accounts, since the principles of registration can vary over time and/or in different countries. Owing to this fact, the EU Commission initiated a standardisation on the European level that is being supported by extensive studies on the GNP of EUROSTAT. But this discussion should start at an earlier point because, first of all, it is crucial to decide which activity should be registered, taxed, and regulated, and then general rules should be set up. For example, should income or consumption be the basis for taxation? Should every market transaction be regulated? In addition to these theoretical considerations, the measurement of economic activity involves many practical problems.

<sup>6</sup> See Frey and Pommerehne (1984); Feige (1989); Lubell (1991); Schneider (1994a); Schneider and Enste (2000a); Schneider and Enste (2006; 2011).

<sup>7</sup> See Cassel and Caspers (1984: 1–7); Tuchtfeldt (1984: 17 f.); and Mückl (1986: 10 f.).

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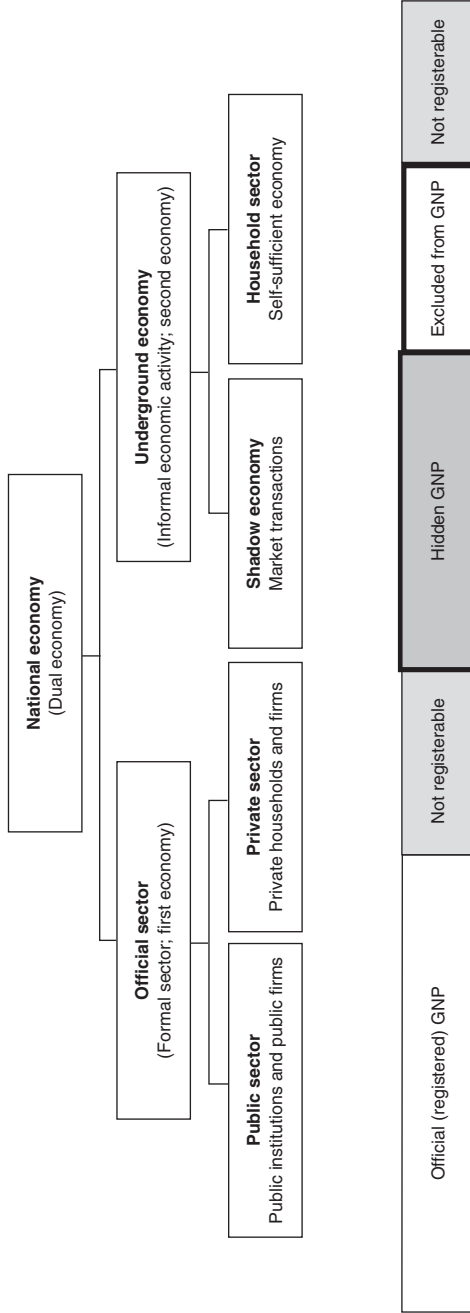


Figure 2.1 The dual economy



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Here, the part of the economy that, apart from small statistical deviations, is encompassed by the national product is defined as the official sector. It comprises the public sector (state activities) as well as the private economy (goods and services of private households and firms that are produced and sold through markets and that are regulated by law, publicly administered, and taxed). When turning to the underground economy, all private economic activities are implied that are not included in the calculation of the GNP, even though they contribute to added economic value. The underground economy can be defined as follows:

The term underground economy comprises all goods and services which normally should be added to the calculation of the national product but are not part of the latter for certain reasons. (Pommerehne and Kirchgässner (1994): 851)

Three reasons are mentioned as to why these activities are not registered.

1. According to international customs, one refrains from registering the activities in the context of the GNP (self-sufficiency economy), or
2. the transactions cannot be recorded in the national account statistics at all, or only partly, owing to practical problems and insufficient methods, or
3. the added value is not revealed, hence it cannot be recorded (shadow economy).

Self-sufficient activities are non-market transactions for individual needs. They imply voluntary activities of non-governmental organisations and, for example, neighbourhood assistance, whose activities are not recorded according to National Income Account conventions. Thus, the self-sufficient economy refers not only to the production of individual households but also to all services that are not obtained on the market – i.e., efforts in social networks ('network assistance').<sup>8</sup> Therefore, this sector of the underground economy is explicitly excluded from registration.<sup>9</sup>

By way of contrast, the shadow economy should be included in the added value, according to the convention of the National Income Accounts. Yet, evasive strategies of the private economy prevent such a recording. In general, these market activities are connected with the evasion of taxes

<sup>8</sup> See also Glatzer and Berger-Schmitt (1986) as well as Meier (1999: 36 f.). For help in social (or 'informal') networks, see also Diewald (1986).

<sup>9</sup> See also Döhrn (1990: 23) as well as Strom, et al. (1999: 272). The production of the agricultural household is often included as an estimated value: yet, in this context, it is added to the shadow economy.

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and social security contributions, as well as the avoidance of regulations (official working time, safety regulations), and social security fraud.

Regarding the *analysis of causes and consequences*, the taxonomy developed here would be of use if one defines the current ‘flight from the official economy’ as a process, which is induced by the socio-economic conditions of the modern welfare state and which drives the individuals under ground (self-sufficient and shadow economy). (Cassel and Caspers (1984): 6; original emphasis)

## 2.2 Shadow economy, tax evasion, and illicit work

The analysis of the varying degrees of legality of activities, as well as their connection to tax evasion, is important for the evaluation of deviant behaviour or actions in the shadow economy. Pure tax evasion via financial transactions is excluded from our analysis as it does not render added value – and is usually not meant – when someone is talking about the shadow economy.<sup>10</sup> The distinction between tax avoidance and tax evasion, mostly based on legal assessments, will not be discussed either. Moreover, the following analysis only broaches the problem of tax compliance, which has been intensively discussed in the literature in the last thirty years. This book is an attempt to transfer arguments from this discussion to the area of shadow economies and illicit work, i.e., areas that are usually excluded, for example, by Andreoni, Erard, and Feinstein.<sup>11</sup>

Unfortunately, there are many important issues that we do not have room to discuss, most notably the vast literature on the underground economy which exists in part as a means of evading taxes. (Andreoni, Erard, and Feinstein (1998): 819)

The difference between ‘pure tax evasion’ and ‘underground economy’ is explained clearly in Lippert and Walker (1997). Shadow economic

<sup>10</sup> Schmolders, who invented the term in the 1980s, generally summarises under ‘the shadow economy’: tax evasion and grey-to-black markets, which are the ‘expression and correction of the official market order’ (Schmolders 1980: 372). In his opinion, the main categorisation criterion is the secrecy of the financial transactions. Hence, the shadow economy comprises the entire turnover which is obtained in this economic system with its specific markets, competition rules, customs, marketing strategies, and investments.

<sup>11</sup> In this context, the survey article by Schneider and Enste (2000b) and this book can be seen as a supplement. Both articles taken together give a broad overview on the shadow economy and tax evasion.