



# Competitiveness Of The National Economies

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Lecture № 10

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# **The Shadow Economy as an obstacle to the Nation's Competitiveness**

# Outline

**1. Introduction**

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**2. Definition**

**3. Theoretical Perspectives and Controversies**

**4. The structure of the Shadow Economy**

**5. The participants of Shadow activity**

# *Goal of this lecture:*

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- Giving a clear view to the definition of the shadow economics
- Defining groups of the shadow economy
- Analyzing the concept of an informal activity
- Analyzing the theoretical Perspectives and Controversies of the informal activity
- Analyzing the theoretical concept of the structure of the Shadow Economy
- Defining the participants of Shadow activity

# 1. Introduction

- (1)** Shadow economic activities are facts of life around the world.

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- (2)** Most advanced economies try to control these activities through measures such as punishment, prosecution, economic growth or education.
- (3)** Gathering information about who is engaged in underground activities, the frequency of these activities but also about the driving forces determining those activities is crucial for efficient decisions regarding the allocations of a country's resources in this area.

# 1. Introduction

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To some people, the shadow economy is a great example of free economic activity at work. It is entirely unregulated except by the participants themselves; no tax is paid on shadow economic activity, and it may be possible to pursue activities in the shadow economy which are prohibited by law unjustly.

At the very least, it is certainly true that in a world in which developed country governments are spending and borrowing more and more, the possibilities for shadow economic activity place a restraint upon governments. One of the reasons for the 'Laffer curve' effect, whereby tax revenues can start to fall as tax rates are increased, is the movement of economic activity out of the taxed economy and into the shadow economy.

A different perspective can be taken, however.

**Firstly**, shadow economy activity can be marred by gang violence and coercion with little legal redress for its victims – this was certainly true of seventeenth- and eighteenth-century smuggling.

**Secondly**, operating in the shadow economy is a serious impediment to the expansion of businesses. Obtaining insurance, formalising employment relationships and advertising can all be difficult when a business is not legally registered.

**Thirdly**, the existence of a large shadow economy means that tax rates are higher for those in the legal economy.

Whichever way one looks at it, the shadow economy should be of interest to those studying the operation of markets. The argument for free-market economists being interested in the shadow economy grows stronger when the causes of its growth are examined.

## 2. Definition

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Most authors trying to measure the shadow economy face the difficulty of how to define it.

- (i)** One commonly used working definition is all currently unregistered economic activities that contribute to the officially Gross National Product.
- (ii)** One of the broadest definitions is: "those economic activities and the income derived from them that circumvent or otherwise avoid government regulation, taxation or observation.
- (iii)** We use the following more narrow definition of the shadow economy:



## 2. Definition

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**The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for any of the following reasons:**

- (1) to avoid payment of income, value added or other taxes,**
- (2) to avoid payment of social security contributions,**
- (3) to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc., and,**
- (4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.**

There are three main groups of actions,  
which can be defined as shadow economy:

Informal economy, otherwise called, "second" or "white-collar"

Fictitious economy or "gray" - an economy of inflated write-ups, speculative deals, bribes, and every other kind of swindle involving the acquisition or transfer of money

Black economy, "illegal", "underground" economy

**Table 1: A taxonomy of types of underground economic activities**

Type of activity	Monetary transactions		Non-monetary transactions	
Illegal Activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; fraud; etc.		Barter of drugs, stolen goods, smuggling etc. Produce drugs for own use. Theft for own use.	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
Legal Activities	Unreported income from self-employment; wages, salaries and assets from unreported work	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work; neighbor help; and voluntary work

Structure of the table is taken from Lippert and Walker (1997, p. 5) with additional remarks

Thus, we will not deal with typically illegal underground economic activities that fit the characteristics of classic crimes such as burglary, robbery, drug dealing, etc. We also exclude the informal household economy, which consists of all household services and production. Table 2 gives examples of activities that are inside and outside the shadow economy according to this definition.

**Table 2 Sample activities and the shadow economy**

<i>Activity</i>	<i>Inside or outside our measure of the shadow economy</i>	<i>Reason if outside</i>
Child-minding with income not declared	Inside	n/a
Selling drugs	Outside	Activity not legal
Paying builder cash, income not declared	Inside	n/a
Building work done by homeowner	Outside	Do-it-yourself activity not subject to tax or regulation
Purchase of cigarettes smuggled from EU country	Inside	n/a
Counterfeit production of an otherwise legal product such as cigarettes	Inside	n/a

Van Eck (1987) lists nearly 30 terms that are used as synonyms for, or are closely related to, the underground economy. The list includes the following:

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Alternate	Counter	Marginal	Peripheral	Twilight
Autonomous	Dual	Moonlight	Secondary	Unexposed
Black	Grey	Occult	Shadow	Unofficial
Cash	Hidden	Other	Submerged	Untaxed
Clandestine	Invisible	Parallel	Subterranean	Underwater
Concealed	Irregular			

These terms can all have different shades of meaning. One might hypothesize that concealed economy meant the same as underground economy, that grey economy covered underground and informal sector production, and that invisible economy might include illegal production as well, but this would be pure speculation. There is no way of knowing what any of the terms might mean in any particular document unless the authors have included definitions.

### 3. Theoretical Perspectives and Controversies

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The typology of [Chen, Jhabvala, and Lund \(2002:6\)](#) offers a useful starting point for a discussion of the relationship of informality and inequality. The authors outline a three-part categorization of informal economic activity based on the premise that the informal economy and mainstream economy must be thought of in relationship to one another.

This relationship is ***dualist, legalist, or structuralist*** depending on the relationship of illegitimate and legitimate modes of exchange.

1. The *dualist* (or *development*) perspective on informal economies builds on the central theoretical contributions of dual labor market theory (Doeringer and (p. 642) Piore 1971). This perspective adheres to a conventional labor market classification. Namely, the primary sector includes well-paying legitimate jobs; a secondary sector is based on unskilled, temporary employment; and finally the informal sector and the illegal criminal sector make up the remainder (see also [Losby et al. 2002](#)). In the dualist perspective, the informal economy is thought to function more or less independently of the legitimate sector. There is relatively little interest among proponents of this view for overlaps and permeable boundaries.

This perspective tends to conflate informal economic activity with the survival practices of low-income populations—as opposed to, say, white-collar underground revenue generation, organized crime, or gambling across income strata. The poor are presumed to work irregularly, if at all, in legitimate jobs, and so the informal economy becomes their principal space for earning revenue for basic survival ([Marcelli, Pastor, and Joassart 1999](#)). The notion is that the informal economy is a safety net for the poor (see also [Ferman, Henry, and Hoyman 1987](#); [Stack 1974](#)).



2. The *legalist* (or *neoliberal*) perspective originates in the work of [Hernando De Soto \(1989\)](#). Unlike the dualist perspective, the legalist view places heavy emphasis on the role of the state, particularly in terms of state regulations that support the creation and maintenance of economic activity. Indeed, in this view, some scholars have gone so far as to write, “the relationship of the informal economy and the state is, by definition, one of inevitable conflict” ([Centano and Portes 2006:30](#)).

De Soto argued that informal economies were neither a function of poverty nor a structural necessity of late capitalism. Instead, he suggested that informality is a choice made by rational actors facing a legal environment that hinders creative entrepreneurship. Thus, if the state is not seen as welcoming particular forms of material gain, those so interested will move underground to pursue their interests.

The legalist perspective holds that low-income populations can be understood as more than simply survivalists—which is the dominant characterization of the dualist view. Instead, the poor are innovators and rational actors who are realizing aspirations that would be recognizable to anyone in that society. What the poor lack however—and what distinguishes them from other classes—is support from the state for their property rights and enforcement of the contracts they develop in their petty accumulation strategies. Without this backing, the poor are assigned to work in economic sectors that are inherently stable and on the societal margins.

3. The *structuralist* (or *neo-Marxist*) perspective, championed by [Castells and Portes \(1989\)](#); [Portes and Sassen-Koob 1987](#)) deviates from both dualist and legalist perspectives. The informal economy in advanced countries enables capitalists to reproduce “uncontrolled, exploitative relationships of production” by doing away with labor unions, and labor, health, and environmental regulations. Capitalists are thus able to cut costs and increase their competitiveness ([Portes and Walton 1981](#)) “under the auspices of government tolerance” ([Castells and Portes 1989:27](#)). Workers—especially, but not only, undocumented migrants—experience “downgraded labor” ([Sassen-Koob 1984](#)). In this perspective, informalization is a logical development of the shifting needs of capitalism. The need to reduce the production costs of commodities motivates industrialists to use informality as a cost-saving principle ([Sassen 1994, 1997](#)).

The structuralist perspective has been particularly attractive for scholars observing so-called global cities in which the fast pace of economic change results in off-the-books activity that is virtually impossible to regulate through conventional means. Informality enables newcomers, such as immigrants and undocumented workers, to quickly establish a foothold via their inclusion in mainstream economic circuits—albeit in a way that can be exploitative. Structuralists criticize dualist perspectives by equating the informal economy with poverty.

The idea of the informal economy as fundamentally exploitative and being functional to the needs of late capitalism contrasts with the notion that informality may be understood as a “popular economy,” or a “counter-economy.” In this latter view, the formal sector is the locus of capitalism, rational calculation, and contractual relations, while the informal economy gives rise to solidarity, deepened and enhanced (p. 645) social bonds, in particular at the local and familial level ([Lautier 1994](#)). In England for instance, research of 511 respondents from poor and rich neighborhoods found that the rich and the poor equally use off-the-books labor. However, the rich favor market-like economic relations, and they quit using informal arrangements once their needs have been met. Such instrumentalism is not present among the lower income populations, for whom informal arrangements are means to strengthen social relations among friends and relatives ([Williams and Windebank 2001](#)).

## 4. The structure of the Shadow Economy

The shadow economy should be considered as a special segment of the public economy, which has the following systemic properties:

**Universality;**

**Integrity;**

**Communication with the external environment;**

**Structural;**

**Ability to self-organization and continuous development;**

According to the OECD, five groups of activities comprise the “non-observed” economy. They are:

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- (1) the hidden sector, consisting of legal but unreported activity;
- (2) the illegal sector;
- (3) the informal sector;
- (4) household production for own final use;
- 5) other activities that are not captured due to deficiencies in official data collection programmes.

**The hidden sector (or underground production)** is defined as “those activities that are productive and legal but are deliberately concealed from public authorities,” usually to avoid payment of income, sales and payroll taxes. Transactions may also be hidden to enable the participants to ignore health standards, labour laws, or administrative procedures established by governments. Off-the-book construction work and unreported rental income are prominent examples of this kind of hidden sector activity.

**The illegal sector**, according to the OECD, consists of goods and services whose production, sale, distribution or even possession is forbidden by law. It also includes activities which are legal but become prohibited when carried out by unauthorized or unlicensed producers. Illegal transactions include the production and distribution of banned drugs, pornographic materials, prostitution (where it is illegal), unlicensed medical practices, unauthorized gambling, unlicensed production of alcohol, illegal fishing/ poaching, the sale of counterfeit goods, the unauthorized reproduction of copy-righted materials, smuggling, and fencing, bribery, and money laundering. Of interest, some countries, such as the UK, are now looking to include more categories of illegal activity in their national accounts, which will have the effect of boosting their reported GDP

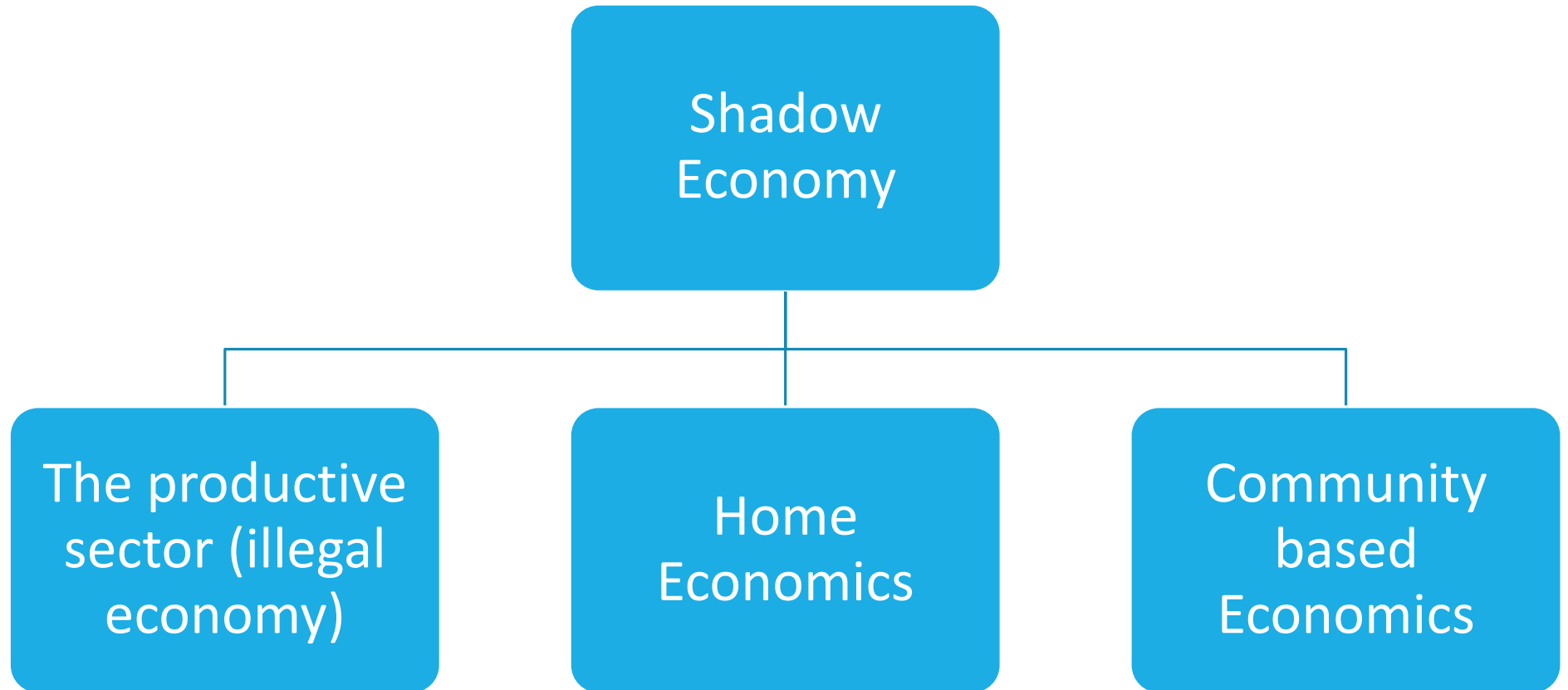
**The informal sector** describes market transactions involving individuals or entities that are not registered with the authorities and operate outside of the scope of official surveys and other data-collection systems (such as Statistics Register). Examples of informal activities that can be missed in estimates of GDP are the provision of child care services, a range of outsourced household services (e.g., home cleaning), other personal care services, and direct sales of agricultural products at road-side stands.



Production **by households for own final use** covers goods and services consumed by households that are also produced by the same households. All goods produced by households for own-use are theoretically included as part of the national accounts; however, in practice only food grown by farmers for own-consumption is counted as part of GDP. Statistics does not attempt to capture services that are self-produced and consumed by households, such as cleaning and laundry.

**Deficiencies in the basic collection of data** refers to situations where, for various reasons, transactions are not adequately captured via standard data-collection techniques.

## 4. The structure of the Shadow Economy



# Productive Sector

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Productive sectors are the real sectors of the economy. Sectoral components of GDP such as agriculture, industry and services are the productive sectors. It reflects the viable, creditworthy picture of an economy emerging.

# The Shadow components of the productive sector

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- a) Legal activities carried out illegally, for example, without a license or special permit; hidden production in the legal economy;
- b) illegal employment, work for hire – Undeclared work;
- c) economic activity prohibited by law

# Community based Economics

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Community-based economics or community economics is an economic system that encourages local substitution. It is most similar to the lifeways of those practicing voluntary simplicity, including traditional Mennonite, Amish, and modern eco-village communities. It is also a subject in urban economics, related to moral purchasing and local purchasing.

It operates within the framework of communities that are formed on the basis of various forms of social ties: related, neighborly, friendly relations, closeness of cultures, religious views, profession, ideological orientation, etc.

A community economy is a form of development of the home economy when the latter leaves the family. If the exchange of goods within a different kind of community begins in a monetary form, the communal economy becomes illegal.

# Home Economics

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The home economy is represented by the sphere of socially necessary productive household labor, which is not paid for and is outside the sphere of commodity exchange. The home economy includes labor activities for the production of products that replace goods purchased for money in the official economy.

The signs of the economy are: productive character, lack of accounting and official regulation, uncontrolled nature, lack of exchange in market and non-market forms.



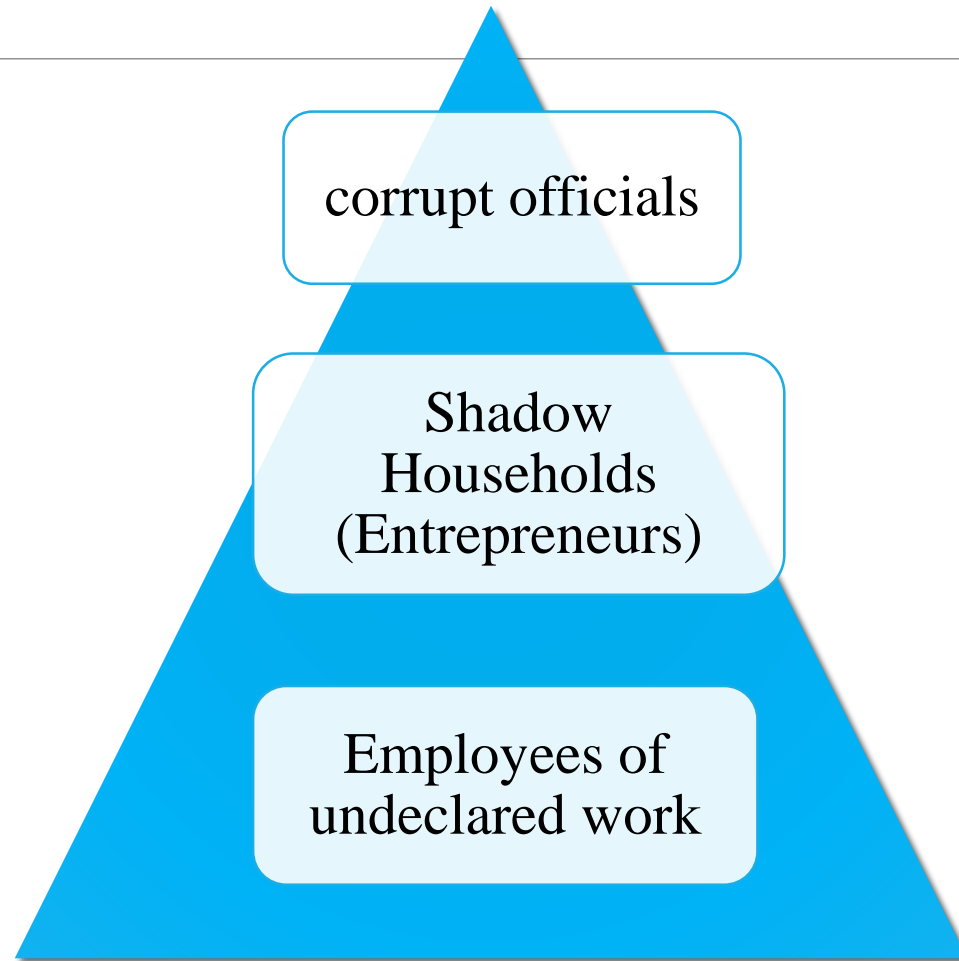
# 1. The participants of Shadow activity

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The shadow economy is organized according to the pyramid principle. The shape of the pyramid explains: first, it maintains verticality (the dependence of "below located" on "above-located") interaction of subjects of the shadow economy. Secondly, with a certain percentage of assumptions clearly demonstrates the number of participants in each horizontal segment.

# The participants of the shadow economy

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# Causes of Shadow Economy

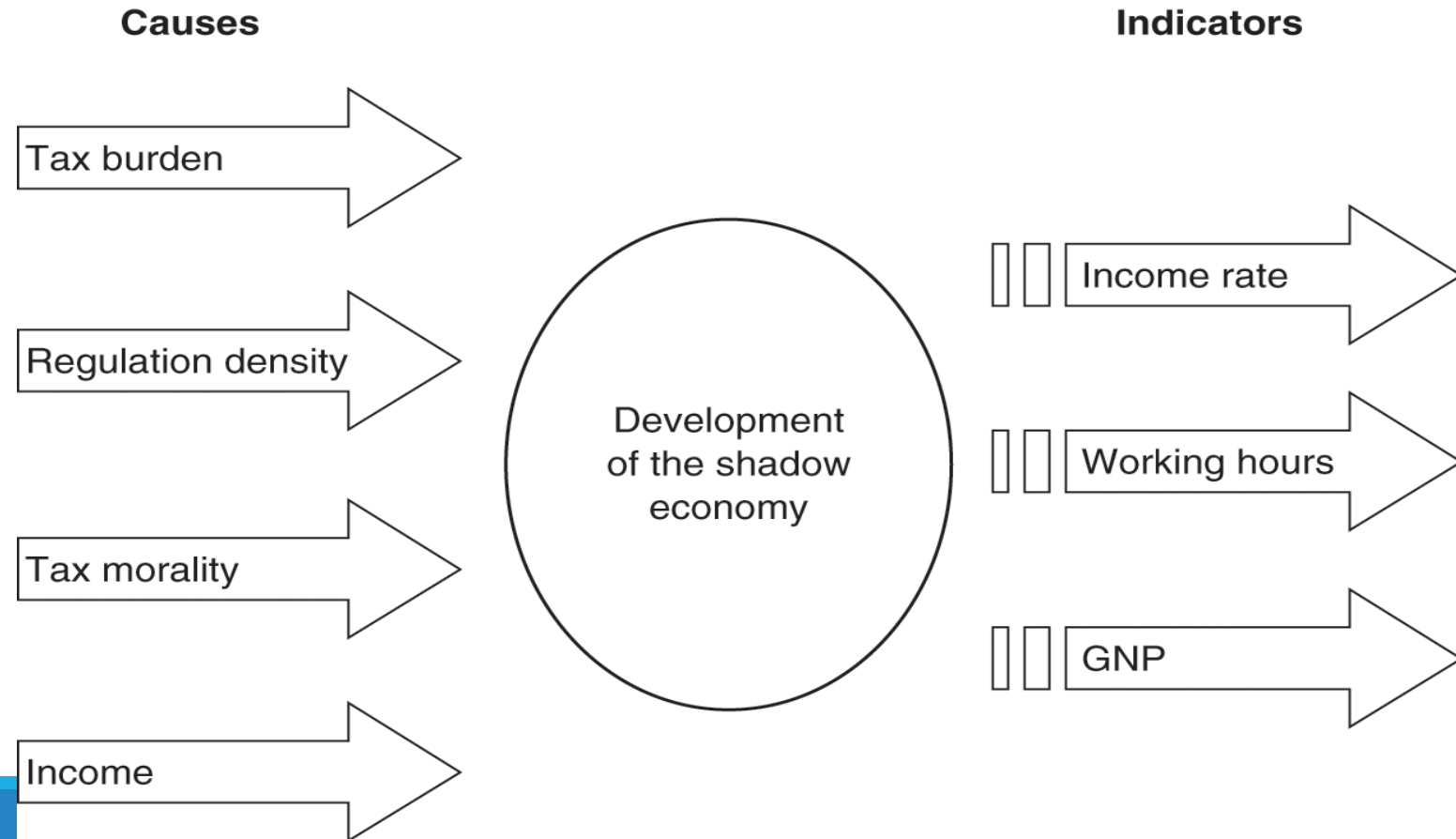
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Taxes;

Regulations;

Prohibitions;

Corruption.



# 1. Taxes

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- Income taxes
- Value added taxes
- Excises
- Social security taxes
- Foreign trade taxes
- Taxes on capital transfers

## ➤ Tax characteristics:

Rates

## Administrative aspects:

(a) efficiency of tax administration

(b) penalties for tax evasion

(c) exemptions levels

(d) cost of compliance

## Other aspects:

(a) corrupt tax inspectors

(b) taxpayers morality

(c) quality of public spending

There are three parameters that determine the level of tax evasion in an economy:

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The level of tax rates.

The likelihood of detection and punishment.

The level of fines imposed.

## Who evades taxes?

There is a truth that is more or less valid throughout the world: the self-employed and small businesses avoid paying their taxes. From the United States to Germany, and from Italy to Bulgaria, there are small businesses and many freelancers that fail to accurately declare their true income to authorities. Unlike salaried workers or large businesses, they are able to hide their income because the likelihood of detection is very low and the incentive to issue invoices and to declare every cent they make is smaller. This phenomenon has a relatively small impact on tax revenues in most developed countries for one simple reason: The number of very small businesses in those economies is lower, and the self-employed represent a smaller percentage of the workforce. According to studies, the self-employed **hide around 57-58.6% of their income**, while salaried workers are only able to hide about **0.5-1%**.

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2. REGULATIONS and their effects:

(a) labor markets

(b) goods and services markets

(c) domestic financial markets

(d) foreign exchange markets

### 3. PROHIBITIONS and their effects

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- (a) illegal drugs
  - (b) illegal gambling
  - (c) usury lending
  - (d) production and sale of dangerous substances and services
  - (e) criminal activities

Prohibition and criminal activities raise important question for the definition (and the measurement of the shadow economy). Should incomes obtained from illegal activities (prostitution, sale of illegal drugs and weapons, proceeds from gambling or extortion) be considered parts of shadow economy? They can be very large.

# Political corruption

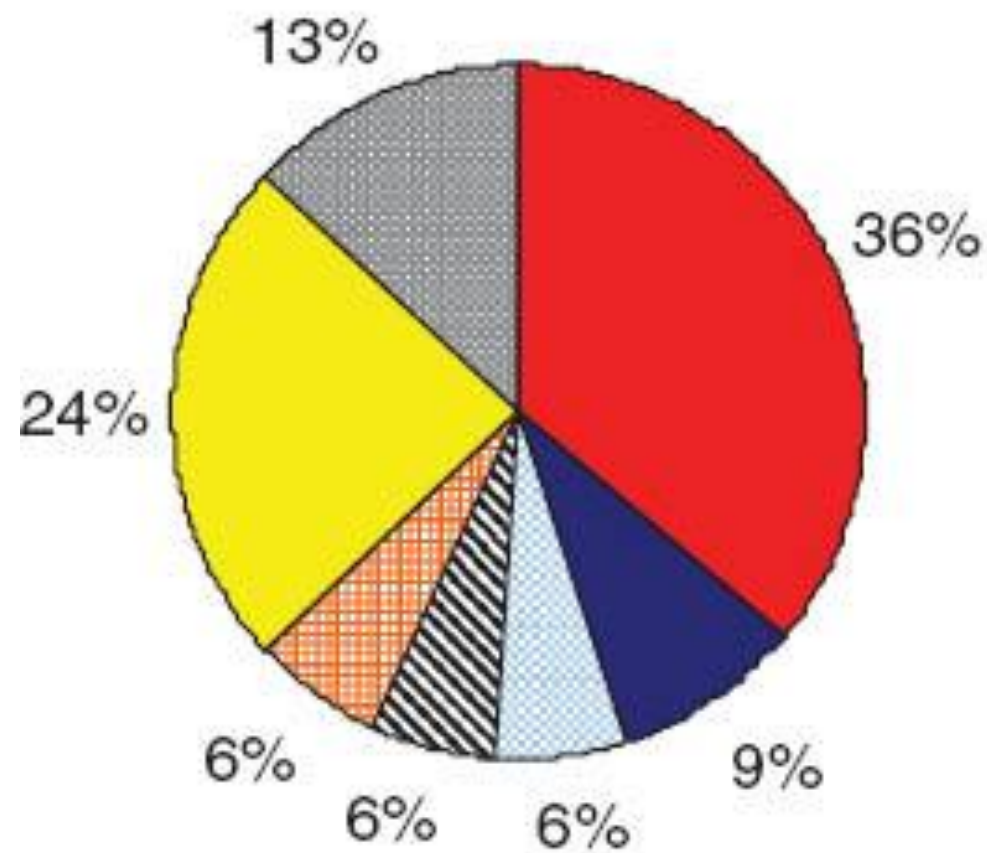
Political corruption is the use of powers by government officials for illegitimate private gain. An illegal act by an officeholder constitutes political corruption only if the act is directly related to their official duties, is done under of law or involves trading in influence.

Forms of corruption vary but include bribery, extortion, cronyism, nepotism, parochialism, patronage, influence peddling, graft, and embezzlement. Corruption may facilitate criminal enterprise such as drug trafficking, money laundering, and human trafficking, though is not restricted to these activities. Misuse of government power for other purposes, such as repression of political opponents and general police brutality, is also considered political corruption.

The activities that constitute illegal corruption differ depending on the country or jurisdiction. For instance, some political funding practices that are legal in one place may be illegal in another. In some cases, government officials have broad or ill-defined powers, which make it difficult to distinguish between legal and illegal actions. Worldwide, bribery alone is estimated to involve over 1 trillion US dollars annually. A state of unrestrained political corruption is known as a kleptocracy, literally meaning "rule by thieves".

Some forms of corruption – now called "institutional corruption"– are distinguished from bribery and other kinds of obvious personal gain. A similar problem of corruption arises in any institution that depends on financial support from people who have interests that may conflict with the primary purpose of the institution.

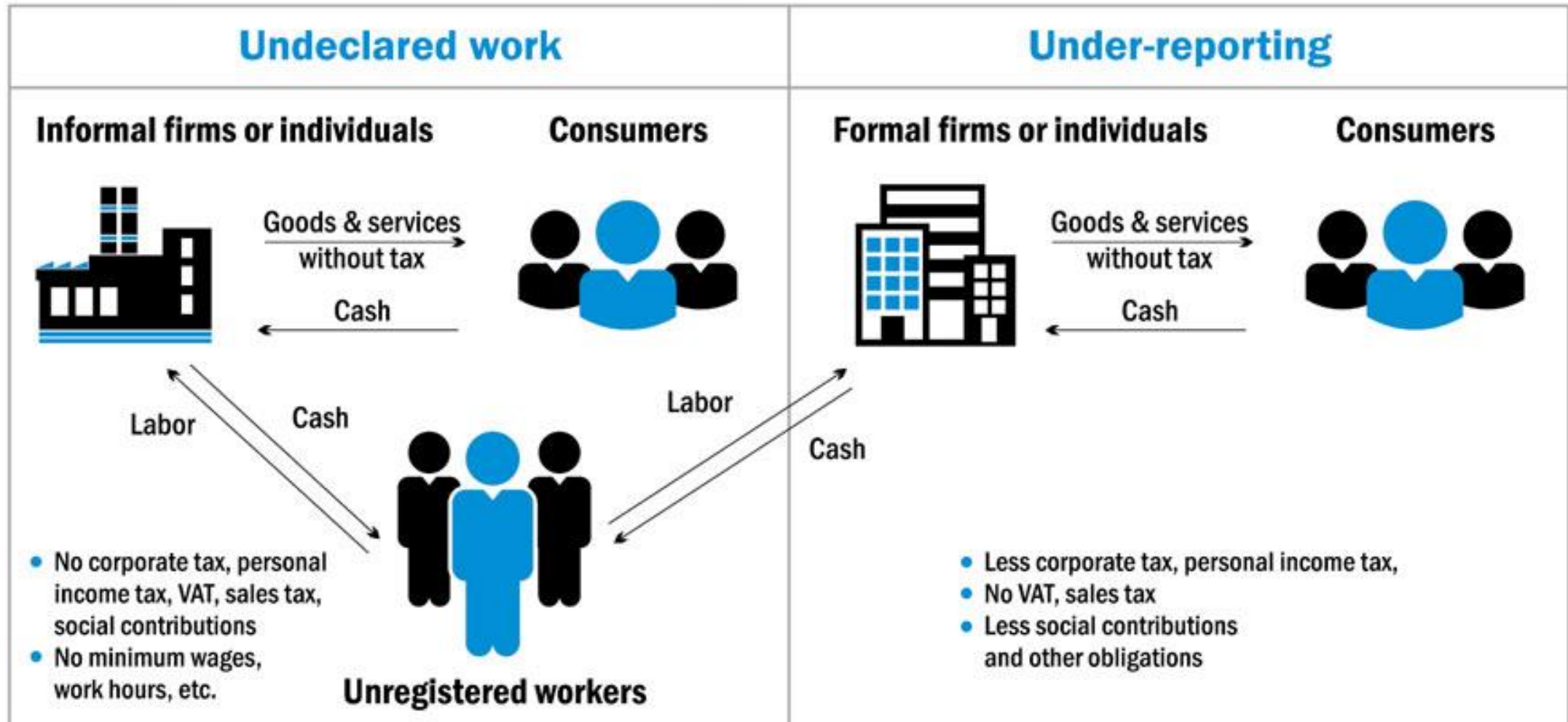
Increase of shadow economic activity:  
influence in %



- Increase of tax and social sec. contribution burdens
- Intensity of state regulations
- Social transfers
- Specific labour market regulations
- Public sector services
- Tax morale
- Other influences



# Two types of shadow economy and their structures



Source: 'Can Tax Incentives for Electronic Payments Reduce the Shadow Economy?' Myung Jae Sung, Rajul Awasthi and Hyung Chul Lee, World Bank Group, January 2017

# What are the solutions?

- **a reduction of tax rates** and of emergency taxes on already-taxed income;
- expanded use of "**plastic money**" and expansion of **electronic invoicing**;
- effective and intensive auditing and **effective resolution of tax disputes** (through administrative and legal processes);
- improvement of **organization and modernization of the tax authorities**;
- creation of an **electronic tax administration**;
- **training and education of tax administration employees**, along with an increase of their wages;
- tightening of **penalties in cases of tax evasion**;
- creation of a **stable and simplified tax system**;
- a gradual change in the **structure of the Greek economy**;
- creation of **tax awareness** and **cultivation of tax education**.

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Thank  
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