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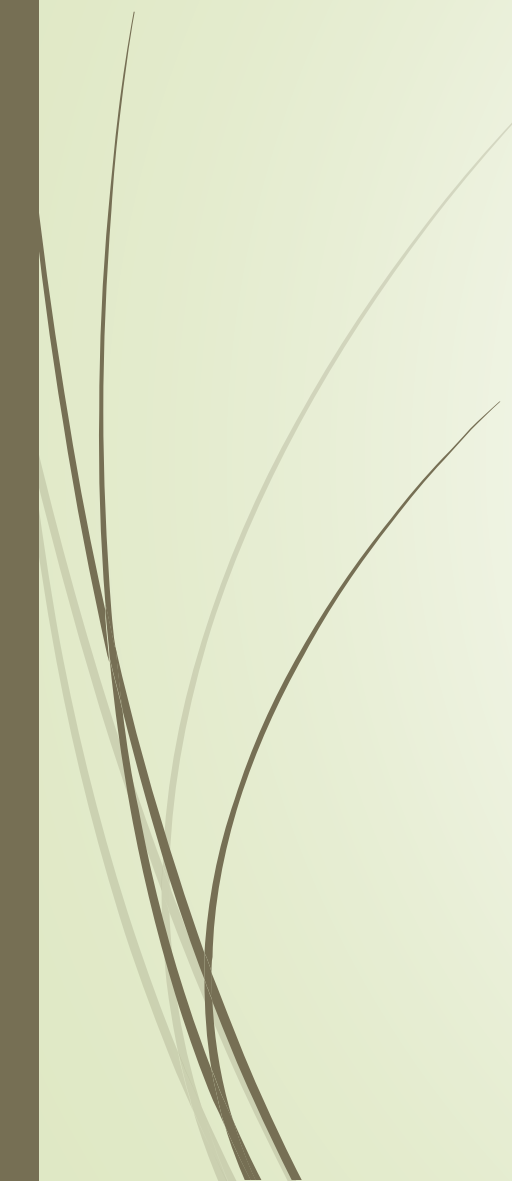
The theoretical remarks about the shadow economy



ESSENCE AND STRUCTURE OF THE SHADOW ECONOMIC ACTIVITY



Outline

- **1. Introduction**
 - **2. Definition**
 - **3. Theoretical Perspectives and Controversies**
 - **4. The structure of the Shadow Economy**
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Goal of this lecture:

- 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



1. Introduction

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

- ▶ 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

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

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




The concept of informal economic revenue generation appears under a variety of conceptual guises ([Losby et al. 2002](#):1; [Venkatesh 2008](#)). Attention to such activities became popular in the social science literature after the Second World War as global national productivity seemed to be running alongside a second, parallel stream of commerce that was suggestive of the kind of traditional highly localized economies one found in premodern civilizations ([Valentine 1978](#); [Marable 1983](#); [Fusfield and Bates 1984](#)).

The first author to (explicitly) mention informal economic activities is [Keith Hart \(1973\)](#), a social anthropologist. During the 1960s, Hart conducted fieldwork among the Frafras, a group of poor Ghanaian migrants who moved about from rural districts to Accra (Ghana's capital) in search of material opportunities. Hart wrote, "Does the 'reserve army of urban unemployed and underemployed' really constitute a passive, exploited majority in cities like Accra, or do their informal economic activities possess some autonomous capacity for generating growth in the incomes of the urban (and rural) poor?" ([Hart 1973](#):61).



Hart had identified practices rather than a coherent system of material interrelationships. Hart was studying income generation using the household as a unit of analysis. He described how poor people facing a context of low wages, inflation, and lack of safety nets would engage in creative ways to make ends meet. At the same time, the International Labor Organization (ILO) launched the World Employment Program, which spurred a set of studies in the third world. The Kenya Report ([ILO 1972](#)) featured an entire chapter (pp. 223–32) on the “informal sector” (defined as tax evasion and lack of government regulation) that emphasized its innovativeness and dynamism.


Hart’s research did not speak of the informal economy but of “informal economic activities” or “income opportunities.” By contrast, ILO’s Kenya Report, focusing on firms (not households), aimed at describing an entire economic *sector*. Specifically, in the ILO’s view, developing economies featured a “modern sector,” which looked like a capitalist, rational, formal, modern, Western economy, and a “traditional sector,” with small units of production, low productivity, and little state regulation ([Lautier 1994](#)).



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:

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.



The definition of the shadow economy plays an important role in assessing its size. By having a clear definition, a number of ambiguities and controversies can be avoided, though some important shadow economic activity will be omitted. The extent of the activities we omit, such as non-marketed household work, may well be affected by the same factors as affect the size of the shadow economy as defined here (for example, the level of taxes), but they raise different issues as well as measurement problems.

The economic activities we focus on contribute to the country's value added even though they are not captured in the national accounts. From the economic and social perspective, soft forms of illicit employment and their contribution to aggregate value added can be assessed rather positively.

3. Theoretical Perspectives and Controversies

- ▶ 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:


- (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.



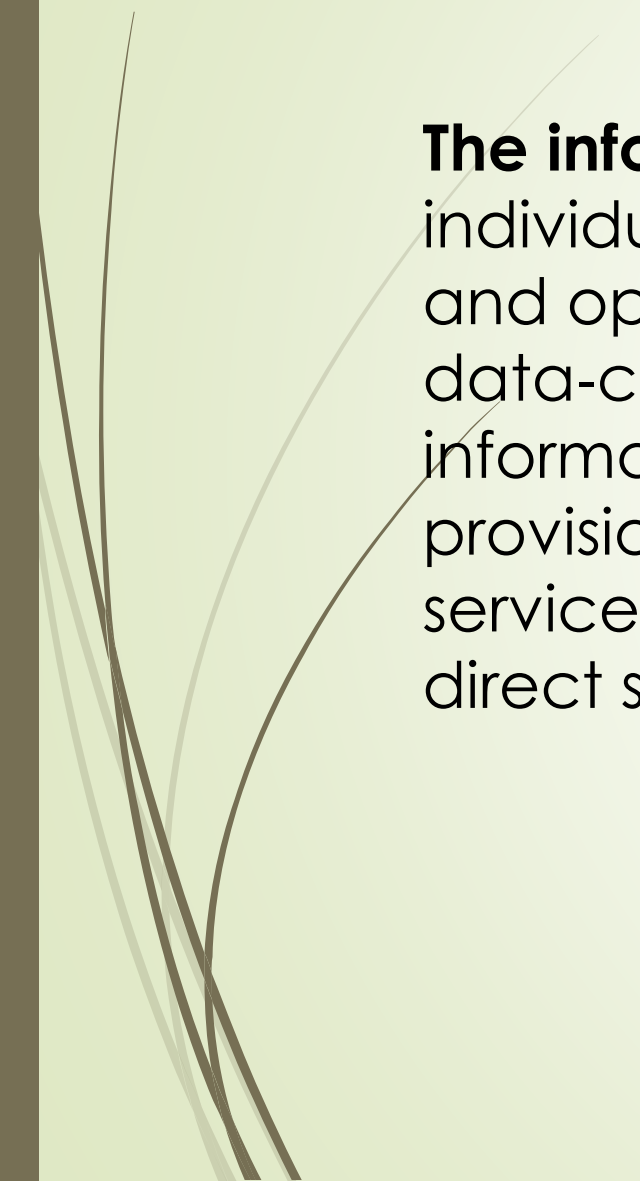
The hidden sector (or underground production) is defined as “those activities that are productive and legal but are deliberately concealed from public authorities,” usually to avoid payment of income, sales and payroll taxes. Transactions may also be hidden to enable the participants to ignore health 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.

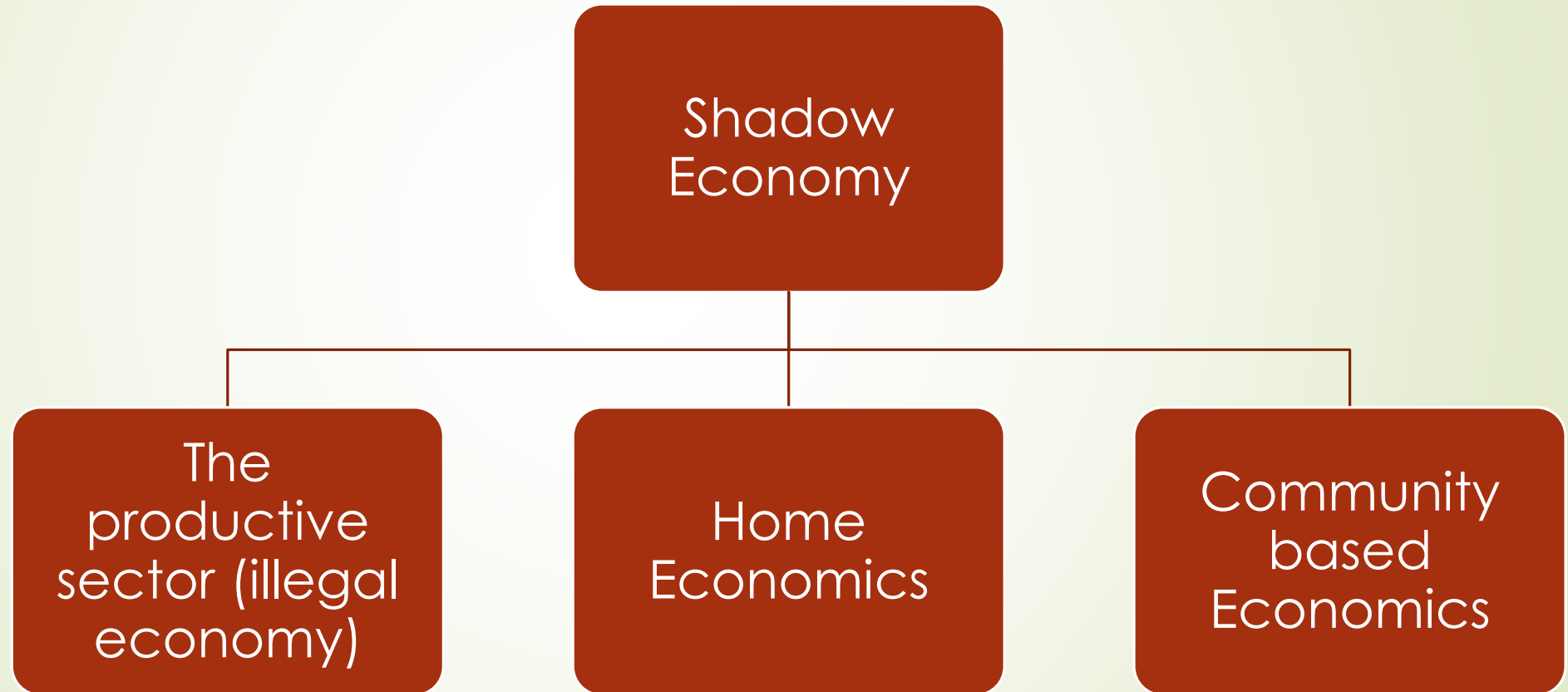




Production **by households for own final use** covers goods and services consumed by households that are also produced by the same households. All goods produced by households for own-use are theoretically included as part of the national accounts; however, in practice only food grown by farmers for 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

- ▶ 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.
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The Shadow components of the productive sector

- 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



- ▶ 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

- ▶ 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.
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Thank
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