

Shadow economies essay sample

[Economics](#)



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1 Introduction

Shadow economies exist in every country and have significant implications for economic development and the allocation of scarce resources. Various terms are used in economic literature to describe the shadow economy such as ‘hidden’, ‘unofficial’, ‘underground’, ‘non-observed’, ‘informal’, ‘black-market’ and more recently ‘System D’. A common misconception about the shadow economy is that it is solely based on illegal activities such as prostitution and drug dealing. However, in reality, the shadow economy is a more complex phenomenon as it also encompasses legitimate economic activities where reporting standards are not followed. This paper serves as a brief introduction to the concept of shadow economies. First, we will endeavour to define the shadow economy and analyse its extent. Then, we will examine the major drivers of the shadow economy and how it impacts the official economy.

2 Definition and Extent of the Shadow Economy

According to Friedrich Schneider (2012), a leading expert on the underground economy, the shadow economy can be defined as “those economic activities and the income derived from them that circumvent or otherwise avoid government regulation, taxation or observation”. In other words, the deliberate concealment of market-based activities from authorities to evade taxes or to avoid complying with regulations.

These activities are not recorded in official government statistics such as gross domestic product (GDP). A common factor for these activities is that they are mainly cash transactions, which leave no trace and so it is easy to

avoid reporting them. This paper will focus on the two main categories of legitimate shadow economic activities: undeclared work, which is mainly ‘cash-in-hand’ from activities such as construction, domestic services, and agricultural labour, and the under-reporting of revenue by businesses who deal primarily in cash such as small food establishments, taxi firms, etc. (Schneider, 2013).

Gathering statistics and determining the extent of the shadow economy is challenging as it is not directly observable, however, it is estimated that the informal economy in Europe exceeds \$2. 15 trillion (Schneider, 2013).

Economists use two main methods to measure the shadow economy: direct micro-level methods which are based on statistical surveys, and indirect methods, which use macroeconomic indicators that show the development of the shadow economy over time. However, direct calculations can underestimate the size of the shadow economy, as many actors in the informal sector do not wish to be discovered by the government (Schneider, 2013). Consequently, economists tend to concentrate on the more indirect methods.

The unofficial economy exists to a greater or lesser extent in every country around the world. The OECD has predicted that the informal economy will employ two-thirds of the global labour force by 2020 (Rabinowitz, 2011). In emerging market economies, the hidden economy can reach over 50% of the country’s GDP (Hassan and Schneider, 2016). According to a report by the International Monetary Fund (IMF), Georgia has one of the largest shadow economies with 64. 9% of official GDP (Medina and Schneider, 2018). The size of the shadow economy in highly developed OECD countries is much

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lower (Appendix 1). The chart below summarises the size of the shadow economy in terms of percentage of GDP in OECD countries (McCarthy, 2017).

As shown in the table below, the shadow economy in developed OECD countries has steadily decreased in size since 2009, as the official economy recovers from the sub-prime crisis in 2008 (Schneider, 2016).

3 Why the Shadow Economy exists and its impact

3. 1 Causes

There are many reasons why the shadow economy exists, however, for the purposes of this paper, we will focus on four major causes:

- Taxation
- Regulations
- Public services and institutions
- The state of the official economy

3. 1. 1 Taxation

The shadow economy attracts businesses and individuals because they can evade taxes (e. g. income tax, value added tax). Taxes affect the choices of households and firms in any economy. In contemporary society, the increase in taxation has made labour more costly and has lowered net revenue giving individuals and firms more incentive to operate in the underground economy (Schneider, 2012). Moreover, employers can reduce their labour expenditure, while employees earn more if they pay less or no social security contributions. However, as a consequence of tax evasion, governments are deprived of much-needed revenue.

3. 1. 2 Regulations

Government regulations, such as regulatory market legislation, labour conditions and licensing requirements are key factors in the formation of shadow economies. Current economic literature suggests a positive relationship between regulation intensity and the growth of the shadow economy (Johnson, Kaufmann, and Shleifer, 1997). Organisations and employers in the formal economy suffer escalated production fees and increased labour costs due to these associated regulations; they must adjust the salary of employees to have better profit margins (Tanzi, 2002). Increasingly rigorous regulations reduce freedom of choice for individuals in official economies, consequently creating incentive to move to the shadow economy instead.

3. 1. 3 Public services and institutions

The shadow economy can be driven further by the perceived quality of public services and their related bodies. When public services (for example: healthcare, public administration and education) deliver quality and meet the requirements of communities, families and businesses, individuals are much more incentivised to pay taxes and remain a part of the official economy. Research confirms that countries with less efficient public institutions and a greater degree of corruption are more likely to have larger shadow economies (Torgler and Schneider, 2007). Conversely, countries with high-quality public institutions and perceptions of a just government tend to have smaller shadow economies.

3. 1. 4 The state of the official economy

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Economic literature points out the relationship between economic cycles and the growth of shadow economies. Macroeconomics shows us that economic cycles have four phases: a period of expansion which leads to a peak, followed by recession leading to a trough. These cycles affect the global level of the official economy – output growth, unemployment and inflation – which in turn have an impact on the extent of the shadow economy.

When the official economy is in a period of economic boom (expansion), the size of the unofficial economy tends to decrease as households and firms have more disposable income, therefore, they can meet their needs without having to earn extra income from informal employment. However, if a country is in a period of recession (contraction), the shadow economy increases exponentially as levels of cyclical unemployment and inflation increase, which leads individuals to participate in the shadow economy (Schneider, 2013). This can be seen with the 2008 subprime crisis: the size of the European shadow economy in terms of GDP increased by 0.5% in 2009 (Schneider, 2016).

3. 2 Implications

The shadow economy has many implications for the official economy and for the macro-economic objectives of countries. Although there are some positive aspects, the negative aspects are more evident.

3. 2. 1 Employee

Employees in the informal sector tend to have lower education levels and lower wages. As the shadow economy does not comply with labour

regulations, employees have inferior working conditions and no employment rights such as minimum wage, health insurance or unemployment benefits.

3. 2. 2 Consumers

Products and services may be cheaper in the shadow economy but may not be up to quality standards

3. 2. 3 Companies

Firms that operate in the shadow economy circumvent market regulations, which can give businesses an unfair market advantage (no minimum wage, no need for licenses, etc.), penalising organisations who follow the rules.

3. 2. 4 Governments

The existence of the shadow economy has major implications for governments. Firstly, as a result of the loss of state revenue from taxes, the quality of public services will deteriorate, which may lead more individuals into the shadow economy. These individuals will evade taxes which will continue to feed this vicious circle, and economic growth could be negatively impacted.

Another effect of the shadow economy is the loss of regulatory control over the quality of jobs and services. Economic projections can be distorted (imprecise estimates of GDP and unemployment rates) which can lead to unreliable fiscal and monetary policies along with the ineffective use of scarce resources, such as government spending and human capital.

3. 2. 5 Positive effects

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The shadow economy also has some advantages as it provides millions of people with a source of income especially in poor countries where people who are unemployed receive no financial assistance. It can also help establish new markets and encourage further growth in the official economy. Moreover, income earned in the shadow economy is reinjected into the official economy as it is used to purchase goods and services (Goel, Saunoris and Schneider, 2017).

4 Conclusion

Shadow economies are an integral part of modern-day society. Shadow economies tend to be bigger in developing nations but decrease in size as these emerging countries modernise and government institutions improve. Developed economies, such as countries in the Eurozone, are designing policies to curb shadow economic activity. These measures aim to diminish the adverse effects of the shadow economy and range from improving deterrents and changing attitudes to creating better systems of taxation and regulation. Needless to say, shadow economies have helped shape the world we know today.