

## The Shadow Economy

### SUMMARY

- Measurement of the shadow economy is notoriously difficult as it requires estimation of economic activity that is deliberately hidden from official transactions. Surveys typically understate the size of the shadow economy but econometric techniques can now be used to obtain a much better understanding of its size.
- The shadow economy constitutes approximately 10 per cent of GDP in the UK; about 14 per cent in Nordic countries and about 20–30 per cent in many southern European countries.
- The main drivers of the shadow economy are (in order): tax and social security burdens, tax morale, the quality of state institutions and labour market regulation. A reduction in the tax burden is therefore likely to lead to a reduction in the size of the shadow economy. Indeed, a virtuous circle can be created of lower tax rates, less shadow work, higher tax morale, a higher tax take and the opportunity for lower rates. Of course, a vicious circle in the other direction can also be created.
- Given this relationship, the high level of non-wage costs (averaging 39 per cent of total labour costs) and the penalty on individuals who move from earning one third to two thirds of the median wage (averaging 58 per cent of the

increase in earnings for a one-earner couple) in the European Union should be a matter of real concern. The latter figure is 79 per cent in the UK and thus low-paid UK workers have a huge incentive to supplement their incomes in the shadow economy.

- The number of participants in the shadow economy is very large. Although up-to-date figures are not available, at the end of the twentieth century up to 30 million people performed shadow work in the EU and up to 48 million in the OECD. Reliable detailed studies are not available for many countries. In Denmark, however, the latest studies suggest that about half the population purchases shadow work. In some sectors – such as construction – about half the workforce is working in the shadow economy, often in addition to formal employment. Only a very small proportion of shadow economy workers can be accounted for by illegal immigrants in most countries.
- In western Europe, shadow work is relatively prevalent among the unemployed and the formally employed. Other non-employed (for example, the retired, homemakers and students) do relatively less shadow work. This has implications for policy in terms of the importance of social security systems that reduce the opportunities for shadow work among the unemployed and the importance of tax systems that do not discourage the declaring of extra income.
- Policies focused on deterrence are not likely to be especially successful when tackling the shadow economy. The shadow economy is pervasive and made up of a huge number of small and highly dispersed transactions. We should also be wary about trying to stamp out the shadow economy as we may

stamp out the entrepreneurship and business formation that goes with it.

- There are, however, huge potential benefits from allowing the self-employed and small businesses to formalise their arrangements. Businesses cannot flourish if they remain in the shadow economy. They might be reluctant to formalise, however, if it involves admitting to past indiscretions. Worthwhile policies include: reducing business compliance regulation; amnesties; providing limited tax shelters for small-scale informal activity such as the provision of interest-bearing loans to relatives and friends; and allowing businesses to formalise using simple ‘off the shelf’ models. Such policies have been successful in other countries – and to a limited extent in the UK – with high benefit-to-cost ratios.
- Given that the shadow economy constitutes a high proportion of national income, and varies between less than 8 per cent of national income and over 30 per cent of national income in OECD countries, official national income statistics can often be misleading. Comparisons are made even more difficult because some countries adjust figures for the shadow economy (for example, Italy) and others do not.
- In less developed countries, the informal sector constitutes typically between 25 and 40 per cent of national income and represents up to 70 per cent of non-agricultural employment. In such countries, informal activity often arises because of the inadequacies of legal systems when it comes to formalising business registration.