



BAD MEN?

Shedding light on the
SHADOW ECONOMY

IEA Editorial and Programme Director **PROFESSOR PHILIP BOOTH**
and **COLIN C. WILLIAMS**, Professor of Public Policy at the University
of Sheffield, examine a new IEA monograph on a murky
and mysterious world...

The shadow economy – size and causes

There is remarkably little economic commentary on the shadow economy. This is possibly because, by its nature, it is difficult to measure. Survey evidence tends to underestimate the shadow economy because many respondents either do not wish to reveal their activities or they convince themselves that their activity is legal.

However, there are some more sophisticated ways of estimating the shadow economy that go beyond simply asking people whether they participate. And, in the latest research presented in the recent IEA Hobart Paper, *The Shadow Economy*, the figures are quite alarming.

In the UK, about 10 per cent of economic activity is unofficial; in Mediterranean countries the figure is about 20 per cent.

Some supporters of a free economy might be in two minds about the shadow economy. For some people, it is a great example of free, untaxed endeavour. Supporters of free markets should not be too sanguine however. Shadow economic activity can be marred by gang violence and coercion with little legal redress for victims. Also, operating

earnings) is 80 per cent in Germany and only slightly lower in the UK. Given these figures some people might think “why work?”. Others might prefer to work – or employ people – but then do not declare it to the authorities.

Who works in the shadow economy?

There are no comparable figures for the UK, but 30 per cent of “unemployed” people in Germany do some shadow work. However, it should not be thought that undeclared work is limited to those on unemployment benefits. Micro-studies have been done in some countries to ascertain exactly who undertakes shadow economy work. It turns out, for example, that, in Denmark, nearly 50 per cent of all construction workers do some shadow work. Given the current political discussions about immigration it is worth noting, however, that the proportion of shadow economy workers who are illegal immigrants is tiny. Table 2 gives examples of the proportion of workers in different sectors who are engaged in at least some shadow economy work as reported in the Danish study.

The bad news is that there can

economic activity and so on...The good news is that this circle can be turned virtuous. If taxes and burdens on employers and employees are reduced then the shadow economy is likely to shrink, tax revenues will rise and tax rates can be reduced further.

This really is an issue of great urgency in most of the euro zone crisis countries. Shadow economies of 20 per cent or so of national income suggest a serious breakdown of trust

Not just an economic problem

The shadow economy is, of course, both a moral issue and an economic one. In a society where honesty has broken down, the shadow economy will be large. However, trying to ensure that everybody behaves honestly when the penalties for declaring income are so large is like pushing water uphill. Indeed, one can ask whether it is moral for government to put such temptations in our way. When most couples with three children in a country such as the UK face taxes and a loss of benefits of over 70 pence of every extra pound they earn, is it surprising if they do a bit of babysitting “for cash”? We need to ask whether our tax and welfare systems, at least as currently designed, are contributing to undermining the moral fabric of society.

The informal economy in less developed countries

The shadow economy is also endemic in less developed countries. A level of 40 per cent would not be unusual in Africa. However, the issues here are different. In poor countries, the informal economy – perhaps a more appropriate term in this context – is not made up of the self-employed and small businesses deliberately evading tax. Instead, there are often no effective formal mechanisms by which businesses can be registered, contracts formalised and enforced, and so on.

SO WHAT ARE THE CAUSES OF THE SHADOW ECONOMY? IT TURNS OUT THAT TAX LEVELS ARE A MAJOR DRIVER...

in the shadow economy can be a serious impediment to the expansion of businesses: obtaining insurance, formalising employment relationships and advertising can all be difficult when a business is operating extra-legally. Thirdly, the shadow economy leads to those in the regular economy paying still higher taxes.

Perhaps the causes and their contribution to the size of the shadow economy are not especially surprising (see Table 1). In 2010, EU figures suggest that non-wage costs for those in the bottom half of the earnings spectrum in Germany were nearly 50 per cent of the value added per worker – and Germany is not particularly an outlier. The low-wage trap (the proportion of earnings taken in taxation or reduced benefits when a worker increases his earnings from one-third to two-thirds average

be a vicious circle: higher taxes lead to more shadow economic activity, lower tax revenues, higher tax rates, lower quality public services, a reduction in tax morale (as people do not believe that others are paying their fair share of tax), higher shadow

Cause	Influence on the size of the shadow economy (%)
Tax and social security burdens	35-38
Quality of state institutions	10-12
Labour market regulation	7-9
Transfer payments	5-7
Public sector services	5-7
Tax morale	22-25
Influence of all above factors	84-98

Table 1 – Causes of the shadow economy

The informal economy is often the norm. Reducing the shadow economy in these cases really requires “meta reforms” to institutions which would bring huge benefits more generally

What should be done?

As well as long-term changes to improve the quality of public institutions and reducing tax burdens, there are a number of other actions that can be taken that will help reduce the shadow economy. An examination of the World Bank’s *Ease of Doing Business* report illustrates the problems that need to be overcome, especially in some southern EU countries. When it comes to “ease of starting a business”, for example, Greece ranks 146 out of 185 countries surveyed worldwide. Perhaps it is not surprising to find that many budding entrepreneurs prefer to operate in the shadows. In terms of “quick fixes” possible measures fall into three categories: doing nothing; eradication; and legitimising the shadow economy. These are explored below.

Doing nothing

A first potential policy option is to ‘do nothing’ about the shadow economy. The rationale is that over half of all businesses start by operating in the shadow economy and that this sphere is therefore a principle seed-bed for new enterprise creation, a breeding ground for the micro-enterprise system and a test-bed for fledgling businesses and should therefore be left alone. The problem, however, is that this hidden enterprise culture has negative impacts on legitimate businesses, those working in the shadow economy, their customers and governments.

Legitimate businesses witness unfair competition and end up paying higher taxes than would otherwise be the case and cannot compete on a level playing field. Even if the reality is that their tax burden would not rise significantly as a result of shadow entrepreneurs, the effect on tax morale would be damaging. The tax system could come to be perceived as unfair.

At the same time, shadow entrepreneurs are unable to develop and grow due to their inability to gain access to capital, advertise their business or secure support. Customers of shadow enterprises, furthermore, find themselves without legal recourse if a poor job is done; without insurance cover; without guarantees in relation to the work conducted; and with no certainty that health and safety regulations have been followed. Those working for the

Legitimising the shadow economy

A third policy option is to facilitate the legitimisation of work in the shadow economy. Table 3 outlines the range of approaches and measures that can be used.

Based on the understanding that the non-compliant are ‘rational economic actors’ who will evade tax as long as the pay-off from evasion is greater than the expected cost of being caught and punished, the conventional approach has been to

IT SHOULD NOT BE THOUGHT THAT UNDECLARED WORK IS LIMITED TO THOSE ON UNEMPLOYMENT BENEFITS...FOR EXAMPLE, IN DENMARK, NEARLY 50 PER CENT OF CONSTRUCTION WORKERS DO SOME SHADOW WORK

shadow economy business encounter similar problems. Finally, governments witness a loss of revenue in terms of non-payment of taxes owed and, if a significant segment routinely engages in such endeavour, it may well encourage a more casual attitude towards the law more widely. In sum, the negative impacts of doing nothing mean that actions to tackle the shadow economy are desirable.

Eradicating the shadow economy

Stamping out such endeavour is another option. The major problem with seeking to eradicate the shadow economy, however, is that it is a principal breeding ground and seedbed for entrepreneurship. To pursue its eradication would therefore result in one hand of government seeking to stamp out precisely the entrepreneurship and enterprise culture that another hand of government is seeking to nurture in order to foster economic development and growth. Eradication, therefore, is not an option.

deter shadow work by changing the cost:benefit ratio confronting those engaged or thinking about engaging in undeclared work. This is achieved by concentrating on the cost side of the equation and increasing the penalties and the perceived or actual likelihood of detection.

This, therefore, is a ‘negative reinforcement’ approach that seeks to elicit a change in behaviour using a ‘stick’ to punish those engaged in non-compliant or ‘bad’ behaviour so that they will change their actions. However, much of the research suggests that increasing the perceived severity of punishment and likelihood of detection amplifies rather than lowers tax evasion by reducing respect for the system’s fairness. Not surprisingly, therefore, other approaches and measures are beginning to be used.

Just as it is recognised that rewarding ‘good behaviour’ is better at changing children’s behaviour than being over-punitive when they do something wrong, tax authorities are beginning to realise that a ‘positive reinforcement’ approach can also be used to deal with the shadow economy. As such, more enabling measures are being adopted that make participating in the official economy easier and more beneficial. In the realm of tax non-compliance, such a positive reinforcement approach can take at least three different forms.

Firstly, preventative measures can be adopted to stop non-compliance from the outset. Such

Sector	Proportion of workers participating in the shadow economy (%)
Building and construction	48
Motor vehicle sales and repairs	43
Financial and business services	28
Public and personal services	26

Table 2: Participation in the shadow economy

Approach	Method	Examples of measures
Deterrence <i>(pursue and punish)</i>	Improved detection	<ul style="list-style-type: none"> • Data matching and sharing • Joined up strategy • Joint operations
	Increased penalties	<ul style="list-style-type: none"> • Increased penalties for evasion
	Increase perception of risk	<ul style="list-style-type: none"> • Advertising the penalties for informal working • Advertising the effectiveness of detection procedures.
Enabling formalisation	Prevention <i>(deter entry)</i>	<ul style="list-style-type: none"> • Simplification of compliance • Direct and indirect tax incentives • Smooth transition to self-employment • Introducing new categories of work • Micro-enterprise development
	Curative <i>(encourage movement out of shadow economy)</i>	<ul style="list-style-type: none"> • Demand-side incentives (e.g. targeted direct taxes; targeted indirect taxes) • Supply-side incentives (e.g. amnesties; voluntary disclosure; formalisation services)
	Fostering commitment <i>(retain in the formal economy)</i>	<ul style="list-style-type: none"> • Promoting benefits of formal work • Education • Peer-to-peer surveillance • Tax fairness • Procedural justice

Table 3: Policy measures for legitimising the shadow economy

measures could include: simplifying regulatory compliance; introducing new categories of legitimate work; the provision of business support and advice; and the development of initiatives to smooth the transition to self-employment.

CURATIVE MEASURES COULD INCLUDE OFFERING AMNESTIES – EITHER GENERALLY TO ALL FIRMS OR TO SPECIFIC INDIVIDUALS AND FIRMS

Secondly, incentives can be used to help those already participating in the shadow economy to become legitimate. These curative measures could include: offering amnesties – either generally to all firms at a particular time or to specific individuals and firms who put their affairs in order; offering advisory and support services to those seeking to formalise their business or employment; and providing a range of targeted direct or indirect tax incentives encouraging customers to use declared rather than undeclared work.

Thirdly, commitment measures can

be adopted that seek to encourage an allegiance to tax morality. Such measures include tax education and awareness raising about the benefits of declared work; peer surveillance; and the pursuit of perceived tax fairness, procedural justice and redistributive justice.

These policy approaches and measures are not mutually exclusive and can be sequenced in various ways. The Australian government in its ‘responsive regulation’ approach for example, uses commitment measures in the first instance to facilitate compliance, followed by preventative and curative enabling measures and only then punitive measures to tackle tax non-compliance. Thus the tax authority starts with the least intrusive measures and then moves on to more intrusive approaches. A similar approach could be adopted in the UK.

Conclusion

The shadow economy is more pervasive than is perhaps widely thought; its measurement is difficult; and successful policy solutions are not always easy to implement. However, this IEA monograph, *The Shadow Economy*, has suggested how to turn the tide.

It is necessary to have high tax morale combined with a tax system that is coherent and works with – rather than against – the grain of human nature. This relates not just to the size of the tax burden but to the particular incentives that apply to specific groups within society when they undertake more work or earn more money.

In addition, a range of more detailed policy approaches can be



The Shadow Economy, by Friedrich Schneider and Colin C. Williams, is available to download for free at www.iea.org.uk

taken. In many senses these “micro measures” are “win-win” policies in that they cost relatively little money and just involve ensuring that there is a sensible regulatory and legal framework within which business should operate.

If this monograph starts to encourage governments to adopt such approaches, then it will have achieved its objective.

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