

# The Shadow Economy

*An International Survey*

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# Contents

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<i>List of figures</i>	<i>page</i>	ix
<i>List of tables</i>		x
<i>Foreword by Vito Tanzi</i>		xiii
1 The shadow economy: a challenge for economic and social policy		1
2 Defining the shadow economy		6
2.1 Informal economic activity and national income accounts		7
2.2 Shadow economy, tax evasion, and illicit work		10
3 Methods to estimate the size of the shadow economy		15
3.1 Direct approaches		15
3.2 Indirect approaches		16
3.3 The model approach		24
3.4 Summary of the methods used to estimate the size of the shadow economy		27
4 Size of shadow economies around the world		29
4.1 The results for seventy-six countries		29
4.2 The development of the shadow economy in the OECD countries from 1970 to 1999		37
4.3 Comparing the results for different estimation methods		39
5 The size of the shadow economy labour force		43
5.1 Illicit work and the shadow economy labour force		43
5.2 Developing countries		44
5.3 Transition countries		45
5.4 OECD countries		51
6 An integrated approach to explain deviant behaviour		54
6.1 Structure of the model		54
6.2 Criticising the neoclassical and welfare-theoretical considerations		57
6.3 Micro-economic foundation		63
6.4 Institutional and sociological aspects		76
6.5 Explanatory approaches in socio- and economic psychology		84
		vii

6.6	An integrative approach	95
6.7	An evolutionary theory of the shadow economy	97
7	Analysing the causes and measures of economic policy	102
7.1	Government failure – the main cause of illicit work	102
7.2	Growing tax burden in the official sector	106
7.3	Density of regulation	124
7.4	Working hours agreements	127
7.5	Empirical examination of the influence of main causes	143
7.6	Control frequency and the level of punishment	149
7.7	Tax morality and the supply of public goods	151
8	Effects of the increasing shadow economy	155
8.1	Allocation effects	157
8.2	Distribution effects	166
8.3	Stabilisation effects	169
8.4	Fiscal effects	171
9	The ‘two-pillar strategy’	178
9.1	On the necessity for a rational economic policy	178
9.2	‘Exit’ and ‘voice’ as behavioural options	179
9.3	Decreasing the attractiveness of the ‘exit option’	181
9.4	Strengthening the ‘voice option’	183
9.5	Legalising illicit work?	185
9.6	Combating illicit work: the perspective of public choice theory	185
10	Conclusion and outlook	190
	<i>List of references</i>	194
	<i>Index</i>	215

## Figures

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2.1	The dual economy	<i>page</i> 8
2.2	Categorisation of the underground economy	11
2.3	The structure of illicit work in Austria	13
2.4	The structure of illicit work in Germany	14
3.1	The basic monetary methods to measure the shadow economy	18
3.2	The basic idea of ‘soft modelling’	25
6.1	The causal analysis	56
6.2	The integrative RREEMM human concept	59
6.3	Economic explanation for deviant behaviour	64
6.4	Economic factors influencing illicit labour supply	66
6.5	The basic model with optimal allocation of working and leisure time	70
6.6	Overtime, illicit work, and regular working hours	73
6.7	Reduction of working hours and illicit work	74
6.8	Sociological explanation based on Homo Sociologicus	76
6.9	Sociological and institutional determinants	78
6.10	Willingness to work illicitly, evade taxes, and abuse the system	80
6.11	Economic and socio-psychological explanation of deviant behaviour	85
6.12	Correlation between weight of tax burden, perception of tax burden, and tax evasion, and their determinants	90
6.13	A few psychological causes	92
6.14	Attitudes towards a choice of causes for illicit work	94
6.15	Integrative model for deviant behaviour	96
6.16	The correlation between tax yield, tax rate, and the development of the shadow economy	99
7.1	Economic causes for the shadow economy	104
7.2	Correlation of tax burden and size of the shadow economy	111
8.1	Systematisation of allocation effects	157
9.1	Behavioural options of households and firms	180
9.2	General economic policy recommendations	182

## Tables

---

3.1 A summary of all the approaches to estimate the extent of the shadow economy	<i>page 27</i>
4.1 The size of the shadow economy in developing countries	31
4.2 The size of the shadow economies in transition	34
4.3 The share of the shadow economy of official GNP in the OECD countries: a comparison of estimation with different methods	35
4.4 The size of the shadow economies in OECD countries	36
4.5 The size of the shadow economies: summary and comparison	37
4.6 The development of the shadow economy in OECD countries from 1970–97	38
4.7 The extent of the shadow economies in German-speaking countries, 1998 and 1999	39
4.8 A comparison of the results of the estimations of the shadow economies of five OECD countries using nine different methods over the period 1970–90	40
4.9 Comparing estimations of the size of the shadow economy using different methods	41
5.1 Shadow economy labour force in Africa	46
5.2 Shadow economy labour force in Asia	48
5.3 Shadow economy labour force in Latin and South America	49
5.4 Shadow economy labour force in transition countries	50
5.5 Shadow economy labour force in OECD countries	52
7.1 The development of public expenditure and tax rates in OECD countries	108
7.2 Shadow economies, tax, and social security contributions in OECD countries in 1996	109
7.3 The density of regulation as an influencing factor for the size of the shadow economy	126
7.4 Regulation regarding working hours and overtime in OECD countries	128
7.5 Part-time employment in the OECD countries 1973–96	130

7.6	The share of gainfully employed persons older than 55 years	132
7.7	'Atypical' working hours of employees in the EU (1993)	134
7.8	The divergence between agreed and desired working hours in Germany (1997)	137
7.9	Estimation results for the cash demand function	145
7.10	Influence of changes to the taxation system on the development of the Austrian shadow economy	146
7.11	Dividing the development of shadow economic activities into its components by their respective influencing factors	147
7.12	The tax moral as an influencing factor for the rise of the shadow economy	152
8.1	Tax deficits due to illicit work in Austria (1997)	176

# 1 The shadow economy: a challenge for economic and social policy

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In the eighties, the causes, effects, and problems generated by increasing shadow economic activities were extensively and controversially discussed in countries belonging to the Organization for Economic Cooperation and Development (OECD). Now, once again, attention is being drawn to the shadow economy because of dramatically rising unemployment (e.g., in the European Union) and the problems of financing public expenditure, as well as the rising anxiety and disappointment about economic and social policies. Public discussion of illicit work, tax evasion, and all the other activities in the shadow economy has grown increasingly pointed. Broad initiatives on behalf of the EU Commission and EU Parliament, as well as at state-level, show that politicians have finally felt the need to act as well.<sup>1</sup>

Politicians are in a dilemma. While the fact that the wealthy are evading taxes leads to widespread public indignation, illicit workers are often much less criticised, although some politicians argue that they are behaving antisocially and are a source of growing unemployment and social injustice. This opinion is broadly shared in regard to social fraud, illegal employment, and extensive tax evasion. But what about part-time illicit work in the evening ('moonlighting') which, for example, about half of the population in Germany would tolerate, or even take advantage of, if they had the opportunity to make use of it?<sup>2</sup> Can more sanctions and controls, combined with more regulation, be the ultimate solution to combat illicit work? What is the right way to deal with undeclared work?

In the popular scientific media and daily newspapers, this discussion naturally does not go into detail. Here, judgement on the nature of the shadow economy fluctuates between two extremes: either the shadow

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<sup>1</sup> See for example EU Commission (1998), EU Parliament (2000).

<sup>2</sup> See Enste (2001, pp.158f).

economy is blamed for many problems of economic policy, such as unemployment, high public debt, and the recession, or it is regarded as a legitimate free space in an economic system that is characterised by high taxes and too much regulation. New data on the size of the shadow economy are often used by certain pressure and interest groups who focus on only a few unilateral issues concerning illicit work. In the social sciences, articles and papers dealing with the shadow economy often focus on one single aspect only, mostly on the difficulties and challenges involved in measuring its size. In addition, the basis of the analysis of the causes and consequences of the increasing shadow economy is often quite narrow and does not take the results and insights of other social sciences into account. Therefore, a comprehensive overview and scientific analysis of this complex phenomenon is necessary. This book is an attempt to provide this analysis and fill the gap.

The main focus of interest in the shadow economy is concentrated on three areas, which will be analysed in more detail here:<sup>3</sup>

(a) In *economic and social politics*, the driving force for dealing with illicit work is the fact that these illegal and semi-legal activities are undesirable for official institutions. A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the 'exit option' rather than the 'voice option'.<sup>4</sup> If the growth of the shadow economy is caused by a rise in the overall tax and social security burden, together with 'institutional sclerosis' (Olson 1985), then the 'consecutive flight' into the underground may erode the tax and social security bases. The result can be a vicious circle of further increase in the budget deficit or tax rates, additional growth of the shadow economy, and gradual weakening of the economic and social foundation of collective arrangements.

In addition, the effects of the shadow economy on the official economy must be considered because illicit work can be a source of allocation distortions, since resources and production factors are not used in the most efficient way. On the one hand, a growing shadow economy may attract (domestic and foreign) workers away from the official labour market and create competition for official firms. On the other hand, at least two-thirds of the income earned in the shadow economy is spent in the official economy, thereby having a positive and stimulating effect on the official economy.<sup>5</sup>

<sup>3</sup> See also Weck, Pommerehne, and Frey (1984); Gaertner and Wenig (1985); Petry and Wied-Nebbeling (1987); Feige (1989); and Thomas (1992).

<sup>4</sup> See Chapter 9.

<sup>5</sup> This figure has been derived from polls of the German and Austrian population about the (effects of) the shadow economy. For further information see Schneider (1998b).

Furthermore, a prospering shadow economy may cause severe difficulties for politicians because official indicators, e.g., on unemployment, labour force, income, GDP, and consumption, are distorted. Policy based on erroneous indicators is likely to be ineffective, or worse. Therefore, the reciprocal effects between the shadow and the official economy have to be considered when planning measures of economic policy, especially fiscal policy. If underground activities occur in an economy, the tax revenue might reach the negatively sloped part of the Laffer-Curve, where higher tax rates result in a lower tax yield.<sup>6</sup>

(b) In *social sciences*, the shadow economy is first and foremost a challenge for economic theory and economic policy. In economic and social science, answers have to be found for questions like: Why are people working illicitly? Why are transactions made in the shadow economy? What are the effects resulting from this behaviour? Currently, theoretical approaches in different social sciences exist that concentrate on single aspects of this complex phenomenon. But since a coherent, integrative, and interdisciplinary approach for the analysis of the causes is missing, the development of a systematic, basic ‘model’ is necessary.

In empirical studies, the problems of measuring the size and development of the shadow economy by different methods have to be examined. The theoretically derived causes and consequences of shadow economic activities have to be investigated empirically. Feedback effects on the official economy, as well as interactions between the two sectors, have to be considered and measured.<sup>7</sup>

(c) The most difficult task for *economic policy researchers* is to convey the often not very much appreciated results of scientific analysis to politicians, and then to convince them that the findings are relevant and correct. Here, we try to make suggestions for economic policy measures that are based on the analysis of the relationships between causes and effects of the shadow economy. They go far beyond the guidelines laid down by the EU Commission in their pan-European employment strategy for combating illicit work.<sup>8</sup> The latter’s guidelines demand an exchange of ‘good practice models’ and coordination at the EU level to combat illicit work, e.g., by stricter controls and harsher sanctions. Unfortunately, these propositions are not new and they often do not go beyond trying to cure

Moreover, the results of these polls show that two-thirds of the value added produced in the shadow economy would not be produced in the official economy if the shadow economy did not exist.

<sup>6</sup> See Section 6.7.

<sup>7</sup> See Schneider and Enste (2000a,b); Cowell (1990); Thomas (1992); Pozo (1996); Spiro (1997); and Lippert and Walker (1997).

<sup>8</sup> In Europe, these occupations supposedly resemble 10–28 million regular employment positions. See the Commission’s publication: ‘Undeclared Employment’ of 11 June 1998.

the symptoms. Instead, reforms of the tax system and the social security system are necessary, which could improve the dynamics of the official economy and make the official institutions more competitive within the (national and international) different institutional arrangements.

The discussion about adequate economic policy is often influenced by ideologies. One comes across every position from a forced denial of the phenomenon of a 'shadow economy', to imaginative exaggerations of its size and impact. The starting point for debate is the fact that there are differences in estimates of the size of the shadow economy. Clearly, such estimates are vital for reliable analysis. Unfortunately, as a result, research efforts are concentrated on questions like: which is the best method to estimate the extent of the shadow economy? How large is the shadow economy labour force and how is it changing over time?

The collection of information about underground (or criminal) activities and the frequencies with which these activities occur, as well as their magnitude, is crucial for making effective and efficient decisions. But it is very difficult to obtain accurate statistics about shadow economy activities, since the individuals engaged in these activities do not wish to be identified. Hence, the estimation of shadow economy activities can be seen as a scientific passion for knowing the unknown. An extensive literature on single aspects of the hidden economy exists, including a comprehensive survey.<sup>9</sup> But there is still disagreement about the definition, the estimation methods, and the 'right' estimation of the shadow economy. Much controversy arises in discussion over these issues.<sup>10</sup>

Nevertheless, there are strong indications of a growth of the shadow economy on a global scale. The size, the causes, and the consequences vary in each country, but some comparisons can be made that are of interest to social scientists and the public in general, and helpful to politicians who will need to deal with this phenomenon sooner or later. Therefore, we will not restrict ourselves to only the documentation of the size of the shadow economy and its labour force in more than seventy countries from 1970 to 1998 (and to 2000 for some countries). An analysis of the

<sup>9</sup> The literature on the 'shadow', 'underground', 'informal', 'second', 'cash-' or 'parallel', economy is increasing rapidly. Various topics on how to measure it, its causes, and its effect on the official economy are analysed. See, for example, the first publications by Tanzi (1982); Frey and Pommerehne (1984); and Feige (1989); survey-type publications by Thomas (1992); Loayza (1996); Pozo (1996); Lippert and Walker (1997); Schneider (1994a,b, 1997b, 1998a); Johnson, Kaufmann, and Shleifer (1997); and Johnson, Kaufmann and Zoido-Lobaton (1998a); and for an overall survey of the global evidence of its size Schneider and Enste (2000a,b).

<sup>10</sup> See e.g., *Economic Journal* 109, no. 456 (June 1999) the feature 'Controversy: on the hidden economy' including the different opinions of Tanzi (1999), Thomas (1999), and Giles (1999a,b).

cause and effects is also carried out. After defining the shadow economy (chapter 2) and discussing the different estimation methods (chapter 3), we will present our extensive data on the shadow economy (chapter 4) and its labour force (chapter 5). After this empirical part of the book, the theoretical fundamentals are elaborated. Besides presenting the economic theory to analyse the relationships between the causes and effects of the shadow economy, we introduce a social sciences approach that adds socio-psychological and sociological components to the economic considerations (chapter 6). On this basis, the causes of the increase of the shadow economy will be analysed, and different economic policy measures will be discussed in the context of illicit work (chapter 7). The analysis of the effects of the shadow economy on the resource allocation, income distribution, and stabilisation policy, as well as on the official economy in general (chapter 8), provides the foundation for propositions of economic policy for the treatment of illicit work as an economic and social challenge (chapter 9). We will propose a ‘two-pillar strategy’ with two approaches for dealing with the phenomenon: (1) Reducing the attractiveness of evading taxes and regulations (‘exit option’), and (2) Improving the ways of voting and influencing the formal institutions (‘voice option’). The book concludes with a summary and an outlook (chapter 10).