

SHADOW ECONOMY AND UNDECLARED WORK

Since several years the currency demand approach to measure the size of the shadow economy is dominating the academic debate on this topic and is also influential in the public discussion on facts, causes and remedies of shadow activities. The basic idea of the approach is that the shadow economy is predominantly characterised by cash transactions. The growth rate of non-bank cash holdings in an economy is then taken as an indicator for the development of the shadow sector. The approach, thus, demands relatively little informational input and permits to calculate the share of the shadow economy for many countries and long time series. A problem with this approach is that the size of the shadow sector in a start year must be known – or assumed. The famous regression equation proposed by Tanzi (1983) included even variables which are supposed to be in a causal relation to shadow activities, as e.g. the tax load. A survey on the shadow economy around the world, with own and up-to-date calculations based on the currency demand approach, has recently been published by Friedrich Schneider and Robert Klinglmair (March 2004).

Only two months later the European Commission came out with a 240 pages report on “Undeclared work in an enlarged Union” (authors: Piet Renooy et al., May 2004). The main difference to the work of Schneider and Klinglmair is with respect to both the size of the shadow sector and the method employed.

What concerns the size of the shadow economy the two studies differ quite substantially (see chart).

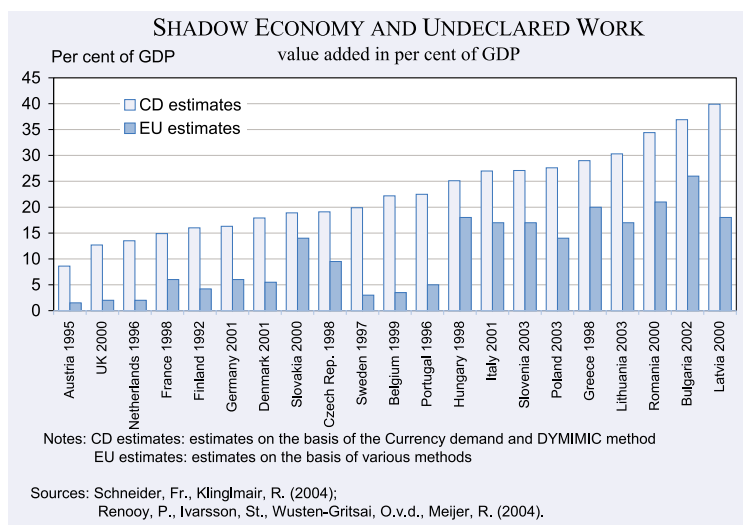
The EU report comes to estimates in the range of 2 percent of GDP (Austria) and 26 percent (Bulgaria), while the figures of Schneider and Klinglmair are between 8 percent (again Austria) and 40 percent (Latvia). For each country the estimates of Schneider and Klinglmair are higher than those of the EU study. Relatively small differences occur for some new EU countries as Slovakia and Hungary and entry candidates as Bulgaria, while the differences are rather large for some old EU

member countries as Netherlands, Sweden or Belgium. This leads also to different orders of ranking.

Unfortunately, the comparability of the two studies is limited. The EU report covers a much smaller number of countries (only those in the chart), while Schneider and Klinglmair calculate the shadow sector for about 120 countries. Moreover, the basic year in the EU report is neither identical for the countries covered nor always very recent. For Finland, e.g., the EU study reports figures for 1992. Fortunately, the time series presented by Schneider and Klinglmair permit to compare figures for the same year.

The different estimates for the size of the shadow economy are finally rooted in different methods applied. The currency demand approach proceeds indirectly, while the authors of the EU study try to use direct methods, viz. mainly observation, interviews and surveys. An important role in developing this type of a repeatable empirical methodology has been played by the Danish Rockwool Foundation which produced in depth studies on the shadow economy for five countries (Denmark, France, Germany, Sweden, UK; results in Pedersen 2003 and Brodersen 2003). Unfortunately, the use of direct methods is limited to the named countries. For other countries, specifically the new and candidate EU member countries, the size of the shadow economy has been estimated by the national statistical offices. They had to proceed, however, on similar ways which had been commonly agreed upon.

Neither the study of Schneider and Klinglmair nor that of the EU sheds new light on the question of



the causes of shadow activities. The former study presents a review of the literature and summarises the main factors as being the burden of taxation and social security contributions, the intensity of regulations and the rule of law. The latter study puts the causal focus on labour market rigidities, imperfections of the goods markets as well as on factors like trust to and strength of the bureaucracy. A high tax burden is also mentioned as a possible explaining factor. But the authors, contrary to Schneider and Klinglmair, are convinced that it is not possible to establish empirically for this factor a neat connection to the size of the shadow economy (see also Osterkamp 2000). An important part of the EU study is dedicated to the description and analysis of what is seen as “good practices” in several countries for containing and rolling back the shadow economy.

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References

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