

The informal economy

Not all economic activity is recorded in the national accounts. Therefore, the size of an economy might actually be much larger than the official statistics indicate. Because the extent of the informal economy is likely to differ from country to country, international comparisons of GDP per capita might not fully reflect a true comparison of actual living standards, only that output which has been measured.

The size of the informal economy is important in its own right. As any income generated by it is unlikely to be taxed it has important implications for the budget, and hence the levels of government spending and rates of tax in the economy. It also has efficiency implications. The informal economy is likely to consist of small fragmented units which are unable to generate economies of scale. There is no incentive to expand production as this increases the probability of detection by the authorities.

A paper by Freidrich Schneider (2002) entitled 'Size and measurement of the informal economy in 110 countries around the world' (IZA working paper) calculates measures of the informal economy for a large number of countries around the world. The paper also provides a comprehensive review of the methods used to calculate the size of the informal economy.

There are two main types of underground activities. The first consists of illegal activities such as trade with stolen goods, drug dealing and manufacture, prostitution, smuggling and fraud. The second are legal activities that are just not reported. These might consist of unreported income from self employment, employee discounts and fringe benefits, the barter of legal goods and services and do it yourself work.

The methods used to estimate the size of informal economy can also be split into two subsections- direct and indirect approaches. Direct methods involve tax auditing and compliance in order to detect the amount of fraud. The discrepancy between income declared for tax purposes and that from selective checks (fiscal auditing) can estimate the amount of undeclared taxable income generated in an economy.

Indirect measures are often called indicator approaches as they rely on a variable that approximates the amount of activity in the economy which can then be compared with official activity measures. There are several indirect methods which can be used to judge the size of the informal economy over time.

In national accounting, output measured by the income and expenditure approaches should in theory add to the same value. This is a consequence of the circular flow of income outlined in chapter 1. Therefore, the discrepancy between national expenditure and income statistics might indicate the size of the informal economy. However, this discrepancy can result from other sources such as measurement error. Also, national statisticians have a strong desire to reduce the size of this discrepancy and balance the different measures so as to report a consistent set of accounts.

In a similar vein, the discrepancy between the official and actual labour force is a potential indicator of labour in the informal economy. A decline in labour participation might reflect an increase in informal activity. However, the same caveats

made above also apply. Movements in labour participation can arise from a much wider set of factors than just workers moving from the official to the underground economy.

A transactions approach assumes that there is a constant relationship over time between the volume of transactions and official GNP. Any short-term deviations will represent changes in the size of the informal economy. Again, this measure is likely to be highly approximate.

The conventional approach in advanced economies is the currency demand approach. Most shadow economy transactions tend to be undertaken in cash so no trace is left for the authorities to chase up. Therefore, changes in the informal demand might be picked up in changes in the demand for cash. An excess increase in cash that cannot be explained by normal determinants of the demand for money such as interest rates, liquidity costs, taxes, official wage and salary income etc. is assumed to flow into the informal economy.

The currency demand approach is the conventional approach to measuring the size of the informal economy in more advanced economies. It is more intuitive than the indirect measures above, but it should be considered that not all informal activity is paid in cash. Also, money demand is often highly unstable and fitting good regression models is difficult- there could be a large residual or error component in estimates produced in this way.

Finally, overall (official and informal) activity can be proxied by a physical indicator such as electricity consumption. Often an electricity/GDP ratio is found to have elasticity with respect to the size of the overall economy close to unity. All that is required is that the size of the official economy is then subtracted from the overall measure of activity to leave an estimate of the informal economy.

Figures 1 and 2 report estimates of the informal economy as a proportion of GNP in Africa and Western Europe. There is a clear trend in that the informal economy tends to be larger in relatively poorer nations, with the average in Africa exceeding that in Western Europe. This is not unsurprising. The lack of social security benefits and the small formal economy means that the informal economy is many individual's best and only chance for subsistence. This labour is often referred to as disguised unemployment, i.e. labour employed in low productivity informal occupations that would otherwise be unemployed if social security was available at the basic subsistence level.

Schneider though analyses the determinants of the size of the informal economy in more detail. Nations with high tax and social security burdens are more likely to have larger informal economies, as there are fewer incentives to engage in the official economy. In figure 3 there is some evidence of a positive association between the size of the informal economy and the burden of taxes and social security payments.

Where the intensity of regulations is greater the informal economy is also likely to be larger. Laws and regulations often impose costs on labour and reduced freedom of choice for individuals involved in the official economy. Labour restrictions for foreigners are also likely to be circumvented by joining the informal economy.

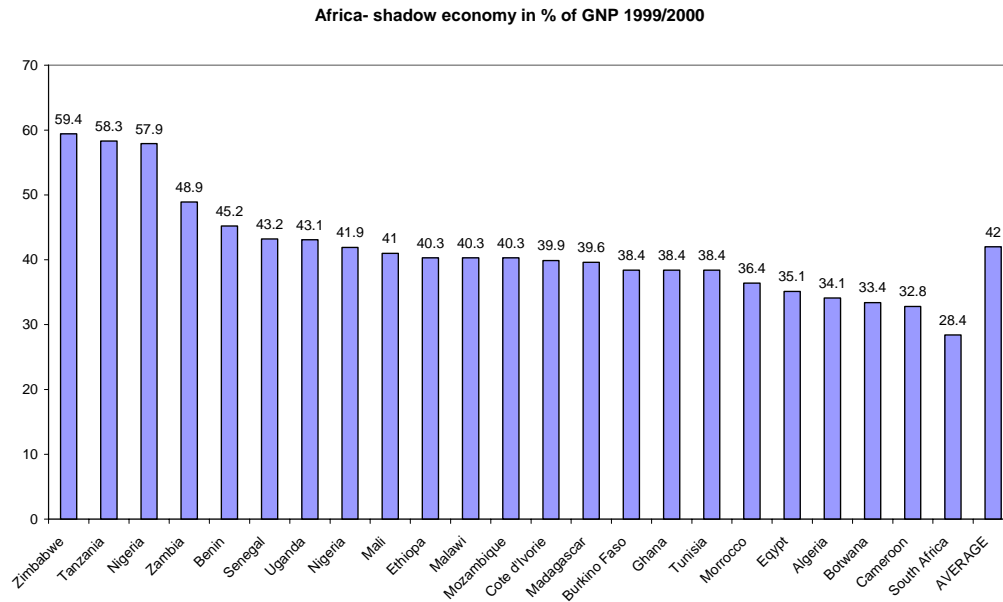


Figure 1: Source Schneider (2002)

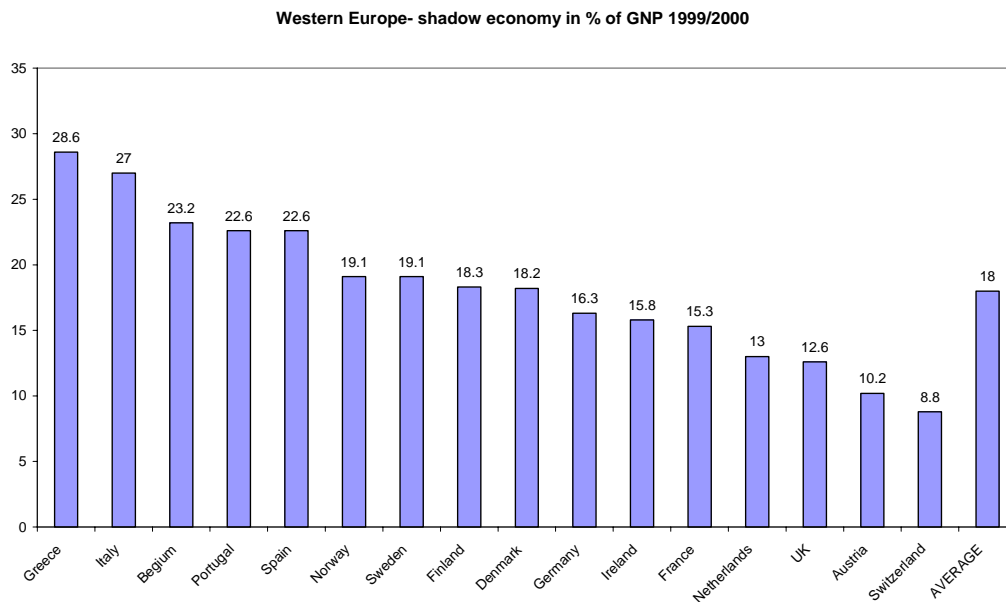


Figure 2: Source Schneider (2002)

The size of the informal economy and the burden of taxes and social security contributions (1996)

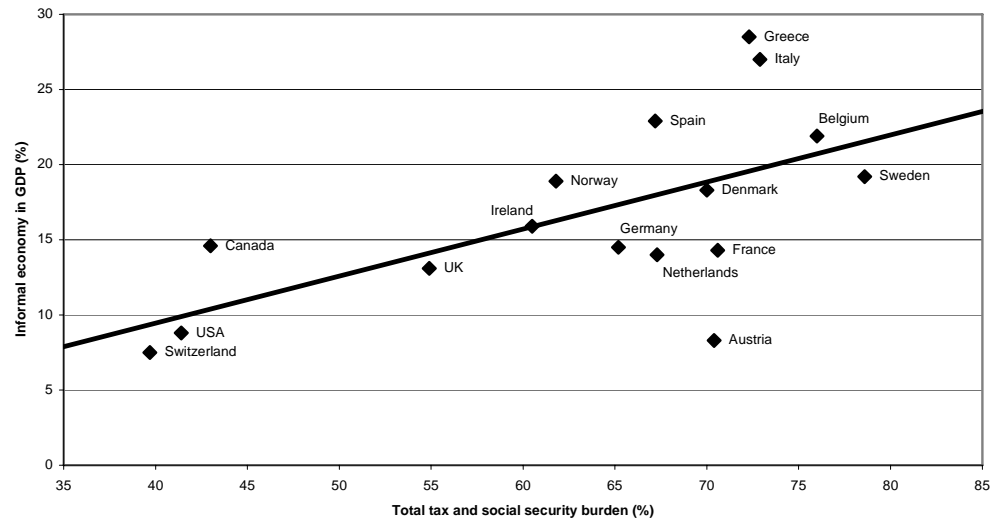


Figure 3: Source Schneider (2002)