

The size and development of the shadow economy: An empirical investigation from states of India[☆]

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Abstract

Using the state level data from India, this paper investigates the size of the hidden economy in Indian states over the period 1974/75 to 1995/96. Our analysis has shown that after liberalization of the Indian economy in 1991/92, the growth in the size of the hidden economy has decreased on an average. Our results show that the growth in the size of the hidden economy is approximately 4% less in scheduled election years than in all other years. We also demonstrate that the growth is significantly lower in those states where the coalition government is in power. An increased growth of newspapers and the literacy rates translate to cleaner governance, e.g. to fewer amounts of shadow economy activities in the economy.

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1. Introduction

Economists and social scientists have shown considerable interest in recent years to measure the gap between the observable and the actual. This has led to the conceptualization of the

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‘hidden economy’, although several synonyms such as black, shadow, underground, unobserved, unofficial, unrecorded, and parallel were used for the ‘hidden economy’. In general, it tries to capture the activities beyond measurement by official activity.² The hidden economy consists of legal and illegal activities outside the reach of the government.³ Empirical estimates demonstrate that underground activities have been on the rise since the 1970s when the presence of government activity became stronger in the economies around the world. With increase in tax rates to finance larger public spending programs, the desire to escape taxes and regulatory restrictions also gained in prominence (Tanzi and Schuknecht, 1997). Popular print-media articles were also ready to accept the notion that the underground economy had increased significantly over the years. Given such media attention, the nexus of the black economy into the public glare has created a consciousness about the gravity of the phenomenon all over the world.

Given the importance of the phenomenon, the next question that naturally arises is regarding the definition of the hidden economy. Tanzi (1999) suggests that the shadow economy crops up because of presence of activities that are difficult to measure and tax, like household work and also criminal and illegal activities. Schneider (1986) sums this point by defining the underground economy as “all economic activities that contribute to the value added and should be included in national income in terms of national accounting conventions but are presently not registered by national measurement agencies”. Bhattacharyya (1999) describes the hidden economy as reflected by the unrecorded national income “calculated as the difference between the potential national income for the given currency in circulation and the recorded national income”. Bagachwa and Naho (1995) consider it as a combination of informal (small-scale production and distribution units), parallel (illegal production of legal activities) and black market activities (production and distribution of market and non-market goods forbidden by the government). Acharya (1985), in the Indian context, refers to the black economy as “the aggregate of incomes which are taxable but are not reported to the tax authorities” and also “the extent to which estimates of national income and output are biased downwards because of deliberate, false reporting of incomes, output and transactions for reasons of tax evasion, flouting of other economic controls and related motives”. A commonly used working definition is: all currently unregistered economic activities, which contribute to the officially calculated (or observed) Gross National Product.⁴ Smith (1985, p. 18) defines it as “market-based production of goods and services whether legal or illegal that escapes detection in the official estimates of GDP”.

The above discussion suggests that the shadow or hidden economy deals with the portion of the income earned from legal and illegal activities that cannot be accounted for by the standard measurement procedures used in compilation of national income accounts. We, in this paper, adopt this as a relatively broad definition of the ‘underground economy’.

In this paper, we try to estimate the size of the hidden (shadow) economy for fourteen major states of India over the period 1974/75 to 1995/96 using a multiple indicator multiple cause (MIMIC) model. Given the estimates of the size of the shadow economy, we also offer an empirical investigation to determine the role of socioeconomic, political and institutional factors

² See the Economic Journal, vol. 109, no. 456, June 1999 the feature “Controversy: on the hidden economy”.

³ The literature about the “shadow”, “underground”, “informal”, “second”, “cash” or “parallel”, economy is increasing. Various topics, on how to measure it, its causes, and its effect on the official economy are analyzed. See for example, survey type publications by Frey and Pommerehne (1984); Johnson et al. (1997, 1998); Lippert and Walker (1997); Loayza (1996); Pozo (1996); Schneider (1994a,b, 1997, 1998, 2005) and Thomas (1992); and for an overall survey of the global evidence of its size in terms of value added Schneider and Enste (2000, 2002).

⁴ This definition is used for example, by Feige (1989, 1994), Frey and Pommerehne (1984), and Lubell (1991) and Schneider (1994a, 2005).

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