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Shadow economies around the world: what do we really know?

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Abstract

This paper presents estimates of the shadow economy for 110 countries, including developing, transition and developed OECD economies. The average size of the shadow economy as a proportion of official GDP in 1999–2000 in developing countries was 41%, in transition countries 38%, and in OECD countries 17%. An increasing burden of taxation and social security contributions underlies the shadow economy. If the shadow economy increases by 1%, the growth rate of the “official” GDP of developing countries decreases by 0.6%, while in developed and transition economies the shadow economy respectively increases by 0.8% and 1.0%.

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1. Introduction

Shadow economic activities are a fact of life around the world. Most societies attempt to control these activities through measures such as punishment and prosecution, or by relying on economic growth or education. Gathering statistics about who is engaged in shadow economy activities and the frequencies with which these activities occur and magnitudes, is important. It is difficult to obtain accurate information because individuals

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engaged in shadow economy activities do not wish to be identified. Hence, the estimation of shadow-economy activities is a scientific passion for knowing the unknown. Although there is quite a large literature on particular aspects of the hidden or shadow economy and a comprehensive survey exists,¹ the subject remains controversial.² There are disagreements about the definition of shadow-economy activities, the appropriate estimation procedures, and the use of the estimates in economic analysis and policy.³ Around the world, there are some indications of increases in shadow economies but little is precisely known about the size of shadow economies in transition, low-income, and high-income countries over the period 1990–2000. The goals of this paper are (1) to estimate the shadow economy for 110 countries, (2) to provide insights about the main causes of the shadow economy, and (3) to study the dynamic effects of the shadow economy on the official economy. Section 2 defines the shadow economy and theoretical considerations about why the shadow economy is increasing are proposed. Section 3 presents the empirical results. Section 4 presents the dynamic effects of the shadow economy on the official economy. Section 5 summarizes and suggests policy conclusions. The appendices set out the various methods for estimating the shadow economy and describe the data. Some further econometric results are also shown.

2. Theoretical considerations

2.1. Defining the shadow economy

Researchers attempting to measure the size of shadow economy face the question of the definition. One commonly used working definition is all currently unregistered economic activities that contribute to the officially calculated (or observed) Gross National Product.⁴ Smith (1994, p. 18) uses the definition “market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP.” One of the broadest definitions includes “those economic activities and the income derived from them that circumvent or other wise government regulation, taxation or observation”.⁵ As these definitions still leave open a lot of questions, Table 2.1 is helpful for developing a feeling for what could be a reasonable consensus definition of the underground (or shadow) economy. From Table 2.1, it is clear that a broad definition of the shadow economy includes unreported income from the production of legal goods and services, either from

¹ See Frey and Pommerehne (1984), Thomas (1992), Loayza (1996), Pozo (1996), Lippert and Walker (1997), Schneider (1994a,b, 1997, 1998a), Johnson et al. (1997, 1998a), Belev (2003), Gerxhani (2003), and Pedersen (2003). For surveys of evidence, see Schneider and Enste (2000, 2002), Schneider (2003) and Alm et al. (2004).

² See the *Economic Journal*, vol. 109, June 1999.

³ Compare the different opinions of Tanzi (1999), Thomas (1999), Giles (1999a,b) and Pedersen (2003).

⁴ This definition is used, for example, by Feige (1989, 1994), Schneider (1994a, 2003), and Frey and Pommerehne (1984). Do-it-yourself activities are not included. For estimates of the shadow economy and do-it-yourself activities for Germany, see This definition is taken from Del’Anno (2003), Del’Anno and Schneider (2004) and Feige (1989). See also Thomas (1999) and Fleming et al. (2000). Karmann (1990).

⁵ This definition is taken from Del’Anno (2003), Del’Anno and Schneider (2004) and Feige (1989). See also Thomas (1999) and Fleming et al. (2000).

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