

Accepted Manuscript

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PII: S0164-0704(17)30001-0
DOI: [10.1016/j.jmacro.2018.04.004](https://doi.org/10.1016/j.jmacro.2018.04.004)
Reference: JMACRO 3016



To appear in: *Journal of Macroeconomics*

Received date: 3 January 2017
Revised date: 30 March 2018
Accepted date: 4 April 2018

Please cite this article as: Mario Solis-Garcia, Yingtong Xie, Measuring the size of the shadow economy using a dynamic general equilibrium model with trends, *Journal of Macroeconomics* (2018), doi: [10.1016/j.jmacro.2018.04.004](https://doi.org/10.1016/j.jmacro.2018.04.004)

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Measuring the size of the shadow economy using a dynamic general equilibrium model with trends*

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April 5, 2018

Abstract

We propose a methodology for measuring the size and properties of the shadow economy. We use a two-sector dynamic deterministic general equilibrium model with four different trends: hours worked, investment-specific productivity, formal productivity, and shadow productivity. We find that the shadow productivity trend is endogenous, in the sense that it is an exact function of model parameters and the other three trends. We also document that, in order to be consistent with observed (real-world) trend growths, the shadow sector needs to exhibit increasing returns to scale, which is contrary to the standard procedure of imposing decreasing returns to this sector. We apply our methodology to a set of seven Latin American and Asian countries and document several empirical regularities that emerge from our analysis, the most important one being that the volatility of shadow sector output is considerably larger than the one in formal sector output.

JEL codes: E26, E32, O17.

Keywords: shadow economy, business cycles, DSGE models.

* We thank seminar participants at the 2016 Workshop on Macroeconomics Research at Liberal Arts Colleges, the 2016 Southern Economic Association meetings, the University of Minnesota's Freeman Center for International Economic Policy's Global Policy Seminar and Jesús Rodríguez-López, Gary Krueger, and two anonymous referees for helpful comments. Finally, we gratefully acknowledge support from the Allianz Life Insurance Company Student Summer Research Fund.

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