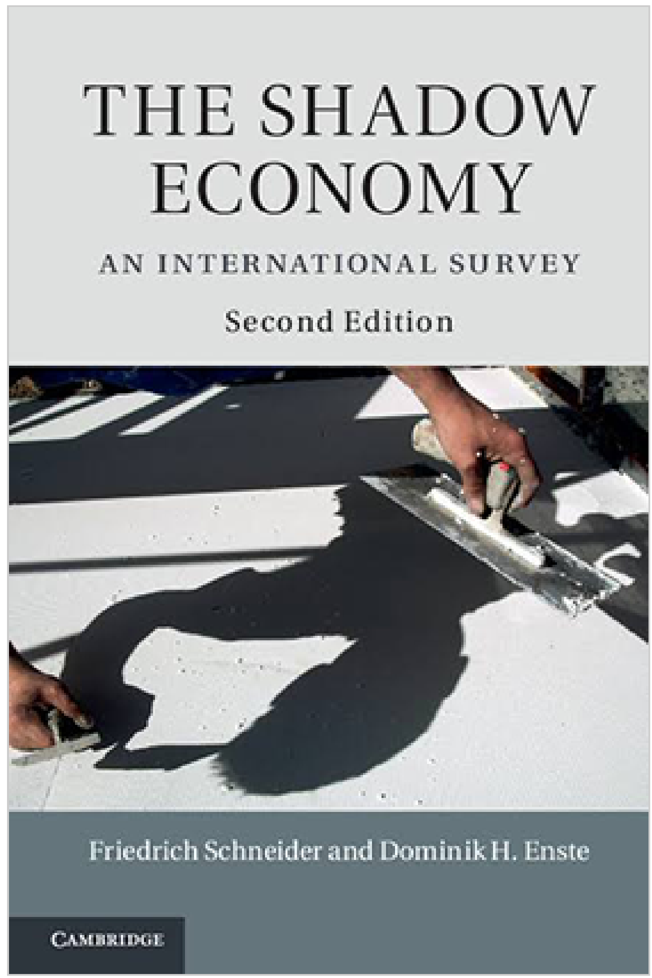
Monthly Labor Review
April 2017

Navigating the shadow economy: only the shadow knows

The Shadow Economy: An International Survey, 2nd ed. By Friedrich Schneider and Dominik H. Enste. Cambridge, UK: Cambridge University Press, 2013, 216 pp., $32.99 paperback.



Ashlie M. Koehn
koehn.ashlie@bls.gov

Ashlie M. Koehn is an economist in the Dallas-Kansas City regional office, U.S. Bureau of Labor Statistics.

As a teenager, I often babysat for neighbors and family friends. Little did I know that these informal arrangements put myself and drug traffickers in the same collective: the shadow economy. *The Shadow Economy: An International Survey*, by Friedrich Schneider and Dominik H. Enste, provides a comprehensive overview and analysis of the shadow economy for policymakers and specialists. Schneider and Enste argue that rising tax rates and increasing regulation are the main drivers of the growth of the shadow economy. This second edition gives updated estimates of the size of the shadow economy relative to gross domestic product (GDP), and the size of the labor force working in the shadow economy, in 151 countries.

According to the authors, the shadow economy consists of economic transactions occurring outside the officially sanctioned economy. Schneider and Enste dissect the shadow economy into two subsectors: the irregular subsector, where production and distribution are illegal but output is not; and the criminal subsector, where production, distribution, and output are all illegal. An example of the former is a hairdresser informally plying his or her craft outside of the workplace in order to avoid taxes; an example of the latter is a labor trafficking ring.

To estimate the size of the shadow economy in a given country, the authors used a model that incorporated the following variables:

Causal variables

- Size of government
- Share of direct taxation
- Total tax burden
- Fiscal freedom
- Business freedom
- Economic freedom
- Unemployment rate
- GDP per capita
- Regulatory quality
- Government effectiveness
- Openness
- Inflation rate

Indicator variables

- Growth rate of GDP per capita
- GDP per capita
- Labor force participation rate
- Labor force growth rate
- Currency

Schneider and Enste varied the causal and indicator variables on the basis of a country's economic status as a developing, transitional, or OECD economy. According to their estimates, among the countries examined, Switzerland, with a shadow economy that averages 8.6 percent of GDP, and the United States (8.8 percent) have the lowest shadow-economy–to–GDP ratios while Bolivia (68.1 percent) and Georgia (68.8 percent) have the highest.

The authors then used World Bank informal employment data to explore the estimated size of the illegal workforce in major global cities. Assuming that illicit employment in rural areas takes place at the same rate as, if not higher than, in urban areas, they extrapolated the World Bank data to the national level to estimate the size of the illicit labor force across 151 countries. One significant conclusion from this section is that informal employment in developing countries is the norm rather than the exception. For example, at 80 percent of its official labor force, the Gambia has one of the largest shadow economy labor forces in the world.

Schneider and Enste weave together sociology and behavioral economics to explain the various motivations for participating in the shadow economy alongside or in lieu of participating in the formal economy. First, there are external norms as well as internalized social norms. For instance, a person who knows many others working in the shadow economy will himself or herself be more likely to join. Second, the reaction an individual has to a perceived loss of control, such as increased regulations, rising taxes, income redistribution, or changing government control of financial institutions, can determine whether or not he or she joins the shadow economy. When facing a loss of control, people have two options: voice their concerns, or exit the economy by either physically relocating their operations or transferring their services to the shadow economy. The authors empirically support their claims by citing a survey conducted in Germany which showed that the most evident motivational factor for participating in the shadow economy was the desire to avoid a tax or social security burden. For firms in OECD countries, the demand for illegal labor is also often driven by the additional costs of officially hiring someone. Among these costs are increased taxes, higher contributions to employee benefit plans, and the costs of complying with legal administrative regulations, such as the employer's cost of contributing to social security upon hiring a worker.

The book then turns to the effects of the shadow economy, which go beyond the notable fiscal effects from lower tax yields. Illicit workers can free ride public benefits and distort social security programs such as benefits, pensions, health insurance, and unemployment insurance. Not all of the effects of the shadow economy are negative: Schneider and Enste state that an estimated two-thirds of shadow economy income is spent in the official economy, supporting regular employment and wages. However, in the long run, it is important for nations to address the shadow economy, because it undermines the rule of law they depend on for legitimacy of their governance.

The authors then separate policy implications into four categories: allocative effects, distributive effects, stabilization effects, and fiscal effects. Some allocative effects, such as production factor inputs, are positive: competing prices for scarce resources between the regular and shadow economy, an increased division of labor in the economy, intensified competition, an additional potential for innovation, and the utilization of otherwise unused resources. The negative allocative effects are wasted resources, and reduced economic growth due to both a distorted production structure and insufficient infrastructure financing. However, if the state cuts the social budget in response to the shadow economy's reducing social contributions, such policies could have a regressive distributive effect and end up increasing the size of the shadow economy. Stabilization policies aim to reduce cyclical fluctuations in employment and structural shifts in the economy. One of the predominant effects of such policies is inefficient state control due to inaccurate data. The shadow economy can distort economic indicators and result in inaccurate measures of gross national product (GNP), economic growth, inflation, and employment rates, key measures that nations use in controlling their economies. Finally, the shadow economy causes negative fiscal effects. By avoiding paying income taxes, those participating in the shadow economy decrease a state's income. Furthermore, businesses operating in the shadow economy avoid payments to social security systems (e.g., they don't pay unemployment insurance taxes), thereby threatening the overall stability of programs built upon these systems.

As mentioned previously, Schneider and Enste point to two broad ways people address economic dissatisfaction: voice their concerns and exit the formal economy. On the basis of this idea, the authors suggest that nations adopt the policy of increasing the voice people have in their governance or decreasing the attractiveness of exiting the formal economy. In the case of the former, nations can use moral suasion and encourage direct democratic communication channels, such as referenda or citizen initiatives, to increase people's participation in their governance. With regard to the latter, nations can decrease the attractiveness of exiting the formal economy through reductions in tax rates, in corruption, and in the density of the regulations they promulgate.

Of the various policy instruments cited, directly combating illegal work is the least attractive alternative, according to Schneider and Enste. Employees, voters, and taxpayers immediately feel the costs, but are less certain about the longer term benefits, of a potential wider tax base achieved through decreasing the size of the shadow economy. In addition, although small firms publicly condemn the shadow economy, many privately condone and directly benefit from it. Furthermore, politicians and policymakers care only about the lost tax revenues. They realize that most of the public does not care about the shadow economy, and they find it best to pretend to combat illicit work while not obtaining substantial results.

While this book provides a valuable overarching addition to the literature on the shadow economy, it falls short in a couple of important respects. The subtitle, *An International Survey*, promises an international perspective, yet the bulk of the narrative focuses on Germany. Because of this shortcoming, the book loses an opportunity to explore the role of the shadow economy within different cultures and countries. Another flaw is that the authors do not clarify how they measured and weighted the variables in estimating the size of the shadow economy—an oversight that leaves many unanswered methodological questions about their fundamental approach. Perhaps what this book does best is point to the challenges that are involved in measuring the unmeasurable and grappling with the indiscernible.