Introduction

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The goal of this handbook on the shadow economy is to provide the reader with some of the latest developments in the size and development of the shadow economies, the driving factors of the shadow economy and the interaction of the shadow economy, with tax morale, government institutions and corruption. In the last ten years some progress has been made with respect to estimating the size and development of the shadow economies using one method over 160 countries from the end of the 1990s up to 2007/08. This is discussed in Part I. In Part II, the regional variation in the size and development of the shadow economy is demonstrated. Part III deals with the shadow economy and illicit work and related activities. In particular, the interaction between do-it-yourself (DIY) activities and the shadow economy is shown. Part IV deals with the difficult issue of tax morale and shadow economy, and Part V, the relation between corruption and the shadow economy and other government institutions is shown.

Chapter 1, by Friedrich Schneider, Andreas Buehn and Claudio Montenegro, deals with shadow economies all over the world with new estimates for 162 countries from 1999 to 2007. This chapter presents estimations of the shadow economies for 162 countries, including developing, Eastern European, Central Asian and high income OECD countries over 1999 to 2006/07. According to the authors’ estimations, the average size of the shadow economy (as a percent of ‘official’ GDP) in 2006 in 98 developing countries was 38.7 per cent, in 21 Eastern European and Central Asian (mostly transition) countries 38.1 per cent and in 25 high income OECD countries 18.7 per cent. The authors find that an increased burden of taxation, combined with labour market regulations and the quality of public goods and services as well as the state of the ‘official’ economy are the driving forces of the shadow economy.

In Chapter 2, Lars P. Feld and Friedrich Schneider provide a survey on the shadow economy and undeclared work in OECD countries. The authors start from the observation that in most OECD countries the policy instrument of choice to prevent people from working in the shadows has been deterrence. While deterrence policy is well-founded
from a theoretical point of view, the empirical evidence on its success is weak: compared to the impact of tax morale, deterrence is quantitatively less important. Moreover, tax policies and state regulation increase the shadow economy. The discussion of the recent literature underlines that economic opportunities, the overall situation of the labour market and unemployment are substitutive processes and are crucial for an understanding of the dynamics of the shadow economy.

In Chapter 3, Kausik Chaudhuri and Friedrich Schneider provide a case study of the size and development of the shadow economy in India. Their analysis shows an increasing trend in the size of the hidden economy over the years, from 8.9 per cent (1960/61) to about 23 per cent (1997/98). Given this development of the shadow economy, they try to explain the growth in the size of the hidden economy in India by political and institutional factors. Their results demonstrate that per capita newspaper circulation exerts a negative significant impact on the growth in the size of the hidden economy. This growth is around 1 per cent significantly lower in the election year compared to a no-election year.

In Chapter 4, Christoph A. Schaltegger provides new evidence on the size and development and perception of the shadow economy in Switzerland, another case study. Schaltegger states that in Switzerland the size of the shadow economy is traditionally estimated to be below 10 per cent of the official GDP. However, the extent of the shadow economy has nearly tripled during the last 30 years. Against this background, Swiss politics has intensified its efforts to tackle moonlighting. Nevertheless, according to surveys, the Swiss population does not perceive the shadow economy as a major problem in comparison to other challenges, even though a majority of the population categories moonlighting as a severe offence. In any case, a successful strategy to fight the black economy has to cope with the causes. Pursuit and higher penalty clauses fight the symptoms but are limited in scope. Recent studies point out that the institutional framework represents an important factor which should not be neglected.

Chapter 5, by Colin C. Williams and Jan Windebank, presents regional variations in the nature of the shadow economy: evidence from a survey of 27 European Union member states. In their chapter the authors show that there are considerable regional variations in the nature of the shadow economy in European countries and that an overall aggregated value may be specially misleading, if there is regional variation. For example, in the south of Italy there is a shadow economy of 30 per cent, while in the north of Italy it is 12 per cent. The aim of their chapter is to move beyond depicting the shadow economy as possessing universal characteristics and logics and to begin charting its spatially variable configuration and character.
To achieve this, the results of the first extensive survey of the nature of the shadow economy in the western world are reported involving 26,659 face-to-face interviews in 27 European Union countries. This reveals marked regional and urban–rural variations in the nature of the shadow economy. In southern European and East–Central European nations, as well as urban areas, a greater share of all shadow work is wages employment and the shadow economy is more likely to be conducted for chiefly economic rationales. Meanwhile, in Nordic and Continental European nations and rural areas more shadow work is carried out on an own-account basis and a higher proportion undertaken for closer social relations and for reasons other than purely monetary gain. The outcome clearly demonstrates that it is necessary to move beyond theorisations that impose universal characteristics and logics on to the shadow economy and towards an understanding of the nature of work in the shadow economy sensitive to its spatially variable meanings.

In Chapter 6, Regional Patterns of Shadow Economy: Modelling Issues and Evidence from the European Union, written by Helmut Herwartz, Friedrich Schneider and Egle Tafenau, for the first time a multiple indicators multiple causes approach, amended to include spatial effects, is adopted to estimate the extent of the shadow economy in the European Union at the NUTS 2 regional level. The authors find that in the year 2004 the shadow economy was smallest in regions of the Netherlands, below 10 per cent, while Polish regions had the largest share of shadow economy, around 30 per cent. Their results are, in general, consistent with country level estimates from earlier studies. The variation of the extent of the shadow economy is, in some countries, considerable. Thus policy measures against shadow activities should take specific institutional situations into account. Moreover, in implementing the regional policies of the European Union, interactions with the shadow economy should be considered.

Chapter 7, written by Andreas Buehn and Alexander Karmann, deals with shadow economy and do-it-yourself activities. The authors begin by explaining that while much is known about the shadow economies around the world, DIY activities have attracted less attention. Consequently, the relationship between the shadow economy and DIY activities is almost unexplored. Their chapter tries to fill this gap. Using appropriate determinants, they estimate a structural equation model for the shadow economy and DIY activities in Germany. Their results suggest that institutional factors determine the shadow economy, while DIY activities respond to individual constraints. Goods and services produced in the DIY economy are not complemented by the demand for services in the shadow economy. Rather, it seems that the shadow economy and DIY activities are substitutive to each other.
Chapter 8, the contribution of Christopher Bajada, deals with the shadow economy in the residential construction sector. A growing body of literature on the shadow economy has focused on aggregate country-level estimates, but little is known of the industry level measures that comprise the aggregate size of the shadow economy. Using the results from a comprehensive telephone survey of home builders, Bajada provides the first known estimates of the shadow economy in the construction sector in Australia – a sector which has been under significant scrutiny by the Australian Taxation Office in recent years. From these survey results, he finds that there is considerable shadow economy activity in the residential construction sector and that both builders and owners alike initiate negotiation involving cash transactions to reduce transaction costs. The survey results provide a number of reasons for builders to engage in shadow economy activity and the means to reduce it.

In Chapter 9, Dominik H. Enste asks who is working illicitly and why? Enste starts with the remark that some economic activities such as illicit work, take place beyond official rules and generate added value, which is not registered in official national accounts. In Germany, 20 per cent of the population has worked illicitly during the last 12 months and 30 per cent have employed someone illicitly. In more than 4 million households, a person, who is not officially registered is, for example, caring for the elderly. This adds up to 150 billion Euros of value added not covered in the statistics. The fact that people do not act according to the law reveals that their acceptance of official institutions and formal norms is rather low. This may in turn give an insight into the necessity of reforms in the institutional framework to decrease the attractiveness and acceptance of deviant (shadow economy) behaviour. In order to investigate this phenomenon, Enste undertook an analysis, which focuses on the results of representative surveys, asking for people’s attitudes towards illicit work. One of his most important results is that perceived norms in the social environment play by far the most important role if one offers or demands illicit work oneself.

In Chapter 10, Gebhard Kirchgaessner considers tax morale, tax evasion and the shadow economy. Kirchgaessner asks under what conditions is moral justification of taxation possible? This question does not only interest philosophers and economists from a scientific point of view but has considerable practical relevance because the willingness of citizens to pay taxes may depend upon whether they consider taxation to be morally justified or not. Kirchgaessner first considers theoretical arguments on the role of tax morale, and when tax evasion might be considered as justified by citizens. Then he asks how tax morale can be measured. Next, he discusses the role of tax morale in the shadow economy, before determinants of tax morale and empirical results for the impact of tax morale and tax
compliance are discussed. For a high tax morale, institutional and cultural factors are at least as important as economic incentives.

In Chapter 11, Martin Halla investigates the link between the intrinsic motivation to comply and compliance behaviour. Halla starts with the observation that recent economic literature emphasises the importance of moral considerations to explain compliance behaviour with respect to underground activities such as tax evasion. A considerable amount of effort has been made to identify factors (both at individual and country levels) that affect the intrinsic motivation to comply. However, the causal link between the intrinsic motivation to comply and actual compliance behaviour has not been established yet. Halla provides a clear discussion of the underlying identification problem and suggests (potentially) feasible empirical strategies to uncover a causal effect.

In Chapter 12, by Lars P. Feld, Andreas J. Schmidt and Friedrich Schneider, the authors show that the traditional Allingham–Sandmo-type theory of tax evasion stresses deterrence: higher expected punishment is alleged to cause lower tax evasion and undeclared work. Hence, deterrence measures appear to be the most favoured policy instruments in almost all OECD countries. However, when it comes to field data outside the USA, empirical evidence on this relation remains rather scarce. In this chapter, the authors survey the legal environment of deterrence policy in Germany and present a new long-run time series of measures for deterrence as well as for the shadow economy in Germany. These two sets of time series data are connected by an econometric analysis on their causal relationship using Granger causality tests.

In Chapter 13, Axel Dreher, Christos Kotsogiannis and Steve McCorriston deal with the impact of institutions of the shadow economy and corruption. The authors first analyse a simple model that captures the relationship between institution quality, the shadow economy and corruption. They demonstrate that an improvement in institutional quality reduces the shadow economy and affects the corruption market. The exact relationship between corruption and institutional quality is, however, ambiguous and depends on the relative effectiveness of the institutional quality in the shadow and corruption markets. The predictions of the model are empirically tested, by means of structural equation modelling that treats the shadow economy and the corruption market as latent variables, using data from OECD countries. The results show that an improvement in institutional quality reduces the shadow economy directly and corruption both directly and indirectly.

In Chapter 14, Benno Torgler, Friedrich Schneider and Alison Macintyre provide an analysis of the shadow economy, voice and accountability and corruption. The authors use an international data set to
empirically analyse how governance or institutional quality affects participation in the shadow economy. They focus on two key factors, namely voice and accountability and corruption to estimate the relationship as these factors are particularly important for understanding the level of the changes in underground activities. The results of this investigation provide additional empirical evidence to the literature, confirming the connection between institution, quality and the shadow economy. The authors then extend the analysis to include tax performance and find that lower institutional quality not only affects the extent of the shadow economy but also reduces the tax effort.