

# **INFORMAL ECONOMY. THE SPECIAL TAX REGIME FOR SMALL AND MICRO BUSINESSES: DESIGN AND IMPLEMENTATION**

by

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## **Introduction**

1. In the economic literature, there are often references about the underground activities of the informal or shadow economy. Conceptually, a simple definition of this phenomenon: “underground activities” are those that have legal ends but employ illicit means. In other words, they are activities which may not intrinsically have a criminal content, but must be carried out illicitly, even though they are licit and desirable activities for the economy. Since the informal economy is so multifaceted, most research papers that deal with it remain vague as to its exact definition. Some studies simply give a list of characteristics of informal sector activities. These include activities that :

- (a) evade taxes (either as part of general fiscal collections or as specific service charges);
- (b) avoid regulatory requirements (e.g., "licensing") or ignore currency requirements (e.g., local currency as the only legal tender);
- (c) fail to appear in statistical reporting mechanisms;
- (d) are per se illegal (e.g., drug dealing).

The most precise and predominantly used definition seeks to relate the underground economy to officially measured national income: It comprises all presently not recorded productive (i.e. value-adding) activities which should be in the national product (GNP). This definition allows to compare and to add the underground economy to GNP. This definition excludes two major activities: (a) Production that by convention is not part of GNP, in particular private household activities. The evaluation of its size has gendered a research area of its own. Depending on the approach and measurement technique, the household sector comprises between 30% and 50% of GNP. (b) Tax evasion is not value adding but redistributive and is therefore not included as such in the above definition (e.g. when taxes on interest payments are evaded). However, in general, no taxes are paid on underground activities (such as moonlighting for house building) which are value-adding. Thus, underground activities and tax evasion are related but certainly not identical. These characteristics form a typology with potentially innumerable situations, which would be covered by a strict definition of shadow. The potential confusion is intensified by the fact that firms, especially in economies in transition, often fall in between the polar cases of these characteristics. It is perhaps fitting for a subject as imprecise as the shadow economy that there is not even agreement on its name. The term "informal" has tended to refer to artisanal and unlicensed small-scale activities and is mostly associated with the developing countries context. The term "hidden" and

"underground" have tended to be associated with tax evasion. The terms "parallel," and "black" seem to be most associated with currency dealings. "Unofficial" and "unrecorded" activities seem to mostly refer to economic activities that escape the national statistics collection agencies. As observed by Mogensen<sup>1</sup> "the shadow economy develops all the time according to the 'principle of running water': it adjusts to changes in taxes, to sanctions from the tax authorities and to the moral attitudes, etc." The term "shadow" is also used in the context of countries with economies in transition. Furthermore, some regulatory restrictions can proscribe some activities that would be otherwise completely legal -and even necessary-in a well-functioning market economy. Thus, from an economic point of view, the most important characteristic of informal activities is that those directly involved in them as well as society in general benefit more if the law is violated than if it is followed. Almost all countries try to control the shadow economic activities through education, punishment or prosecution. Thomas<sup>2</sup> notes that it is difficult to provide a formal definition of the shadow economy and suggests that it covers those activities which are not recorded in the national income accounts. Schneider and Enste define the shadow economy in a similar manner as all economic activities which contribute to the officially calculated (or observed) gross national product. Bhattacharyya<sup>3</sup> argues that the hidden economy is best described as unrecorded national income, calculated as the difference between the potential national income for the given currency in circulation and the recorded national income. Smith<sup>4</sup> defines this sector as market-based production of goods and services, whether legal or illegal, which escapes detection in the official estimates of GDP. The alternative approach finds that shadow economic activities are best defined with respect to the particular behavioral characteristics of the activities in question. Feige reports that the Journal of International Affairs describes the distinguishing feature between official economic activity and informal (shadow) activity as: whether the activity adheres to the established, prevailing institutional rules of the game. Adherence to the established rules constitutes participation in the formal economy whereas noncompliance or circumvention of the established rules constitutes participation in the informal economy. Feige adds an important caveat that is generally omitted from other definitions: The characteristics of each distinct informal economy are determined by the particular set of institutional rules that its members circumvent. He notes that institutional rules cause members of the formal sector to

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<sup>1</sup> Mogensen, Gunnar V., Kvist, Hans K. ; Komendi, Estzer and Soren Pedersen (1995) : *The Shadow economy in Denmark, 1994 : Measurement and Results*, Study No. 3, Copenhagen, The Rockwool Foundation Research Unit.

<sup>2</sup> Jim J. Thomas, *Informal Economic Activity* (Ann Arbor: University of Michigan Press, 1992) p. X; Edgar L. Feige, *Defining and Estimating Underground and Informal Economies: The New Institutional Economics Approach*, *World Development*, 18, no. 7 (1990) pp. 989-1002; Friedrich Schneider and Dominik H. Enste, *Shadow Economies: Size, Causes, and Consequences*, *Journal of Economic Literature* (forthcoming 2000).

<sup>3</sup> Dilip K. Bhattacharyya, *On the Economic Rationale of Estimating the Hidden Economy*, *The Economic Journal*, 109, no. 456 (June 1999) p. 348.

<sup>4</sup> Philip Smith (1994): *Assessing the Size of the Underground Economy: The Canadian Statistical Perspectives*, *Canadian Economic Observer*, Catalogue No.: 11-010, 3.16-33, 18 March 1994, cited in Schneider and Enste, p. 5.

confront a different set of transaction costs than those faced by members of the informal sector<sup>5</sup>.

2. Due to definitional problems, the terms “informal” and “shadow” economy are used here interchangeably. Economic activity that falls outside the purview of government accounting is known by various names: shadow, informal, hidden, black, underground, gray, clandestine, illegal and parallel. Implicit in each is that these economic activities include conscious efforts to avoid official detection. Indeed, some unrecorded activities, such as the drug trade, are illicit. Some activities, such as day labor, however, are legal but may include an illicit component, such as, unrecorded payments. Still others, such as, household production, are wholly legal. Finally, it may be that unrecorded activities occur in a sector of the economy that is simply unregulated, rather than illicit. As these nuances indicate, simply defining the shadow economy is a challenge. Although most authors agree that it is a fuzzy concept, the notion that activity in the shadow economy has important implications for the official economy is essentially unchallenged. Despite decades of study on the issue from an empirical and historical point of view, little agreement has been reached on the fundamental principles that underlie the shadow economy. The lack of consensus in formulating a unified theory of the shadow economy, or even a precise definition of the components that comprise it, suggests that important questions remain unanswered. To what extent does the exclusion of shadow economic activity distort official estimates of macroeconomic variables, including output, employment and inflation? What are the policy ramifications of these exclusions? What is the distribution of shadow economic behavior between unrecorded, but legal, and illicit activities? Can the overall size of the shadow economy be estimated, and is it changing over time? Do countries at different stages of development possess different types of hidden economies? What is the relationship between regulatory (in)efficiency and the size of the shadow economy?

3. Government regulations can substantially raise the cost of labor to firms in the official economy. Such regulations include license requirements, labor market regulations, trade barriers, and labor restrictions for foreigners. Employers in the official economy who shift most of the associated additional costs on to their employees give them a strong incentive to move into the shadow economy. Firms that enter the shadow economy due to multiple causes, one of which being tax avoidance, tend to lose access to official channels of financing, reduce their capital intensity of production, and operate with shorter time horizons. They may also further reduce compliance in other areas of regulation. This can have a profound effect on long-run economic growth and lead to the deterioration of social norms. By focusing on the shadow economy per se, these linkages become both clear and relevant, even if they are not usually considered in the tax evasion literature. Furthermore, studying the shadow economy provides insights regarding the reverse decision, namely, returning to the official economy. An improvement in the tax

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<sup>5</sup> Fleming, Matthew H., John Roman and Graham Farrell (2000): The Shadow Economy : Journal of International Affairs, Spring 2000, 53, no. 2 @The Trustees of Columbia University in the City of New York.

code may not bring an immediate improvement in compliance if being in the shadow is associated with hysteresis. Several studies show that countries with more regulation of their economies have larger shadow economies. For example, among 84 developing, transition, and advanced economies, a one point increase in a regulation index (ranging from 1 to 5) is associated with a 10 percent increase in the shadow economy. Labor market regulations, in particular, have a major effect on employers' costs and workers' incentives. In many OECD countries, high total labor costs are an important cause of high official rates of unemployment, and, simultaneously, of expansion in the shadow economy, which employs many people who are officially unemployed. Some governments (France, for example) and labor unions (for example, in Germany) have restricted the hours that people may work in the official economy, in an attempt to reduce unemployment. The basic objective is to redistribute a limited quantity of work more fairly, but enforced reductions of work in the official economy may push people into the shadow economy. For example, after a motor car company in Germany reduced its working hours, noticeably more reconstruction and renovation of houses took place around where the firm's employees lived than in other areas.

4. The size, causes and the consequences stemming from the existence of shadow or informal economies are different for different types of countries and any attempts for measurement of the size of thereof are obviously problematic since shadow economic activities are performed in a way as to avoid any detection. The rise and growth of the informal economy causes concern for the following reasons<sup>6</sup>:

- (a) If the increase in the informal economy is caused by a rise in the overall tax and social security burden, this may lead to an erosion in the tax and social security bases with a consequential decrease in tax receipts and increase in the budget deficit and size of the informal economy. The state activities are seen to overburden the citizens who take further recourse to the informal economy,
- (b) The growth of informal economy may result in inaccurate “official” figures of unemployment, national income, consumption etc and affect formulation of an effective economic policy and the direction of intended policy measures may become questionable.
- (c) On the other hand, a growing informal economy attracts domestic and foreign workers away from official economy and on estimate, about two thirds of income earned in informal economy is spent in the official economy thereby having stimulating effect on the official economy.

Three sets of factors are taken to be the main motivators of whether to engage in the unofficial economy:

(i) Incentives to exit the official economy are the burden of taxation and of social security contributions, as well as government regulations. The latter hinder or even prohibit activities in the official economy (e.g. because of a lack in work permit, especially for foreigners) which provides an incentive to undertake them unofficially. This holds, of course, also for illegal activities such as the production and distribution of drugs. An

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<sup>6</sup> Schneider, Friedrich and Dominik Enste (2000) “*Shadow Economies around the World: Size, Causes and Consequences*” IMF Working Paper WP/00/26.

important reason to exit the official sector are the restrictions imposed on working time. Low work hours, long holidays, early retirement, and above all unemployment are important reasons for moonlighting.

(ii) Disincentives to be active in the underground economy are the expected punishment of doing so. It is composed of the probability to be caught and the size of punishment. For persons outside the established society (for example for illegal immigrants), or being self-employed, expected punishment is lower than for other persons, and therefore a higher rate of participation in the underground sector is likely.

(iii) Another disincentive to be active in the underground economy is the moral costs entailed. A good citizen has moral qualms to undertake a forbidden activity. These moral costs are closely related to “tax morale” which motivates citizens to pay their dues to the state. The effects of the underground economy are reflected in the traces visible in the labor, money and product markets discussed above. A specific econometric technique called “unobservable variables” allows to estimate the size of the underground economy lying between the causes and effects. This approach is the most comprehensive and builds on a well-structured behavioral model but it requires a large amount of data. As these are often not available (in particular not for developing and transition economies) this approach is not generally applicable. The estimation technique moreover tends not to be statistically robust (i.e. small changes in specification and values of variables strongly affects the estimates).

5. The origin of informality cannot be found in a cultural shortcoming, nor in a religious or ethnic problem, but in the inefficiency of the law. Technically speaking, activities are informal because of the cost of legality. It is generally not recognized that the law has a cost like everything else--namely, the amount of time and information necessary to comply with it. In many developing countries in Latin America, the cost of the law is very high; in fact, comparatively higher than in the United States. The difference between developed and developing countries, as Douglass North<sup>7</sup> (1990) has so brilliantly documented, can be found in efficient institutional organization. In other words, the difference can be found in transactions costs or the cost of the law. In a prosperous country, transactions costs are low relative to national income, while the opposite is true in a poor country. We only measure the cost of the law when the cost of complying with it is greater than its benefits. People comply with the law when it is convenient. When it is not, they do not comply with it. It is only rational that it be like that. In Latin America, there is tangible evidence that the law is costly. It is so costly that it distorts the market and excludes from it the least-favored sectors of the population. Why are there informals, then? Because people, given their small incomes, cannot work otherwise, cannot comply with the law, cannot pay taxes, cannot have access to formally built housing because they cannot afford it. That is the objective reality. It is not a cultural shortcoming; it is not a mental problem; it is not an ethnic heritage; it is legal discrimination.

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<sup>7</sup> North, D.C. (1990): *Institutions, Institutional Change and Economic Performance*. New York: Cambridge University Press.

6. Speaking about the Latin America, in the case of a street vendor whose goals are licit, but he must use illicit means--noncompliance with legal regulations, noncompliance with labor laws, nonpayment of taxes--because he has no other alternative. He cannot incorporate himself in the formal economy because the latter imposes so heavy a cost on Latin American societies as to make it impossible for people and entrepreneurs with minimal income to enter it. Informality, then, is a situation whereby people want to work legally, but cannot. The only alternative left is to work in that area of relative illegality created by the legal cracks in Latin American society. Although it varies from country to country, the importance of informality is very wide. In the case of a country in South America, it has been calculated that, in general terms, the equivalent of 38 percent of gross domestic product and 60 percent of man-hours worked take place in the informal sector which leads to draw some initial conclusions. First, informality is socially and economically significant because, if 60 percent of man-hours are in the informal sector, the government only controls 4 out of 10 hours worked. Plainly stated, the majority of labour works outside the law. The second conclusion is that, despite its quantitative significance, informal activities have very low productivity, since 60 percent of the labor produces only 38 percent of the product<sup>8</sup>. That leads to some problems, especially the lack of a transparent legal system. The "informals," for instance, cannot go to a court of justice to enforce their contracts; they cannot insure themselves against risk; and they cannot acquire secure property rights. As a result, their long-run productivity suffers.

### **Informal Construction**

7. In the case of Latin America it is significant, at least as illustrated by several experiences, that the informal sector has a key presence in the construction and housing sector. In fact, urban development in some countries has taken place mostly at the hands of the informal sector. The majority of a capital city of 8 million people, approximately half of its geographical area, has been developed completely outside the law, in what are euphemistically refer to as "young towns," or *pueblos jóvenes*, which are nothing more than slums, or marginal urban neighborhoods developed after the invasions of public and private lots by migrants from the countryside during the last 40 years. The development of the informal housing sector has great economic, social, and political importance. First of all, it is economically significant because the investment people have made in their own informally built homes amounts to \$8 or \$8.5 billion, an investment that has been made with no government aid of any kind. Second, it is socially important because it represents the emergence of a new proprietary class. Traditionally, in Latin America the less privileged classes of society had not been property owners. The access to property had been limited to the wealthy or aristocratic classes. Through this process of informal construction, however, the least privileged sectors of Latin America have been able to revindicate for themselves the right to private property and make it a reality in their cities. Finally, informal construction has had a remarkable political significance because, in the final analysis, only the property owners can fight for their rights. Only when one has a right to own something, does one have a sense of responsibility, struggle, and political challenge. Countries without private property are countries where civil society is weak

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<sup>8</sup> De Soto, H.; Ghersi, E.; and Ghibellini, M. (1986) *El Otro Sendero*. El Barranco, Peru: Instituto Libertad y Democracia.

and the citizenry does not confront political power because, in the final analysis, there is very little room left for individual development.

### **Informal Industry**

8. The presence of informality is also significant in industry and services. In the case of industry, informal activity is clearly underground but the expression the “underground economy” gives an impression of concealment that is not accurate in all cases. In fact, informal urbanization, commerce, and public transportation services are absolutely public and visible. The terms submerged, hidden, or "own-account" economy are even more misleading and imprecise. Nevertheless, in the case of industry, there are indeed underground activities. There are two kinds of informal industrialists in Latin America. One is that of the formal industrialist who informalizes part of his production as a result of the high cost of regulation or taxes. Even though he may conceal part of his production, he belongs to the community of established industrialists. In many cases the high cost of legality in Latin America has forced him to move part of his production to the informal sector. Thus, he has to abandon the formal sector to hide totally or partially in the informal sector. That happens every time inflation rises, which is an indirect way of raising taxes. The other kind of informal industrialists is made up of artisans and fully informal industrialists, who are employed illegally in the manufacturing sector. There are areas of many Latin American countries where that activity is very pronounced. They include textiles and ready-to-wear clothing, furniture making, and automotive repairs. For instance, in the craft industry, there are people who, in the security and intimacy of their own homes, set up workshops with relatives and friends who, in many instances, do not get paid or get paid indirectly by being taught the trade. In this way, a significant amount of micro-enterprise activity is generated.

### **Informal Services**

9. As in the previous cases, the level of informal activity in the service sector is quite high. The most remarkable case is public transportation. In developed countries, public transportation is generally state-run; in developing countries, public transportation is generally private and informal. In Latin America, the emergence of big cities has gone hand in hand with the development of huge systems of informal transportation. In 1990, 95 percent of urban transportation was in the hands of the small entrepreneurs, each one the owner of his bus or *kombi*. (The term "*kombi* capitalism" has come to describe that kind of entrepreneur.) That same year, the entire state-owned public transportation system went bankrupt. In one country, the government dissolved the only public enterprise that existed in the public transportation sector by selling to each driver the vehicle he was driving and thus completely informalizing urban transportation. Also in 1990, a mayor of a capital city liberalized urban transportation when he deregulated routes, rates, and market entry and exit. That forced drivers to use their imagination because, as entrepreneurs, they had to identify the desires of their customers and offer differentiated services. The liberalization of rates also has resulted in a variety of services and a range of prices depending on the degree of comfort desired by the commuters and the willingness to pay accordingly.

## Causes of existence of informal economy

10. Identifying and analyzing the forces that lead to the informal economy can contribute toward finding the policy prescription to deal with it. The best way to approach the issue of the causes of the existence of the informal economy is to analyze the incentives faced by economic agents (firms or individuals) making the decision whether to be official. For this purpose, it is necessary to identify the costs and benefits of moving from the official to the informal economy and vice versa. Among the benefits to entering the informal economy, the most popular mentioned in the literature is tax rates. The common theme is that high taxes (both marginal and total) have a negative impact on the decision of economic agents on whether to operate officially.<sup>9</sup> In fact, Friedman, Johnson, Kaufmann, and Zoido-Lobaton<sup>10</sup> even find that higher taxes are associated with lower shadow activity. One explanation could be that only a country that has good prospects for tax collection will raise its tax rates. Another is that higher taxes afford higher quality public services, which attract firms into the official economy. Nevertheless, some researchers recently suggest that perhaps it is not the most important cause and Friedman et al. believe that institutional aspects are more important than taxes in promoting shadow economies. In cross-country studies that include less-developed, transition, and OECD countries, Johnson et al. (1998) and Friedman et al. (1999) find that the key determinant of underground activity is the extent of regulatory discretion. When regulations are lax and rule of law is weak, bureaucrats make decisions on individual cases without supervision. This creates corruption, which causes firms to become unofficial. Additional regulatory causes were suggested in various studies. For LDCs, trade restrictions were often mentioned. For OECD countries, the emphasis is on the increase in regulations and especially labor regulations, such as, a forced reduction of weekly working time, early retirement, and labor market restrictions on foreigners. Schneider and Enste<sup>11</sup> (2000) also mention the social welfare system that discourages beneficiaries from working in the official economy, since by doing so they lose eligibility for some of the benefits. Turning to the cost side, public services may be lost to an economic agent in the informal economy. Primary is the loss of access to the legal system (important as a support for contracts) and to police protection. Access to social services such as those related to health and pensions can also be lost, depending on the country and the type of the informal economy activity. Among the private sector services that may be lost to a firm in the informal economy are those related to banking, capital markets, and non-financial (e.g., insurance) services. These losses stem from the unregistered nature of such firms, their reluctance to leave "paper trails," and the requirement by the service providers for some sort of legally binding collateral.

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<sup>9</sup> S. Johnson, D. Kaufmann and A. Shleifer (1997): The unofficial economy in transition. *Brooking Papers of Economic Activity* 0 2 (1997), pp. 159-221.

S. Johnson, D. Kaufmann and P. Zoido-Lobaton (1998): Regulatory discretion and the unofficial economy. *American Economic Review* 88 2 (1998), pp. 387-392.

<sup>10</sup> Friedman, E., Johnson, S., Kaufmann, D., & Zoido-Lobaton, P. (1999). *Dodging the grabbing hand: the determinants of unofficial activity in 69 countries*. World Bank Discussion Paper. Washington, DC: The World Bank.

<sup>11</sup> Schneider and Enste (2000) : *op.cit.*



11. The relationship between corruption and informal economy activity remains an unresolved issue in the literature. It is difficult to determine whether unofficial activity and corruption complement each other, since firms go underground to avoid corrupt officials or go underground by bribing officials. Or are the two substitutes, which will be the case if the official economy is a sanctuary from corruption? Recent empirical evidence suggests some complementarity (Johnson et al, 1998 *op. cit.*; Friedman et al., 1999, *op.cit.*). Yet, this positive relationship may be due to the fact that both corruption and informal sector activity are caused by a common factor such as a weak judiciary system. But, the fact that at a particular moment the benefits of being official outweigh the costs does not imply that the economic agent will immediately become official. This decision must be analyzed in a dynamic context, where expectations about the future benefits and costs of remaining or moving back to the previous state may have a role. This may have implications for policy prescriptions. Moving between various types of legal status incurs fixed costs, which are associated with the phenomenon of hysteresis. These costs can be viewed as entry or exit "barriers." Thus, if the appearance of additional inappropriate regulations pushes firms into the informal economy, their removal may not tempt the firms to return to the official economy. The "height" of such barriers may be partially determined by mental factors, such as distrust toward the political system, but are often affected by public policy, an example being a tax amnesty. As many countries have discovered, amnesties can often be a two-edged sword. Amnesties may lower barriers into the official economy but they can also lead to the expectation that they might be repeated in the future, thus reducing the incentive to operate officially. Though there are similarities between informal economies in OECD, developing countries, and economies in transition, one should be cautious before applying lessons from one set of countries to the other. The informal economy in the OECD countries is usually attributed to high taxation and onerous labor regulation. In developing countries, the driving forces are usually tax and regulation avoidance, corruption, and general distrust by citizens of the political system. All the aspects mentioned above are relevant also to the economies in transition. Yet, in the case of economies in transition, there are additional unique dimensions. These include the communist heritage, the transition from a command to a market economy, the dramatic structural change of industry and of government in a short period of time, and the process of quick and massive privatization. Moreover, several of the countries in Africa and economies in transition are new states with little experience in "growing" the institutions of government. These features affect all aspects of the informal economy, including its characteristics, its impacts, the possibility for its measurement, and the type of public policy prescriptions. Particularly, in economies in transition, the following characteristics appear<sup>12</sup>:

- (a) in economies in transition the state sector takes part in unofficial activities, and even the large state enterprises participate in both official and unofficial activities

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<sup>12</sup> D. Kaufmann and A. Kaliberda (1996): Integrating the unofficial economy into the dynamics of post-socialist economies: a framework of analysis and evidence. In: B. Kaminski, Editor, *Economic transition in the newly independent states*, M. E. Sharpe Press, Armonk, NY (1996).

- (which are often identical except for bookkeeping purposes). Such behavior allows state officials and managers to extract private incomes from state firms.
- (b) unofficial activities are sometimes big and visible. This is perhaps a departure from the traditional view of shadow activities as comprising rural or household activities.
  - (c) unofficial activity is mostly nonviolent and non-criminal, having become unofficial mostly to avoid the burden of administrative regulations and taxation.
  - (d) operating in the shadow economy does not cut the firm off from its accessibility to social services and state subsidies. This can be attributed to the socialist legacy.
  - (e) the unofficial activities in transition countries are relatively sensitive to economic incentives from governments (the exception being activities that are per se illegal). EBRD<sup>13</sup> speculates that this is because much of the unofficial economic output in transition economies, unlike in other regions, comes from misreported or undeclared production of registered firms. These are quite responsive to relative cost differences between the informal and official economies. Informal activities in economies in transition use barter and foreign exchange as main means of exchange. This is in contrast to OECD countries where shadow transactions are usually done in local currency cash

### **Desirability of activities of informal economy**

12. Clearly, then, there is pressing need for study of the size and nature of the shadow economy. But is all shadow economic activity undesirable? Should we pursue policies to incorporate all shadow economic activity into the folds of the official economy? Implicit in much of the literature on the shadow economy is the view that shadow activity is undesirable (even the terms shadow or hidden carry somewhat negative connotations). This is most evident with respect to the illicit sector: by making an activity illegal, a society attaches a stigma to that activity. However, it is not certain that all shadow economic activity should be discouraged. As discussed earlier, an active shadow economy might imply the presence of inefficient economic policies. As such, activity which overcomes inefficiencies in the existing system is conceivably a good thing: de Soto proposes that non-compliant activity circumventing onerous regulations may be more efficient<sup>14</sup>. Along these lines, shadow economic activity is thought to have helped the transition towards market economies and to have mobilized entrepreneurial endeavors in transition economies<sup>15</sup>. Schneider finds that there is a positive stimulating effect of

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<sup>13</sup> EBRD (1996): *Transition report*. London: European Bank for Reconstruction and Development.

<sup>14</sup> . For his description of the consequences of onerous laws, see de Soto (*op.cit.* pp. 158-172.) . Much of de Soto's case is formulated on the concept that Peru is governed by a set of laws that are relatively less efficient than those that guide the informal sector. For a description of proposed responses to this situation, see pp. 248-259.

<sup>15</sup> Aleksandar Atulhofer, "Between Opportunism and Distrust: Socio-Cultural Aspects of the Underground Economy in Croatia," in Edgar L. Feige and Katarina Ott, eds., *Underground Economies in Transition: Unrecorded Activity, Tax Evasion, Corruption and Organized Crime* (Brookfield, VT: Ashgate, 1999) p. 44; Svetlana Glinkina, "Russia's Underground Economy During the Transition", in Edgar L. Feige and Katarina Ott, eds.

shadow economic activity on the official economy, as at least two-thirds of the income earned in the shadow economy is immediately spent in the official economy<sup>16</sup>. And the informal sector of the overall shadow economy is recognized in developing and even transition countries as a provider of fundamental goods and services. From some perspectives it has been argued that even the criminal sector generates benefits for a nation's economy. Wealth generated in the criminal sector may feed back into the formal, official economy. Maurer, discussing the situation of narcotics in Colombia, states the following: ...other sectors also profit indirectly via a multiplier mechanism from the employment, income, and demand created by the drug business. The purchasing power in these sectors has indirectly created hundreds of other employment opportunities in legal sectors. Capital goods, such as agricultural equipment, chemicals as well as consumer goods and services (banking, legal advice) are offered increasingly in the remote coca cultivation areas. This "trickling down" also represents a distribution of the drug profits<sup>17</sup>. Such activity comes at a price: the state (or perhaps other states) faces potentially considerable expenditures in order to prevent criminal activity, such as police and military counter-drug units and operations, and society may face higher rates of crime, particularly violent crime. Also, because criminal activity escapes taxation, the state must provide the public goods of law and order with tax revenues that may be insufficient. Benefits, such as those described by Maurer, need to be weighed in the context of their political, economic and social costs. Moreover, we should consider that while shadow economic activity has in many cases effectively served as a survival mechanism, or has assisted in the transition to a market economy, it has not done so without consequences. Glinkina notes that "the emergence and growth of a large underground economy poses serious concerns, which on balance dominate" and that:

"The effective management of the economy by the state is undermined. The taxation and foreign exchange base that any state needs to manage its economy is eroded by the rapid flight from the official to the underground economy. Macroeconomic stability is thus harder to attain and sustain. Further, the legitimacy of the overall legal and regulatory system is challenged."<sup>18</sup> Ott provides an unequivocal assessment, though it is made in reference to transition economies: We find that in transition countries, which have a weak institutional structure for supporting market economic activity, underground economies pose a grave danger, that of undermining the establishment of the rule of law that is

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Underground Economies in Transition: Unrecorded Activity, Tax Evasion, Corruption and Organized Crime (Brookfield, VT: Ashgate, 1999) p. 104.

<sup>16</sup> Friedrich Schneider, "Stellt das Anwachsen der Schwarzarbeit eine wirtschaftspolitische Herausforderung dar? Einige Gedanken aus volkswirtschaftlicher Sicht," *Mitteilungen des Instituts für angewandte Wirtschaftsforschung (IAW)*, Linz, 98, no. 1, cited in Schneider and Enste, p. 4.

<sup>17</sup> Eva Maria Maurer, "The Cocaine Business: Impact on Colombia's Economy and Possible Solutions," Eberhard Karls University, Tübingen, Germany (August 1992), cited in Marion Libreros, "Including Illegal Productive Activities in the National Accounts: The Case of the Illicit Drug Industry in Some Latin American Countries" paper presented to 24th General Conference of the International Association for Research on Income and Wealth (Lillehammer, Norway, 18-24 August, 1996) p. 14.

<sup>18</sup> Glinkina, p. 104. *Journal of International Affairs* 398

increasingly seen as a necessary component of successful transition.<sup>19</sup> While informal sector employment may provide employees with basic subsistence needs, it does so in the face of oppressive and /or unsafe working conditions; incomes usually at or below the poverty line; restricted access to state-provided social protection, training and social services; and frequent exploitation and infringement of workers' rights.<sup>20</sup> The benefits derived from the shadow economy may or may not outweigh the costs associated with such activity, and the influence of shadow economic activity on growth and development remains unclear.<sup>21</sup> This is one area that calls for future research, particularly with respect to the informal sector, in which the direction of the impacts are ambiguous.

### **The impacts of the informal economy in economies in transition**

13. It is necessary to consider the question whether a bigger informal economy help or cripple economic development. It is usually the case that the economy is better off if, *ceteris paribus*, an activity is done officially than if it is done in the informal economy. It is much less obvious, however, that it is better that the activity not be done at all rather than be done in the informal sector. Perhaps only activities that are per se illegal can fall into this latter category. This presents a major difficulty to policy analysis, since the simple fact that we observe a large informal economy does not reveal what the alternatives to the informal sector were. There are specific linkages between the existence of the informal economy and economic performance and growth. The negative impacts can be arranged according to whether they lead to macroeconomic, microeconomic, or social problems. As may be demonstrated by a Laffer curve, if high tax rates push activities out of the official economy, they can shrink the tax base and thereby eventually reduce overall tax revenue. This revenue loss induces the government to increase taxes and, in the case where informal economies are significant, decrease the quality of public goods and services. This drives firms further away from the official economy, resulting in a vicious circle. In addition, when tax revenues provide an insufficient source of budgetary financing (and debt and domestic bond markets are unavailable), governments are often forced to resort to inflationary financing, which can destabilize the economy. The presence of a informal economy can make macro policy less effective. This, in turn, can make it harder to attain and sustain macroeconomic stability. For example, monetary policy is weakened since shadow economy firms use the banking system less (reducing intermediation) and are less connected capital markets. In many economies in transition and particularly those such as the Ukraine, which experienced bouts of high inflation informal activities flee cash and transact in barter or in foreign currencies. In addition, official statistics provide the wrong indicators for macro-policy decisions.<sup>22</sup> For example, an increase in *official* unemployment may not signal as serious a need for a major Keynesian-style fiscal stimulus, but rather a shift of economic activity into the shadow

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<sup>19</sup> Ott, p. 29.

<sup>20</sup> ILO (1999) p.1

<sup>21</sup> Thomas (1999) pp. 381-389.

<sup>22</sup> Tanzi, Vito (1999) : Uses and abuses of estimates of the underground economy. *Economic Journal* **109** 456 (1999), pp. 338-347.

economy. There are a host of microeconomic efficiency problems created by the presence of a shadow economy.

- (a) the existence of a shadow economy creates distortions in resource allocation.
- (b) firms in informal sector have an unfair advantage in labor markets since they are not subject to labor regulations. They can also draw demand away from the official firms that need to pay taxes.
- (c) since they are not being registered, firms in informal sector may have trouble providing collateral, thus distorting their investment decisions.
- (d) one may expect the potential for informal economy activity to affect the composition of national economic output. This is because resources may be allocated according to which sectors are most amenable to informal economy activity (e.g., trade, services, and construction).
- (e) the inherent greater risk of doing business in the informal economy and the greater difficulty in raising funds from the capital markets, lead the informal economy to focus on the short-term and neglect large-scale and sophisticated investments. As a consequence, shadow economy firms may tend to de-capitalize their assets or operate more labor-intensively than would be optimal.
- (f) finally, operating in the shadow implies additional direct losses that raise the cost of production. These include time spent on bribing, avoiding licenses and taxes, and seeking private sector alternatives to public services.

14. Regarding the social consequences of an informal economy, Schneider and Enste (2000) *op.cit.* and others point out that the presence of a large shadow economy, where free-riding on public services paid for by few is common, may possibly lead to a sense of unfairness and deepen the distrust toward the ability of the political system to govern. Moreover, it could lead to an atmosphere where avoiding state predation can even appear morally just, adversely affecting the respect for official institutions, norms, and rule-of-law. This could lead to the disintegration of social norms. It is not clear, however, to what extent the informal economy is the cause of bad morals rather than just an indicator of a deficit of legitimacy of the present social and economic order. Another potential concern of an expanding shadow economy is the possible reduced eligibility of social safety net services (e.g., health, unemployment) for workers in shadow firms. This may be less a problem for some economies in transition that have a tradition of state-provided services independent of employment status. In addition, if shadow activities are associated with anti-competitive conduct, it may transfer economic surplus from consumers to equity owners, increasing inequality.

### **The size of the informal economy**

15. Regardless of whether shadow economic activity is viewed as adverse or benign, there are clearly benefits to understanding the size and extent of this activity. Considerable work has been devoted to estimating the size of the shadow economy in countries around the world, using a variety of methods. Unfortunately, all of these methods are, to some degree, imperfect, and different methods appear to generate divergent estimates (for those countries that are common to multiple studies). The results of such research have come under intense scrutiny, with some observers suggesting

that without first grounding the concept of the informal economy in economic theory, efforts to generate a “magic number” for the size of the sector are meaningless.<sup>23</sup> We briefly discuss the methodological approaches found in the literature and explore relevant criticisms. We then present estimates for the size of the informal economy in transition, developing and developed economies.

16. Estimating the size of the shadow economy is difficult<sup>24</sup>. After all, people engaged in underground activities do their best to avoid detection. But policymakers and government administrators need information about how many people are active in the shadow economy, how often underground activities occur, and the size of these activities, so that they can make appropriate decisions on resource allocation.

Thus, economists and government statisticians have made a variety of calculations to gauge how large the shadow economy is. To estimate the size of the shadow economy, researchers have focused on a sample of 84 countries, using a variety of estimation methods. The results show that for all 84 countries investigated, value added in the shadow economy has reached a remarkably large amount. Over the years researchers of the informal economy have acknowledged the considerable difficulties in its measurement, which is not surprising since informal economy activity, by definition, is activity that attempts to avoid detection. While numerous methods have been used over the years to quantify the size of the shadow economy, such as, micro surveys, tax audits, the currency demand method, the transaction method, the electricity method, the labor approach, the National expenditures and income statistics discrepancy method and the model method. [See Schneider and Enste (2000) for a detailed survey of measurement methods], methods developed for the OECD or developing countries may not be suitable for an economy in transition.

17. **Developing countries:** According to a survey conducted in 1998–99 in Africa, Nigeria and Egypt had the largest shadow economies, equivalent to 77 percent and 69 percent of GDP, respectively; South Africa, by contrast, had a shadow economy of only 11 percent of GDP. In Asia in the same period, Thailand ranked number one with a shadow economy of 70 percent of GDP; Hong Kong SAR and Singapore had the smallest shadow economies, both at 14 percent of GDP. In Latin America in 1998–99, the biggest shadow economy was in Bolivia, at 67 percent of GDP, and the smallest was in Chile, at 19 percent. A rough comparison of the size of the underground economy relative to official GNP for a selection of developing and transition economies for the beginning of the 1990s, using the physical input (electricity) demand approach shows that some of these countries (Nigeria, Egypt, Thailand) are estimated to have an underground sector nearly three quarters the size of officially recorded GNP. In many countries the size is one quarter to one third of GNP. In Asian countries with a comparatively low public sector, high tax morale or high expected punishment (Hong Kong, Singapore) the underground economy is estimated to be similar to that in many “northern” European countries

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<sup>24</sup> Friedrich Schneider with Dominik Enste (2001): *Hiding in the Shadows The Growth of the Underground Economy*

**18 Transition countries :** Among the states of the former Soviet Union in 1998–99, Georgia's shadow economy was the largest, at 64 percent of GDP; Russia's was 44 percent of GDP; and Uzbekistan's was the smallest, at 9 percent. Among the transition countries of central and eastern Europe in the same period, Bulgaria's was the largest, at 34 percent of GDP, and Slovakia's the smallest, at 11 percent. A proper measure of the shadow in transition should take into account these countries' idiosyncrasies, the fact that they went through a period of dramatic structural changes, and the limitations of data availability. Given these considerations the physical input methods, and particularly the electricity method, seem to be the only appropriate method. Eilat and Zinnes<sup>25</sup> (2000) have given a detailed discussion of other measurement methods and their inappropriateness for the case of transition countries. The electricity method has been used by Kaufmann and Kaliberda (1996)(*op.cit.*) for transition economies. The method measures overall economic activity by assuming that the ratio of electric power consumption to total (official and unofficial) economic activity (TEA) is constant. Under such an assumption, the growth of total electricity consumption reflects growth in TEA. After the growth in TEA is found, the difference between the growth rate of registered GDP and the growth rate of TEA is attributed to the growth in the shadow economy. Applying this shadow growth rate to an independent base year estimate of the shadow economy's share of GDP allows the calculation of the share of the shadow economy over time. As the method has been applied to date, however, its weaknesses are many. First, not all shadow activities use energy electricity in particular. Second, technical progress that changes the efficiency of use of energy may change the electricity/TEA ratio over time and across countries. So can many other factors such as changes in industrialization, efficiency changes in the industry and changes in energy prices. These problems become particularly manifest during transition when the share of industry typically contracts profoundly and the share of non-energy-intensive agriculture expands. Moreover liberalization of the energy market could cause big changes in electricity prices and use. Finally, the massive modernization efforts associated with transition will undoubtedly increase the energy efficiency of output. In an attempt to correct for some of the faults of the total electricity use method, we have developed a "modified" total-electricity-approach (MTE). This method accounts for changes in other factors (e.g., prices, output composition, and efficiency), and then relates the residual, unexplained changes in electricity use to changes in the shadow economy.

**Estimates of the size of the shadow economy in various transition economies**

Country Size of shadow economy in percent of GDP, average over 1990-93

Central Europe, Hungary, Bulgaria and Poland	20-28%
Romania, Slovakia and Czech Republic	7-16%
Former Soviet Union Georgia, Azerbaijan, Ukraine and Belarus	28-43%

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<sup>25</sup> Eilat, Y., Zinnes C. (2000). *The evolution of the shadow economy in transition countries: consequences for economic growth and donor assistance*. CAER II Discussion Paper, No. 83, United States Agency for International Development, contracts PCE-C-00-95-00015-00 and PCE-C-00-95-00016-00.

[Source: Schneider and Enste (forthcoming)]

**19. OECD countries :** In the 21 OECD countries in 1999–2001, Greece and Italy had the largest shadow economies, at 30 percent and 27 percent of GDP, respectively. In the middle group were the Scandinavian countries, and at the lower end were the United States and Austria, at 10 percent of GDP, and Switzerland, at 9 percent. More particularly, the South European countries (Greece, Italy) have an underground economy almost one third as large as the officially measured GNP: followed by Spain, Portugal and Belgium having a shadow economy between 20-24 % (of official) GNP. According to these estimates, the Scandinavian countries also have a sizeable unofficial economy (between 18-20 % of GNP), which is attributed mainly to the high fiscal burden. The “central” European countries (Ireland, the Netherlands, France, Germany and Great Britain) have a smaller underground economy (between 13-16 % of GNP) probably due to a lower fiscal burden and moderate regulatory restrictions. The lower underground economies are estimated to exist in countries with relatively low public sectors (Japan, the United States and Switzerland), and comparatively high tax morale (United States, Switzerland).

### **How Much Has the Shadow Economy Grown?**

20. In most transition and all investigated OECD countries, the shadow economy has been growing rapidly. (The trend in developing countries as a group cannot be judged accurately, for lack of data.) Shadow economies grew bigger between 1990 and 1998 in the states of the former Soviet Union—from about a fourth to more than a third of GDP—though in central and eastern European states they remained almost stable at about a fifth of GDP. In the 21 OECD countries surveyed the shadow economy has been growing for 30 years—doubling from less than 10 percent of GDP in most of these countries in 1970 to 20 percent or more of GDP by 2000 in Belgium, Denmark, Italy, Norway, Spain, and Sweden. Growth has also occurred in countries with smaller shadow economies; in the United States, for example, the shadow economy doubled from 4 percent of GDP in 1970 to 9 percent in 2000. For the OECD countries, the growth in shadow economies has been fastest in the 1990s: in the group as a whole, the shadow economy rose from 13 percent in 1990–93 to 17 percent in 1999–2000. Late in the decade, the shadow economy was still growing in most OECD countries. .

### **Why Are Shadow Economies Growing?**

21. Countries with relatively low tax rates, fewer laws and regulations, and a well-established rule of law tend to have smaller shadow economies. Macroeconomic and microeconomic modeling studies based on data for several countries suggest that the major driving forces behind the size and growth of the shadow economy are an increasing burden of tax and social security payments, combined with rising restrictions in the official labor market. Wage rates in the official economy also play a role.



**22. Taxes and social security contributions:** Taxes and social security contributions add to the cost of labor in the official economy and hence are key factors driving the growth of the shadow economy. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings from work, the greater the incentive for employers and employees to avoid this difference and participate in the shadow economy. The difference can be very large; in Germany and Austria, for example, the tax and social security payments by firms and their workers amount to the wages that workers effectively earn. Since the difference depends broadly on the social security system and the tax regime, these are key determinants of the shadow economy. Several studies have found strong evidence that the tax regime influences the shadow economy. In Austria, the burden of direct taxes (including social security payments) has been the biggest influence on the growth of the shadow economy, followed by the number of regulations affecting firms and workers, and the complexity of the tax system. Other studies show similar results for the Scandinavian countries, Germany, and the United States. In the United States, analysis shows that as the marginal federal personal income tax rate increases by one percentage point, other things being equal, the shadow economy grows by 1.4 percentage points. Also in the United States, holding down the top marginal income tax rate may prevent further growth of the shadow economy. A study of Quebec City in Canada shows that people are highly mobile between the official and the shadow economy, and that as net wages in the official economy go up, they work less in the shadow economy. This study also emphasizes that where people perceive the tax rate as too high, an increase in the (marginal) tax rate will lead to a decrease in tax revenue.

**23. State regulations:** Government regulations can substantially raise the cost of labor to firms in the official economy. Such regulations include license requirements, labor market regulations, trade barriers, and labor restrictions for foreigners. Employers in the official economy who shift most of the associated additional costs on to their employees give them a strong incentive to move into the shadow economy. Several studies show that countries with more regulation of their economies have larger shadow economies. For example, among 84 developing, transition, and advanced economies, a one point increase in a regulation index (ranging from 1 to 5) is associated with a 10 percent increase in the shadow economy.

**24.** Labor market regulations, in particular, have a major effect on employers' costs and workers' incentives. In many OECD countries, high total labor costs are an important cause of high official rates of unemployment, and, simultaneously, of expansion in the shadow economy, which employs many people who are officially unemployed. Some governments (France, for example) and labor unions (for example, in Germany) have restricted the hours that people may work in the official economy, in an attempt to reduce unemployment. The intent is to redistribute a limited quantity of work more fairly, but enforced reductions of work in the official economy may push people into the shadow economy. For example, after Volkswagen in Germany reduced its working hours, noticeably more reconstruction and renovation of houses took place around where the firm's employees lived than in other areas.

**25. Governance:** Shadow economies tend to be smaller in countries where government institutions are strong and efficient. Indeed, some studies have found that it is not higher taxes per se that increase the size of the shadow economy, but ineffectual and discretionary application of the tax system and regulations by governments. A heavily regulated economy combined with weak and discretionary administration of the law provides especially fertile ground for shadow activities. These are also the conditions under which corruption flourishes. Few studies empirically investigate the relationship between corruption and the shadow economy, but those that do so observe that countries with more corruption have relatively larger shadow economies. Corruption is essentially the abuse of public power for private benefit. Activities that provide opportunities for corruption include:

- regulation or licensing to engage in particular activities (opening a shop or driving a taxi, for example);
- land zoning and other similar official decisions;
- administration of, or ready access to, publicly provided goods and services;
- control over decisions regarding procurement of public investment contracts;
- control over provision of tax incentives; and
- control over hiring and promotion within the public sector.

Several studies have found a direct correlation between a reduction of the level of corruption in a country and the extent of the shadow economy. All studies found that more corruption resulted in a larger shadow economy. One of these studies points out that "wealthier countries of the OECD, as well as some in Eastern Europe, find themselves in the good equilibrium of relatively low tax and regulatory burden, sizable revenue mobilization, good rule of law and corruption control, and a (relatively) small unofficial economy. By contrast, a number of countries in Latin America and the former Soviet Union exhibit characteristics consistent with a bad equilibrium: tax and regulatory discretion and burden on the firm is high, the rule of law is weak, and there is a high incidence of bribery and a relatively high share of activities in the unofficial economy."

### **Effects on the Official Economy**

26. A change in the size of the shadow economy may be reflected in a change in:
- Monetary indicators. Shadow economy transactions tend to be in cash. Rising activity in the shadow economy is likely to push up the demand for currency.
  - Labor market participation rates and working hours. As growing numbers of people work in the hidden sector, participation rates in the official economy may fall. Similarly, as people work more hours in the hidden sector, hours worked in the official economy may fall.
  - Output statistics. As the shadow economy grows, production inputs, especially labor, move at least partly out of the official economy. This displacement may depress the official growth rate of the economy.

### **Implications for Action**

27. As mentioned earlier, an increase in the size of the shadow economy is likely to result in reduced state revenues, which in turn reduces the quality and quantity of publicly provided goods and services. Ultimately this can lead to an increase in tax rates for firms and individuals, quite often combined with a deterioration in the quality and administration of the public goods such as roads and hospitals provided by the government. On the other hand, two thirds of the income earned in the shadow economy is immediately spent in the official economy. This can be a boost for the official economy and may lead to additional overall economic growth. The growth of the shadow economy therefore affects everyone. But it is difficult to evaluate whether the shadow economy ultimately affects the official economy in a positive or a negative way. Governments can act to curb the shadow economy. Research shows that smaller shadow economies appear in countries with higher tax revenues that are achieved by lower tax rates (resulting in greater compliance), fewer laws and regulations combined with consistent enforcement, and less bribery facing companies.

28. The major driving forces behind the size and growth of the shadow economy appear to be an increasing burden of taxation and social security payments, combined with more pervasive state regulatory activities. Weak and arbitrary enforcement of laws and regulations encourages shadow economic activity; the findings emphasize the importance of the rule of law in curbing both corruption and associated shadow economic activity. The findings contain some useful implications for policymakers:

- Even major reductions in tax rates will not substantially shrink the shadow economy, but they may be able to stabilize it.
- Marginal tax rates are more relevant to people's shadow-economy work decisions than are average tax rates; replacing direct taxes with indirect taxes is unlikely to improve tax compliance.
- More frequent tax audits and heavier penalties for tax evasion may reduce the size of the shadow economy.
- Governments should put more emphasis on legalizing certain shadow economy activities, for example by liberalizing the labor market.
- Reforms that liberalize regulations and make the economy more competitive reduce the incentives for corruption, and encourage firms to move from the shadow economy into the official one.
- Governments should put emphasis on the rule of law and on the strict enforcement of a minimum necessary set of regulations, rather than on increasing the number of regulations.

29. The growth of the underground economy over the last decades and its effect on the official economy both in general perception and scholarly research has prevalently been evaluated as a negative development which should be counteracted. In particular, politicians and public officials have pointed out that the state's capacity to provide the desired public services is undermined. But not all commentators share this view. Some see it as a welcome and effective limit on governments' tendency to continually raise the fiscal burden, and to impose more and more restrictions on the economy and society. It

has also been argued that many developing and transition economies would break down or function at a much lower level of production and welfare if the underground economy did not exist. As has just been argued in section 4, too, unofficial activities are seen as a desirable addition to the official economy whose productivity is strongly reduced by excessive taxation and bureaucratic restrictions. A less pronounced evaluation points out that the rise of the underground economy indicates that the relationship between the state and the citizens is fragile and needs improvement. The fight against the underground economy is a recurrent theme in many countries. The dominant method is to increase deterrence. The probability of being caught is raised by more regular and intensive controls, often by the police. Punishment is raised by imposing higher fines and, in severe cases, prison sentences. The target are both buyers and suppliers of goods and services produced in the underground sector. The success of such deterrence policies is rather uncertain. In the case of the underground sector related to drug, prostitution and alcohol prohibition the effect has turned out to be at best weak, if not counterproductive. Many persons active in the underground economy move more deeply into illegality in order to make detection more difficult. As a result, the underground activities become more criminalized, and more difficult to observe and to influence. Well organized and ruthless organized crime (often called the Mafia) becomes more dominant. A deterrence policy needs not always be a failure but the successes tend to be short run. Provided the demand for underground goods and services remains intact, the profit opportunities in the underground economy become so large that supply reappears and the underground economy recuperates. A less oppressive policy is to lure people into the official economy by legalizing parts of the underground economy, and by facilitating the move into the official economy (e.g. by granting an amnesty). Such measures have proved to be only moderately successful. A positive approach to raise the motivation to stay in the official economy by improving the efficiency of public services, reducing the tax and social security burden imposed on labor and/or by raising civic virtue has been used only rarely. Many policy makers doubt whether such measures work at all. In any case, they are effective only in the longer run. One possibility is to adjust public supply more closely to what the citizens desire, and to lower cost for a given quantity and quality of public supply. This can be attempted by streamlining public sector activities (e.g. by New Public Management). A more fundamental way is to improve the political process via opening the political arena to contending interests, and strengthening the democratic participation rights of the citizens

### **Special tax regime for small businesses: Case of India**

30. With the growth of economic activities, in many developing and transitional economy countries, there is an inevitable emergence of the informal economy largely composed of the unorganized underground sector which owes its existence to complex rules and complicated procedures relating to carrying out of the economic activities as also to high tax rates, strict rules for labour welfare and social security contributions payable by employers. In many countries, the informal economy makes significant addition to the Gross Domestic Product without making any contribution to the tax revenues. While the governments should make concerted efforts to bring the informal economy within the folds of the mainstream economy through various means, the Board

of Revenue should devise special provisions generally known as presumptive taxation for the taxation of income earned by small enterprises, petty shopkeepers, and self-employed professionals not requiring intellectual inputs, such as, electricians, plumbers, masons, carpenters etc. Most of these persons do not maintain proper books of account and cannot afford professional assistance. There should be rough and ready method to determine income of such categories of taxpayers and public officials should make special efforts to gain their confidence by showing the necessary leniency and accessibility to them. There should be simplified procedure for determination of tax liability and collection of taxes in these cases. There is need to undertake extensive outdoor surveys by the tax administration to discover new taxpayers who should be made liable to pay their statutory dues. Many new taxpayers fight shy of approaching the tax administration to fulfil their legal obligation either due to diffidence or ignorance. The survey officials will have to be properly instructed to deal with the new cases with patience and firmness. There should also be strict supervision and control over survey officials to ensure that they perform their duty diligently and honestly so that there is no avoidable loss of revenue through indulgence in corrupt practices.

31. With a view to building an atmosphere of trust and confidence and also to widen the tax base by encouraging small shopkeepers to pay their taxes, the Government of India through the Finance Act, 1992 introduced a new simplified procedure for taxation. The new procedure was intended to help small shopkeepers in meeting their tax liability by filing a simple statement-cum- tax payment voucher at the bank counter without having to go through the intricacies of income-tax law and procedure. The salient features of the simplified procedure are as follows :

(a) the scheme was optional ;

(b) it was open to individuals and family business organization, not assessed to tax earlier, who have income of not more than Rs. 35,000 (US\$ 1,000) from the business of retail trade or of running an eating place or any vocation and, in the case of business of retail trade, have an annual turnover of upto Rs. 5 lakhs (US \$15,000);

(c) a person carrying on the business of retail trade and opting for the simplified procedure was deemed to have a turnover of Rs. 5 lakhs and his total income will be deemed to be seven per cent. of this turnover. Thus, in effect, his total income was presumed to be Rs. 35,000. A person running an eating place or engaged in any vocation and opting for the simplified procedure was deemed to have total income of Rs. 35,000. Thus, the tax in respect of income from the business of retail trade or of running an eating place or any vocation worked out to Rs. 1,400 (US \$40);

(d) persons opting for the simplified procedure should not have taxable income exceeding Rs. 5,000 (US \$150) from any source other than the business or vocation mentioned above. No deduction under Chapter VIA

except under section 80L was allowed. No rebate under Chapter VIII was allowed. Tax in respect of income up to Rs. 5,000 from any other source (as reduced by deduction under section 80L) was required to be paid at the appropriate rate--which at present is 20 per cent.

(e) such persons was not required to file any income-tax return. Chapter XIV relating to "Procedure for assessment" will not apply in their case. Instead, a simple prescribed statement containing the name, address, nature of business, and a declaration that the conditions mentioned in (b) above are fulfilled ;

(f) the tax was required to be paid along with the prescribed statement by the 31st March of the financial year (1<sup>st</sup> April to 31 March of the succeeding year) in which the income is earned ;

(g) there was no enquiry nor assessment ;

(h) no proceeding under any other provision of the Income-tax Act was to be initiated against a person opting for the scheme, in respect of his income from retail trade, from running an eating place or from any vocation, for the assessment year for which the statement under the scheme has been filed, unless the Department had evidence in its possession that the statement furnished by the person is untrue :

(i) the scheme was in force initially for two assessment years viz. assessment years 1993-94 and 1994-95.

For the purposes of this provision, vocation had been defined to include tailoring, hair-cutting, washing clothes, typing, photocopying, repair work of any kind and other services of a similar nature. Other services of a similar nature would include vocations which are of the same genus as the ones mentioned in the definition that is to say, vocations which do not require any substantial intellectual input. Illustrations of this would be persons earning their livelihood as carpenters, electricians, plumbers, painters, welders, lathe machine operators, taxi drivers etc. The simplified procedure will, thus, not be available to professionals like lawyers, accountants, consultants, engineers, architects, teachers, etc.

32. The scheme of simplified procedure for assessment of income earned by small shopkeepers and petty professionals did not generate much confidence amongst the targeted categories of taxpayers for a variety of reasons, chief amongst them being the mistrust of the department about its potential for harassment of initiating actions for earlier years, resentment on the part of tax practitioners due to loss of potential clientele and general apathy of tax officials. The scheme was discontinued in 1997 in the wake of the initiation of a Voluntary Disclosure Scheme (Amnesty Scheme).

## Conclusion

33. There is a widespread feeling that a substantial and increasing share of activities take place outside the official economy. This holds, in particular, for developing countries and economies in transition but also for high income economies. Such activities are unrecorded by the system of national income accounting, which has become the accepted standard in all countries of the world. The existence and increase of an underground economy gives rise to three major sets of concerns. The economic and social conditions of individuals, household and countries are evaluated in a biased way if one relies on the official statistics. Thus, the official number of unemployed persons may hide that an (unknown) share of them actually work and receive wage income. As a consequence, the macro economic policies are likely to be too expansionary and social policy too excessive. A second concern is the loss of tax revenue as underground activities escape taxation. A third concern interprets the underground economy as an indicator of an unhealthy state between citizens and government. The taxpayers are dissatisfied with what public services they get for their contributions and seek to restress the balance by evading to the underground economy. It is feared that such reaction makes government unable to finance the public goods necessary for an economy and society. In contrast, opponents of government welcome such a development.

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