
The Informal Economy in the EU Accession Countries: Size, Scope, Trends and Challenges to the Process of EU Enlargement

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Contribution paper

Concerning the round-table topics

Size and Scope of the Informal Economy: Methods of Assessment
EU Accession



The [Center for Economic Development](http://www.ced.bg) released on 29 of November 2001 its printed publication "Statistical Aspects on the Non-Observed Economy" (in Bulgarian only)¹.

The paper "Statistical Aspects on the Non-Observed Economy" presents the statistical understandings of that phenomenon called non-observed economy. The main methodological document referred to is the international statistical paper "Handbook for Measurement of the Non-Observed Economy"²

One of the goals of the paper is to announce in advance the forthcoming publishing of the Handbook to the Bulgarian users of macroeconomic data, to provide additional information to them, which might be useful in their own assessments on the credibility of the official statistics.

¹ It is available on: <http://www.ced.bg/bg/projects/project16/publications/unobserv.pdf>

The printed publication was distributed to a long list of experts of the National Statistical Institute of Bulgaria and to the audience of the conference "The grey economy in Bulgaria: why it exists and what to do?" which was held on 25-26 October 2001 in Sofia. The conference was organized by Centre for Social Practices and Institute for Anthropological Field Research at the New Bulgarian University supported by Center for International Private Enterprise USA.

²  [Handbook for Measurement of the Non-Observed Economy Preliminary Draft \(English\)](http://www.oecd.org/pdf/M00020000/M00020031.pdf), the first preliminary draft texts available through Internet by the middle of 2001. Meanwhile the second draft version of the handbook was released in Internet:  [Handbook for Measurement of the Non-Observed Economy - Second Draft 04/07/01](http://www.oecd.org/pdf/M00020000/M00020031.pdf) At the time being the final draft for printing 06/02/02 is available at <http://www.oecd.org/pdf/M00020000/M00020031.pdf>

"Statistical Aspects on the Non-Observed Economy" gives to the Bulgarian readers the latest definitions and measurement strategies developed by the international statistical community. The System of national accounts is the conceptual background to define the most general term non-observed economy (NOE). Its compound terms, from the side of the socio-economic generation of the phenomena, are underground, illegal, informal activities and own final use productive activities of households.

The non-observed economy can be very simply defined in a statistical sense as "productive activities, which are not covered by the national statistical system". The statistical aspects of the NOE are summarized in two main groups – those based on socio-economic reasons and those based on statistical reasons. Socio-economic reasons generate illegal, informal and economically underground activities. Socio-economic reasons are function of the economic behaviour of the subjects of these activities, the economists should analyse this behaviour and it is a field of influence by means of the economic policy. National statistical system is the place where can be act on overcoming of the statistical reasons connected with the statistical reflection of the NOE: "not (updated) registered", "no response", and "misreporting".

The paper makes also a short presentation of the work of Eurostat with the candidate countries in the field of practical ensuring the exhaustiveness of their national accounts. More details can be find in the document Enlargement and exhaustiveness: Eurostat Pilot Project with the EU candidate countries, Dr. Silke Stapel, Eurostat [Non-Observed Economy Workshop](#).

Additional information on the issues of the non-observed economy and about the handbook is currently available on the new OECD web-site structure on the following address <http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-429-15-no-24-20034-429,FF.html>

For the English readers there is a short summary of the paper "Statistical Aspects on the Non-Observed Economy", available on the web-site of the Center for Economic Development at http://www.ced.bg/eng/projects/project16/research/n_observ.html

Concerning the round-table topic *Size and Scope of the Informal Economy: Methods of Assessment*:

- What is informal economy, other terms: shadow economy, underground economy

Handbook for Measurement of the Non-Observed Economy - Final Draft for Printing 06/02/02 (page12) uses the term Non-Observed Economy (NOE) and draws on the 1993 System of National Accounts for the definition of the terms used in the its definition, including:

- **Underground production**, defined as those activities that are productive and legal but are deliberately concealed from the public authorities to avoid payment of taxes or complying with regulations;

- **Illegal production**, defined as those productive activities that generate goods and services forbidden by law or that are unlawful when carried out by unauthorised producers;
 - **Informal sector production**, defined as those productive activities conducted by unincorporated enterprises in the household sector that are unregistered and/or are less than a specified size in terms of employment, and that have some market production;
 - **Production of households for own final use**, defined as those productive activities that result in goods or services consumed or capitalised by the households that produced them.
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- What is the conceptual framework for the methods of assessment of the informal economy, other terms: shadow economy, underground economy

Handbook for Measurement of the Non-Observed Economy - Final Draft for Printing 06/02/02 (Scope and Objectives, page 10) has a conceptual framework

“provided by relevant international standards, in particular the System of National Accounts 1993 (1993 SNA) produced by five international organisations (Commission of European Communities et al, 1993). Thus, the scope of the Handbook is economic production as defined by the 1993 SNA. This provides a solid basis but also implies a restriction on the range of issues that are considered. In particular, as further elaborated in Chapter 2, the Handbook does not include the measurement of many services provided by household members to themselves, such as housework or preparing meals, because they are not within the 1993 SNA production boundary. These are not regarded as being missing production.

1.8 The main focus of the Handbook (Chapters 2-7) is to provide guidance on how to produce exhaustive estimates of GDP. This means ensuring that as many productive activities as possible are observed, i.e., directly measured in the basic data on production, incomes, and expenditures from which the national accounts are compiled. It also means ensuring that non-observed activities are nevertheless accounted for, i.e., indirectly measured during compilation of the national accounts.

1.9 The groups of activities most likely to be non-observed are those that are underground, illegal, informal sector, or undertaken by households for their own final use. Activities may also be missed because of deficiencies in the basic statistical data collection programme. These groups of activities are referred to in this Handbook as the problem areas. Activities not included in the basic data because they are in one or more of these problem areas are collectively said to comprise the nonobserved economy (NOE). Thus, measurement of the non-observed economy involves action on two fronts:

- Improvements in **direct measurement** by the data collection programme, resulting in fewer **nonobserved** activities and hence fewer **non-measured** activities; and
- Improvements in **indirect measurement** during compilation of the national accounts, resulting in fewer **non-measured activities**.

1.10 Although the main goal of the Handbook is to help statisticians produce exhaustive estimates of GDP, it is recognised that there are many issues in addition to exhaustiveness closely related to the NOE. In particular, in many countries, especially developing ones, a large number of persons are involved in informal sector production, which has a very significant role in employment creation, income generation and poverty reduction. Data on the size and characteristics of the informal sector and its contribution to GDP are thus required for research and policy making. In response to this demand, the Handbook provides advice on the production of stand-alone statistics for the informal sector and of household production undertaken for own final use.

1.11 Other issues that are sometimes considered to be related to the NOE are capital flight, shuttle trade, cross border shopping, tax evasion, and drug trafficking. Some of the concern that official statistics do not properly reflect the magnitude of such activities stems from a misunderstanding of what is included in the GDP. In particular, capital flight and tax evasion are not productive activities and thus are not measured in the GDP. Whilst it is not the aim of the Handbook to deal explicitly with these issues, it does provide some guidance. In particular, it details methods for the production of stand-alone statistics for underground production and describes its relationship to tax evasion, shuttle trade and other items commonly associated with the underground economy. It also discusses the most common types of illegal production.

1.12 It is worth emphasising what the Handbook does not attempt to do. It does not lay claim to presenting new material, nor to providing the single best solution. Rather it is a compendium of existing good practices, with guidance on how they might best be used. Furthermore, it does not aim at reduction of underground, illegal, informal sector activities or household production for own final use. Rather it aims at ensuring that productive activities are observed to the extent possible, and that those that are non-observed are nevertheless measured in the national accounts. In doing so, the Handbook may provide some ideas regarding the causes and magnitudes of underground and illegal activities, but their reduction is a matter for government administrators, not for statisticians.

1.13 The Handbook gives insight into tax evasion only to the extent that tax evasion is associated with activities within the 1993 SNA production boundary. However, tax evasion also occurs in connection with activities that are non-productive and which are therefore not included in the GDP.

As further discussed in Chapters 4 and 9, estimates of missed tax revenues may be useful in assessing priorities for measuring the NOE and even for determining adjustments for missing production.

Conversely, GDP estimates that have been adjusted to include some non-observed activities are indicative of the lower limits of the shortfall in tax receipts through tax evasion.”

- What are the comments of the Handbook for Measurement of the Non-Observed Economy - Final Draft for Printing 06/02/02 (Macro-Model Methods, pages 177-183) on the macro-model methods for estimating informal economy, other terms: shadow economy, underground economy etc.

“12.1 Macro-model methods is the term used in this Handbook for methods that produce an estimate of the entire NOE, or one of its component parts such as the underground economy, by means of a single model. Such methods are discussed in this chapter not because they are considered useful in obtaining exhaustive estimates of GDP or in estimating underground production, but because they tend to produce spectacularly high measures, which attract much attention from politicians and newspapers. As Gylliane Gervais (Statistics Canada, 1994) wrote:

“The size and growth of the ‘underground economy’ have kindled a lot of interest in Canada in the past few years...Hardly a week goes by without the media quoting someone claiming that underground transactions amount to 10%, 15% or even 20% of GDP, or that the deficit could be eliminated if taxes were collected on these transactions. If the figures often quoted are even approximately accurate, then the level and possibly growth of Canada’s GDP are considerably understated to the extent that the information given (to) policy makers about current economic conditions is misleading. Our statistical system, at least in so far as economic statistics are concerned, would be sorely inadequate if it failed to detect ‘hidden’ transactions of such magnitude.”

12.2 Without a doubt, the media reports to which this paragraph refers were based on the use of macro-model methods. For example, Schneider and Enste (2000) quote estimates of the average level of the “shadow economy” (apparently meaning non-measured economy) in Canada over the period 1990-93 between 10.0% and 13.5%, whereas the Statistics Canada report just referenced concluded that the upper limit to the “underground economy” (defined as market production of legal goods and services that escapes measurement in the official GDP estimates) in 1992 was 2.7%.

12.3 It is often, but entirely wrongly, conjectured that the difference between these macro-model results and the official estimates of GDP is non-measured production. However, as illustrated in this chapter, there are serious problems with macro-model methods that cast doubt on their utility for any purpose in which precision is important. In particular, they are completely unsuitable for use in compiling the national accounts. In brief the problems are:

- The activities that the models aim to measure are not precisely defined; it is often unclear whether the models are estimating non-observed or non-measured production, or whether they include informal sector or illegal activities as well as underground activities;
- The assumptions underlying the models overly simplistic;
- The results the models produce are not stable in the sense that changes in assumptions for the same model can produce quite different values;
- There are many models and they give different results;
- The methods provide only a global estimate for the economy as a whole, whereas users frequently want GDP broken down by industry or expenditure category; and
- The results can not be readily combined with other measurements, in particular those obtained by the detailed, data based methods that are used in compiling the national accounts, as described in earlier chapters of this Handbook.

12.4 To illustrate these points, three types of macro-model methods are described in the following sections:

- Monetary methods, which assume that the non-measured production can be modelled in terms of stocks or flows of money;
- Global indicator methods, in which non-measured production is modelled in terms of a single variable (usually a physical indicator) with which it is believed to be highly correlated, electricity consumption being the most commonly used.
- Latent variable methods, in which modelling is in terms of two groups of variables, one group that is assumed to determine the size and growth of non-measured production and a second group that provides the “trace” (i.e., evidence) of the missing activities.

12.5 In presenting their methods, the authors refer variously to the “underground”, “hidden”, or “shadow” economy without always clarifying whether this includes all non-observed activities, or just those that are legal, or those that are non-measured in the official GDP estimates, or some other subset.”

Concerning the **EU Accession** aspects of the round-table:

On October 2, 2001 Eurostat released the publication [Eurostat Projects On Non-Financial National Accounts With The Candidate Countries – 1998-2000](#) This product exists only in electronic form - PDF File available for  [download](#).

We would like to focus the attention of the users of national accounts data to this publication because the subject of this publication – National Accounts – is one of the core areas of information for the candidate countries needed by the [European Union](#) during the enlargement process and when they enter the Union.

The publication describes the results of 11 activities undertaken by Eurostat with the Candidate Countries on improving the coverage and reliability of their national accounts. The activities described cover the period between October 1998 and March 2001.

The most important and wide-ranging activity is the **Pilot Project on Exhaustiveness (PPE)**, dealing with the **measurement of the non-observed part of the economy** as well as other elements of exhaustive accounts. The publication presents the methods used to improve the exhaustiveness of the Candidate Countries’ GDP, as well as summary numerical results from the project. The other 10 more specific activities described in the publication cover following fields of the national accounts: Private household consumption, Estimation methods at constant prices, General Government and Non-profit institutions serving households, Financial intermediation services indirectly measured, Tourist expenditure and shuttle trade, National accounts database and data transmission using EDI, Changes in inventories, incl. the estimation of holding gains, Dwelling services, Supply and use tables, Capital stock and consumption of fixed capital.

This publication enables a wider audience of users of national accounts data to be informed and appreciate the nature of the work undertaken and the improvements achieved, providing them accurate assessment of the conceptual and practical harmonisation work already undertaken by the candidate countries and tracking the further statistical work necessary to prepare for membership of the [European Union](#).