

# The Shadow Economy and Institutional Change in EU Accession Countries

- A Two Pillar Strategy for the Challenges ahead

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# 1 The Shadow Economy – A Challenge for Economic and Social Policy

The causes, effects and problems generated by increasing shadow economic activities are extensively and controversially discussed in OECD and transition countries. Attention is drawn to the shadow economy, due to the dramatically rising unemployment (e.g. in the EU), and the financing problems of public expenditure, as well as the rising vexation with and disappointment about economic and social policies. Broad initiatives on behalf of the EU-Commission and EU-Parliament, as well as on state-level show that politicians eventually felt the need to act as well.<sup>1</sup>

But they are in a dilemma. While the fact that the wealthy are evading taxes, leads to widespread public indignation, illicit workers are often much less criticised, although some politicians argue, that they are behaving anti-socially and are a source of growing unemployment and social injustice. This opinion is broadly shared in regard to social fraud, illegal employment and extensive tax evasion. But what about part time illicit work in the evening (“moonlighting”), which e.g. about half of the population in Germany would tolerate or even take advantage of, if they had the opportunity to make use of it?<sup>2</sup> Can more sanctions and control combined with more regulation be the ultimate solution to combat illicit work, or what is the right way to deal with undeclared work?

In popular scientific media and daily newspapers, the discussion about the nature of the shadow economy fluctuates between two extremes: Either, the shadow economy is blamed for many problems of economic policy, such as unemployment, high public debt, and the recession. Or, it is regarded as a legitimate free space in an economic system, which is characterised by high taxes and too much regulation. In social science, articles and papers dealing with the shadow economy often only focus on one single aspect, mostly the difficulties and challenges to measure its size. In addition, the basis of the analysis of the causes and consequences of the increasing shadow economy is often quite narrow and does not take results and insights of other social sciences into account. Therefore, a comprehensive overview and scientific analysis of this complex phenomenon is necessary.<sup>3</sup>

The main interest in the shadow economy focuses on three areas, which will be analysed in more detail here:<sup>4</sup>

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<sup>1</sup> See for example EU-Commission (1998), EU-Parliament (2000).

<sup>2</sup> See Enste (2001a, pp.158f; 2002).

<sup>3</sup> See for a comprehensive and more detailed analysis Enste (2002).

<sup>4</sup> See also Weck/ Pommerehne/ Frey (1984); Gaertner/Wenig (1985); Petry/ Wied-Nebbeling (1987); Feige

a) In *economic and social politics* the driving force for dealing with illicit work is the fact that these illegal and semi-legal activities are undesirable for official institutions. A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the “exit option” rather than the “voice option”, that is voting and using . If the increase of the shadow economy is caused by a rise in the overall tax and social security burden together with “institutional sclerosis” (Olson, 1985), then the “consecutive flight” into the underground may erode the tax and social security bases. The result can be a vicious circle of a further increase in the budget deficit or tax rates, additional growth of the shadow economy, and gradual weakening of the economic and social fundament of collective arrangements.

In addition, the effects of the shadow economy on the official one must be considered, because illicit work can be a source of allocation distortions, since resources and production factors are not used in the most efficient way. On the one hand, a growing shadow economy may attract (domestic and foreign) workers away from the official labour market and create competition for official firms. On the other hand, at least two-thirds of the income earned in the shadow economy is spent in the official economy, thereby having a positive and stimulating effect on the official economy.<sup>5</sup>

Furthermore, a prospering shadow economy may cause severe difficulties for politicians because official indicators, e.g. on unemployment, labour force, income, GDP, and consumption, are distorted. Policy based on erroneous indicators is likely to be ineffective, or worse. Therefore, the reciprocal effects between the shadow and the official economy have to be considered when planning measures of economic policy, especially fiscal policy. If underground activities occur in an economy, the tax revenue might reach the negatively sloped part of the Laffer-Curve, where higher tax rates result in a lower tax yield.

b) In social *sciences* the shadow economy is foremost a challenge for economic theory and economic policy. In economic and social science answers have to be found for questions like: why are people working illicitly, why are transactions made in the shadow economy, and what are the effects resulting from this behaviour? Currently theoretical approaches in different social sciences exists, that concentrate on single aspects of this complex phenomenon. But, since a coherent, integrative and interdisciplinary approach for the analysis of the causes is missing, the development of a systematic, basic “model” is necessary.

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(1989) und Thomas (1992).

<sup>5</sup> This figure has been derived from polls of the German and Austrian population about the (effects of) the shadow economy. For further information see Schneider (1998b). Moreover the results of these polls show that two-thirds of the value added produced in the shadow economy would not be produced in the official economy if the shadow economy did not exist.

In empirical studies, the problems of measuring size and development of the shadow economy with different methods have to be examined. The theoretically derived causes and consequences of shadow economic activities have to be investigated empirically. Feedback effects on the official economy as well as interactions between the two sectors have to be considered and measured.<sup>6</sup>

c) The most difficult task for *economic policy researchers* is to convey the often not very much appreciated results of the scientific analyses to politicians, and to convince them, that the findings are relevant and correct. But we try to make suggestions for economic policy measures, that are based on the analysis of the relations between causes and effects of the shadow economy. They go far beyond the guidelines laid down by the EU-Commission in their pan-European employment strategy for combating illicit work.<sup>7</sup> Their guidelines demand an exchange of “good practice models” and a co-ordination on the EU level to combat illicit work, e.g. by stricter controls and harsher sanctions. Unfortunately, these propositions are not new and they often do not go beyond trying to cure the symptoms. Instead, reforms of the tax system and the social security system are necessary, which could improve the dynamics of the official economy and make the official institutions more competitive within the (national and international) different institutional arrangements.

The discussion about adequate economic policy is often influenced by ideologies. One can find every position, from a forced denial of the phenomenon “shadow economy” to imaginative exaggerations of its size and impact. The starting point of nearly all controversies are the different estimates of the size of the shadow economy, as this is often regarded as vital for a reliable analysis. Unfortunately – due to this attitude – research efforts are fixated on questions like: which is the best method to estimate the extent of the shadow economy, how large is the shadow economy labour force and how is it changing over time?

But the analysis of causes and consequences of the increase of the shadow economy is much more important. The analysis of causes and of the effects of the shadow economy on the resource allocation, income distribution, and stabilisation policy as well as on the official economy in general provides the foundation for propositions of economic policy of treating illicit work as an economic and social challenge. I will propose a “Two-Pillar-Strategy”, with two approaches of dealing with the phenomenon: (1) Reducing the attractiveness of evading taxes and regulations (Exit-Option) and (2) Improving the ways of voting and influencing the formal institutions (Voice-Option).

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<sup>6</sup> See Schneider/ Enste (2000a/ 2000b) and Cowell (1990); Thomas (1992); Pozo (1996), Spiro (1997), and Lippert/ Walker (1997).

<sup>7</sup> In Europe, these occupations supposedly resemble 10-28 million regular employment positions. See publication of the Commission: "Undeclared Employment" of 11th June 1998.

## 2 Shadow Economy, Tax Evasion and Illicit Work

When examining the phenomenon “shadow economy“ the definition is of utmost importance. Many scientific controversies and political discussions arise due to differing or unsatisfactory definitions.<sup>8</sup> To analyse the causes and, above all, to estimate and evaluate the consequences of the increasing shadow economy, it is necessary to clarify what is meant by the latter in each context.

Since the term “shadow economy” comprises numerous economic activities it is difficult to provide a formal definition. For example, one has to distinguish between goods and services produced and consumed within the household, “soft” forms of illicit work (“moonlighting”), illegal employment and social fraud, as well as criminal economic activities.<sup>9</sup>

In general, the shadow economy can be seen as the „emigration from the established ways of working” (Stützel, 1980, p.453; own translation) or, as the German Council of Economic Experts (SVR, 1980, p.145, Tz.296 own translation) – defines it, as „a decision against the official norms and formal institutions for economic activity.“

But a more detailed definition is needed for analysing the (il-)legality of economic activities as well as their connection to tax evasion. Pure tax evasion via financial transactions is excluded from this analysis, as it does not render added value and is usually not meant, when someone is talking about the shadow economy.<sup>10</sup>

The difference between “Pure Tax Evasion” and “Underground Economy” is explained clearly in Lippert/ Walker (1997). Shadow economic activities almost always imply the supply of goods and services, which are produced with resources such as work, managerial or industrial activities and capital. In opposite to this, pure tax evasion usually results from financial transactions, carried out with the objective to conceal income, e.g. capital income.

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<sup>8</sup> A small selection of terms, which are either used synonymously or for different areas, according to the respective author: underground economy, illicit work, informal sector, irregular sector, leisure economy, alternative economy, black economy, hidden economy, unofficial economy, parallel economy, shadow economy, unobserved economy, unrecorded economy. See amongst others Thomas (1992 p.125).

<sup>9</sup> See Bhattacharyya (1999); Dixon (1999); Giles (1999b); Tanzi (1999) and Thomas (1999).

<sup>10</sup> Schmoelders, who invented the term in the 1980s, generally summarises under shadow economy tax evasion, and grey to black markets, which are „expression and correction of the official market order (Schmoelders, 1980, p. 372 own translation). In his opinion, the main categorisation criterion is the secrecy of the financial transactions. Hence, the shadow economy comprises the entire turnover, which is obtained in this economic system with its specific markets, competition rules, customs, marketing strategies and investments.

These aspects are especially important for fiscal policy and public finance and are elaborated on in these areas.

From the point of view of economic policy, those shadow economic activities related to the added value as well as their influence on the allocation of resources are particularly relevant. Concerning the evaluation of the activities (in a context of economic order), one has to distinguish between the output of illegal and legal activities on the one hand and legal and illegal production and distribution of these activities on the other. The following Figure 1 clarifies this definition. Yet, the boundaries between the sectors are not clearly defined and they are changing during economic development.<sup>11</sup>

*Figure 1: Categorisation of the underground economy*

The underground economy can in principle be divided into four sectors. The informal economic activities may be defined in terms of the two criteria of market transactions and legality. Hence, the underground economy can be logically separated into a legal and an illegal sector.<sup>12</sup> Then, the legal sector can be defined as self-sufficient economy and the illegal one as shadow economy or hidden economy.

The self-sufficient economy can be differentiated according to whether market transactions take place (informal sector, alternative economy) or not (household sector). The latter includes e.g. Do- It- Yourself (DIY). The informal sector is predominant in developing and transforming countries, where small firms produce a large share of the economic added value.<sup>13</sup> The difference between the latter and the irregular sector is that these informal activities are not prosecuted in many countries, even though certain regulations and administrative rules are ignored or they act on the border of illegality. Thomas (1992, p. 4; pp. 87f) introduces “law enforcement” as a boundary criterion. Hence, not the existence of laws and regulation is relevant but their enforcement and supervision by the administration. The latter is hardly present in the informal sector whereas there are intensive controls and investigations in the irregular sector. Thus, the activities in the informal sector are often not connected to tax evasion and they are part of a mostly legalised field, which is tolerated by the state.

As opposed to this, activities in the shadow economy in specific are connected to gainful employment accompanied by tax evasion or unlawful behaviour. The difference between the

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<sup>11</sup> See also Asea (1996); Mirus/ Smith (1997, p.5); Smith (1997, p.13); Petry/ Wied-Nebbeling (1987, p.14ff); Thomas (1992, p.6).

<sup>12</sup> See also Thomas (1992, p. 4 and 6).

<sup>13</sup> De Soto (1989) describes this area very imaginative by the example of Peru. He also clarifies the difficulties, which often arise when the individual wishes to switch into the official sector.

“Criminal Sector” and the “Irregular Sector” (Thomas, 1992, pp.3f) stems from the fact that production/ distribution *and* output of criminal activities are illegal (drugs trafficking, slave trade, prohibited gambling). On the other hand, the occupation in the irregular sector only becomes part of the shadow economy, if the distribution and the production is illegal, since the output is legal! Most of these irregular activities can be summarised under the term “Illicit Work“. Irregular actions include producing goods or offering services, while receiving social insurance without informing the labour office (social security fraud); being self-employed and operating an industrial enterprise without complying with the regulations of the industrial code or practising a handicraft without being registered. Offences against this legislation are prosecuted as irregularities and are punished with a fine of up to 300.000 Euro since 2002 in Germany.<sup>14</sup>

In opposite to this, in a lot of OECD-countries economic activities resulting from favours, neighbourhood assistance and small scale activities are explicitly excluded from punishment. Therefore, these are in this cases part of the informal sector.

The irregular sector is analysed more closely here. It is characterised by market transactions. The production and distribution of these goods and services becomes unlawful either by illegal production or by prohibited trade or in combination with tax evasion. The produced goods or services themselves are not illegal. A paperhanger plastering wallpaper in Germany only works illicitly, if he does this on the weekend and receives a cash payment without an invoice. Usually, a wide range of activities is summarised under the term “illicit work”, such as e.g. minor handicraft services after regular working hours and organised illegal employment in combination with tax evasion. Or bypassing the laws of competition and of craftsmanship and social security fraud. The irregular sector also includes legal activities, which are carried out legally, but are still regarded as part of the shadow economy when combined with tax evasion, as this income is not grasped by the inland-revenue office (e.g. the occasional freelancing, usually subject to income tax, as well as the non-declaration of tips and assessable gifts).

With this specification highlighted grey in the Figure, the production of private households as well as voluntary work for charities is excluded from the further analysis. Following Tanzi’s line of argumentation (1999, p. 338), activities, which do not generate added value but merely imply a financial gain for the individual, are also ruled out (prostitution, murder, kidnapping etc.). Furthermore, pure tax evasion is not included in the following analysis either. Hence, the shadow economy (especially illicit work combined with tax evasion) is the subject of this study. Illicit work, carried out either on a part-time basis by individuals (“moonlighting”) or

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<sup>14</sup> See also § 1 SchwArbG, BMA (1998).



as part of the activities of a firm (“sole job”) constitutes the largest element of the shadow economy.<sup>15</sup>

### **3 An Evolutionary Theory of the Shadow Economy**

A growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose the “exit option” rather than the “voice option”. Because the increase of the shadow economy is caused by a rise in the overall tax and social security burden together with institutional sclerosis, the increase of underground activities erodes the tax and social security bases. The result is a further increase in the budget deficit or tax rates, additional growth of the shadow economy, and gradual weakening of the economic and social fundament of collective arrangements. This effect is illustrated in figure 2.

Apart from the shadow economy, physical or economic migration into other countries are important “exit”-options. The increasing mobility within the EU strengthens the effectiveness of the latter, as long as there is no harmonisation of the tax and social security systems. When dissatisfied with the public goods offered in the own country, the tax-payer can emigrate. Also the possibility to engage in shadow economic activities limits the taxation authority of the government. The Shadow economy forms an endogenous boundary.

The correlation between individual reaction and taxation is illustrated in the following modified figure of the Laffer-Curve (1979), which originally depicts the effect of tax evasion via more leisure time. Gutmann (1981) modified the figure by integrating the possibility to engage in shadow economic activities.

The top part of the graph shows the correlation between tax rate and tax yield, which is the centre of the political discussions, especially in the USA. However, this has not yet been underpinned either theoretically or empirically. The axes show the aggregated tax rate in per cent of the income and the tax yield. The more the state increases the tax rates, the more the opposition augments. If the yield maximum in S (tax rate  $t^*$ ) is surpassed, the internal revenue decreases despite rising tax rates, as the citizens try to avoid paying. Lowering the rates would in this case even result in a higher yield, as the negative incentives are no longer evident.

*Figure 2: The Correlation Between Tax Yield, Tax Rate and the Development of the Shadow Economy*

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<sup>15</sup> The most recent figures of the size and development of the shadow economy in OECD and transition countries would have normally been added here. Please refer to the article of Schneider in this volume for this figures and data.

The lower part of the graph shows the connection to the shadow economy.<sup>16</sup> To simplify, the economy is divided into three sectors (public sector, official and shadow economy). Considering the development of an economy over time, at the beginning, the informal sector was prominent. The introduction of an extensive official economy is not possible without state activity. If the former grows, so does the latter, as it requires resources.

When taxes are introduced, the positive effects predominate. There are positive incentives to switch to the official economy, if the state actually ensures property rights as an equivalent for taxes. Where exactly the optimum lies, cannot be generalised, it differs from country to country. One possibility is that the citizens get accustomed to the increasing use of resources by the state, so that this does not necessarily result in a growing shadow economy.

Due to the tax yield maximisation connected to the budget maximisation, the taxes are increased. Frey und Weck (1983a) show, that this leads to an increase in the supply of jobs in the public sector resulting in an immigration of individual, who were employed in the official sector. The rising tax burden results in stronger incentives to work illicitly. Once the tax yield has reached its maximum, the public sector can no longer expand, as the working persons will increasingly engage in shadow economic activities at each attempt of elevating taxes. If the public sector expands even more, this could entail a return to the pre-constitutional state of the economy, in the extreme case anarchy. Then, a new set of rules would be developed for society, as regulations and supplying resources for state activity are of advantage. Financing the state requires seizing economic activities. A part of the shadow economic activities is transferred into the official sector, as here p. ex. property rights are protected.

These considerations show that the perception of public equivalents is an important criterion for the decision to work illicitly. If the former is legitimate, this will not result in a rise of shadow economic activity.

The Income-Leisure-Model is suitable to illustrate the basic economic conception, where avoiding allocation distortions is always the main objective. Yet, there are some topics that need to be looked at critically. These will be explained with help of the Welfare Theory on taxation. In Welfare Economics, one assumes a government that acts as a „benevolent“ dictator and wants to maximise aggregate welfare. On account of this, broad tax liabilities, low marginal tax rates or ideally even poll taxes are proposed to avoid allocation distortions and to optimise taxation. The demands concerning taxation and transfer payments, based on this theory have been thoroughly discussed in Public Finance. Besides the constraining assumptions, neglecting the behaviour of the government and other institutions is criticised.

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<sup>16</sup> For a simplified figure, which ignores the effects of state activity, see Frey/ Weck (1983a); Neck/ Schneider/ Hofreither (1989); Blankart (1998, pp. 240f) and Windisch (1984).

The optimistic assessment of the governing body, who does not maximise its own utility but that of society and thus acts entirely differently than otherwise assumed in economics does not seem plausible to the supporters of modern Public Finance.<sup>17</sup>

In the current Public Finance, the presumption of the welfare maximising government is substituted by an egoistic one, whose objective is to maximise its budget to gain more influence over public funds and thus have further power. In the Leviathan theory on taxation, it is assumed that the government raises more taxes than needed to supply the optimal amount of public goods, i.e. it reaps the full benefits of the taxation potential. The tax-payer has no possibility of reacting except via tax evasion. Therefore Brennan and Buchanan (1980) refuse to support optimal taxation, even if allocation distortions could be avoided. A broad tax base with little possibilities of evasion would ultimately augment the taxation power of the government and the tax-payer would be at the mercy of the „Leviathan state“ even more. Hence, Brennan and Buchanan find it necessary to develop clear boundaries for taxation, i.e. regulation for taxation and for budgeting. Despite the critique of the Leviathan Model, which is related to the pessimistic judgement of the government, the model has contributed to describing the politicians as actors. With this it counterbalances the Welfare-Economic Theory.

In the context of the New Political Theory, currently numerous approaches are being developed, where it is attempted to explain the behaviour of the governing body more realistically. Blankart (1998, pp.227f.) proposes the implementation of democratic elements to stop budget maximisation and the waste of taxes. This is an alternative to the usual suggestion of introducing constitutional regulations as an effective control mechanism of the government. One possibility would be to introduce facultative referendums on the total budget or on the public budgeting via taxes and loans. This form of control and protection is necessary in the context of regarding politicians as being self-interested economic actors as well as in that of the considerations from the New Political Economy and the Leviathan-state Model.

This short insight into an evolutionary approach to the implications of the shadow economy, which serves as a normative foundation for the following analysis and the proposals for economic policy, is further elaborated and theoretically derived in Enste (2002).

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<sup>17</sup> For an illustrative compressed explanation of the various theoretical approaches, see Blankart (1998, pp. 201-248).

### 3 What are the Main Causes of the Increase of the Shadow Economy?

The increase of the shadow economy has been caused by many different factors but the most important and most often cited ones are:<sup>18</sup>

- the rise of the burden of taxes and social security contributions combined with the increase in the density and intensity of regulations in the official economy, especially on labor markets’,
- the (forced) reduction of weekly working time, the earlier retirement and the increasing unemployment rate, and
- the long-term decline of civic virtue and loyalty towards public institutions combined with a declining tax morale.

An interdisciplinary analysis of the causes responsible for the increase of the shadow economy seems to be necessary, since the economic factors can only partly explain the increase.<sup>19</sup> Especially micro-sociological, and psychological approaches can provide interesting additional insights in the decision process of individuals choosing to work in the underground. In an interdisciplinary approach (like undertaken in Economic Psychology) variables such as tax morale, which was first discussed by Günter Schmolders (1960, 1975), and other factors like acceptance and perceived fairness of the tax system are considered.<sup>20</sup>

#### 3.1 *The Influence of Tax and Social Security Contribution Burden*

In almost all studies the rise of the tax and social security contribution burdens is one of the most important causes of the increase of the shadow economy.<sup>21</sup> Since taxes affect labor-leisure choices, and also stimulate labor supply in the shadow economy, or the untaxed sector

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<sup>18</sup> When dealing with the various causes in the following sections 4.1 to 4.5 the most important references are given. For an overall view see the studies by Tanzi (1982); Frey and Pommerehne (1984); Thomas (1992) and Schneider and Enste (2000b).

<sup>19</sup> Although until now interdisciplinary research focuses on tax compliance, see e.g. Alm, Gary H. McClelland and William Schulze (1999), Cowell (1990), Pommerehne, Albert Hart and Frey (1994) and the special issue on “Economic Psychological Perspectives on Taxation” of the Journal of Economic Psychology (December 1992), it is also useful for explaining other (hidden) activities, see Frey (1997b).

<sup>20</sup> For a further discussion of the importance of interdisciplinary research see Jon Elster (1998), and Shira B. Lewin (1996). For a broader view see Robert H. Frank (1988) and Frey (1997b).

<sup>21</sup> See e.g. the studies by Tanzi (1982); Frey and Pommerehne (1984a/b); Feige (1989); Susan Pozo (1996); Owen Lippert and Michael Walker (1997); Schneider (1994a, 1994b, 1997, 1998a); Thomas (1992), Hernando De Soto (1989), Ben-Zion Zilberfarb (1986), Tanzi (1999), Giles (1999a) and Schneider and Enste (2000b).

of the economy, the distortion of this choice is a major concern of economists. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings (from work), the greater is the incentive to avoid this difference and to work in the shadow economy. Since this difference depends broadly on the social security system and the overall tax burden, they are key features of the existence and the increase of the shadow economy.

A recent macroeconomic analysis of some of the causes for the increase of the shadow economy is given by Norman V. Loayza (1996). He presents a simple macroeconomic endogenous growth model whose production technology depends on congestable public services. The determinants and effects of excessive taxes and regulations on the informal sector are studied, where the government lacks the capability to enforce compliance. His empirical approach treats the informal sector as an unobserved variable for which multiple causes and multiple indicators exist and he uses the Multiple-Indicator-Multiple-Cause (MIMIC) model (see part 6.3). He estimates the size of the informal sector in 14 Latin American countries and finds some evidence for three determinants being significantly relevant at the 10 percent confidence level. Tax burden (0.33) and labor-market restrictions (0.49) affect the relative size of the informal sector positively, while the strength and efficiency (-0.42) of the government institutions have a negative influence leading to a decrease of the informal sector.<sup>22</sup> Because Loayza's approaches only show statistical correlations rather than causal relations, he can only partly provide answers to questions like: Why do people choose to work in the shadow economy? What other factors (besides income motive) cause an increase of informal activities? Can other theories provide further help in determine relevant factors? Since, according to the methodological individualism, only individuals can choose, it might be helpful to have a closer look at the individual decision (with respect to the influence of the tax and social security burden) to work in the shadow economy.

The strong influence of indirect and direct taxation on the shadow economy can be demonstrated by discussing empirical results in the case of Austria and the Scandinavian countries. In the case of Austria, Schneider (1994b) estimates a currency demand function including as driving forces for the shadow economy the following four types of variables:

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<sup>22</sup>The numbers indicate the change of the size of the informal sector (in standard-deviations) with a one-standard deviation increase in each of the determinants.

- The burden of total direct taxation,
- the burden of indirect taxation,
- the complexity of the tax system and
- the intensity of government regulations.

The estimated coefficient of the independent variable, direct tax burden (including social security payments), has the biggest influence, followed by the intensity of regulation and complexity of the tax system on the currency demand. A similar result has been achieved by Schneider (1986) for Scandinavia (Denmark, Norway and Sweden). In all three countries various tax variables (average direct tax rate, average total tax rate (indirect and direct tax rate)) and marginal tax rates have the expected positive direction of influence (on currency demand) and are highly statistically significant.<sup>23</sup>

Two other recent studies provide strong evidence of the influence of income taxes on the shadow economy: Richard J. Cebula (1997), using Feige data for the shadow economy, found evidence of the impact of government income tax rates, IRS audit probabilities, and IRS penalty policies on the relative size of the shadow economy in the United States. Cebula concludes that a restraint of any further increase of the top marginal income tax rate may at least not lead to a further increase of the shadow economy, while increased IRS audits and penalties might reduce the size of the shadow economy. His findings indicate that there is generally a strong influence of state activities on the size of the shadow economy: For example, if the marginal federal personal income tax rate increases by one percentage point, *ceteris paribus*, the shadow economy rises by 1.4 percentage points. In another investigation, Roderick Hill and Muhammed Kabir (1996) found empirical evidence that marginal tax rates are more relevant than average tax rates, and that a substitution of direct taxes by indirect taxes seems unlikely to improve tax compliance.

More evidence on the effect of taxation on the shadow economy is presented by Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobatón (1998a, 1998b), who come to the conclusion that it is not higher tax rates *per se* that increase the size of the shadow economy, but the ineffective and discretionary application of the tax system and the regulations by governments. Their finding, that there is a *negative* correlation between the size of the unofficial economy and the *top* (marginal) tax rates, might be unexpected, but since other factors like tax deductibility, tax reliefs, tax exemptions, the choice between different tax systems, and various other options for legal tax avoidance were not taken into account, it is

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<sup>23</sup> Similar results are reached by Gebhard Kirchgassner (1983, 1984) for Germany and by Jan Klovland (1984) for Norway and Sweden.

not all that surprising. Eric Friedman, Johnson, Kaufmann and Zoido-Lobato (1999) found a similar result in a cross country analysis that *higher* tax rates are associated with *less* unofficial activity as percent of GDP. They argue entrepreneurs go underground not to avoid official taxes but they want to reduce the burden of bureaucracy and corruption. However looking at their empirical (regression) results the finding that higher tax rates are correlated with a lower share of the unofficial economy is not very robust and in most cases, using different tax rates, they do not find a statistically significant result. The overall conclusion of the studies is, that there is a large difference between the impact of either the direct tax or the corporate tax burden and institutional aspects, like the efficiency of the administration, the extent of control rights held by politicians and bureaucrats, the amount of bribery and especially corruption. Johnson, Kaufmann, and Zoido-Lobato (1998b) think these aspects play a bigger role in the “bargaining game“ between the government and the taxpayers than the tax burden.

### 3.2 *Intensity of Regulations*

The increase of the intensity of regulations (often measured in the numbers of laws and regulations, like licenses requirements) is another important factor, which reduces the freedom (of choice) for individuals engaged in the official economy.<sup>24</sup> One can think of labor market regulations, trade barriers, and labor restrictions for foreigners. The influence of labor regulations on the shadow economy is clearly described and theoretically derived in studies, e.g. for Germany.<sup>25</sup> Regulations lead to a substantial increase in labor costs in the official economy. But since most of these costs can be shifted on the employees, these costs provide another incentive to work in the shadow economy, where they can be avoided.

Further empirical evidence provides the model of Johnson, Kaufmann and Andrei Shleifer (1997), which predicts, inter alia, that countries with more general regulation of their economies tend to have a higher share of the unofficial economy in total GDP. A one-point increase of the regulation index (ranging from 1 to 5, with 5 = the most regulation in a country), ceteris paribus, is associated with an 8.1 percentage point increase in the share of the shadow economy, when controlled for GDP per capita (Johnson, Kaufmann, and Zoido-Lobato (1998b, p. 18). They conclude that it is the enforcement of regulation, which is the key factor for the burden levied on firms and individuals, and not the overall extent of regulation - mostly not enforced - which drive firms into the shadow economy. Friedman, Johnson, Kaufmann and Zoido-Lobato (1999) reach a similar result. In their study every

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<sup>24</sup>See for a psychological, theoretical foundation (theory of reactance) of this feature Jack W. Brehm (1966, 1972), and for a (first) application to the shadow economy Linde Pelzmann (1985). See Enste (2002) for an integration of this theory in an interdisciplinary (rational choice) approach.

<sup>25</sup> See Deregulation Commission (1990/91), Monopolkommission (1998).

available measure of regulation is significantly correlated with the share of the unofficial economy and the direction of the correlation is unambiguous: *more regulation is correlated with a larger shadow economy*. A one point increase in an index of regulation (ranging from 1-5) is associated with a 10 % increase in the shadow economy for 76 developing, transition and developed countries.<sup>26</sup>

These findings demonstrate that governments should put more emphasis on the reduction of the density of regulations or at least on improving enforcement of laws and regulations, instead of increasing the number of regulations. Some governments, however, prefer this policy option (more regulations and laws), when trying to reduce the shadow economy, mostly because it leads to an increase in power of the bureaucrats and to a higher rate of employment in the public sector. Besides, politicians might not really have an interest in a substantial decrease of the shadow economy, since a lot of voters gain from unofficial activities. The signaling of “fighting for law and order” might therefore be more useful for the chances of being reelected than radical reforms of the tax and the social security systems.<sup>27</sup>

### 3.3 *Labor Market*

The numerous regulations on the official labor market and the total wage costs are also driving forces for the shadow economy. Two main aspects - the effects of the reduction in official working hours and the influence of the unemployment rate on the increase of the shadow economy - are discussed quite often in this context:

- As in most OECD-countries unemployment is to a large extend caused by the fact that total labor costs are too high, this can be seen as a cause for an increase of the shadow economy.
- The reduction in working hours in the official economy was introduced by governments (e.g. France) and/or labor unions (e.g. Germany) in order to reduce the unemployment rate. An overview of these economic policy measures is given in OECD (1998, pp. 123-188). The idea behind this is that there is only a limited quantity of work, and that this quantity has to be “redistributed“. But this idea neglects a key factor that especially a forced reduction of working hours against the preferences of the employees increases the potential of hours that can be worked in the shadow economy, see for example Jennifer Hunt (1999).<sup>28</sup> Early retirements can also lead to more unofficial activities and part time

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<sup>26</sup> De Soto (1989) describes in his famous book in more detail the costs of regulation in Peru.

<sup>27</sup> See for example Frey (1989) for an application of the Public Choice Theory to the shadow economy and for a further discussion Enste (2001).

<sup>28</sup> After Volkswagen in Germany reduced the working hours considerably, there is some (until now basically anecdotal) evidence, that in the area around the firm, much more reconstruction and renovation of houses took



work offers great opportunities to the individual to adopt another job in the untaxed, unregulated economy, as argued by de Gijssel (1984) and Riebel (1983, 1984). The redistribution of work can only be successful, if the reduction is either in accordance to the individual preferences and they want to maximize their leisure time or they are incapable of work, because otherwise they might choose to keep on working – in the underground.<sup>29</sup>

More detailed information of the labor supply decision in the underground economy is given by Lemieux, Fortin, and Fréchet (1994) using micro data from a survey conducted in Quebec City (Canada). The results of their study suggest that hours worked in the shadow economy are quite responsive to changes in the net wage in the regular (official) sector. Their empirical findings clearly indicate, that “participation rates and hours worked in the underground sector also tend to be inversely related to the number of hours worked in the regular sector“ (Lemieux, Fortin, and Fréchet 1994 p. 235). In total their results emphasize a large negative elasticity of hours worked in the shadow economy with respect to the wage rate in the regular sector and also a high mobility between the sectors. A (further) reduction of (official) working hours can therefore lead to an increase of the shadow economy, since – for example in Germany – almost all recent empirical investigations show that most of the employees do not want a further reduction at all (Enste 2002, DIW 1998, Bosch and Lehndorff 1998). Hence, a reasonable economic policy suggestion is a higher flexibility of working hours in accordance to the preferences of the employees, because this minimizes the distortion of the individual decision by this kind of labor market restrictions.

### 3.4 *Public Sector Services*

An increase of the shadow economy leads to 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 the tax rates for firms and individuals in the official sector, quite often combined with a deterioration in the quality of the public goods (such as the public infrastructure) and of the administration, with the consequence of even stronger incentives to participate in the shadow economy. Johnson, Kaufmann, and Zoido-Lobaton (1998b) present a simple model of this relationship. Their findings show that smaller shadow economies appear in countries with higher tax revenues, if achieved by lower tax rates, fewer laws and regulations and less bribery facing enterprises. Countries with a better rule of the law, which is financed by tax revenues, also have smaller shadow economies. Transition countries have higher levels of regulation leading to a significantly higher incidence of bribery, higher effective taxes on

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place compared to similar other regions.

<sup>29</sup> See Gary S. Becker (1965) for the theoretical foundation and F. Thomas Juster and Frank P. Stafford (1991) for a more detailed analysis of the allocation of time.

official activities and a large discretionary framework of regulations and consequently to a higher shadow economy. Their overall conclusion is 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, sizeable revenue mobilization, good rule of law and corruption control, and (relatively) small unofficial economy. By contrast, a number of countries in Latin American 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.” (Johnson, Kaufmann and Zoido-Lobaton 1998a p. I).

Therefore, in a lot of countries the public sector is facing the challenge to impose substantial reforms of the social security and tax systems to prevent the total defeat of the protective welfare state, because of the vicious circle of high tax and regulation burdens causing an increase of the shadow economy, causing additional pressure on public finance resulting in higher tax rates, which are again increasing the incentives to evade taxes and to escape in the shadow economy and so on. The shadow economy can therefore be seen as a challenge to the welfare state. Since in a cumulative process existing institutions and rules might lose their acceptance in the society, ending up in a situation, where democratic voting (voice) is less attractive than using the exit option “shadow economy”. Eventually, the loyalty to the democratic political institutions is abandoned or cannot be developed as can be seen in some former Soviet Union states. The institutional and economic change is described in the following, simplified figure.

*Figure 3: Economic and Institutional Change*

### *3.5 Main Causes in Eastern Europe*

In Eastern Europe, in addition to the causes mentioned above, the following main causes for the increase of the shadow economy are important:

- Lack of competence and trust in official institutions (e.g. legislation, administration/bureaucracy, courts).
- The administration is often inefficient and corrupt.
- Property rights can not be guaranteed by the official institutions and people search for other options.
- The development of informal and unofficial institutions, causes negative side effects (e.g. more power for the “Mafia”), but also positive effects of forming informal social structure supporting the weak official structures.

- Inadequate enforcement of laws and regulations.
- High costs and administrative burden for entrepreneurs.
- High taxes – in combination with no adequate supply of public goods and infrastructure – lead to less acceptance of formal rules and laws.
- A low probability of being caught as a illicit worker or tax evader results in a cost-benefit-calculation where illicit work is more attractive than regular and official work.
- Sometimes “hiding in the shadows” is essential for surviving or to establish a business.
- Finally, a broad acceptance of illicit work (e.g. access to credits and banks in the shadow economy), makes it difficult to fight illicit work.

## 4 The Effects of the Shadow Economy on the Official Economy

The analysis of the effects of an increasing shadow economy is quite difficult and comprehensive empirical evidence is not available. Most studies focus on the influence on the allocation of resources and the loss of revenue for the state. But the impact on the official institutions, norms and rules is even more important. The shadow economy can be seen as an indicator of a serious deficit of legitimacy of the present social order and the current rules of official economic activities. The exit-option “shadow economy” is an important restriction for the Leviathan state and can secure economic freedom and liberty.<sup>30</sup>

In order to study the effects of the shadow economy on the allocation of resources in the economy, several studies integrate underground economies into macroeconomic models.<sup>31</sup> John F. Houston (1987) develops a theoretical macro model of business cycle as well as tax and monetary policy linkages with the shadow economy. He concludes from his investigation of the growth of the shadow economy that, on the one side its effect should be taken into account in setting tax and regulatory policies and on the other side the existence of a shadow economy could lead to an overstatement of the inflationary effects of fiscal or monetary stimulus. Markus C. Adam and Victor Ginsburgh (1985) focus on the implications of the shadow economy on "official" growth in their study for Belgium. They find a positive

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<sup>30</sup> See for the importance of institutions and the impact of the shadow economy for example Geoffrey Brennan and James M. Buchanan (1980, 1985).

<sup>31</sup> For Austria this was done by Neck, Hofreither, and Schneider (1989). For further discussion of this aspect see Peter J. Quirk (1996) and Giles (1999a).

relationship between the growth of the shadow economy and the "official" one and under certain assumptions (i.e. very low entry costs into the shadow economy due to a low probability of enforcement) they conclude that an expansionary fiscal policy has a positive stimulus for both the formal and informal economies. A study for the United States by Ronald Fichtenbaum (1989) argues that the U. S. productivity slowdown over the period 1970 to 1989 was vastly overstated, as the underreporting of income due to the more rapid growth of the U. S. shadow economy during this period was *not* taken into account.

Another hypothesis is, that a substantial reduction of the shadow economy leads to a significant increase in tax revenues and therefore to a greater quantity and quality of public goods and services, which ultimately can stimulate economic growth. Some authors (e.g. Loayza, 1996) found evidence for this hypothesis.

Depending on the prevailing view of the informal sector, the underground economy might be seen as optimal in the sense that it responds to the economic environment's demand for urban services and small-scale manufacturing. From this point of view the informal sector provides the economy with a dynamic and entrepreneurial spirit and can lead to more competition, higher efficiency and strong boundaries and limits for government activities. The informal sector may also offer great contributions "to the creation of markets, increase financial resources, enhance entrepreneurship, and transform the legal, social, and economic institutions necessary for accumulation" (Asea 1996 p. 166). The voluntary self-selection between the formal and informal sectors may provide a higher potential for economic growth and, hence, a positive correlation between an increase of the informal sector and economic growth. The effects of an increase of the shadow economy on economic growth therefore remain considerably ambiguous.

The empirical evidence of these opposite hypotheses is also not clear. Since many Latin American countries had or still have a tradition of excessive regulations and weak government institutions, Loayza (1996) finds some evidence of the implications of his growth model in the early 1990s in these countries: The increase in the size of the shadow economy negatively affects growth (1) by reducing the availability of public services for everyone in the economy, and (2) by using the existing public services less efficiently, or not at all. But the positive „side effects“ of shadow economy activities must be considered, too. Empirical findings of Schneider (1998b) show clearly that over 66 percent of the earnings in the shadow economy are rather immediately spent in the official sector. This additional expenditure has positive effects for economic growth and for the (indirect) tax revenues. Dilip K. Bhattacharyya (1993, 1999) found clear evidence for the United Kingdom (1960-1984) that the hidden economy has a positive effect on consumer expenditures of non durable goods and services, but an even stronger positive effect on consumer expenditures of durable goods and services. A close

interaction between official and unofficial economies is also emphasized in Giles (1999a) and in Tanzi (1999).

A summary of main consequences is presented in the following figure:

*Figure 4: Consequences of the Increasing Shadow Economy*

## **5 The “Two Pillar Strategy” - „Exit“ and „Voice“ as Behavioural Options**

Following Hirschman (1974), the behavioural options for people can be divided into the options “Exit“ and “Voice“, which are the two aspects of the „Two-Pillar-Strategy“.

*Figure 5. Behavioural Options by Households and Firms*

In a democracy, one has the possibility to voice ones preferences regarding public goods through elections. One votes the party, whose policy corresponds best with the own attitude. To further influence economic order and policy measures, one can either make use of non-democratic communication channels, e.g. referendums, or direct elections, or organise citizen initiatives. Actively participating in pressure groups and unions has an even more intensive impact on the contents of the political process as these not only follow their own interests, but are an important source of information for the politicians.<sup>32</sup>

Furthermore, mass media can manipulate considerably. Even though the power of the media has not yet been fully explained in theory, its importance cannot be denied.<sup>33</sup> Its “Agenda Setting Function” is very suited to bring certain topics to the public attention and raise the public awareness.<sup>34</sup> One example for such an influence is the discussion about the 630-DM jobs, intensively lead by the media.<sup>35</sup> If the mass media publishes surveys, these could possibly influence the public opinion and election results.<sup>36</sup>

Policy consulting also plays a significant role. Various expert councils and economic research institutes form an opinion on political decision on a regular basis and strive to influence politics with numerous publications. To complete the elements of influencing politics, expert

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<sup>32</sup> See e.g. Kirchgässner/ Frey (1994, pp.201f) and Pommerehne/ Weck- Hannemann (1996).

<sup>33</sup> For an illustration of the theoretic approaches of the research on media effects and empirical results, see Schenk (1987).

<sup>34</sup> See Enste (2001, 2002) and Schneider/ Enste (2000a, pp.192-202).

<sup>35</sup> See Schneider/ Enste (2000a, p.1-2) for a documentation.

<sup>36</sup> See Noelle-Neumann (1982, 1989a/b) on the Theory of the “Silence-Spiral”.

opinions by commissions and boards or committees are another possibility of co-determination.<sup>37</sup>

The alternative to this voice option”, which is regarded as unsuccessful by many, is the market reaction “exit”. Free trade firms have the option of changing locations to evade an unwanted economic, taxation or social security system and households can decide to migrate.<sup>38</sup> Engaging in shadow economic activities is another possibility. Here, the options are either tax evasion, e.g. via financial transactions or a fictitious change of location. Or the individuals can decide to work illicitly in the informal, the household or the criminal sector.

The fact that these options exist implies that the democratic state is restricted, as it cannot ignore the preferences of its citizens. This internal pressure to correct economic policy is intensified by external pressure stemming from the rising globalisation. Mobility is increased and so is the number of alternatives. The limit of loyalty is reached if the financial burden becomes too great. The political and social stability and the “bonum commune” are endangered by the rise of the shadow economy. This could cumulate in a malfunction of democracy.<sup>39</sup> The shadow economy is a signal for considerable disruptions within the regulatory system.

### *5.1 Decreasing the Attractiveness of the “Exit-Option*

Implementing the “Two-Pillar-Strategy” decreases the threats to society. The recommendations can be summarised as follows:

*Figure 6: Economic Policy Recommendations to Reduce the Attractiveness of the Shadow Economy*

Reducing the tax rate considerably is the main demand, as it has been determined to be the main cause for the rise of the shadow economy in the integrative model. In addition, the system has to be simplified to attain more transparency and less density in regulation. The latter have undermined the tax base and made tax law complicated, which results in mis-allocation, distortions regarding input and welfare losses. In the long run, tax moral is eroded.<sup>40</sup> Furthermore, an extensive reform of the social security system is necessary, to reduce the burden of contribution payments.

Reactance Theory proposes the following possibilities to reduce the resistance against the tax burden: On the one hand, credibly setting a time limit to the burden could avoid Reactance

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<sup>37</sup> Kirchgässner/ Frey (1994) elaborate on the different methods.

<sup>38</sup> For a simple explanation of the implications of the four basic freedoms within the EU, see Sinn (1995).

<sup>39</sup> See Biedenkopf (1986); Enste (2002); Rürup (1983); Schmidt (1988); Pommerehne/ Kirchgässner (1994).

<sup>40</sup> See section 3.

and negative economic consequences due the migration into the shadow economy.<sup>41</sup> On the other hand, if the infringement of personal freedom is perceived as being legitimate, it will not lead to Reactance. The demand for more transparency of the taxation system and the expenditure policy<sup>42</sup> are then based on the objective, positive social-psychological theory. The loyalty towards the state can also be increased by cutting corruption and waste of tax yield within the public administration. A significant correlation between the two is confirmed by various surveys.<sup>43</sup>

Transfer payments should be increasingly examined regarding the indigence while simultaneously also be made subject to a time limit. This adds to the motivation of the people concerned and avoids many fatal habits. At the same time the transfer payers regard this as being legitimate.

Reducing the density of regulation while at the same time increasing its security, especially on the labour market is a further element of a rational economic policy. Competition would be augmented due to the lower market entry barriers and could thus develop its dynamic welfare effects. Considering the preferences of the employed individuals regarding working time would ensure that these would have less time to engage in illicit activities.

## *5.2 Strengthening the Voice-Option*

On principle, Reactance can be dismantled by solidarity. In economic policy, this has been dealt with under the term “moral suasion“. This means that if the individual accepts the necessity of an infringement of personal freedom, she/ he declares her/ his solidarity with society and perceives the benefits of the state as being sensible. However, if the state informs the citizens about the extent of tax evasion and illicit work, this may have a contradictory effect: citizens willing to pay taxes will only then be informed about the size of the shadow economy. The consequence might be, that they will also work illicitly because they then perceive an unjustness of the burden and hence will try to do something about it.

This negative process can successfully be stopped by the active participation of the people concerned. An often cited example are vendors and politicians, who spiritualise the opinions of the persons they have to represent and make these their own, even if they differ from the opinion they had initially.<sup>44</sup> Transferred onto the democratic decision procedures, this means

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<sup>41</sup> The introduction of the solidarity contribution in Germany was an example for this. However, keeping the set time limit once again poses a considerable problem.

<sup>42</sup> More than 77% of the population demand cuts in state expenditure to finance a tax reform to decrease the burden. (Research Institute for Empirical Social Economy, 1997, p.35).

<sup>43</sup> For a more current overview, see Bardhan (1997); Rose-Ackerman (1999); Mauro (1995); Tanzi (1998).

<sup>44</sup> See Pelzmann (1985 pp.56f).

that the federal elements have to be strengthened and further instruments of the direct democracy (e.g. referendums, legal initiatives) have to be introduced, so that the citizens can increasingly contribute e.g. to the design of the taxation system. The regional commitment and citizen initiatives trying to influence decision could be a clue for the desire to keep or regain control. An increased participation will always diminish the perception of being subject to unfair restrictions of the personal freedom. At the same time, the moral and loyalty is ameliorated, which aids in combating the rise of the shadow economy.<sup>45</sup>

One should act according to the subsidiarity principle on all levels and a further centralization should be impeded.<sup>46</sup> The increasing shift of decision making towards Bruxelles and justifying this with European pressure (e.g. the augmentation of the VAT in Germany for reasons of harmonisation does not strengthen the perception of control over the spending for the taxpayers. The rising centralization often combined with harmonization is not the correct way, when considering the growing shadow economy. An increasing fiscal federalism would counteract the “detachment of state activities from the desires of the citizens“ (Pommerehne/ Kirchgässner 1994, p. 860; own translation). Hence, Frey (1996, 1997a) demands a “new federalism for Europe“. The objective is a combination of federalism and direct democracy. The main features of his proposed new governmental units can be summarized by the term “Functional Overlapping Competing Jurisdictions (FOCJ)“ (Frey 1996, p.275). They are characterized by functional differences in size and geographic over-lapping, resulting in a competition of regions or systems. The individuals can state their preferences in referendums or citizen initiatives. These measures correspond to the subsidiarity principle, because they enable the people to control the politicians and they are bringing the power back to the level, where a lot of problems can be solved more efficiently. Enabling such an institutional framework, which increases the inter-regional competition would on the one hand imply a trust in the citizens, but on the other increase the trust of the public regarding political institutions.<sup>47</sup>

The increased participation of the public raises the commitment, i.e. the personal contribution and the interest for governmental issues and as a consequence can dam up “moral hazard behaviour. Strengthening the participation right can reduce the “Free-rider” problem, as state efforts are regarded as being a fair equivalent ultimately boosting tax moral. One important

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<sup>45</sup> The relatively small Swiss shadow economy can be accounted to the extensive Voice Options. See Kirchgässner (1999) and Weck-Hannemann/ Pommerehne (1989).

<sup>46</sup> In Public Finances and social policy, this principle is regarded as the axiom of the distributions of duties between the private and the public sector as well as communal institutions. Following the subsidiarity principle, one can derive that the tasks can only then be delegated to a higher level, if the lower level is unable to solve the problem. The state should only then assume social assignments, if the individual or the family is over-burdened.

<sup>47</sup> For a theoretical realisation, see Pommerehne/ Frey (1992).



reason for the small extent of the Swiss shadow economy as opposed to other OECD countries is the considerable amount direct democracy elements.<sup>48</sup> In the long run, this leads to a strengthening of social capital and sense of community, which both contribute considerably to the successful survival of societies and the further supply of public goods.<sup>49</sup>

## 6 Conclusion and Outlook

Failing economic policy was confirmed as the most important cause for the strong increase in shadow economic activity. Not only the rising tax burden and regulation density are important reasons for the migration into the hidden economy, but also the defensive labour market policy directed at a re-distribution of working hours. In addition, in transition countries the lack of clear and stable institutions are a driving force of informal economic activities. In combination with a reduced tax moral and less loyalty to the government, this potential will be exploited increasingly. This leads to the conclusion, that a systematic fight of the causes is necessary.

This demand is supported by the causal analysis. Merely increasing the costs of illicit work by intensified controls and higher fines would not bring about positive effects on the overall welfare. Empirical surveys show that a fundamental tax reform was much more apt to impede migration. Besides the allocation effects, the stabilisation effects are important for the whole economy, as the black market acts as stabilisator and buffer, slightly reducing cyclical fluctuations. This holds especially in the current situation with its sclerotic labour markets and strongly regulated industries.

The tax deficits and evasion of social security contributions are the main arguments, with which the state wishes to substantiate its fight against the shadow economy. However, when taking a closer look at the further consequences, the yield losses are no longer as high as generally assumed. An example clarified, that not only the economy profits from the black market due to the higher supply and demand, but also the state receives compensation, e.g. through increased VAT income. Nevertheless, substantial deficits remain, which have been heavily lamented by politicians. In the long run, reforms are inevitable not only due to the globalisation but also the rising importance of the shadow economy. The agents will increasingly opt for the “exit option” if the “voice option “ is not strengthened by more direct democratic elements such as referendums on budget decisions, etc. They will either choose to work illicitly or search for a system, which corresponds to their preferences.

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<sup>48</sup> See Pommerehne/ Hart/ Frey (1994) for a simulation regarding the differences in tax moral and – honesty in direct and representative democracy.

<sup>49</sup> For the importance of social capital, see e.g. Coleman (1990, pp.300f), Hirschman (1994).

In this context, the shadow economy can be regarded as part of an evolutionary process, making the economic and societal development increasingly dynamic. On the one hand the societal pressure on deregulation and tax reduction is increased and on the other new innovative forms of living together and economising outside the restrictions are fashioned. This could be regarded as a test for the official sector.

In the long run, however, a society cannot accept the offence against laws and rules, as these form the basis of the state. Yet, it is not sensible to persecute illicit work with intensified controls and higher fines. The tendency to engage in shadow economic activities should be perceived as a warning signal by the politicians. There is an increased resistance against the existing norms and laws of the economy, which can only be met with adoption of the two pillar strategy.