

The Shadow Economy, Its Causes and Its Consequences*

by
Vito Tanzi

*PowerPoint for a lecture to be given at the International Seminar on the Shadow Economy Index in Brazil”, Brazilian Institute for Ethics in Competition, 12 March 2008

The Shadow Economy, Its Causes and Its Consequences

- Historical background on the phenomenon:
 - its “discovery”
 - terms to describe it
 - shadow economy and informal economy
 - economy-related definition
 - tax-related definition
 - frequent confusion between the two.

The Shadow Economy, Its Causes and Its Consequences

- MAIN CAUSES OF SHADOW ECONOMY
 1. Taxes
 2. Regulations
 3. Prohibitions
 4. Corruption

The Shadow Economy, Its Causes and Its Consequences

1. Taxes

- Income taxes
- Value added taxes
- Excises
- Social security taxes
- Foreign trade taxes
- Taxes on capital transfers

The Shadow Economy, Its Causes and Its Consequences

- Tax characteristics:

Rates

Administrative aspects:

- (a) efficiency of tax administration
- (b) penalties for tax evasion
- (c) exemptions levels
- (d) cost of compliance

The Shadow Economy, Its Causes and Its Consequences

Other aspects:

- (a) corrupt tax inspectors
- (b) taxpayers morality
- (c) quality of public spending

The Shadow Economy, Its Causes and Its Consequences

2. REGULATIONS and their effects:
 - (a) labor markets
 - (b) goods and services markets
 - (c) domestic financial markets
 - (d) foreign exchange markets

The Shadow Economy, Its Causes and Its Consequences

3. PROHIBITIONS and their effects
 - (a) illegal drugs
 - (b) illegal gambling
 - (c) usury lending
 - (d) production and sale of dangerous substances and services
 - (e) criminal activities

The Shadow Economy, Its Causes and Its Consequences

- Prohibition and criminal activities raise important question for the definition (and the measurement of the shadow economy). Should incomes obtained from illegal activities (prostitution, sale of illegal drugs and weapons, proceeds from gambling or extortion) be considered parts of shadow economy? They can be very large.

The Shadow Economy, Its Causes and Its Consequences

4. CORRUPTION: should the proceeds from corruption be counted?

The Shadow Economy, Its Causes and Its Consequences

- CONSEQUENCES OF SHADOW ECONOMY
 1. Equity consideration: some are taxed and some are not
 2. Effects on markets and on competition
 3. Effects on tax systems
 4. Effects on the measurement of some important economic variables (GNP, growth, tax burden, unemployment, productivity)
 5. Effect on the country's international interest
 6. Effect on economic policy when economic variables are distorted.

The Shadow Economy, Its Causes and Its Consequences

- The above effects may depend on the definition of the shadow economy
- Recent economic changes have likely affected the shadow economy
 - (a) deregulation policies (in financial markets, foreign trade, other)
 - (b) tax policy

The Shadow Economy, Its Causes and Its Consequences

- Comments on the relation between shadow economy and unemployment
 - (a) are unemployed busy working in the shadow economy?
 - (b) or are those in the underground economy people that officially are not allowed to work?

The Shadow Economy, Its Causes and Its Consequences

- Shadow economy and tax evasion
 - shadow economy can exist without tax evasion
 - tax evasion can exist without shadow economy
 - relation between tax evasion and shadow economy
 - does tax evasion necessarily imply that GDP is underestimated?

The Shadow Economy, Its Causes and Its Consequences

- Concluding remarks

References:

1. Vito Tanzi, "The Underground Economy in the United States: Estimates and Implications", Banca Nazionale del Lavoro Quarterly Review, No. 135, December 1980.
2. _____, 1981, "A Second (and More Skeptical) Look at the Underground Economy in the United States," Paper presented at Wertheim's Conference on the Underground Economy (New York, June 24, 1981).
3. _____, 1982, The Underground Economy in the United States and Abroad (Lexington Books).
4. _____, "The Underground Economy in the United States: Annual Estimates, 1930-80", in IMF Staff Papers, Vol. 30, No. 2 (June 1983).
5. _____, "The Underground Economy: Causes and Consequences of this Global Phenomenon", in Finance & Development, December 1983, Vol. 20, No. 4.
6. _____, "Uses and Abuses of Estimates of the Underground Economy", The Economic Journal, Vol. 109, No. 456, June 1999.
7. _____, "The Underground Economy and the Unemployment Rate", Chapter 12 of Vito Tanzi, Policies, Institutions and the Dark Side of Economics, (Elgar: 2000).