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**Article**

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CES Working Papers

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*Suggested Citation:* Maftai, Loredana (2013) : A Brief Analysis of the Shadow Economy in Europe, CES Working Papers, ISSN 2067-7693, Alexandru Ioan Cuza University of Iasi, Centre for European Studies, Iasi, Vol. 5, Iss. 4, pp. 548-555

This Version is available at:

<https://hdl.handle.net/10419/198273>

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# A BRIEF ANALYSIS OF THE SHADOW ECONOMY IN EUROPE

Loredana Maftai\*

**Abstract:** *Shadow economy affects all country around the world. European countries are affected by undeclared work, under-reporting and tax evasion. This phenomenon increases from West to East, the most affected being the Balkan area. The size of shadow economy is growing due to government actions, such as regulation and tax implementation. From a macroeconomic perspective, the economic cycle sustain the shadow economy levels. To combat this phenomenon it is necessary to adopt electronic payments, to reduce tax implementations and social contributions, to bring encouragement in cash deposits use and broaden credit cards.*

**Keywords:** shadow economy; tax evasion; regulation; undeclared work; under-reporting

**JEL Classification:** O17; O5; E26

## INTRODUCTION

This new era of globalization redefined in a particular way the world face, increasing the power of institutional systems such as governments, international corporations and so on, emphasizing the need to know, to be competitive, to produce on a large scale, to sell and to be present at the table of opportunities and big decisions. Easily, this new configuration has brought besides the wealth factor also a set of imperfections regarding the legislative system. Practically, the other side of globalization has created a favorable environment for illegal economic activities. According to the economic literature, what can be good for free trade can be also good for criminal networks around the world. In the same way in which business can flourish, the criminal networks can develop profitable activities but which are found and placed at the illicit border.

Entitled as non-observed economy, secondary economy, informal economy, parallel economy and so on, the underground economy covers all the economics activities or income sources which are not registered in the gross domestic product official records and which avoid the taxations and governments regulation.

Clandestine trade with gems, special fabrics, poaching are activities well known to these days; the complementary trade, border trafficking with different kind of goods, common especially within the socialist systems, arms trafficking, human being trafficking, drugs,

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tobacco, alcohol and all the other activities which emerge as an adaptation to everyday realities have been defining the shadow economy (Bari, 2003, p.383).

Along with this description the phenomenon of illicit behavior it is also mentioned, which covers banking fraud, different type of scams, corruption, blackmail, money laundering, unfair competition, disclosure of economic secrecy, false accounting documents etc. developed by some transnational corporation or different economic actors, which usually have an important social and economic position in some institutions or organizations. This kind of behavior is named white collar criminality. Together with the undeclared work and illegal activities associated with criminal organizations, the illicit behavior presents the overall shape of shadow economy.

At the European level it is hard to determine precisely the size of underground economy, but it compresses all this kind of activities. Most societies attempt to control these activities through measures such as punishment and prosecution, or by relying on economic growth or education. Gathering statistics about who is engaged in shadow economy activities and the frequencies with which these activities occur and magnitudes, is important. It is difficult to obtain accurate information because individuals engaged in shadow economy activities do not wish to be identified (Schneider, 2005, pp.598-599).

According to the economic literature and the latest statistics the eastern countries of Europe or the new European Union members (Bulgaria, Cyprus, Latvia, Czech Republic, Lithuania, Poland) show a higher shadow economies than the „old" European Union countries (Austria, Belgium, Germany, Italy). Basically, the shadow economy increases from west to east. The economic crisis has created a major concern for European governments due to increase of black market and organized crime that generates billions of dollars annual, fact that can deny member states an important amount in tax revenues, money that they really need to move forward.

Europe continues to deal with competition between private business and counterfeit goods, with undeclared work boosted by the immigration phenomenon, factors that threatens the euro region`s economic recovery, forcing the authorities to adopt new methods to combat the illicit activities.

## 1. THEORETICAL CONSIDERATIONS

A vast literature makes an attempt to define the concept of shadow economy and to offer theoretical approaches about the causes and the most important determinants. Most authors have encountered difficulty to define shadow economy, especially when they tried to measure it. The main idea of shadow economy is centered on all unregistered economic activities that contribute to the officially calculated Gross National Product. Smith has tried to define shadow economy as market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP" (Smith, 1994).

Generally, the core idea of most definitions describe the action of avoiding payments or incomes, value added tax and also other type of taxes like social contributions. Besides these factors are mentioned the avoiding of certain legal labor market standards (minimum wages, maximum working hours, safety standards, security at work etc.) and certain administrative procedures (different type of administrative questionnaires). Table 1 presents a set of possible definitions of the shadow economy.

**Table 1 - A taxonomy of types of underground economic activities**

Type of activity	Monetary transactions		Non-monetary transactions	
Illegal activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud; etc.		Barter of drugs, stolen goods, smuggling etc. Produce or growing drugs for own use. Theft for own use.	
	Tax evasion	Tax avoidance	Tax evasion	Tax avoidance
Legal activities	Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

Source: Schneider, F., (2005) *Shadow Economies Around the World: What do We Really Know?*, European Journal of Political Economy, Vol.21 (2005) 598-642

Studies point out that the main causes that stand along the shadow economy are usually tax and social security burdens. The existence of this phenomenon is due to the increase of

taxes that affect in some way the labor-leisure choices. Practically, new taxes influence and introduce a major concern in the development of underground economy. The increase of government regulation can reduce the freedom of choices for individuals engaged in the official economy and to indirectly determine them to avoid the legal system. This road of regulations politics can lead to reduced state revenues and also to introduce a form of deterioration in the quality of individual life, firms and administration sector, etc.

Countries with 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 official activities, and a large discretionary framework of regulations, and consequently to a higher shadow economy. (Schneider, 2005, p.602).

According to the economic literature the conclusion is that usually the wealthier countries (OECD and some countries from Eastern Europe) are found in the phrase of „good equilibrium" because of corruption control, low taxes, regulatory burden, mobilization, good rule of law and so one. By contrast with this type of countries, there are found a number of countries like those from Latin America or the former Soviet Union, that are dealing with the „bad equilibrium" case, which describes higher taxes applied to firms, the weakness of law rule, the incidence of bribery and corruption, which add a significant share of illicit activities in the informal economy.

## 2. THE CASE OF EUROPEAN SHADOW ECONOMY

Describing Europe`s shadow economy can be a really difficult task. People usually consider that shadow economy is only reduced to activities linked with organized crime, like Italian Mafia, illegal drugs trafficking, counterfeit products. But it is necessary to point out that OGS`s activities have evolved surprisingly, this illicit groups behaving now like a real business, growing and expanding in many other sectors of economy and technology industry, for example moving into cybercrime area where the money-laundering represents the main objective to raise money. For sure black money come from many directions, only because this underground market has diversified a lot, taking advantage of institutions weaknesses.

Regarding Europe`s shadow economy activities, it can be presented through two categories, that are very common across this region. A very well-known category is definitely the **undeclared work**, which seems to account about two-thirds of Europe shadow economy.

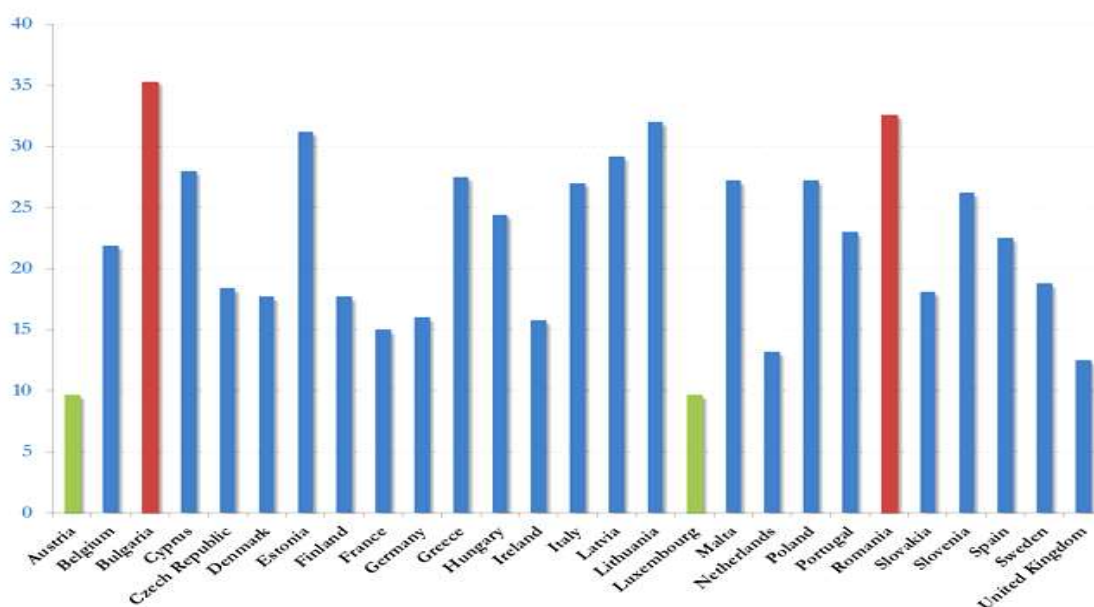
This category is characterized mainly by common workers and different kind of business (construction, agriculture, household services etc.) that avoid the rule of taxation by not declaring the required documents, suggested by the government.

**Underreporting** is the second category, which describes those kind of businesses, that are dealing primary with cash (small shops, bars, taxi companies etc.) and their behavior is summarize to report only a part of their income to maintain in this way a lower tax burden.

The size of the shadow economy in Europe reached a 10 year low in 2013, and is now estimated at €2.15 trillion (see Figure 1). On average across Europe, the shadow economy is as large as 18.5 percent of economic activity (Schneider, 2013, pp.3-4). According to economic literature and the newest methodology, apparently the shadow economy is concentrated mostly in Europe`s five largest economic powers, Germany, France, Italy, Spain and the United Kingdom (Schneider, 2013). Despite the European economic power, it seems that Eastern European countries are dealing with a much larger shadow economy, regarding the relation maintain with the size of the official economy. For example, in Austria and Switzerland, the shadow economy equals roughly 7 to 8 per cent of the size of those countries official GDP, compared to Poland, which has a shadow economy of €95 billion, compared to an estimated GDP of €400 billion, or 24% (Schneider, 2013, p.4).

In the Balkans, some countries like Bulgaria, Lithuania or Croatia present a shadow economy estimated at 30 per cent from the size of the official economy.

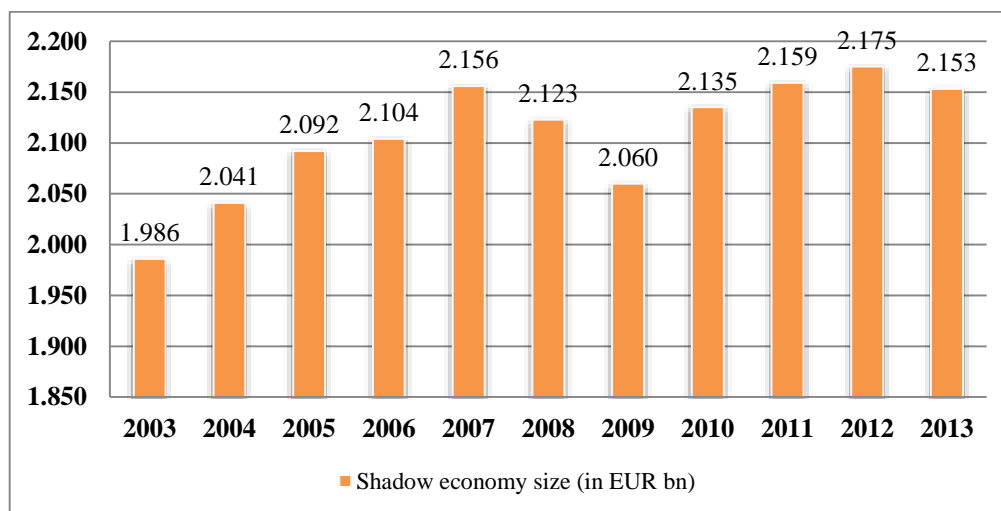
**Figure 1 - The Size of Shadow Economy by Country (% Total)**



Source: Durden, T., (2013) *Europe`s Shadow Economy: As Big As Germany*, available at <http://www.zerohedge.com/news/2013-05-06/europes-shadow-economy-big-germany>

A report launched by Tax Research, suggests that Austria and Luxemburg have the smallest shadow economies in the euro area at 9.7% of GDP, while Bulgaria at 35.3% and Romania at 32.6% top the list. Of the major economies, Germany clocks in at 16%, France at 15%, Italy at 27% and Spain 22.5%. (Durden, 2013).

**Figure 2 - The development of the shadow economy in Europe 2003-2013**



Source: Schneider, F. (2013) *The Shadow Economy in Europe*, 2013, ATKearney analysis, Eurostat, p.5

Figure 2 tries to present a shadow economy trend, starting with 2003, and including also the fact of economic downturns. Previous studies reported that shadow economy increases especially in time of crises, when the unemployment scale rises, when the wages are lower and the saving rates are quite lower. During this periods, individuals trend to "adopt" those kind of shadow activities (undeclared work, underreporting) in order to improve their personal budgets, fact which affects seriously the governments national budgets. Roughly, it is demonstrated that economic cycle maintains a strong relationship with the shadow economy fluctuations, situation presented in the figure 2.

### 3. GOVERNMENTAL COMBATING MEASURES

The shadow economy is a tax avoiding phenomenon across Europe, driven by the major factors like undeclared work and under-reporting. Economic crises has been a major cause for European governments to take measures against the underground economy. It was a need for the budget recovery and a necessary change to combat the causes of shadow economy. One of the most important measure was the correlation with the number of electronic payments, which

have reduced notable the size of the shadow economy. Easily this system was adopted by every European country. For example in countries where electronic payments are widely used, such as the UK, the size of the shadow economy is significantly smaller than in a country such as Bulgaria where electronic payments are not widely embedded (VISA EUROPE, 2013). Other important measures were focused on the reducing the undeclared work and the under-reporting phenomenon and also in implementing several controls to tackle the tax evasion, Portugal and Turkey are very involved in this effort. To combat the shadow economy, Germany has placed the „mini-jobs" reform, only to encourage the lower-wage workers, to join the official economy.

During time many Eastern European countries showed a strong participation to encourage the official economy. Countries like Russia, Hungary introduced flat rates for individuals and corporations, other countries reduced significantly the social security contributions to combat in this way the tax evasion. Other important measures adopted by the European countries were the electronic payments, the use of POS, the encouragement of cash deposits and broaden card acceptance.

## CONCLUSIONS

Shadow economy activities are found in every country around the world. Undeclared work, under-reporting, tax evasion have widely implications which affect significantly the macro-economic objectives of countries also the quality of life, the productivity and social cohesion. All this factors bring a negative consequences that from a macroeconomic perspective, tends to affect the fair competition on the market and among firms, affect the social protection and also causes productive inefficiencies. Shadow economies are very complex being present in all type of economies (developed, transition, highly developed). Individuals are engaged this kind of activities due to government taxation and regulation. Taking in considerations all this conclusions, it is obvious that shadow economy poses a serious challenge or all European countries and beyond them. Successful implementation can bring stabilization and reduction of the size of the shadow economy.



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