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Gorana Krstic & Friedrich Schneider (Eds), *Formalizing the Shadow Economy in Serbia: Policy Measures and Growth Effects*. Springer, 2015, 179 pp. $60 Hardcover.

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Book Review

Tax evasion, illicit work and social security fraud are even in Europe widely spread - especially in Eastern and Southern European Countries. Up to an additional one fourth of the official economic activities takes place in the underground. Most governments focus on fighting this deviant behaviour by punitive measures. But empirical data shows in opposition to standard economic theory that this way is expensive, inefficient, and finally unsuccessful. Governments have to change institutions (e.g. tax system) and regulations to reduce incentives for illicit work and tax evasion. An increasing burden of taxation and social security contributions is – as well as regulations and the poor quality of institutions – the driving force for the increase of the shadow economy especially in OECD-countries, as various empirical analyses have shown (e.g. Enste, 2015). For Central and Eastern European countries, multivariate analyses provide evidence for the significant influence of corruption, economic freedom, and the quality of institutions on the size of the shadow economy.

In this context the main contribution of the book by Krstic, Schneider, and Co-Authors is that the authors apply systematically the general findings of research on the shadow economy during the last 20 years to the Serbian case. The structure of the book, the analysis of causes and consequences, and the political implications are very similar to general analyses of shadow economies around the world. In addition, a broad survey among 1.251 business entities is presented, providing evidence on the shadow economy from the point of view of entrepreneurs and businesses in Serbia. Therefore, the micro, meso, and macro perspective of the shadow economy in a transition country can be described.

Main Causes: The development of tax and duty burden is the most important cause for the changing size of shadow economies. Values and the tax morale are the second most important factor influencing the shadow economy, according to many studies. In Serbia size and structure of the tax burden, efficiency of the tax administration in collecting taxes, penalty policy, complexity and fairness of the tax system, and compliance costs are among the most important causes.

The overall intensity of state regulations imposed on firms and individuals and the specific Labor Market Regulations are very important, too. For Serbia the

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minimum wage, working hour regulation, unemployment benefits, and other regulations are analysed and their impact is discussed in the book.

The quality of institutions, the efficiency of the public sector services, and the provision of public goods are also relevant for the shadow economy since they might act as pull factors to move from the shadow into the light. In Eastern Europe – and especially in Serbia – the following factors are in addition relevant for the growth of the shadow economy: the lack of competence and trust in official institutions (e.g. legislation, bureaucracy, courts) combined with inefficient and corrupt administration. Property rights cannot be guaranteed by the official institutions combined with inadequate enforcement of laws and regulations. High costs and administrative burden for entrepreneurs hinder economic development. A low probability of being caught as an illicit worker or tax evader can result in a cost-benefit calculation that makes illicit work ~~is~~ more attractive than regular and official work. Sometimes "hiding in the shadows" is essential for surviving or establishing a business, due to slow bureaucracy. Broad acceptance of illicit work (e.g. access to credits and loans in the shadow economy), makes it difficult to fight this phenomenon. In chapter 4 of the book all these factors are evaluated carefully based on data for Serbia. The book profits from the special expertise by the authors working in Serbia and doing research on their home country.

Size of the Shadow Economy: Chapter 5 and 6 provide a broad overview of the results for Serbia based on various methods such as macroeconomic approaches and survey data. The extent of the shadow economy in Serbia varies between 21 and 30 percent of the GDP, depending on the methods used.

Main Consequences and Effects: The main effects of the shadow economy are (1) that officially unused resources are at least used for production (no waste of resources); (2) an additional supply of services and goods (may increase overall welfare); (3) an increase of public deficits and a decrease of investments in public infrastructure (can reduce future welfare and growth); (4) undermining official institutions and state power (puts the future economic and political development and the welfare state at risk); (5) more crime and less support for official institutions. To sum up, the main consequences can be a dangerous development for the state leading to a "dual economy" in the long run, with more crime and less support for official institutions. But the authors use their findings not only for analysing and data mining, but also to draw conclusions for politians in Serbia.

Political Implications: What is the best policy measure in order to reduce the incentives to go underground, taking the results of the analysis for Serbia into account? Above all, liberalisation and more economic freedom are a solid foundation for this policy because more economic freedom helps to reduce corruption, leads to better institutions, and decreases the attractiveness of illicit work. Therefore, the authors recommend completing the process of transition into a market economy. This recommendation is derived from empirical results.

Especially the lack of stable institutions is another driving force of irregular economic activities in Serbia. In combination with a reduced tax morale and less loyalty to the government, these are the most important factors for "migration" into the shadow economy. But increasing the costs of illicit work by intensified controls and setting higher fines will not merely bring positive effects on overall welfare. Still, the growth of the shadow economy leads to reduced state revenues which in turn reduce quality and quantity of publicly provided goods and services. Ultimately, this may lead to an increase of the tax rates for firms and individuals in the official sector, quite often combined with a bad public infrastructure and a corrupt public administration, which lead in consequence to even stronger incentives to participate in the shadow economy. Serbia is facing the challenge to impose substantial reforms regarding the social security and tax systems in order to prevent the total defeat of the protective state and create growth of the official economy~~,~~ because this ultimately reduces the incentives to go underground.

The dilemma is a vicious circle: High tax and regulation burdens cause higher growth rates of undeclared economic activities, which boost the pressure on public finance to either save money or increase tax rates. But high tax rates again increase the incentives to evade taxes and to escape in the shadow economy, and so on. One option to intervene into the vicious circle is to improve the quality of institutions and the institutional framework and to create macroeconomic stability. Fighting corruption e.g. in tax administration by increasing the transparency perfectly fits into this policy recommendation because it will reduce the incentives to work illicitly as well as it will strengthen the loyalty towards the state – as the authors state.

To sum up: The book is a valuable piece of analysis for Serbian politians and could serve as a role model for further country specific analysis.