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The effects of the underground economy on economic competitiveness

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Abstract: *A real, almost palpable, connection exists between the official and the underground economy. More than that, both sides of the economy (official and underground) are connected with the competitiveness of a country. Strangely a large presence of underground in the economy is a sign of competitiveness. Although we would be tempted to say that underground is bad for competitiveness the reality is that due to taxes and regulations the resources (especially the human ones) used "illegally" would probably be wasted. In the end the wages from the underground economy return to the official one supporting it and hence the competitiveness of the country.*

Keywords: official economy, underground economy, illegal activities, tax evasion, economic competitiveness

JEL Classification: E26, H26

The shadow economy is a result of statehood, and its aggravated forms are effects of the remoteness of the state of his concept of minimal state. Basically we can not talk about underground activities without referring to the official in terms of which it is defined. Interconnections between the two market types are bidirectional flows of capital (human, technical, etc.).

In a fairly large extent, through the two-way flows the two markets are mutually reinforcing themselves. For example the incomes from the shadow economy (profits, wages, etc.) are used to achieve consumption in the official economy.

An error often made is the confusion between the underworld and underground, but we must clearly distinguish between them. Although both contain groups that deliberately violate the law, the first one is related to people who commit crimes, fraud and illegal acts in society and the other category includes people who seek refuge from the evils caused by their government.

If we consider the government to be the aggressor we can state that the underground economy is more moral than the official one. In the "underground" we have companies and entrepreneurs which are more viable economically, which can offer lower prices (as determined

by the free market these prices are fairer and more moral) than those of the official. How low are the prices? Sufficiently low to provide entrepreneurs an attractive profit for taking the risk.

At a superficial analysis it would seem that the "underground", tends to a pure and perfect competition, but the reality is different because it does not meet all the criteria for this. For example, market access is difficult (entrepreneurs need to take offense, must pass the barriers imposed by those already active in the market, etc.) and the degree of transparency is quite low

Many economists have written on the relationship between the two types of economies, but we will focus on one that stands out. Hans F. Sennholz (1922-2007) was a less known Austrian economist. Born in Germany he participated in the Second World War in the Luftwaffe forces. After the war he took a first doctorate in Cologne in 1949, and then emigrated to the U.S. where he was the first doctoral student of Ludwig von Mises in America. By the end of his life Hans Sennholz had a prestigious journalistic activity writing about 17 books and over 500 articles.

The shadow economy can only be defined in terms of the official one, the concepts that make this definition possible are: tax evasion, failure to pay social security contributions (whether or not intentional), etc. It can be said, moreover, that the economy is created by the bad macroeconomic policies applied by the government (e.g.: an excessive level of fees, excessive tax regulations, etc.).

The subject of underground economy was frequently approached in the last 35 years both from the qualitative and quantitative side. The subject began to draw attention to sociologists and economists (Tanzi, 2002) in the second half of the 70s (although some interest was shown during the World War II, especially in the U.S.). The same Tanzi (2002) identified four major categories of causes that led to the "birth" of the underground economy: (1) taxes, (2) regulations, (3) prohibitions and (4) corruption.

Underground economic activities (Schneider, 2000) - employment, production and trade not reported to government authorities - represent a large and growing share of all economic activities in the world. Although these activities, by their very nature can not be measured accurately, attempts were made to estimate their magnitude and to correlate the magnitude of tax rate and other determinants. They (Uzunoglu, Yuruk & Atakisi) can be defined as economic activities registered by "official tax collectors". Their motivation comes from licensing and regulatory requirements for high repressive government on economic activities.

On the qualitative side one of the most clear and pertinent approach was the one of the Austrian economist Hans F. Sennholz. He (1984) notes that the economy is a hectic world where jobs, services and business transactions are conducted through direct contact and paid cash to avoid government officials control. The underground economy is as old as government itself and its existence flows from human nature to choose between given alternatives. Forced to deal with government agencies and their extortions, the operator may choose to go "underground".

Basically it does nothing else than to choose the lowest opportunity cost. The unchanging nature of man makes it to act and react constantly to the world around him. Thus when government action is expected to be harmful the economic agent can accept it, can try to fight it or to avoid harmful effects by circumvention and evasion. They have two options: to act on the black market where they defied the laws of reason and control prices or to go "underground" where political edicts are ignored.

The main categories of underground activities (Sennholz, 1984) are:

- (1) Tax revenues which are not reported;
- (2) economic production that violates one or more government mandates;
- (3) Productive activities of the beneficiaries receiving benefits transfer of social services or receive public assistance; and
- (4) Productive activities of illegal immigrants without residential status. It is possible that they pay taxes on income and other taxes, but they must remain underground for fear of deportation.

The main category of cases that determine the economy "underground" economic conditions are the taxes which are affecting producers and therefore reduce their ability to consume and invest. By reducing revenue for productive effort occurs a reduction in the marginal utility of effort and an increase of the usefulness of resting. That makes the taxpayer to prefer longer vacations or to seek tax-exempt benefits instead of working.

Taxation lowers the marginal utility of productive employment and reduces economic result. The shadow economy raises the marginal utility of labor and increases the economic outcome, but does it with the risk of being discovered by officials and government agencies. The risk is directly proportional to the productivity of the "underground" worker.

Dabl-Norris & Feltenstein (2003) conducted a study in which they concluded that the lack of budgetary flexibility and the increase of taxes to an extreme level determine companies to focus on the shadow economy, thus decreasing the tax base. They also reached at the conclusion that low fees eliminate the underground economy, but result in the inability to support the budget and trade deficits. Thus the optimal tax rate, from a macroeconomic perspective, can lead to a certain amount of "underground activity".

Progressive taxation and rising inflation rates are strong reasons for economic activities to go "underground". But the main reason for the existence of underground economy (Sennholz, 1984) is more substantial than tax evasion; it is the inalienable right to life and property that contains the right to support life and property through honest labor.

In a climate characterized by stagnation and decline (Sennholz, 1984) the shadow economy has a useful economic and social function. It provides jobs for millions of willing workers and for learning the importance of individual initiative. Basically it's an important safety valve that eliminates complaints and tension in a world affected by political disturbances. It is essentially a phenomenon of employment. Where government causes layoffs the "underground" provides ample employment opportunities. The classic example is constituted by the minimum wage which denies the right to work to millions of people and condemns them to a "humiliating" life based on charity and public assistance.

Reyneri (2003) associated shadow economy with immigrants and he is concerned about the negative effects it has on them. Thus:

- (1) most immigrants, including those who have a legal status, are able to find only illegal jobs (underground); and
- (2) provision of employment predominantly in the underground economy and living without the necessary documents contributed to the stigmatization of immigrants;

Ballon, Kwan & Pastore (2009) addresses the issue from the perspective of the underground workers' rights versus those who work in controlled conditions. Their study takes a closer union momentum. Thus, economy industries tend to be characterized by exploiting the following behavior:

- (1) avoiding the licenses;
- (2) often pay salaries in cash;

- (3) employ vulnerable workers, especially new immigrants or undocumented ones;
- (4) often fail to pay the federal and state mandated minimum wage; and
- (5) often do not adhere to minimum safety conditions for workers and jobs.

Viewed from the perspective of officialities the underground economy is probably the most important challenge and the greatest danger for all planners and government regulators, because it manages to defy their authority and control. Penalties for the evaders vary, in the totalitarian societies they are killed and fined or imprisoned in the democratic ones.

Underground economic activities "are causing" tax evasion (Uzunoglu, Yuruk & Atakisi). And increasing underground economic activities dominate the economy. Thus in some economical sectors it is difficult for legitimate businesses to compete with underground firms. With its vivid and imperceptible characteristics underground economy jams the macroeconomic perspective preventing formal market operators to take good decisions.

The effects of the underground economy on the economic competitiveness of a country

First we should ask ourselves whether underground economies affect the economic competitiveness of nations, then we should find out how the economy affects the economic competitiveness of nations.

Somehow, shadow economy increase competitiveness because it provides a significant proportion of the population (the part which is unemployed) the opportunity to earn some kind of income. The part of the population consists of individuals who otherwise would have been forced to live on social benefits.

In addition, in this economy prices are formed closer to the ideal of pure and perfect competition markets. Here the demand and supply function closer to normality because entrepreneurs succeed to provide the lowest prices, although there are restrictions on both sides represented by state agencies checks.

An economy with a high share of underground could be a sign of risk taking. In fact a large number of entrepreneurs who take the risk of evasion can mean two things that seem opposite:

- the State pressure is too high;
- the economy has a relatively high competitive potential.

On this market are hired those individuals which are not permitted to work in the real economy because of the minimum wage policy, which would otherwise have to live on social benefits.

Even if the total amount of fees has a lower amount because of a series of taxes not collected by the state, there exists a range of incomes (wages of these employees, revenues of the illegal employers) that end up back in the real economy.

The shadow economy is not taken into account in developing the competitiveness rankings. Regarding the relationship of the underground economy with economic competitiveness there is a high risk to disregard the first one because it is not taken into account into these rankings. We should note however that this discredits the rankings, because they are unable to reflect the real value of the indicators of economic competitiveness.

There is a relationship between the share of the shadow economy and the level of economic competitiveness. If the share of the "underground" component in the economy is reduced it means that the tax level in the economy is low. If the taxes and regulations are low it means that the country is competitive. If the taxes and regulations are low the country is more attractive to investors because of its higher competitive potential.

Regarding the economy and economic competitiveness, we could see a kind of paradox. Theoretically an increase in the level of taxes determines the development of the shadow economy and indicates a loss of competitiveness. A developed underground sector shows a high competitive potential, and that on the long-term the market is attractive to entrepreneurs.

Conclusions

Many contemporary economists speak with great ease about market failures and the need for state intervention. The shadow economy has, among other things, a function for adjusting the state failures (formal economy). It has a critical role in regulating shortages or, where appropriate, excesses of demand or supply. The actions of entrepreneurs economy do nothing else than to regulate the shortage or excess of demand, or supply, from the official economy.

If some of the underground entrepreneurs would like to move the work places in the formal economy they would not be able to support the job creation because of the diminishing

productivity, due to official wage taxes. We can say that "the two economies" need each other to exist and that they are mutually corrected and adjusted.

We can speculate that large quantities of goods and services are produced without being reported to government authorities, that the real unemployment rate is much lower than reported in official figures and actual saving rate is much higher than expected.

A developed underground economy is a sign of low economic competitiveness but at the same time, is an indication of a high competitive potential. It is a market with high attractiveness for investors.

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