CAUSES AND CONSEQUENCES OF NON – OBSERVED ECONOMY

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Abstract

This paper analyse the non – observed economy, its causes and consequences for economy on the whole. There are a lot of scientific works written until now about non - observed economy, but now we must develop the methodology how systemically to define and evaluate the shadow economy and how to control it. The topic of this paper is to generalize and systematize the opinion of scientists about shadow economy and find out the causes and consequences of non - observed economy. The paper systemically defines the non - observed economy and gives the various definitions based on opinion of scientists and international organizations. This article also analyse what makes the influence for shadow economy and what consequences does the non - observed economy for national economy and society, and find out if there is a possibility to control and do the influence for the size of the shadow economy and the non – observed economy on the whole.

Keywords: non – observed economy, shadow economy.

Introduction

Non - observed economy exists whole over the world and depended form it is size does the influence for national economy of a country, social society and politicians. The law base and taxation can be ineffective if the size of shadow economy in the country is great. The bigger tax rate can stimulate the growth of the non-observed economy. So honest people and enterprises will pay more taxes then they should, because the taxation system, in such counties, does not evaluate those who are in the shadow. Size of manufactures, incomes and expenses, made in non - observed economy, does not let exactly to evaluate the economic conditions of a country. So politicians can not form the reasonable strategy of country development and regulation in national economy. An official statistic becomes worthless because it does not evaluate the real situation in the country. The economic strategy of a country grounded by such statistics is irrational, because the data is far away from the real situations. Situation like that stops the economic growth so all the countries are trying to limit the size of non-observed economy.

Scientific problem: there are a lot of scientific works written until now about non - observed economy, but now we must develop the methodology how systemically to define and evaluate the shadow economy and how to control it.

Objective: generalize and systematize the opinion of scientists about shadow economy and find out the causes and consequences of non - observed economy.

Goals:
- Systemically define the non – observed economy and give the various definitions of non-observed economy based on opinion of scientists and international organizations.
- Analyse what makes the influence for shadow economy.
- Except what consequences does the non - observed economy for national economy and society.
- Find out if there is a possibility to control and do the influence for the size of the shadow economy and the non – observed economy on the whole.


Keywords: non - observed economy, shadow economy.

Definition of Non – Observed Economy

More then last three decades from 1982 a lot of scientists, such as V. Tanzi, E. L. Feige, F. Schneider, B. S. Frey and W. W. Pommerenehne, P. Smith, N. Brooks, O. Lippert, M. Walker, F. A. Cowell, D. Enste, C. C. Williams, H. JAE, M. T. Seevers, J. B. Gassenheimer analysed the non-observed economy and the problems becoming from shadow economy. In the literature we can find definitions of shadow economy or non - observed economy from various points of view - economical, legitimate, juridical, social and other, but no exact definition, which is used by many scientists. Some times, in the literature, we can find the underground economy definition.

P. Smith (1994) describes the non – observed economy as market – based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of gross domestic product.

An other scientist R. Del’Anno (2003) presumes that the shadow economy is those economic activities and the income derived from them that circumvent or other wise government regulation, taxation or observation.

N. Brooks (2001) defines the shadow economy as the value of economic activities which would be taxed if they were declared for institutions of taxation.

Organisation for Economic Co – Operation and Development (2002) the term of non – observed economy refers to those economic activities which should be included in the GDP but which, for one reason or another, are not covered in the statistical surveys or administrative records from which the national accounts are constructed.

We can summarize that all definitions of non – observed economy has one and the same feature – created but unregistered valuables. To non – observed economy we can assign any economic activity which increases the total value of national product, but it is not included in national account or shown in gross domestic product.

We think that non – observed economy is the secondary market with trade deals that would be possible in official economy but were taxed or would not be possible at all because of law.

Non – observed economy expand market from $E_E$ to $E_{E+Non}$. As we can see in the figure 1, $E_E$ shows the equilibrium of official economy, but nearby we have non – observed economy with it is supply ($S_{Non}$), where the prices are lower because of non-taxation, and demand ($D_{Non}$), where the non – taxed money can be spend.

That is why we need to go deeper into causes and consequences of the shadow economy, because it could help us unanimously and systemically to estimate the size of the shadow economy, to define and to find the tools how to control the non - observed economy and its consequences.

**Causes of non – observed economy**

Non – observed economy is more flexible then official economy. The main reason why – is there are no entrance or exit barriers. The same reason influences more aggressive competition in the market of non –
observed economy. Because of that, if there is any gape for expand of shadow economy, it will grow instantly.

The research of F. Schneider (2006) show the main causes for the increase of shadow economic activities. In figure 2 we can see, that the tax and social security contribution burdens makes the numerous influence for non – observed economy. R. J. Cebula (1997) has counted, that the rise of tax in 1 percent expands the non – observed economy by 1.4 percent. Individuals are always very sensitive if talk about money and their income. People want to see and to feel what they are paying for, that is why they want to get extra value and good social transfers. Only if there will be equilibrium between tax and welfare of people, individuals will not hide in the shadow. But still one thing is left – it is man value judgement. The greater difference between total cost of labour in the official economy and after tax income from work, the greater is the intention to work in the non – observed economy.

![Figure 2. Main causes for the increase of shadow economic activities](source: F. Schneider (2006))

Empirical studies made by F. Schneider (2002, 2005), H. Wagner (1984) and D. H. Enste (2002, 2005) show that labour market regulations for employees and workers protection gives the positive effects in the long term. Nevertheless, in short term people think that state regulations restricts personal freedom and that is the beginning of non – observed economy. F. Schneider thinks that fulfilling laws normally causes supplementary cost and may have a negative influence on production possibilities and competitiveness of individuals and firms. A higher scope of regulation leads in most cases to higher bureaucratic expenditures for individuals and firms as well as for public authorities and may be the reason for corruption. The findings of Colesca, S. E. (2009) indicated that citizen's higher perception of technological and organisational trustworthiness, the quality and usefulness of e-Government services, the Internet experience and propensity to trust, directly enhanced the trust in Government. So, that should decrease the level of shadow economy. In conclusion we can say that increasing the intensity of regulation leads to a growth of the non – observed economy.

Any regulation in labour market makes the influence for the size of non – observed economy. For example increasing of maximum working hours or age for retirement, on the one hand, will reduce the size of the shadow economy, because the people will not have time for activities in the shadow economy, on the other hand, they would like to work in the shadow, because of freedom from such laws. Higher benefits reduce the incentive to work in the official economy, because people can take the benefit and work in the non – observed economy.

Higher non – observed economy can lead to the deficit of the state budget and the quality and quantity of public goods and services will be reduced. That can lead to an increase in the tax rates for getting more revenue to the state budget. While having higher taxes and worse social welfare the growth of non – observed economy is certified. Studies made by J. Kaufmann and Z. Lobaton (1998) find that smaller shadow economies appear in countries with lower tax rates, fewer law and regulations, and less corruption.
Underground economy shrinks

Underground economy expands

Figure 3. Laffer’s curve and the underground economy
Source: M. E. Sharpe (2007)

Higher tax means bigger shadow. A. Laffer hypothesis (Figure 3) say that the national income grow until particular level of tax. That is because people in some point do not feel the significant difference in social security and they lose the point to pay more tax, than they think they need to. Piligrimiene, Z., & Buciuniene, I. (2008) made the conclusion, while analysed quality of health care: every person understand and describe health care service quality in different ways. That is why it is very hard to find the equilibrium point in taxation system.

Cekanavicius, L. and G. Kasnauskiene (2009) think that emigration influences the shrinkage of shadow economy in donor country, because of demand reduction in welfare payments and remittance flows.

Non – observed economy is like buffer during economical crisis, because shadow economy creates money in the market and after crises such enterprises legalizes if conditions in the market are friendly. In spite of that non – observed economy makes a lot of negative consequences for economy.

Consequences of Non – Observed Economy

Non – observed economy makes the influence not only for state and its economy but society too. Officially working people needs to pay taxes for those who are working in the shadow. We can say the same about enterprises. Those who hold on the law mast pay bigger tax then they deserved. That is how the deficit of the budget is compensated.

Theoretical and empirical studies show that negative consequences non – observed economy makes for official economy:

- Budget deficit
- Economic crisis
- Political instability
- Inefficient policy of country
- Corruption in country
- Cumulative structural economic deviation
- Moral degradation of society

No one can predict what size of shadow economy will be in the future and how many companies and individuals will leave an official market to be in the non – observed economy. Such movements give negative influence for budget and make the deficit bigger. That leads to economical crises. The corruption level and politics are closely related. If the size of shadow economy in the county is high, that means that subjects from non – observed economy makes the impact for politics. And on the contrary, if the corruption in the country is high, that is the best environment for those, who are in the shadow. In such countries
politics are in the hands of those who have money and no one cares if that money is from non–observed economy or from official economy. That shows political instability.

Moral degradation of society let people not to pay tax and hold that as a norm. Non–observed economy divide economy in two big groups: those who are paying tax and those who do not. So, one have more money then the others, because they hide their incomes from the government. We know that money makes money, so the gape between those groups will be bigger and bigger.

Despite that, non–observed economy has socially unmoral, but not bad influence for economy on the whole.

- Non–observed economy stimulates the economy
- Non–observed economy helps to solve the unemployment
- Non–observed economy increases the efficiency of the economic system over the long term

Gaidelys, V. and G. Buciunas (2008) think that shadow economy let easier make the money laundering.

Takashi Kadokura (2007) states, that the money from underground economy are spent in official economy and that is stimulates the aboveground economy through ordinary spending. The expansion of the non–observed economy gives job opportunities to people who are out of work and helps to solve unemployment. The non–observed economy increases the efficiency of the economic system over the long term. The main reason is that economic activities expand underground because of the existence of unreasonable regulations in the official economy and that restrict efficient economic activity. If we could find loopholes in the regulation system which went too far we could provide an impulse for making improvements to inefficient economic systems.

F. Schneider and D. H. Enste (2002) in work „Hiding in the Shadow the Growth of the Underground Economy“ write that competition in the non–observed economy is much more aggressive then in official economy, that is why non – observed economy is more effective. The growth of the shadow – means the growth of total income. Empirical studies in Germany and Austria show, that two thirds of money from the shadow are instantly spent in official market. Another interesting fact is that two thirds of production made in the shadow economy would not be made at all.

Conclusions

We can summarize that all definitions of non–observed economy has one and the same feature – created but unregistered valuables. We define non – observed economy as the secondary market with trade deals that would be possible in official economy but were taxed or would not be possible at all because of law.

The non – observed economy mainly forms because of the gaps in the tax system, social morality, law that regulates the market and corruption level.

Non–observed economy is very flexible and it can easily adapt to the government regulations, social morality and market on the whole. Because of flexibility shadow economy instantly change form, size and technique. Every new restriction in the official market expands the size of non–observed economy.

Non–observed economy has not only negative consequences for the official economy, but nevertheless countries must limit the size of the shadow if they want to have the economical, social and political stability in the countries.

If we want to avoid the expansion of non – observed economy, first of all we must find the loopholes in the law that regulates the market.

References


