

Informal economy: causes and implications for policymaking

Josip Franic

Institute of Public Finance, Zagreb

Promoting research at RIT Kosovo (A.U.K) community

Pristina, 1 March 2019

The most important definitions

- **Informal sector** - unregistered (or unincorporated) enterprises below a certain size, including: micro-enterprises owned by informal employers who hire one or more employees on a continuing basis; and own account operations owned by individuals who may employ contributing family workers and employees on an occasional basis" (ILO, 2002b).
- **Informal economy** - all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements (ILO, 2002a).
- **Undeclared work** - any paid activities that are lawful as regards their nature but not declared to the public authorities (European Commission, 1998).
- **Non-observed economy** - all productive activities that are not captured in the basic data sources used for compiling national accounts (OECD, 2002).

Main focus of governments and international institutions on undeclared work

- Undeclared work - all **market-oriented productive** activities of individuals and companies that are **legal** in their nature, but **remain unreported to the authorities** so as to evade taxes, to evade social security contributions and/or to circumvent labour regulation (such as legislation on minimum wage, maximum working hours, security standards, etc.) or any other administrative requirement (European Commission, 2007)
- excludes illegal undertakings (e.g. prostitution, human trafficking and drug-smuggling), as well as self-provisioning, neighbour help, voluntary work and other unpaid activities.
- undeclared activities **remain untaxed** and therefore cause direct loss to the public budgets
- undeclared work = tax evasion?

Causes of the informal economy/undeclared work

- high tax burden
- competitive market conditions
- to circumvent labour market legislation
- to avoid administrative hassle
- lack of choice (someone else's decision)
- lack of formal employment

Causes of the informal economy/undeclared work (2)

- insufficient income from other sources
- lack of knowledge
- greed
- defiance
- life philosophy
- social glue (often accompanied with 'pulling-string' practices)

Implications for policymaking - negative sides of undeclared work

- lower tax revenues
- lower amounts of social security contributions collected - direct effect on the sustainability of the pension system, social security and healthcare system, etc.
- unfair competition among companies
- deteriorated labour market conditions

Implications for policymaking - negative sides of undeclared work (2)

- distorts official macroeconomic and microeconomic figures (e.g. estimates of the gross domestic product and labour market statistics)
- increases inequality
- reduces the trust of compliant taxpayers in their fellow citizens
- undermines the confidence of citizens in the state institutions

Implications for policymaking - positive sides of undeclared work

- poverty alleviation tool in times of crisis
- can help companies to survive bad periods
- an efficient solution for temporary upsurges in business activity
- testing field for start-ups
- reinforces social ties

Quantifying concealed economic activities: an overview of available methods

- one of the most problematic and controversial tasks within the economic science
- every single estimation method embraces different set of activities, thus complicating the comparison of resulting figures
- according to the underlying approach, the existing strategies for estimating concealed economic activities can be roughly divided into three groups: direct methods, indirect methods and model-based techniques
- the obtained results are “likely to be no better than guesstimates which should be taken at best as interesting novelties” (Dixon, 1999, p. 335)

Direct estimation methods

- **questionnaire surveys and tax audit programs**
- microanalysis of a selected sample of the population observed (individuals, companies, workers, certain subgroups of interest, etc.), whereby the findings are then generalised to the whole population
- suitable for assessing the prevalence of any predetermined subset of concealed activities
- high implementation cost
- the final figures only represent the lower boundary of the actual prevalence
- not suitable for monitoring the dynamics over the longer period

Indirect estimation methods

- simple and straightforward procedures
- cheap, flexible and time efficient
- grounded on oversimplified assumptions
- most of them overestimate the exact scope of the activities in question
- in most cases not clear what is actually being estimated

Indirect estimation methods (2)

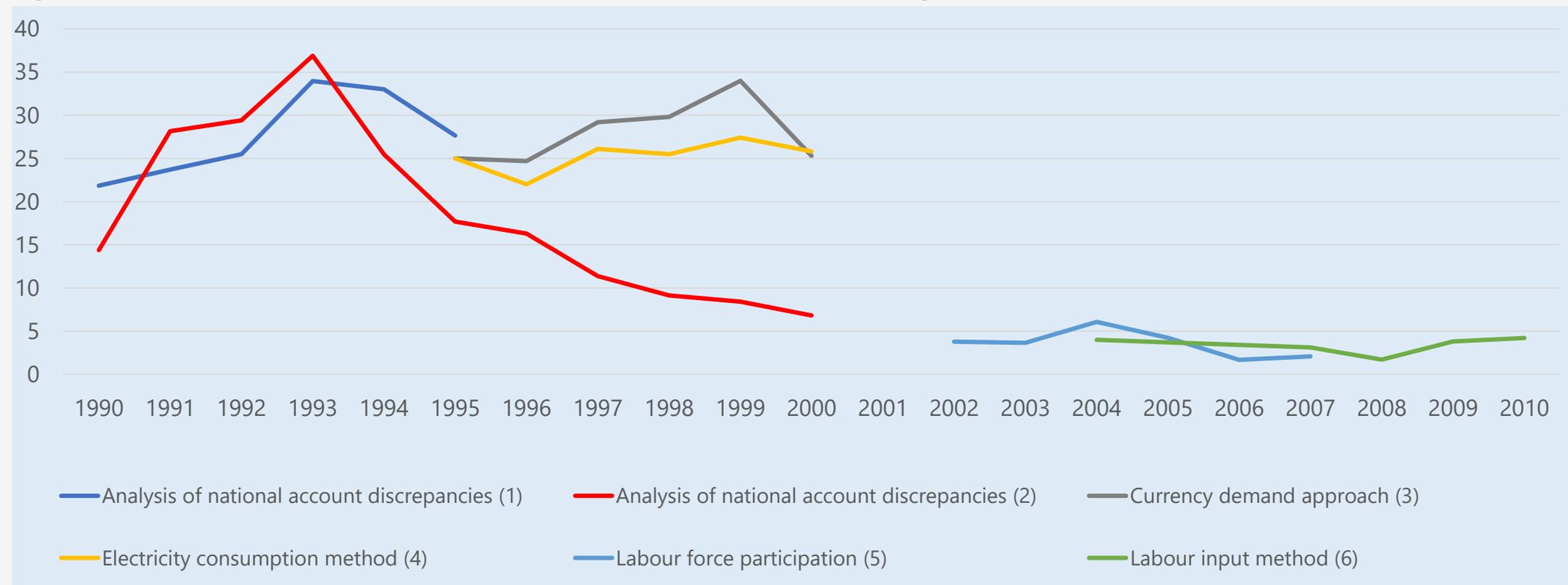
- Analysis of participation in the labour force
- Currency demand approach
- Transaction approach
- Electricity consumption method
- Analysis of national account discrepancies
- **Labour input method**

Latent variable approach - MIMIC method

- one of the most widely applied estimation techniques
- more comprehensive and methodologically trustworthy approach compared to most indirect methods
- structural equation modelling - a sophisticated econometric technique based on factor analysis
- does not impose any conceptual assumptions and restrictions
- susceptible to the changes in input parameters
- not clear what is actually measured

How credible are all these estimation methods?

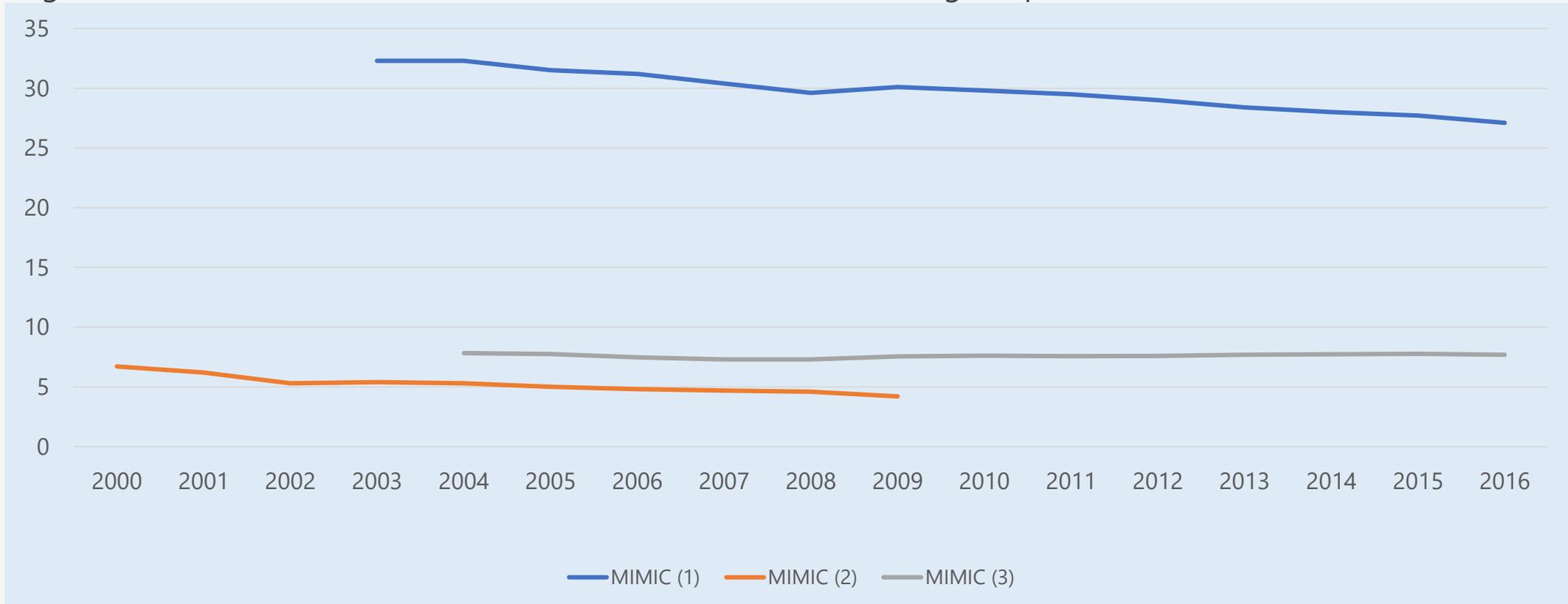
Figure 1 Estimates of concealed economic activities in Croatia during the period 1990-2010, % of GDP



Sources: (1) Madžarević-Šujster and Mikulić (1997), (2) Madžarević-Šujster and Mikulić (2002), (3) Šošić i Faulend (2002), (4) Šošić i Faulend (2002), (5) Švec (2009); (6) Galić Nagyszombaty (2012)

How credible are all these estimation methods? (2)

Figure 2 Estimates of concealed economic activities in Croatia during the period 2000-2016, % of GDP



Sources: (1) Schneider (2017), (2) Klaric (2011), (3) Franic (2019)

Available policy responses

- deterrence is still the most popular approach
- however, the efficiency of repression has been challenged recently
- a lot has been done in terms of prevention (software solutions, financial incentives for new entrants, legislative improvements)
- awareness raising campaigns have been increasingly used
- calls have been made to put more emphasis on indirect policies which seek to repair the psychological contract between the state and citizens, as well as the invisible social contract
- not much is known about the effectiveness of individual policy measures

Conclusion

- concealed economic activities extremely hard to define and classify
- no robust estimation procedure exists
- undeclared work currently in the focus of the authorities
- although the list of negative sides is longer, there are also some positive effects of undeclared work
- It is not clear whether there has been any recent success in the fight against inherently legal economic activities which remain hidden from the authorities

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