

# The shadow economy in industrial countries

## Reducing the size of the shadow economy requires reducing its attractiveness while improving official institutions

Keywords: shadow economy, underground economy, informal economy, illicit work

### ELEVATOR PITCH

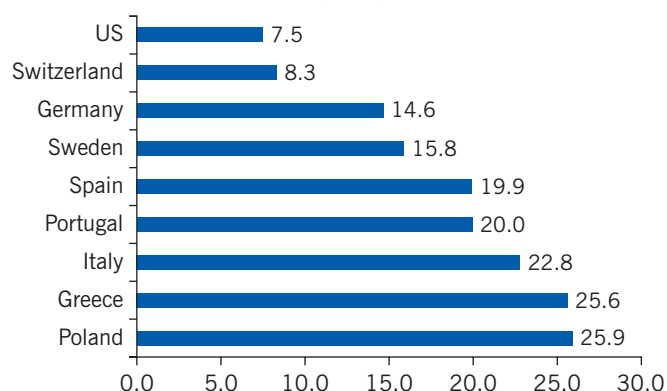
The shadow (underground) economy plays a major role in many countries. People evade taxes and regulations by working in the shadow economy or by employing people illegally. On the one hand, this unregulated economic activity can result in reduced tax revenue and public goods and services, lower tax morale and less tax compliance, higher control costs, and lower economic growth rates. But on the other hand, the shadow economy can be a powerful force for advancing institutional change and can boost the overall production of goods and services in the economy. The shadow economy has implications that extend beyond the economy to the political order.

### KEY FINDINGS

#### Pros

- + High taxes and social security contributions and heavy regulation are the main drivers of the shadow economy.
- + Resources not being used in the official economy can be used in the shadow economy to increase overall supply of goods and services.
- + Opinions on how to deal with the labor force in the shadow economy differ widely.
- + Governments try to encourage firms to move out of the shadow economy by improving public institutions.
- + Fostering stronger popular participation in government decision-making, expanding elements of direct democracy, and eliminating corruption can also reduce the shadow economy.

The shadow economy's share of GDP in industrial countries varies greatly, 2003–2013



Source: Selected countries based on Figure 1.

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World of Labor

#### Cons

- The shadow economy is hard to measure, and different methods yield different results.
- Some measurement difficulties occur because the shadow economy is not clearly defined.
- By worsening fiscal deficits and reducing infrastructure investment, the shadow economy reduces welfare and economic growth.
- The shadow economy can undermine state institutions, leading to more crime and less support for institutions, ultimately threatening economic and political development.
- Trying to reduce the shadow economy through punitive fines and tighter controls is costly and not very effective.

### AUTHOR'S MAIN MESSAGE

The shadow economy should not be seen as solely an economic problem, to be resolved by attacking the symptoms through higher fines and tougher controls. A country-specific analysis of causes and consequences is necessary in order to develop policy measures appropriate to the country's level of development. Policymakers should view illicit work as a signal of the need to decrease the attractiveness of the shadow economy through better regulation, a fair and transparent tax system, and more efficient institutions (good governance). Organized crime and illegal employment should nevertheless be fought through stricter controls and enforcement.