



INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

SHADOW ECONOMY: AN EMPIRICAL ANALYSIS

DR. H. B. APPAJI

Assistant Professor, Dept. Of Economics
Rural College, Kanakapura,
Ramanagara Dist-562117
Karnataka, INDIA

Abstract:

An empirical analysis of the shadow economy involves studying and quantifying the extent and characteristics of economic activities that occur outside the formal sector and are not reported to the government for taxation or regulation purposes. This analysis typically involves collecting and analyzing data from various sources to estimate the size, composition, and drivers of the shadow economy. Researchers employ different methodologies to measure the shadow economy, including direct and indirect approaches. Direct methods involve surveys, interviews, or self-reporting by individuals or businesses engaged in informal economic activities. Indirect methods utilize macroeconomic indicators, such as discrepancies between national income and expenditure, currency demand, or electricity consumption.

Empirical studies on the shadow economy provide insights into its causes, consequences, and potential policy implications. They can help policymakers understand the factors that drive informal economic activities, such as high tax burdens, excessive regulations, or limited access to formal employment opportunities. Additionally, these analyses can shed light on the impact of the shadow economy on government revenues, economic growth, income inequality, and social welfare.

It is worth noting that measuring the shadow economy accurately is challenging due to its clandestine nature. Therefore, empirical analyses may have limitations and uncertainties associated with data collection methods and assumptions made during estimation. Nonetheless, these studies contribute to our understanding of the shadow economy and inform policy discussions aimed at reducing its size and integrating informal economic activities into the formal sector.

Keywords: Economy, Formal Sector, Informal economy, Inclusiveness, Tax evasion

INTRODUCTION:

The shadow economy, also known as the informal economy or underground economy, refers to economic activities that are not regulated or monitored by the government and are not included in official calculations of a country's gross domestic product (GDP) or tax revenue. These activities typically involve transactions that are conducted outside the legal framework, often to avoid taxes, regulations, or other government oversight.

The shadow economy can encompass a wide range of activities, including undeclared work, unregistered businesses, informal labor markets, and illicit trade. Examples may include street vendors, cash-in-hand payments, and undeclared employment, smuggling, and black market transactions. There are various reasons why the shadow economy exists. Some individuals and businesses may engage in informal activities due to high tax burdens, excessive regulations, or limited access to formal employment opportunities. Others may participate in illegal activities to evade law enforcement or exploit loopholes in the system.

The shadow economy poses challenges for governments as it can lead to revenue losses, hinder economic development, and undermine the effectiveness of regulations and social welfare programs. Efforts to reduce the shadow economy often involve improving tax compliance, simplifying regulations, promoting formal employment, and enhancing law enforcement measures. It is important to note that the size and impact of the shadow economy can vary significantly across countries and regions, and accurate measurement is challenging due to its clandestine nature.

Economists and social scientists have in recent years shown considerable interest in considering the difference between the tangible and the real. This focuses on the 'hidden economy', although many synonyms are used for the 'hidden economy': dark, shadowy, underground, invisible, unauthorized, unregistered, the parallels, etc. It generally seeks to capture excessive activity through government activity. Empirical estimates suggest that covert activities have increased since the 1970s Government activity has developed in the world economy. The desire to escape taxation and legal constraints by increasing tax rates to finance larger public budgets also gained prominence (Tanzi and Schuknecht, 1997) Printed articles and media accounts had taken over name also to acknowledge the idea that the underground economy has grown significantly over the years . With such media attention and association with the black economy and the shining eye of society, the severity of this phenomenon has been raised worldwide. Given the significance of the phenomenon, the next question that naturally arises concerns the definition of the hidden economy. Tanzi (1999) argues that the shadow economy grows due to activities such as household chores that are difficult to measure and tax, such as domestic work and criminal and illegal Schneider (1986) summarizes this point when defining covert economically as “all –economic activities that contribute to value-added and should be included in national income in national accounting systems.

Causes for shadow economy

The following are the possible several reasons for the shadow economy:

1. **Tax Evasion:** One of the primary reasons for the shadow economy is to avoid paying taxes. Individuals and businesses may engage in informal economic activities to evade taxes and keep their income hidden from authorities.
2. **Regulatory Burden:** Excessive regulations, bureaucratic red tape, and high compliance costs can push individuals and businesses into the shadow economy. The informal sector provides an alternative for those who find it difficult or costly to comply with formal regulations.

3. **Lack of Access to Formal Employment:** In countries with high unemployment rates or limited job opportunities, individuals may turn to the shadow economy as a means of survival. Informal work provides income-generating opportunities that are not available in the formal sector.

4. **Poverty and Inequality:** Poverty and income inequality can contribute to the growth of the shadow economy. People who are unable to meet their basic needs through formal employment may resort to informal activities to make ends meet.

5. **Corruption:** Widespread corruption can fuel the shadow economy. When public officials demand bribes or engage in corrupt practices, individuals and businesses may opt for informal transactions to avoid dealing with corrupt authorities.

6. **Lack of Trust in Institutions:** In some cases, a lack of trust in government institutions and the legal system can lead to the growth of the shadow economy. People may prefer informal arrangements and transactions over formal channels due to a perceived lack of fairness, transparency, or effectiveness in the formal sector.

It is important to note that the shadow economy has negative consequences, such as reduced tax revenues, limited social protections, and a lack of regulation. Governments often strive to reduce the size of the shadow economy through measures such as tax reforms, simplification of regulations, and efforts to improve governance and transparency.

Measures to Control Shadow Economy

Governments employ various policies to control the shadow economy, which refers to economic activities that occur outside the formal sector and are often unregulated or untaxed. The common strategies are;

1. **Strengthening tax enforcement:** Governments can enhance tax administration and enforcement to reduce tax evasion. This includes improving tax collection mechanisms, implementing stricter penalties for non-compliance, and conducting regular audits.

2. **Simplifying tax systems:** Complex and burdensome tax systems can incentivize individuals and businesses to engage in the shadow economy. Simplifying tax regulations and procedures can help reduce the motivation for tax evasion.

3. **Promoting financial inclusion:** Providing access to formal financial services, such as banking and credit, can discourage participation in the shadow economy. By facilitating financial inclusion, governments can encourage individuals and businesses to operate within the formal economy.

4. **Enhancing transparency and accountability:** Governments can promote transparency and accountability in public administration and governance. This includes measures like implementing anti-corruption initiatives, ensuring fair and transparent procurement processes, and promoting open data practices.

5. **Improving business regulations:** Cumbersome regulations and excessive bureaucracy can push businesses into the shadow economy. Streamlining business registration processes, reducing regulatory burdens, and promoting entrepreneurship can help formalize economic activities.

6. Increasing public awareness and education: Educating the public about the negative consequences of the shadow economy, such as reduced public services and unfair competition, can help discourage participation. Public awareness campaigns can highlight the benefits of operating within the formal economy.

It is important to note that controlling the shadow economy is a complex task that requires a comprehensive approach involving multiple stakeholders, including government agencies, businesses, and citizens.

Challenges

The informal economy or underground economy, refers to economic activities that are not regulated or taxed by the government. Due to its nature, it is challenging to obtain precise statistics on the size and scope of the shadow economy. However, various organizations and researchers have made estimations based on available data and methodologies.

The size of the shadow economy can vary significantly across countries and regions. It is influenced by factors such as the level of economic development, government regulations, tax policies, corruption levels, and social norms.

According to a study by Friedrich Schneider, an expert in shadow economy research, the average size of the shadow economy as a percentage of GDP was around 22.5% for 158 countries in 2019. However, it is important to note that these figures are estimates and can vary over time.

It is worth mentioning that the shadow economy can have both positive and negative implications. On one hand, it can provide employment opportunities and income for individuals who may not have access to formal employment. On the other hand, it can lead to tax evasion, reduced government revenue, and limited social protections for workers.

Efforts to reduce the size of the shadow economy typically involve measures such as improving tax compliance, reducing bureaucratic burdens, promoting formalization of businesses, and enhancing transparency and accountability in governance.

It is advisable to consult specific studies, reports, or government data for more accurate and up-to-date statistics on the shadow economy in a particular country or region.

Conclusion

It is important to note that tackling the shadow economy is a complex and long-term process. These measures should be implemented in a coordinated manner, considering the specific socio-economic context of each country.

As mentioned earlier enhancement of tax enforcement and compliance measures to ensure that individuals and businesses accurately report their income and pay their taxes is required. This can include implementing stricter penalties for tax evasion and improving tax collection mechanisms. Streamline tax laws and regulations to make them more transparent and easier to understand. Simplifying tax procedures can reduce the incentives for engaging in the shadow economy. Government should provide access to formal financial services for all individuals and businesses, especially those in the informal sector. This can be achieved

through initiatives such as expanding banking services, promoting digital payments, and offering financial literacy programs. Policies should create incentives for businesses and workers to operate in the formal economy. This can include offering tax incentives, reducing bureaucratic hurdles, and providing support for small and medium-sized enterprises (SMEs) to transition into the formal sector. Improve efforts to combat illicit activities such as smuggling, counterfeiting, and corruption. This requires effective collaboration between law enforcement agencies, judiciary, and other relevant authorities. Enhancing public awareness is another measure. It is required to educate the public about the negative consequences of the shadow economy, such as reduced public services, unfair competition, and economic instability. Raising awareness can help foster a culture of compliance and discourage participation in the informal sector. Encouraging entrepreneurship and job creation can play a vital role. Policies should promote an enabling environment for entrepreneurship and job growth, which can provide viable alternatives to informal employment. This can involve supporting startups, providing vocational training, and facilitating access to credit for small businesses.

References

- Fleming, Matthew H., John Roman, and Graham Farrell. "The shadow economy." *Journal of international affairs* (2000): 387-409.
- Schneider, Friedrich, and Dominik H. Enste. *The shadow economy: An international survey*. Cambridge University Press, 2013
- Schneider, Friedrich. "The shadow economy and work in the shadow: what do we (not) know?." (2012).
- Schneider, Friedrich. "Shadow economy." *The encyclopedia of public choice*. Boston, MA: Springer US, 2003. 286-296.
- Schneider, Friedrich, and A. T. Kearney. "The shadow economy in Europe, 2013." *Johannes Kepler Universitat, Linz* (2013).
- Dreher, Axel, and Friedrich Schneider. "Corruption and the shadow economy: an empirical analysis." *Public Choice* 144 (2010): 215-238.
- Schneider, Friedrich, ed. *Handbook on the shadow economy*. Edward Elgar Publishing, 2011.
- Feige, Edgar L. "Reflections on the Meaning and Measurement of Unobserved Economies: What Do We Really Know About the 'Shadow Economy'." *Journal of Tax Administration* (2016) Vol 2 (2016).