CAUSES OF NON – OBSERVED ECONOMY

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Abstract

This paper analyse the non – observed economy and its causes. There are a lot of scientific works written until now about non-observed economy, but we must develop the methodology how systemically to define and separate the causes that leads to the growth of the shadow economy. We must find the method how to control the non – observed economy. The topic of this paper is to generalize and systematize the opinion of scientists about shadow economy and find out the causes of non – observed economy. The paper systemically defines the non - observed economy and summarizes the opinion of various scientists. This paper work separates the causes of the shadow economy and goes deeper to the principles of the non-observed economy by analyzing every cause.

Keywords: non - observed economy, shadow economy, causes.

JEL Classification: E26, F41, G18, H26

Introduction

We can find non-observed economy in every country and it is closely related with the official economy and the welfare of the citizens of the county which we are analyzing. The non – observed economy enlarges when there are crisis in the official economy. In 2009 - 2010 there was an economical crisis in the whole world which consequences we can feel today. In our opinion the economy changes in the world left the huge stamp in the non – observed economy and changed it size. The law base and taxation can be ineffective if the size of shadow economy in the country is great. If we want to reduce the size of the non – observed economy, first of all we must understand what influences the enlargement of the size of non – observed economy. In this article we try to systemize and summarize the opinion of scientists and review the causes of the non – observed economy.

We need to find the main causes of the shadow economy. If we could have the model with the ranking of causes of non – observed economy it could help us to make steps for reducing the size of the non – observed economy and to develop the official economy quicker.

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 the non – observed economy and rank the causes of the shadow economy.

Objective: review the non – observed economy during the economical crisis, generalize and systematize the opinion of scientists about shadow economy and find out the main causes of non - observed economy.

Goals:

Systemically to define the non - observed economy and to give the various definitions of non - observed economy based on opinion of scientists and international organizations.

Analyse what makes the influence for shadow economy and make the ranking of the causes of the non - observed economy.

Find out how non – observed economy changes during the economical crisis.


Definition of Non – Observed Economy

More than last three decades from 1982 a lot of scientists, such as V. Tanzi, E. L. Feige, F. Schneider, B. S. Frey and W. W. Pommerehne, 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. These authors define the non-observed economy from various points of view - economical, legitimate, juridical, social and other, but no exact definition, which is used by many scientists. In this article shadow economy and non-observed economy will be used as synonyms. In our previews articles „The size of non – observed economy“ and „Causes and consequences of non – observed economy“ we analysed the definitions of the non-observed economy and we defined it as: an
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 expands the market, but does not increase the government income. We need to go deeper into causes of the shadow economy, because it would let us better understand the whole spectrum of the factors which influences the non-observed economy. By defining the causes we could systemically define the main causes. The arrangement of the causes would let us unanimously to find the tools which would let to control the non-observed economy and its size.

There are two main aspects of the shadow economy. First of all, all the people do not want to give any of their income to someone without getting back anything, because they want to see and to feel what they are getting for the money, which they are paying. The second aspect, that all the people lives in the society which is ruled by the government that needs money. If people feel that they get back the services and the infrastructure that fulfils their requirements they will be ready to pay all the taxes if not – they will try to be unseen in the main economy. (Laukaitis E., Navickas V., 2003)

Martinkus B. and Žilinskas V. writes that non-observed economy exists because of few factors (Martinkus B., Žilinskas V., 2001):

- Supply and demand is not regulated. The law base is ineffective or there are no law at all.
- Barter exist between the economical subjects. So we can’t exactly define the job, that was made and the money amount for it and such a situation is not registered anywhere.

Causes of Non-Observed Economy

By summarizing the opinion of researchers, we think that the existence of non-observed economy is determined by:

- The indicator of economic regulation. From a theoretical perspective it is considered that the intense economic regulation is one of the reasons of non-observed economy. As the economic and law regulation level is high most of individuals are taking certain acts to be unseen in official economy. The result may be ambiguous, because on the one hand the higher regulation level let the country avoid corrupt activities and reduce the size of non-observed economy, but on the other hand it increase the public sector, including the regulation of the economic system. For larger public sector government needs more money and they need to increase the taxes. Such a situation leads to expansion of non-observed economy.

Empirical studies made by F. Schneider, H. Wagner and D. H. Enste 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 restrict 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. 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 size of 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 find that smaller shadow economies appear in countries with lower tax rates, fewer law and regulations, and less corruption.

- Tax burden. This factor is mentioned in all non-observed economic studies as a major cause of non-observed economy. Waiting for a variable of that impact is positive - it means that a higher tax burden encourages individuals remain unaccounted in the economy. Individual researchers take the tax burden not only as the ratio of paid taxes and gross domestic product, but also draw attention to the understanding of
taxpayers as a social welfare goal. Polls show that the countries social welfare from tax payer point of view is far away from the expected. The bigger difference between the total cost of labour in the official economy and the after tax earnings from work, the greater quantity of working people want to find the job in the shadow. Tax burden directly influence the net government income which are distributed for the various sectors, one of which are social security and infrastructure. If there will be enough money for these sectors all will be satisfied and willingly will pay the taxes.

Gutmann (1981) modified Laffer (1979) curve, which shows the correlation between individual reaction and taxation, by integrating the size of non – observed economy, public sector and official economy.

![Laffer Curve](image)

**Figure 1.** Correlation between tax yield, tax rate and the growth of the shadow economy  
*Source: D. H. Enste (2005)*

The axes show the aggregated tax rate in percentage of the income and tax yield. By increasing the taxes people want to avoid them and step by step are moving from the official economy to the non – observed economy. At the point S we can see the maximum income from taxes. But from that point if the tax rate will be increased total income will decrease. At the second part of the figure 1, we can see that the country will need the largest public sector at the “S” point. The size of official economy will be largest and the size of shadow economy will be smallest while the point “S” is not reached.

- **Unemployment rate.** The relationship between non-observed economy and unemployment Tanzi (1999) and Giles and Tedd (2002) approached ambiguously. Rising unemployment rate will influence to find the job in non-observed economy. Never the less, it is also possible that the job opportunities are limited in the non-observed economy, when the unemployment rate is very high. This we can feel during the depression. Unemployment is one of many indicators in the economy and if the unemployment increases - the business sector offers less type of work in both sectors, formal and informal. Thus, the expected outcome of this indicator is also ambiguous. The unemployment rate is one of the main reasons of non-observed economy. If individuals have low disposable incomes, it is expected that they prefer to work in various jobs, even in non-observed economy.

L. Cekanavicius and G. Kasnauskiene (2009) thinks that the hidden benefits of emigration for the donor country include, but are not limited to decrease of unemployment and entailed reduction of demand in
welfare payments, remittance flows, stimulation of exports and technological advancement, shrinkage of shadow economy.

The main motivation for employers and workers for participation in the shadow is the economy. Job in the non-observed economy offers the opportunity to increase the income because of the avoidance of taxation.

V. Navickas (2005) marks three main causes of the existence of undeclared work:

- Appearance of the different demand for “personal service” to families and individuals. These services need very broad range workforce and have low productivity growth.
- Reorganization of companies by making the production more flexible and more open for innovations. This flexibility leads to the emergence of private enterprises, many of which can choose the activity in non-observed economy sector.
- New technologies such as personal computers, smart phones and others are offering new job opportunities and open service activities in shadow economy.

V. Butkeviciene and J. Stravinskiene (2008) made the conclusion that the change of traditional direct trade form to self-service form of trade has increased the product assortment in many groups of products.

Figure 2 shows the changes in the labour market, when the secondary market of non-observed economy appears.

![Figure 2. Changes in the labour market, when the non-observed economy appears](source: V. Navickas (2005))

The elimination of low-skilled workers from the shadow economy will move the supply curve from $S_0$ to $S_1$ and the number of legally employed people would grow up to $E_1$ and the wages would grow from $W_0$ to $W_1$. The higher wages will increase people’s willingness to work, on the other hand it will reduce the number of workers from $E_0$ to $E_1$. These differences depend from particular work, unemployment level, benefits and other factors.

- Corruption. Studies of corruption and non-observed economy correlation are limited, but scientists notice that more corrupted countries has larger size of non-observed economy. Among the activities in which the opportunities for corruption are high, we should notice the regulation and licensing. Almost all the studies stated that a reduction in corruption reduces the level of non-observed economy and vice versa (P. Choi and M. Thum).

The analysis confirms that countries, which has more general type of regulation, usually has higher size of non-observed economy. S. Johnsons and other 1998 survey shows that when the index of regulation rises by one point and other parameters stays unchanged, the level of non-observed economy grows by 8,1 percentage points.

One of the most important aspects of assessing the non-observed economy is the trust in managing authorities of institutions. In countries where confidence is high, we can notice that the size of non-observed economy is usually lower. As stated by W. Mishler and R. Rose, we can notice the high degree of mutual trust between the government and taxpayers. Even an increase of fees, in such countries does not
automatically sweep the size of non-observed economy. Trust of institutions is usually related by two factors: the public service level and mentality.

- **Permanent Salary.** Permanent salary was also used to show a link between this factor and non-observed economy. The theory argues that higher quantity of employees which are getting the permanent salary means smaller size of non-observed economy, as the regular payment of wages can not so easy avoid taxes. This happens because the workers in small firms or self-employed - have more opportunities for informal activities. Small firms and self-employ individuals are closer to its customers and may contract with them to avoid indirect taxes, as well as there are fewer external audit and control than larger firms.

By summarizing this article we would like to give some statistics and rank the causes of non-observed economy. F. Schneider (2006) counted the percentage of main causes for the increase of shadow economic activities. In figure 3 we can see, that the tax and social security contribution burdens makes the numerous influence for non-observed economy.

![Figure 3. Main causes for the increase of shadow economic activities](image)

**Source:** F. Schneider (2006)

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 when we are talking 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 security. 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.

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.

**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 is an economic activity which increases the total value of national product, but it is not included in national account or shown in gross domestic product.

If the economic and law regulation level is high most of individuals are taking certain acts to be unseen in official economy.

Tax burden is mentioned in all non-observed economic studies as a major cause of non-observed economy. Higher tax burden encourages individuals to remain unaccounted in the economy.
Rising unemployment rate will encourage finding the job in non-observed economy. Never the less, it is also possible that the job opportunities are limited in the non-observed economy, when the unemployment rate is very high. This we can feel during the depression.

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F. Schneider (2006) counted the percentage of main causes for the increase of shadow economic activities. The tax and social security contribution burden makes the numerous influences for non – observed economy.

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 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.

References

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