

SHADOW ECONOMIES AROUND THE WORLD: WHAT DO WE KNOW?

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by

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Abstract:

Using various statistical procedures estimates about the size of the shadow economy in 110 developing, transition and OECD countries are presented. The average size of the shadow economy (in percent of official GDP) over 1999-2000 in developing countries is 41%, in transition countries 38% and in OECD countries 18.0%. If the shadow economy increases by one percent the annual growth rate of a developing country (industrialized and/or transition) decreases by 0.6% (0.8 and 1.0 respectively). An increasing burden of taxation and social security contributions combined with rising state regulatory activities are the driving forces for the growth and size of the shadow economy.

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1 Introduction

As crime and other underground economic activities (including shadow economic ones) are a fact of life around the world, most societies attempt to control these activities through various measures like punishment, prosecution, economic growth or education. Gathering statistics about who is engaged in underground (or crime) activities, the frequencies with which these activities are occurring and the magnitude of them, is crucial for making effective and efficient decisions regarding the allocations of a country's resources in this area. Unfortunately, it is very difficult to get accurate information about these underground (or as a subset shadow economy) activities on the goods and labor market, because all individuals engaged in these activities wish not to be identified. Hence, the estimation of the shadow economy activities can be considered as a scientific passion for knowing the unknown.

Although quite a large literature¹⁾ on single aspects of the hidden economy exists and a comprehensive survey has just been written by Schneider (the author of this paper) and Enste. Moreover, the subject is still quite controversial²⁾ as there are disagreements about the definition of shadow economy activities, the estimation procedures and the use of their estimates in economic analysis and policy aspects.³⁾ Nevertheless around the world, there are some indications for an increase of the shadow economy and little is known about the size of the shadow economies in transition, development and developed countries for the year 2000. The size, the causes and the consequences are different for different types of countries, but there are some comparisons that can be made and that might be interesting for social scientists, the public in general, and helpful for politicians.

The scientific fascination of the underground economy has inspired us to tackle this difficult question and undertake the challenging task to estimate the shadow economy for 110 countries, and to provide some insights about the main causes of the shadow economy and its effect on the official economy. In section 2 an attempt is made to define the shadow economy. Section 3 presents the empirical results of the size of the shadow economy over 110 countries

¹⁾ The literature about the „shadow“, „underground“, „informal“, „second“, „cash-“ or „parallel“, economy is increasing. Various topics, on how to measure it, its causes, its effect on the official economy are analyzed. See for example, survey type publications by Frey and Pommerehne (1984); Thomas (1992); Loayza (1996); Pozo (1996); Lippert and Walker (1997); Schneider (1994a, 1994b, 1997, 1998a, 2003); Johnson, Kaufmann, and Shleifer (1997), Johnson, Kaufmann and Zoido-Lobaton (1998a); and Gerxhani (2003). For an overall survey of the global evidence of its size in terms of value added Schneider and Enste (2000, 2002).

²⁾ Compare e.g. in the Economic Journal, vol. 109, no. 456, June 1999 the feature “controversy: on the hidden economy”.

all over the world. Section 4 examines the main causes of the shadow economy. Section 5 presents the dynamic effects of the shadow economy on the official one. In section 6 a summary is given and some policy conclusions are drawn. Finally in the two appendices (1 and 2) the various methods to estimate the shadow economy are presented and the data set as well as some further econometric results are shown.

2 The Definition of a Shadow Economy: An Attempt

Most authors trying to measure the shadow economy face the difficulty of how to define it. One commonly used working definition is: all currently unregistered economic activities which contribute to the officially calculated (or observed) Gross National Product.⁴⁾ Smith (1994, p. 18) defines it as „market-based production of goods and services, whether legal or illegal that escapes detection in the official estimates of GDP.“ Or to put it in another way, one of the broadest definitions of it, includes...”those economic activities and the income derived from them that circumvent or other wise government regulation, taxation or observation”.⁵⁾ As all these definitions still leave open a lot of questions, table 2.1 may be helpful for developing a better feeling for what could be a reasonable consensus definition of the legal and illegal underground or shadow economy.

From table 2.1 it becomes clear that the shadow economy includes unreported income from the production of legal goods and services, either from monetary or barter transactions - hence all economic activities which would generally be taxable were they reported to the state (tax) authorities. In general, a precise definition seems quite difficult, if not impossible as „the shadow economy develops all the time according to the 'principle of running water': it adjusts to changes in taxes, to sanctions from the tax authorities and to general moral attitudes, etc.“ (Mogensen, et. al. 1995 p. 5). This paper does not focus on tax evasion or tax compliance, because it would get to long, and moreover tax evasion is a different subject, where already a lot of research has been underway.⁶⁾

³⁾ Compare the different opinions of Tanzi (1999), Thomas (1999) and Giles (1999).

⁴⁾ This definition is used for example, by Feige (1989, 1994), Schneider (1994a, 2003), Frey and Pommerehne (1984), and Lubell (1991).

⁵⁾ This definition is taken from Dell'Anno (2003) and Feige (1989); see also Thomas (1999), Fleming, Roman and Farrell (2000).

⁶⁾ Compare, e.g. the survey of Andreoni, Erard and Feinstein (1998) and the paper by Kirchler, Maciejovsky and Schneider (2002).

Table 2.1: A Taxonomy of Types of Underground Economic Activities¹⁾

Type of Activity	Monetary Transactions		Non Monetary Transactions	
Illegal Activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud; etc.		Barter of drugs, stolen goods, smuggling etc. Produce or growing drugs for own use. Theft for own use.	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
Legal Activities	Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

¹⁾ Structure of the table is taken from Lippert and Walker (1997, p. 5) with additional remarks.

3 The Size of the Shadow Economies all over the World – Findings for 110 Countries

For single countries and sometimes for a group of countries (like the OECD or transition countries) research has been undertaken to estimate the size of the shadow economy using various methods and different time periods. In tables 3.1 to 3.6, an attempt is made to undertake a consistent comparison of estimates of the size of the shadow economies of various countries, for a fixed period, generated by using similar methods which will be discussed in chapter 6, by reporting the results for the shadow economy for 110 countries all over the world for the year 2000.⁷⁾

3.1 Developing Countries⁸⁾

The physical input (electricity) method, the currency demand and the model (DYMIMIC) approach are used for the developing countries. The results are grouped according to African, Asian and Central and South American countries.⁹⁾ They are shown in tables 3.1.-3.3.

⁷⁾ One should be aware that such country comparisons give only a very rough picture of the ranking of the size of the shadow economy over the countries, because each method has shortcomings, which are discussed in appendix 2 (part 7.2). See, e.g., Thomas (1992, 1999) and Tanzi (1999). At least in this comparison the same time period (2000) is used for all countries.

⁸⁾ For an extensive and excellent literature survey of the research about the shadow economy in developing countries see Gerxhani (2003), who stresses thorough out her paper that the destination between developed and developing countries with respect to the shadow economy is of great importance. Due to space reasons this point is not further elaborated here also the former results and literature.

The results for 24 African countries are shown in table 3.1.

Table 3.1

On average the size of the shadow economy in Africa (in percent of GDP) was 41% for the years 2000. Zimbabwe, Tanzania and Nigeria have with 59.4, 58.3 and 57.9% by far the largest shadow economies. In the middle field are Mozambique, Cote d'Ivoire and Madagascar with 40.3, 39.9 and 39.6%. At the lower end are Botswana with 33.4, Cameroon with 32.8 and South Africa with 28.4%. In sum one realizes that the size of the shadow economies which are more like a parallel economy in Africa is quite large.

In table 3.2 the results for Asia are shown and here it is somewhat difficult to treat all Asian countries equally because Japan, Singapore and Hongkong are highly developed countries and the others more or less developing countries. But as we decided to group according to continents so we leave these countries series as it stands now, realizing that not all are developing countries.

Table 3.2

If we consider the 26 Asian countries¹⁰⁾, where the results are shown in table 3, Thailand has by far the largest shadow economy in the year 2000 with the size of 52.6% of official GDP. Followed by Sri Lanka with 44.6% and Philippines with 43.4%. In the middle are India with 23.1%, Israel with 21.9% and Taiwan and China¹¹⁾ with 19.6%. At the lower end are Singapore with 13.1% and Japan with 11.3%. On average the Asian countries have a size of the shadow economy of 26% of official GDP for the year 2000. One realizes that the average size of the Asian shadow economies is considerably lower compared with the ones of African and South and Latin American States – partly due to the fact that in Asia we have a number of highly developed industrialized countries with low shadow economies.

⁹⁾ The disadvantage of these grouping is that especially in Asia we have also highly developed countries like Japan, Singapore, etc. and also in Africa the South-Africa.

¹⁰⁾ The case of India has been extensively investigated by Chatterjee, Chaudhury and Schneider (2003).

¹¹⁾ Here only parts of China are considered, which are converted into market economy.

Table 3.1: The size of the shadow and official economy of 24 African nations

	AFRICAN nation	GNP at market prices (current US\$, billion) 2000	Shadow Economy in % of GNP 1999/2000	Shadow Economy (current USD in billion) 2000	Shadow Economy GNP per capita (current US\$)	GNP per capita 2000, Atlas method (current US\$)
1	Algeria	506,1	34,1	172,6	538,8	1580
2	Benin	21,5	45,2	9,7	167,2	370
3	Botswana	52,8	33,4	17,6	1102,2	3300
4	Burkina Faso	21,7	38,4	8,3	80,6	210
5	Cameroon	82,8	32,8	27,2	190,2	580
6	Cote d'Ivoire	86,1	39,9	34,4	239,4	600
7	Egypt, Arab Rep.	996,6	35,1	349,8	523,0	1490
8	Ethiopia	63,3	40,3	25,5	40,3	100
9	Ghana	48,3	38,4	18,5	126,7	330
10	Kenya	102,2	34,3	35,1	120,1	350
11	Madagascar	38,0	39,6	15,1	99,0	250
12	Malawi	16,6	40,3	6,7	68,5	170
13	Mali	22,6	41,0	9,3	98,4	240
14	Morocco	324,6	36,4	118,1	429,5	1180
15	Mozambique ¹⁾	35,8	40,3	14,4	84,6	210
16	Niger	18,1	41,9	7,6	75,4	180
17	Nigeria	367,3	57,9	212,6	150,5	260
18	Senegal	42,9	43,2	18,5	211,7	490
19	South Africa	1226,4	28,4	348,3	857,7	3020
20	Tanzania	89,8	58,3	52,4	157,4	270
21	Tunisia	185,7	38,4	71,3	806,4	2100
22	Uganda	61,6	43,1	26,5	129,3	300
23	Zambia	27,9	48,9	13,6	146,7	300
24	Zimbabwe ¹⁾	71,4	59,4	42,4	273,2	460
	AVERAGE	188	41	69	280	764

1) Due to civil war and political unrest unreliable figures.

Source: own calculations based on Worldbank Data, Washington D.C., 2002.

Table 3.2: The size of the shadow and official economy of 26 Asian countries

	ASIA	GNP at market prices (current US\$, billion) 2000	Shadow Economy in % of GNP 1999/2000	Shadow Economy (current USD in bill.) 2000	Shadow Economy GNP per capita (current US\$)	GNP per capita 2000, Atlas method (current US\$)
1	Bangladesh	468,9	35,6	166,9	131,7	370
2	China ¹⁾	10652,8	13,1	1395,5	110,0	840
3	Hongkong, China	1654,7	16,6	274,7	4302,7	25920
4	India	4531,8	23,1	1046,8	104,0	450
5	Indonesia ²⁾	1426,6	19,4	276,8	110,6	570
6	Iran	937,7	18,9	177,2	304,3	1610
7	Israel	1060,1	21,9	232,2	3659,5	16710
8	Japan	49011,6	11,3	5538,3	4025,1	35620
9	Jordan	83,1	19,4	16,1	331,7	1710
10	Korea, Rep.	4550,2	27,5	1251,3	2450,3	8910
11	Lebanon ²⁾	174,2	34,1	59,4	1367,4	4010
12	Malaysia	823,9	31,1	256,2	1051,2	3380
13	Mongolia ¹⁾	9,5	18,4	1,8	71,8	390
14	Nepal	56,9	38,4	21,8	92,2	240
15	Pakistan	596,0	36,8	219,3	161,9	440
16	Philippines	793,2	43,4	344,2	451,4	1040
17	Saudi Arabia	1736,6	18,4	319,5	1330,3	7230
18	Singapore	983,7	13,1	128,9	3240,9	24740
19	Sri Lanka	160,0	44,6	71,4	379,1	850
20	Syria	159,6	19,3	30,8	181,4	940
21	Taiwan, China	3144,0	19,6	616,2	2720,5	13880
22	Thailand	1205,4	52,6	634,1	1052,0	2000
23	Turkey	2009,2	32,1	644,9	995,1	3100
24	Unit. Arab Emir.	0,0	26,4	0,0	7191,4	27240
25	Vietnam ¹⁾	313,5	15,6	48,9	60,8	390
26	Yemen	73,9	27,4	20,2	101,4	370
	AVERAGE	3331	26	531	1384	7037

1) Still a mostly communist dominated country. 2) Due to civil war and political unrest unreliable figures.

Source: own calculations based on Worldbank data, Washington D.C., 2002.

In table 3.3 the size of the shadow economies for the year 2000 for 17 South and Latin American countries is shown. The average size of shadow economy of these 17 countries is 41%.

Table 3.3

The largest shadow economy has Bolivia with 67.1%, followed by Panama with 64.1% and Peru with 59.9%. The lowest shadow economy has Chile with 19.8% and before is Argentina with 25.4%. If one compares the results of tables 3.1 to 3.3 one realizes that the size of the shadow economy of South America and Africa is somewhat similar and the size of the shadow economy in Asia is somewhat lower – mostly due to the fact that in Asia we have a number of highly industrialized and developed countries (Japan, Singapore, etc.).

3.2 Transition Countries

The measurement of the size and development of the shadow economy in the transition countries has been undertaken since the late 80s starting with the work of Lacko (2000), Johnson et.al. (1997), and Kaufmann and Kaliberda (1996). They all are using the electricity method (see chapter 6.2) and come up with quite large figures. In the work of Alexeev and Pyle (2003) their studies are critically evaluated arguing that the so far estimated sizes of the unofficial economies are to a large content a historical phenomenon only partly determined by institutional factors.

In this paper the sizes of the shadow economies of the transition countries which have been estimated the year 2000 using the DYMIMIC approach, are presented in table 3.4.

Table 3.4

23 transition countries have been investigated and the average size of the shadow economy in percent of official GDP is 38% for the year 2000. The by far largest shadow economy has Georgia with 67.3%, followed by Azerbaijan with 60.6% and Ukraine with 52.2%. In the middle field are Bulgaria and Romania with 36.9 and 34.4% and at the lower end are Hungary with 25.1, the Czech Republic with 19.1 and the Slowac. Republic with 18.9%.

Table 3.3: The size of the shadow and official economy of 17 Latin and South American Countries

	SOUTH AMERICA	GNP at market prices (current US\$, billion) 2000	Shadow Economy in % of GNP 1999/2000	Shadow Economy (current USD in billion) 2000	Shadow Economy GNP per capita (current US\$)	GNP per capita 2000, Atlas method (current US\$)
1	Argentina	2774,4	25,4	704,7	1894,8	7460
2	Bolivia	80,6	67,1	54,1	664,3	990
3	Brazil	5697,7	39,8	2267,7	1424,8	3580
4	Chile	681,4	19,8	134,9	908,8	4590
5	Colombia	788,5	39,1	308,3	789,8	2020
6	Costa Rica	146,2	26,2	38,3	998,2	3810
7	Dominican Republic	186,3	32,1	59,8	683,7	2130
8	Ecuador	123,8	34,4	42,6	416,2	1210
9	Guatemala	187,4	51,5	96,5	865,2	1680
10	Honduras	57,9	49,6	28,7	426,6	860
11	Jamaica	69,9	36,4	25,5	950,0	2610
12	Mexico	5597,7	30,1	1684,9	1526,1	5070
13	Nicaragua	21,1	45,2	9,5	180,8	400
14	Panama	93,7	64,1	60,1	2089,7	3260
15	Peru	519,2	59,9	311,0	1245,9	2080
16	Uruguay	193,8	51,1	99,0	3066,0	6000
17	Venezuela, RB	1193,2	33,6	400,9	1448,2	4310
	AVERAGE	1083	41	372	1152	3062

Source: own calculations based on Worldbank data, Washington D.C., 2002.

Table 3.4: The size of the shadow and official economy of 23 European and Asian Transformation Countries

	EUROPE - TRANSFORMATION COUNTRIES	GNP at market prices (current US\$, billion) 2000	Shadow Economy in % of GNP 1999/2000	Shadow Economy (current USD in billion) 2000	Shadow Economy GNP per capita (current US\$)	GNP per capita 2000, Atlas method (current US\$)
1	Albania ²⁾	38,6	33,4	12,9	374,1	1120
2	Armenia	19,3	46,3	8,9	240,8	520
3	Azerbaijan ^{1) 2)}	49,2	60,6	29,8	363,6	600
4	Belarus ¹⁾	299,6	48,1	144,1	1380,5	2870
5	Bosnia-Herzegovina ²⁾	46,2	34,1	15,8	419,4	1230
6	Bulgaria	116,7	36,9	43,1	560,9	1520
7	Croatia	187,2	33,4	62,5	1543,1	4620
8	Czech Republic	500,1	19,1	95,5	1002,8	5250
9	Georgia	30,5	67,3	20,5	424,0	630
10	Hungary	440,6	25,1	110,6	1182,2	4710
11	Kazakhstan ¹⁾	170,5	43,2	73,7	544,3	1260
12	Kyrgyz Republic	12,2	39,8	4,9	107,5	270
13	Latvia	71,8	39,9	28,6	1165,1	2920
14	Lithuania	111,2	30,3	33,7	887,8	2930
15	Moldova ^{1) 2)}	13,6	45,1	6,1	180,4	400
16	Poland	1568,2	27,6	432,8	1156,4	4190
17	Romania	363,8	34,4	125,2	574,5	1670
18	Russian Federation ¹⁾	2484,4	46,1	1145,3	779,1	1690
19	Slovak Republic	187,7	18,9	35,5	699,3	3700
20	Slovenia	180,7	27,1	49,0	2723,6	10050
21	Ukraine	308,5	52,2	161,0	365,4	700
22	Uzbekistan ¹⁾	74,2	34,1	25,3	122,8	360
23	Yugoslavia ²⁾	84,5	29,1	24,6	273,5	940
	AVERAGE	320	38	117	742	2354

1) Still a mostly communist dominated country. 2) Due to civil war and political unrest unreliable figures.

Source: own calculations based on Worldbank data, Washington D.C., 2002.

3.3 Highly developed OECD-Countries

For 21 OECD countries the results are not only shown for the year 2000, but also over an extended time period, i.e. from 1989 to 2002/2003 is presented in table 3.5.

Table 3.5

For the 21 OECD countries either the currency demand method or the DYMIMIC method are used.¹²⁾ Considering again the latest period 2002/2003, Greece has with 28.3% of official GDP the largest shadow economy, followed by Italy with 26.2%¹³⁾ and Portugal with 22.3%. In the middle-field are Germany with a shadow economy of 16.8% of official GDP, followed by Ireland with 15.5% and France with 14.8% of official GDP. At the lower end are Austria with 10.8% of GDP and the United States with 8.6% of official GDP. For these OECD countries one realizes over time quite an increase of the shadow economies during the 90s. On average the shadow economy was 13.2% in these 21 OECD states in the year 1989/90 and it rose to 16.4% in the year 2002/2003. If we consider the second half of the 90s, we realize that for the majority of OECD countries the shadow economy is not further increasing, even (slightly) decreasing, like for Belgium from 22.5% (1997/98) to 21.5% (2002/2003), for Denmark from 18.3% (1997/98) to 17.5% (2002/2003) or for Finland from 18.9% (1997/98) to 17.6% (2002/2003) or for Italy from 27.3% (1997/98) to 26.2% (2002/2003). For others, like Austria, it is still increasing from 9.0% (1997/98) to 10.8% (2002/2003), or Germany from 14.9% (1997/98) to 16.8% (2002/2003). Hence, one can't draw a general conclusion whether the shadow economy is further increasing or decreasing at the end of the 90s. It differs from country to country but in some countries some efforts have been made to stabilize the size of the shadow economy and in other countries (like Germany) these efforts were not successful.

¹²⁾ The case of Australia has been extensively investigated by Bajada (2002) and Bajada and Schneider (2003).

¹³⁾ An extensive study of the size of the shadow economy of Italy was done by Dell'Anno (2003) and Dell'Anno and Schneider (2003), who achieve a similar but somewhat lower magnitude of the Italian shadow economy.

Table 3.5: The Size of the Shadow Economy in OECD Countries

OECD-Countries	Size of the Shadow Economy (in % of GDP) using the Currency Demand and DYMIMIC Method					
	Average 1989/90	Average 1994/95	Average 1997/98	Average 1999/2000	Average 2001/2002	Average 2002/2003 ¹⁾
1. Australia	10.1	13.5	14.0	14.3	14.1	13.8
2. Belgium	19.3	21.5	22.5	22.2	22.0	21.5
3. Canada	12.8	14.8	16.2	16.0	15.8	15.4
4. Denmark	10.8	17.8	18.3	18.0	17.9	17.5
5. Germany	11.8	13.5	14.9	16.0	16.3	16.8
6. Finland	13.4	18.2	18.9	18.1	18.0	17.6
7. France	9.0	14.5	14.9	15.2	15.0	14.8
8. Greece	22.6	28.6	29.0	28.7	28.5	28.3
9. Great Britain	9.6	12.5	13.0	12.7	12.5	12.3
10. Ireland	11.0	15.4	16.2	15.9	15.7	15.5
11. Italy	22.8	26.0	27.3	27.1	27.0	26.2
12. Japan	8.8	10.6	11.1	11.2	11.1	11.0
13. Netherlands	11.9	13.7	13.5	13.1	13.0	12.8
14. New Zealand ²⁾	9.2	11.3	11.9	12.8	12.6	12.4
15. Norway	14.8	18.2	19.6	19.1	19.0	18.7
16. Austria	6.9	8.6	9.0	9.8	10.6	10.8
17. Portugal	15.9	22.1	23.1	22.7	22.5	22.3
18. Sweden	15.8	19.5	19.9	19.2	19.1	18.7
19. Switzerland	6.7	7.8	8.1	8.6	9.4	9.5
20. Spain ³⁾	16.1	22.4	23.1	22.7	22.5	22.3
21. USA	6.7	8.8	8.9	8.7	8.7	8.6
Unweighted Average over 21 OECD countries	13.2	15.7	16.7	16.8	16.7	16.4

Sources: Currency demand and DYMIMIC approach, own calculations

1) Preliminary values.

2) The figures are calculated using the MIMIC-method and Currency demand approach. Source: Giles (1999b).

3) The figures have been calculated for 1989/90, 1990/93 and 1994/95 from Mauleon (1998) and for the later periods own calculations.

Having examined the size and development of the shadow economy in terms of value added over time, the analysis now focuses on the „shadow“ labor market, as within the official labor market there is a particularly tight relationship and “social network” between people who are

active in the shadow economy.¹⁴⁾ Moreover, by definition every activity in the shadow economy involves a “shadow” labor market to some extent: Hence, the “shadow labor market” includes all cases, where the employees or the employers, or both, occupy a „shadow economy position“.¹⁵⁾ In various OECD countries, these costs are greater than the wage effectively earned by the worker – providing a strong incentive to work in the shadow economy.

Illicit work can take many shapes. The underground use of labor may consist of a second job after (or even during) regular working hours. A second form is shadow economy work by individuals who do not participate in the official labor market. A third component is the employment of people (e.g. clandestine or illegal immigrants), who are not allowed to work in the official economy. Empirical research on the shadow economy labor market is even more difficult than of the shadow economy on the value added, since one has very little knowledge about how many hours an average “shadow economy worker” is actually working (from full time to a few hours, only); hence, it is not easy to provide empirical facts.¹⁶⁾

In table 3.6 the estimates for the shadow economy labor force in 7 OECD-countries (Austria, Denmark, France, Germany, Italy, Spain and Sweden) are shown.

Table 3.6

In Austria the shadow economy labor force has reached in the years 1997-1998 500.000 to 750.000 or 16% of the official labor force (mean value). In Denmark the development of the 80s and 90s shows that the part of the Danish population engaged in the shadow economy ranged from 8.3% of the total labor force (in 1980) to 15.4% in 1994 – quite a remarkable increase of the shadow economy labor force; it almost doubled over 15 years. In France (in the years 1997/98) the shadow economy labor force reached a size of between 6 and 12% of the official labor force or in absolute figures between 1.4 and 3.2 million. In Germany this figure rose from 8 to 12% in 1974 to 1982 and to 22% (18 millions) in the year 1997/98. This is again a very strong increase in the shadow economy labor force for France and Germany.

¹⁴⁾Pioneering work in this area has been done by L. Frey (1972, 1975, 1978, 1980), Cappiello (1986), Lubell (1991), Pozo (1996), Bartlett (1998) and Tanzi (1999).

¹⁵⁾ More detailed theoretical information on the labor supply decision in the underground economy is given by Lemieux, Fortin, and Fréchette (1994, p.235) who use micro data from a survey conducted in Quebec City (Canada). These empirical findings clearly indicate, that “participation rates and hours worked in the underground sector also tend to be inversely related to the number of hours worked in the regular sector“.

¹⁶⁾For developing countries some literature about the shadow labour market exists, e.g. the latest works by Pozo (1996), Loayza (1996), especially Chickering and Salahdine (1991).

For other countries the amount of the shadow economy labor force is quite large, too: in Italy 30-48% (1997-1998), Spain 11.5-32% (1997-1998) and Sweden 19.8 % (1997-1998). In the European Union about 30 million people are engaged in shadow economy activities in the year 1997-1998 and in all European OECD-countries 48 million work illicitly. These figures demonstrate that the shadow economy labor market is lively and may provide an explanation, why for example in Germany, one can observe such a high and persistent unemployment.

In table 3.6 a first and preliminary calculation of the official GNP per capita and the shadow economy GDP (working population) per capita is done, shown in US-\$. Here one realizes immediately that in all countries investigated, the shadow economy GDP per capita is much higher - on average in all countries around 30%.¹⁷⁾ In general these very preliminary results clearly demonstrate that the shadow economy labor force has reached a remarkable size in the developed OECD-countries, too, even when the calculation still might have many errors, but again these figures demonstrate, that the shadow economy labor market has reached a sizeable figure in most countries.

4 The Main Causes of Determining the Shadow Economy

4.1 Tax and Social Security Contribution Burdens

In almost all studies¹⁸⁾ it has been found out, that the tax and social security contribution burdens are one of the main causes for the shadow economy. Since taxes affect labor-leisure choices, and also stimulate labor supply in the shadow economy, or the untaxed sector of the economy, the distortion of the overall tax burden is a major concern of economists. The bigger the difference between the total cost of labor in the official economy and the after-tax earnings (from work), the greater is the incentive to avoid this difference and to work in the shadow economy. Since this difference depends broadly on the social security burden/payments and the overall tax burden, they are key features of the existence and the increase of the shadow economy. But even major tax reforms with major tax rate deductions will not lead to a substantial decrease of the shadow economy.¹⁹⁾

¹⁷⁾ This is an astonishing result, which has to be further checked, because in the official per capita GDP figures the whole economy is included with quite productive sectors (like electronics, steel, machinery, etc.) and the shadow economy figures traditionally contain mostly the service sectors (and the construction sector). Hence one could also expect exactly the opposite result, as the productivity in the service sector is usually much lower than in the above mentioned ones. Sources of error may be either an underestimation of the shadow economy labor force or an overestimation of the shadow economy in terms of value added.

¹⁸⁾ See Thomas (1992); Lippert and Walker (1997); Schneider (1994, 1997, 1998, 2000, 2003b); Johnson, Kaufmann, and Zoido-Lobaton (1998a,1998b); Tanzi (1999); Giles (1999a); Mummert and Schneider (2001); Giles and Tedds (2002) and Dell'Anno (2003), just to quote a few recent ones.

¹⁹⁾ See Schneider (1994b, 1998b) for a similar result of the effects of a major tax reform in Austria on the

Table 3.6: Estimates of the Size of the “Shadow Economy Labor Force” and of the Official and Shadow Economy per capita 1974-1998

Countries	Year	Official GDP per capita in US-\$ ¹⁾	Shadow Economy GDP in US-\$ per capita	Size of the Shadow Economy (in % of official GDP) Currency Demand Approach ²⁾	Shadow Economy Labor Force in 1000 people ³⁾	Shadow Economy Participants in % of official Labor Force ⁴⁾	Sources of Shadow Economy Labour Force
Austria	90-91	20,636	25,382	5.47	300-380	9.6	Schneider (1998) and own calculations
	97-98	25,874	29,630	8.93	500-750	16.0	
Denmark	1980	13,233	18,658	8.6	250	8.3	Mogensen, et. al. (1995) and own calculations
	1994	34,441	48,562	17.6	420	15.4	
France	1975-82	12,539	17,542	6.9	800-1500	3.0-6.0	De Grazia (1983) and own calculations
	1997-98	24,363	34,379	14.9	1400-3200	6.0-12.0	
Germany	1974-82	11,940	17,911	10.6	3000-4000	8.0-12.0	De Grazia (1983), F. Schneider (1998b) and own calculations
	1997-98	26,080	39,634	14.7	7000-9000	19.0-23.0	
Italy	1979	8,040	11,736	16.7	4000-7000	20.0-35.0	Gaetani and d'Aragona (1979) and own calculations
	1997-98	20,361	29,425	27.3	6600-11400	30.0-48.0	
Spain	1979-80	5,640	7,868	19.0	1250-3500	9.6-26.5	Ruesga (1984) and own calculations
	1997-98	13,791	19,927	23.1	1500-4200	11.5-32.3	
Sweden	1978	15,107	21,981	13.0	750	13.0-14.0	De Grazia (1983) and own calculations
	1997-98	25,685	37,331	19.8	1150	19.8	
European Union	1978	9,930	14,458	14.5	15 000	-	<i>De Grazia (1983) and own calculations</i>
	1997-98	22,179	32,226	19.6	30 000		
OECD (Europe)	1978	9,576	14,162	15.0	26 000	-	<i>De Grazia (1983) and own calculations</i>
	1997-98	22,880	33,176	20.2	48 000		

1) Source: OECD, Paris, various years

2) Source: Own calculations.

3) Estimated full-time jobs, including unregistered workers, illegal immigrants, and second jobs.

4) In percent of the population aged 20-69, survey method.

They will only be able to stabilize the size of the shadow economy and avoid a further increase. Social networks and personal relationships, the high profit from irregular activities and associated investments in real and human capital are strong ties which prevent people from transferring to the official economy. For Canada, Spiro (1993) found similar reactions of people facing an increase in indirect taxes (VAT, GST). This fact makes it even more difficult for politicians to carry out major reforms because they may not gain a lot from them.

The most important factor in neoclassical models is the marginal tax rate. The higher the marginal tax rate, the greater is the substitution effect and the bigger the distortion of the labor-leisure decision. Especially when taking into account that the individual can also receive income in the shadow economy, the substitution effect is definitely larger than the income effect²⁰⁾ and, hence, the individual works less in the official sector. The overall efficiency of the economy is, therefore (*ceteris paribus*), lower and the distortion leads to a welfare loss (according to official GNP and taxation.) But the welfare might also be viewed as increasing, if the welfare of those, who are working in the shadow economy, were taken into account, too.²¹⁾

Empirical results of the influence of the tax burden on the shadow economy is provided in the studies of Schneider (1994b, 2000) and Johnson, Kaufmann and Zoido-Lobaton (1998a, 1998b); they all found strong evidence for the general influence of taxation on the shadow economy. This strong influence of indirect and direct taxation on the shadow economy will be further demonstrated by discussing empirical results in the case of Austria and the Scandinavian countries. For Austria the driving force for the shadow economy activities is the direct tax burden (including social security payments), it has the biggest influence, followed by the intensity of regulation and complexity of the tax system. A similar result has been achieved by Schneider (1986) for the Scandinavian countries (Denmark, Norway and Sweden). In all three countries various tax variables (average direct tax rate, average total tax rate (indirect and direct tax rate)) and marginal tax rates have the expected positive sign (on currency demand) and are highly statistically significant. These findings are supported by studies of Kirchgaessner (1983, 1984) for Germany and by Kloveland (1984) for Norway and Sweden, too.

Several other recent studies provide further evidence of the influence of income tax rates on the shadow economy: Cebula (1997), using Feige data for the shadow economy, found

²⁰⁾If leisure is assumed to be a normal good.

²¹⁾See Thomas (1992) p. 134-7.

evidence of the impact of income tax rates, IRS audit probabilities, and IRS penalty policies on the relative size of the shadow economy in the United States. Cebula concludes that a restraint of any further increase of the top marginal income tax rate may at least not lead to a further increase of the shadow economy, while increased IRS audits and penalties might reduce the size of the shadow economy. For example, if the marginal federal personal income tax rate increases by one percentage point, *ceteris paribus*, the shadow economy rises by 1.4 percentage points. In another investigation, Hill and Kabir (1996) found empirical evidence that marginal tax rates are more relevant than average tax rates, and that a substitution of direct taxes by indirect taxes seems unlikely to improve tax compliance. Further evidence on the effect of taxation on the shadow economy is presented by Johnson, Kaufmann, and Zoido-Lobaton (1998b), who come to the conclusion that it is not higher tax rates *per se* that increase the size of the shadow economy, but the ineffective and discretionary application of the tax system and the regulations by governments. Their finding, that there is a *negative* correlation²²⁾ between the size of the unofficial economy and the *top* (marginal) tax rates, might be unexpected. But since other factors like tax deductibility, tax relives, tax exemptions, the choice between different tax systems, and various other options for legal tax avoidance were not taken into account, it is not all that surprising.²³⁾ On the other side Johnson, Kaufmann and Zoido-Lobaton (1998b) find a *positive* correlation between the size of the shadow economy and the corporate tax burden. They come to the overall conclusion that there is a large difference between the impact of either direct taxes or the corporate tax burden. Institutional aspects, like the efficiency of the administration, the extent of control rights held by politicians and bureaucrats, and the amount of bribery and especially corruption, therefore, play a major role in this “bargaining game“ between the government and the taxpayers.

4.2 Intensity of Regulations

The increase of the intensity of regulations (often measured in the numbers of laws and regulations, like licenses requirements) is another important factor, which reduces the

²²⁾The higher the top marginal tax rate, the lower the size of the shadow economy.

²³⁾Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) found a similar result in a cross country analysis that higher tax rates are associated with less official activity as percent of GDP. They argue entrepreneurs go underground not to avoid official taxes but they want to reduce the burden of bureaucracy and corruption. However looking at their empirical (regression) results the finding that higher tax rates are correlated with a lower share of the unofficial economy is not very robust and in most cases, using different tax rates, they do not find a statistically significant result.

freedom (of choice) for individuals engaged in the official economy.²⁴⁾ One can think of labor market regulations, trade barriers, and labor restrictions for foreigners. Johnson, Kaufmann, and Zoido-Lobaton (1998b) find an overall significant empirical evidence of the influence of (labor) regulations on the shadow economy, the impact is clearly described and theoretically derived in other studies, e.g. for Germany (Deregulation Commission 1990/91). Regulations lead to a substantial increase in labor costs in the official economy. But since most of these costs can be shifted on the employees, these costs provide another incentive to work in the shadow economy, where they can be avoided. Empirical evidence supporting the model of Johnson, Kaufmann, and Shleifer (1997), which predicts, inter alia, that countries with more general regulation of their economies tend to have a higher share of the unofficial economy in total GDP, is found in their empirical analysis. A one-point increase of the regulation index (ranging from 1 to 5, with 5 = the most regulation in a country), ceteris paribus, is associated with an 8.1 percentage point increase in the share of the shadow economy, when controlled for GDP per capita (Johnson et. al. (1998b), p. 18). They conclude that it is the enforcement of regulation, which is the key factor for the burden levied on firms and individuals, and not the overall extent of regulation - mostly not enforced - which drive firms into the shadow economy. Friedman, Johnson, Kaufmann and Zoido-Lobaton (1999) reach a similar result.

In their study every available measure of regulation is significantly correlated with the share of the unofficial economy and the sign of the relationship is unambiguous: more regulation is correlated with a larger shadow economy. A one point increase in an index of regulation (ranging from 1-5) is associated with a 10 % increase in the shadow economy for 76 developing, transition and developed countries.

These findings demonstrate that governments should put more emphasis on improving enforcement of laws and regulations, rather than increasing their number. Some governments, however, prefer this policy option (more regulations and laws), when trying to reduce the shadow economy, mostly because it leads to an increase in power of the bureaucrats and to a higher rate of employment in the public sector.

4.3 Public Sector Services

An increase of the shadow economy can lead to reduced state revenues which in turn reduce the quality and quantity of publicly provided goods and services. Ultimately, this can lead to

²⁴⁾See for a (social) psychological, theoretical foundation of this feature, Brehm (1966, 1972), and for a (first)

an increase in the tax rates for firms and individuals in the official sector, quite often combined with a deterioration in the quality of the public goods (such as the public infrastructure) and of the administration, with the consequence of even stronger incentives to participate in the shadow economy. Johnson, Kaufmann, and Zoido-Lobaton (1998b) present a simple model of this relationship. Their findings show that smaller shadow economies appear in countries with higher tax revenues, if achieved by lower tax rates, fewer laws and regulations and less bribery facing enterprises. Countries with a better rule of the law, which is financed by tax revenues, also have smaller shadow economies. Transition countries have higher levels of regulation leading to a significantly higher incidence of bribery, higher effective taxes on official activities and a large discretionary framework of regulations and consequently to a higher shadow economy. The overall conclusion is that “wealthier countries of the OECD, as well as some in Eastern Europe find themselves in the ‘good equilibrium’ of relatively low tax and regulatory burden, sizeable revenue mobilization, good rule of law and corruption control, and [relatively] small unofficial economy. By contrast, a number of countries in Latin American and the Former Soviet Union exhibit characteristics consistent with a ‘bad equilibrium’: tax and regulatory discretion and burden on the firm is high, the rule of law is weak, and there is a high incidence of bribery and a relatively high share of activities in the unofficial economy.” (Johnson, Kaufmann and Zoido-Lobaton 1998a p. I).

5 The Dynamic Effects of the Shadow Economy on Official Economy

5.1 Theoretical Background

Generally the view prevails that the informal sector/the shadow economy influences the tax system and its structure, the efficiency of resource allocation between sectors and the official economy as a whole in a dynamic sense. In order to study the effects of the shadow economy on the official one, several studies integrate underground economies into macroeconomic models.²⁵ Houston (1987) develops a theoretical macro model of business cycle as well as tax and monetary policy linkages with the shadow economy. He concludes from his investigation of the growth of the shadow economy that, on the one side its effect should be taken into account in setting tax and regulatory policies and on the other side the existence of a shadow economy could lead to an overstatement of the inflationary effects of fiscal or monetary

application to the shadow economy, Pelzmann (1988).

²⁵ For Austria this was done by Schneider, Hofreither, and Neck (1989) and Neck, Hofreither, and Schneider

stimulus. Adam and Ginsburgh (1985) focus on the implications of the shadow economy on "official" growth in their study for Belgium. They find a positive relationship between the growth of the shadow economy and the "official" one and under certain assumptions (i.e. very low entry costs into the shadow economy due to a low probability of enforcement) they conclude that an expansionary fiscal policy has a positive stimulus for both the formal and informal economies.

Another hypothesis is, that a substantial reduction of the shadow economy leads to a significant increase in tax revenues and therefore to a greater quantity and quality of public goods and services, which ultimately can stimulate economic growth. Some authors found evidence for this hypothesis. A recent study by Loayza (1996) presents a simple macroeconomic endogenous growth model whose production technology depends on congestable public services. The determinants and effects of the informal sector are studied, where excessive taxes and regulations are imposed by governments and where the capability to enforce compliance is low. The model concludes that in economies where (1) the statutory tax burden is larger than the optimal tax burden and where (2) the enforcement of compliance is too weak, the increase of the relative size of the informal economy generates a reduction of economic growth. The reason for this correlation is the strongly negative correlation between the informal sector and public infrastructure indices, while public-infrastructure is the key element for economic growth. For example, Loayza finds empirical evidence for Latin America countries that if the shadow economy increases by one percentage point (of GDP) - ceteris paribus - the growth rate of official real GDP per capita decreases by 1.22 percentage points. This negative impact of informal sector activities on economic growth is not broadly accepted.²⁶ For example, the key feature of the model has been criticized, because the model is based on the assumption that the production technology essentially depends on tax-financed public services, which are subject to congestion. In addition, the informal sector is not paying any taxes but must pay penalties which are not used to finance public services. The negative correlation between the size of the informal sector and economic growth is therefore not very surprising.

Depending on the prevailing view of the informal sector, one might also come to the opposite conclusion. In the neoclassical view the underground economy is optimal in the sense that it responds to the economic environment's demand for urban services and small-scale

(1989). For further discussion of this aspect see Quirk (1996) and Giles (1999a).

²⁶See Asea (1996) for a more detailed criticism of the Loayza model.

manufacturing. From this point of view the informal sector provides the economy with a dynamic and entrepreneurial spirit and can lead to more competition, higher efficiency and strong boundaries and limits for government activities. The informal sector may offer great contributions “to the creation of markets, increase financial resources, enhance entrepreneurship, and transform the legal, social, and economic institutions necessary for accumulation“ (Asea, 1996 p. 166). The voluntary self-selection between the formal and informal sectors, as described above in microeconomic models, may provide a higher potential for economic growth and, hence, a positive correlation between an increase of the informal sector and economic growth. The effects of an increase of the shadow economy on economic growth therefore remain considerably ambiguous.

The task of this part now is to test empirically whether the size of the shadow economy influences economic growth either positive or negative. Estimating a cross section using the OLS-technique [Ordinary Least Squares²⁷] for the year 2000 with explanatory independent variables like inflation rate, labour force growth rate, capital accumulation rate, openness, foreign direct investment [FDI] and the shadow economy in percent of GDP to explain real economic growth 2000 did not deliver useful results [Alm et al. 2003, page 17 - 18] since almost all coefficients are statistically insignificant. Especially the coefficient capturing the effect of the shadow economy [our variable of most interest] is statistically not different from zero on a conventional confidence level. Due to this result we estimated a cross time-series model in order to explain the annual GDP growth rate for a certain time period. This result was more promising, and we constructed a Panel-Dataset²⁸ for the 109 developing, transition and OECD countries for the time period from 1990 to 2000 to estimate possible effects of the shadow economy on the official one.

The panel data set consists of variables²⁹ that the growth theory suggests to be relevant for economic growth [Barro et al. 1995 and Breton 2001]. The dataset includes data on shadow economy, capital accumulation, labour force and population growth, inflation rates, an indicator for openness, figures on foreign direct investment, the ‘corruption index’ ranging from 0 - 10, government expenditures and GDP per capita [to control for the convergence

²⁷ More information about regression analysis with Ordinary Least Squares can be found in Wooldridge 2000, Chapters 2 and 3.

²⁸ A Panel-Dataset is a data set which contains variables [for example economic growth,...] for certain countries over a certain period of time. Then variations over time for a single country as well between countries can be considered.

²⁹ A description of the countries, variables and sources can be found more detailed in the part 7.2, Appendix at the end of this paper.

hypothesis³⁰] that can be used as explanatory and control variables for estimating a model that tries to identify a relationship between economic growth and the shadow economy.

5.2 The Main Results

5.2.1 The sample of 109 developing and developed countries

Our empirical estimation equation is the following:

$$\begin{aligned} \text{economic growth} = & a1 \text{ (shadow economy industrialized countries)} + \\ & a2 \text{ (shadow economy developing countries)} + \\ & a3 \text{ (openness)} + \\ & a4 \text{ (inflation rate industrialized countries)} + \\ & a5 \text{ (inflation rate developed countries)} + \\ & a6 \text{ (government consumption)} + \\ & a7 \text{ (lagged GDP per capita growth rate)} + \\ & a8 \text{ (total population)} + \\ & a9 \text{ (capital accumulation rate)} + \\ & a10 \text{ (constant)} + \varepsilon_{it} \end{aligned}$$

$$\text{expected signs} = \quad a1 > 0, a2 < 0, a3 > 0, a4 < 0, a5 < 0, a6 < 0, a7 > 0, a8 > 0, a9 > 0$$

Not all of the theoretically relevant variables for economic growth just like expenditures on research and development [R&D] as an indicator for technological progress or indicators for human capital like school enrollment and number of persons with secondary and tertiary education were available³¹ for all 109 countries for the regression analysis but the dataset is quite adequate for testing the dynamic influence of the shadow economy on the official one.

Putting all possible (for all countries available) variables into an equation explaining economic growth did not deliver satisfying results, since many variables were insignificant. For example labour force growth has no influence on the GDP growth rate in the model despite the fact that theory suggests a positive relationship between labour force growth and economic growth [Solow Model, see Breton 2001]. Additionally the corruption index ranging

³⁰ The convergence theory argues that countries with a lower GDP per capita should have higher annual GDP growth rates since they are following a catching up process.

³¹ Some variables were not available at all but most variables were available only for a small number of countries and many observations would have been lost if using the particular variable in the regression analysis [for example using patents per year as a proxy variable for expenditures on R&D results in a sample consisting only of 30 countries]. The 109 countries are listed in the appendix 2 (part 7.2).

from 0 to 10³² or foreign direct investment has no statistical impact on the dependent variable annual GDP growth.

The ‘testing down procedure’³³ was a necessary attempt to solve this misspecification and to gather an adequate growth equation. After various different model specifications the following model, reported in table 5.1, resulted. This is indeed the best model that we found with the data available for all 109 countries.

Table 5.1.: Results of the Panel Regression; Time period 1990 – 2000, 109 developing, transition and industrialized countries

<i>Dependent Variable</i>	<i>Annual GDP per capita Growth Rate</i>
<i>Independent Variables:</i>	<i>Estimated Coefficients:</i>
Shadow Economy Industrialized Countries	0.077 (2.63)**
Shadow Economy Developing Countries	-0.052 (2.37)**
Openness	0.012 (2.14)**
Inflation Rate Other Countries	0.023 (1.32)
Inflation Rate Transition Countries	-0.021 (4.10)**
Government Consumption	-0.181 (3.23)**
Lagged Annual GDP per capita Growth Rate	0.154 (3.06)**
Total Population	0.000036 (2.07)**
Capital Accumulation Rate	0.019 (1.88)*
Constant	0.062 (4.13)**
Number of countries	109
Overall R-Squared	0.347
Within R-Squared	0.266
Between R-Squared	0.417
Wald-CHI ²	94.63 (0.000)
<i>Absolute value of z-statistics in parentheses</i>	
<i>* significant at 10%;</i>	
<i>** significant at 5%.</i>	
<i>Random effects GLS-regressions; 104 countries, period 1990-2000; yearly data</i>	

Source: Own Calculation by authors

³² The higher the value of the corruption index, the lower corruption in the observed country.

³³ The ‘testing down procedure’ means that step by step insignificant variables are dropped from the equation after carrying out F-tests on joint significance [see Wooldridge 2000, page 139 - 150]. For example the coefficient on GDP per capita was insignificant and the convergence theory cannot be supported with the

This regression and the model specification presented in table 5.1 clearly shows a highly interesting and statistically significant negative relationship between the shadow economy of developing countries and official economic growth and a statistically significant positive relationship between the shadow economy in industrialized countries and economic growth. If the shadow economy in industrialized countries raises by 1 percentage point of GDP (e.g. shadow economy increases from 10 of 11 percent of official GDP) official growth increases by 7.7 percent. If the shadow economy in developed countries increases by 1 percentage point of official GDP official growth of GDP decreases by 4.9 percent. Also all other variables (except the inflation rate in other countries) have a statistically significant influence. The more open a country the higher is official growth and if the inflation rate in developing countries increases by 1 percent official growth decreases by 2.1 percent. If the state sector increases by 1 percent official growth decreases by 1.8 percent. If the total population increases by 10 million, official GDP increases by 0.36 percent.

In general these results clearly show a statistically significant negative impact of the shadow economy of developing countries on the growth rate of the official economy and a positive influence of the shadow economy on the growth rate of industrialized countries. All other variables have plausible signs and are always the exception of the inflation rate for industrialized countries statistically significant on a 5 percent confidence level

5.2.2 Considering only 21 OECD countries

For 21 OECD countries which are listed as Australia, Belgium, Canada, Denmark, Germany, Finland, France, Greece, Great Britain, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Austria, Portugal, Sweden, Switzerland, Spain, USA again a growth section time series estimation approach of the official growth rate of the period 1990 up to 2000 is undertaken.

For these 21 OECD countries we estimated at the following growth equation.

$$\begin{aligned} \text{official growth (annual GDP per capita)} = & \quad a1 \text{ (trendvariable)} + \\ & \quad a2 \text{ (shadow economy)} + \\ & \quad a3 \text{ (openness)} + \\ & \quad a4 \text{ (capital accumulation rate)} + \\ & \quad a5 \text{ (annual FDY growth rate)} + \\ & \quad a6 \text{ (annual labour force growth rate)} + \\ & \quad a7 \text{ (constant)} \varepsilon_{it} \end{aligned}$$

For the signs we expect $a_1 > 0, a_2 > 0, a_3 > 0, a_4 > 0, a_5 > 0$

Table 5.2.: Growth equation for 21 OECD Countries 1990 - 2000

<i>Dependent Variables</i>	<i>Annual GDP per capita Growth Rate</i>
<i>Explanatory Variables:</i>	
Trend Variable	-0.003 (3.36)**
Shadow Economy	0.078 (2.05)**
Openness	0.016 (2.47)**
Capital Accumulation Rate	0.127 (3.47)**
Annual FDI Growth Rate	0.004 (2.49)**
Annual Labour Force Growth Rate	0.951 (2.44)**
Constant	6.206 (3.36)**
Number of countries	21
Overall R-Squared	0.370
Within R-Squared	0.213
Between R-Squared	0.716
Wald-Chi ²	51.10 (0.000)
<i>Absolute value of z-statistics in parentheses</i>	
<i>* significant at 10%;</i>	
<i>** significant at 5%;</i>	
<i>Random effects GLS-regressions; 21 countries, period 1990-2000; yearly data</i>	

Source: Own Calculation by authors

The empirical estimation results are shown in table 5.2. They clearly show a negative trend of the growth rate of the OECD countries which is not unusual for the period of the 90s for most OECD countries. Again the shadow economy has a positive significant influence. If the shadow economy increases by 1 percentage point (of official GDP) the growth rate increases by 7.8 percent. The capital accumulation rate increases by 1 percentage point, official growth increases by 12.7 percent. Foreign direct investment increases by 1 percentage point, annual growth rate increases by 0.4 percent. If the annual labor force rate increases by 1 percent, growth rate increases by 9.5 percent. Also this result is satisfactory and shows again the positive significant influence of the shadow economy in highly developed countries.

5.2.3 Considering Transition and Developing Countries

As official economy growth of highly industrialized, developing and transition countries may

be quite different and the independent factors influencing the growth rate may also be quite different (due to institutional reasons), we finally present an estimation with only developing and transition countries. For these 75 countries we estimated the following growth equation:

Official growth (annual GDP per capita) =

- a1 (shadow economy transition countries)
- a2 (shadow economy developing countries)
- a3 (foreign direct investment lagged)
- a4 (inflation rate other countries)
- a5 (inflation rate transition countries)
- a6 (government consumption)
- a7 (lagged annual GDP per capita)
- a8 (growth rate)
- a9 (population rate)
- a10 (capital accumulation rate)
- a11 (constant)

For the signs we expect: $a1 > 0$, $a2 < 0$, $a3 > 0$, $a4 < 0$, $a5 < 0$, $a6 < 0$, $a7 > 0$, $a8 > 0$, $a9 > 0$

The empirical results are shown in table 5.3.

Table 5.3.: Results of the Panel Regression; Time period 1990 – 2000, 75 transition and developing countries

Dependent Variable	Annual GDP per capita Growth Rate
<i>Independent Variables:</i>	<i>Estimated Coefficients:</i>
Shadow Economy Transition Countries	0.099** (3.80)
Shadow Economy Developing Countries	-0.045** (-2.36)
FDI lagged	0.00049 (0.05)
Inflation Rate Other Countries	0.0263 (1.28)
Inflation Rate Transition Countries	-0.021** (-3.69)
Government Consumption	-0.184** (3.25)
Lagged Annual GDP per capita Growth Rate	0.154** (3.06)
Total Population	0.000036* (1.80)
Capital Accumulation Rate	0.015 (1.42)
Constant	0.067** (5.00)
Number of countries	75
Overall R-Squared	0.3211
Within R-Squared	0.263
Between R-Squared	0.443
Wald-CHI ²	73.89 (0.000)

Absolute value of z-statistics in parentheses
** significant at 10%;*
*** significant at 5%.*
Random effects GLS-regressions; 75 countries, period 1990-2000; yearly data

Source: Own Calculation by authors

Table 5.3 clearly shows a statistically significant positive influence of the shadow economy of transition countries and a statistically significant negative influence of the shadow economy on developing countries (the usual result). If the shadow economy in transition countries increases by 1 percent (an increase in percent of official GDP) then the official growth in the transition countries still rise by 7.7 percent. The foreign direct investment lagged has no statistically influence. The inflation rate in transition countries has a negative statistically insignificant influence, if it increases by 1 percent, official growth decreases by 2.1 percent. Government consumption or the size of the state sector has again a negative statistically significant influence. If the state sector measured in state consumption in percent of official

GDP increases by 1 percentage point official growth goes down by 18.4 percent. Also the lagged annual GDP per capita growth rate has a statistically significant influence also together with the population. The capital accumulation is not statistically significant. The overall $R^2=0.32$; a quite statistically result.

To summarize: all three regressions in tables 5.1-5.3 clearly indicate that the shadow economy has a statistically significant influence on official growth. For transition countries and in highly industrialized countries this influence is clearly positive and for developing countries the shadow economy has a negative influence on official growth. Our empirical results partly confirm our theoretical considerations in section 5.1.

6 Summary and Conclusions

There are many obstacles to be overcome to measure the size of the shadow economy and to analyze its consequences on the official economy, although some progress has been made. In this paper has been shown that though it is difficult to estimate the size of the shadow economy (in value added and in the labor force), it is not impossible. We have demonstrated that with various methods, e.g. the currency demand, the physical input measure the discrepancy method and the model approach, some insights can be provided into the size and development of the shadow economy of the developing, transition and the OECD countries. The general impression from the results of these methods is that for all countries investigated the shadow economy has reached a remarkably large size. The results are shown in table 6.1.

Table 6.1: Average Size of the Shadow Economy for Developing, Transition and OECD-Countries in Terms of Value-Added for 2000

Countries	Average Size of the Shadow Economy – Value added in % of official GDP 2000
	<i>Currency Demand and DYMIMIC method (Number of Countries)</i>
Developing countries:	
Africa	41 (23)
Central and South America	41 (18)
Asia ¹⁾	29 (26)
Transition countries	35 (23)
Western OECD Countries - Europe	18 (16)
North American and Pacific OECD Countries	13.5 (4)

1) Here not all countries are developing countries like Japan, Singapore or Hongkong.
Source: Own calculations.

To summarize:

- (1) As it has already been argued, there is no „best“ or commonly accepted method; each approach has its specific strengths and weaknesses as well as specific insights and results. Although the different methods provide a rather wide range of estimates, there is a common finding that the size of the shadow economies for most transition and all investigated OECD countries has been growing over the recent decade. A similar finding can be made for the „shadow labor market“ which is attracting a growing attention due to high unemployment in European OECD countries.
- (2) Furthermore, the results of this study show that an increasing burden of taxation and social security payments, combined with rising state regulatory activities, are the major driving forces for the size and growth of the shadow economy.
- (3) A further important result of this study is that the shadow economy has a statistically significant influence on the growth of the official economy. If the shadow economy

increases by one percentage point (shadow economy is percent of official GDP) the official growth declines by 57.1 percent. For developed (industrialized and /or transition) countries we find the opposite result. If the shadow economy increases by one percentage point (in % of GDP) the growth rate in industrialized countries increases by 8 percent in industrialized countries and by 10 percent in transition countries, respectively.

Finally, to conclude: Shadow economies are a complex phenomenon, present to an important extent even in the industrialized and developed economies. People engage in shadow economic activity for a variety of reasons, among most important, of which we can count are government actions, most notable taxation and regulation. With these two insights, goes a third, no less important one: a government aiming to decrease shadow economic activity has to first and foremost analyze the complex and frequently contradictory relationships among consequences of its own policy decisions.

7 Appendices

7.1 Appendix 1: Methods to Estimate the Size of the Shadow Economy

As has already been mentioned in chapter 2 to undertake attempts to estimate the size of a shadow economy is a difficult and challenging task. In this chapter a short comprehensive overview is given about the current knowledge of the various procedures to estimate the shadow economy. To estimate the size and development of the shadow economy three different types of methods are most widely used. They are briefly discussed in the following three subsections.

7.1.1 Direct Approaches

These are micro approaches which employ either well designed surveys and samples based on voluntary replies or tax auditing and other compliance methods. Sample surveys designed to estimate the shadow economy are widely used in a number of countries³⁴⁾. The main disadvantage of this method is that it presents the flaws of all surveys: average precision and results depend greatly on the respondents willingness to cooperate. It is difficult to assess the rise of the undeclared work from a direct questionnaire. Most interviewed hesitate to confess a fraudulent behavior and quite often responses are rarely reliable so that it is difficult, from this type of answers, to calculate a real estimate – in monetary terms – of the extend of undeclared work. The main advantage of this method lies in the detailed information about the structure of the shadow economy, but the results from these kinds of surveys are very sensitive to the way the questionnaire is formulated³⁵⁾.

Estimates of the shadow economy can also be based on the discrepancy between income declared for tax purposes and that measured by selective checks. Fiscal auditing programs have been particularly effective in this regard. Designed to measure the amount of undeclared taxable income, they have been used to calculate the shadow economy in several countries.³⁶⁾ A number of difficulties beset this approach. Firstly, using tax compliance data is equivalent

³⁴⁾The direct method of voluntary sample surveys has been extensively used for Norway by Isachsen, Klovland and Strom (1982), and Isachsen and Strom (1985). For Denmark this method is used by Mogensen (et. al., 1995) in which they report „estimates“ of the shadow economy of 2.7 percent of GDP for 1989, of 4.2 percent of GDP for 1991, of 3.0 percent of GDP for 1993 and of 3.1 percent of GDP for 1994.

³⁵⁾The advantages and disadvantages of this method are extensively dealt by Mogensen et. al (1995) in their excellent and very carefully done investigation.

³⁶⁾In the United States, IRS (1979, 1983), Simon and Witte (1982), Witte (1987), Clotefelter (1983), and Feige (1986). For a more detailed discussion, see Dallago (1990) and Thomas (1992).

to using a (possibly biased) sample of the population. However, since in general a selection of tax payers for tax audit is not random, but based on properties of submitted (tax) returns which indicate a certain likelihood of (tax) fraud, such a sample is not a random one of the whole population. This factor is likely to bias compliance – based estimates of the black economy. Secondly, estimates based on tax audits reflect that portion of black economy income which the authorities succeeded in discovering and this is likely to be only a fraction of hidden income.

A further disadvantage of these two direct methods (surveys and tax auditing) is that they lead only to point estimates. Moreover, it is unlikely that they capture all „shadow“ activities, so they can be seen as providing lower bound estimates. They are unable (at least at present) to provide estimates of the development and growth of the shadow economy over a longer period of time. As already argued, they have, however at least one considerable advantage - they can provide detailed information about shadow economy activities and the structure and composition of those who work in the shadow economy.

7.1.2 Indirect Approaches

These approaches, which are also called „indicator“ approaches, are mostly macroeconomic ones and use various economic and other indicators that contain information about the development of the shadow economy (over time). Currently there are five indicators which leave some „traces“ of the development of the shadow economy:

7.1.2.1 The Discrepancy between National Expenditure and Income Statistics

This approach is based on discrepancies between income and expenditure statistics. In national accounting the income measure of GNP should be equal to the expenditure measure of GNP. Thus, if an independent estimate of the expenditure side of the national accounts is available, the gap between the expenditure measure and the income measure can be used as an indicator of the extend of the black economy.³⁷⁾ However, since national accounts statisticians will be anxious to minimize this discrepancy, the initial discrepancy or first estimate, rather than the published discrepancy should be employed for this purpose. If all the components of the expenditure side were measured without error, then this approach would indeed yield a good estimate of the scale of the shadow economy. However, unfortunately, this is not the case and the discrepancy, therefore, reflects all omissions and errors everywhere in the

³⁷⁾ See, e.g., Franz (1983) for Austria; MacAfee (1980) O'Higgins (1989) and Smith (1985), for Great Britain; Petersen (1982) and Del Boca (1981) for Germany; Park (1979) for the United States. For a survey and critical remarks, see Thomas (1992).

national accounts statistics as well as the shadow economy activity. These estimates may therefore be very crude and of questionable reliability.³⁸⁾

7.1.2.2 The Discrepancy between the Official and Actual Labor Force

A decline in participation of the labor force in the official economy can be seen as an indication of increased activity in the shadow economy. If total labor force participation is assumed to be constant, a decreasing official rate of participation can be seen as an indicator of an increase in the activities in the shadow economy, *ceteris paribus*.³⁹⁾ The weakness of this method is that differences in the rate of participation may also have other causes. Moreover, people can work in the shadow economy and have a job in the „official‘ economy. Therefore such estimates may be viewed as weak indicators of the size and development of the shadow economy.

7.1.2.3 The Transactions Approach

This approach has been developed by Feige.⁴⁰⁾ It assumes, that there is a constant relation over time between the volume of transaction and official GNP. Feige’s approach therefore starts from Fisher’s quantity equation, $M \cdot V = p \cdot T$ (with M = money, V = velocity, p = prices, and T = total transactions). Assumptions have to be made about the velocity of money and about the relationships between the value of total transactions ($p \cdot T$) and total (=official + unofficial) nominal GNP. Relating total nominal GNP to total transactions, the GNP of the shadow economy can be calculated by subtracting the official GNP from total nominal GNP. However, to derive figures for the shadow economy, Feige has to assume a base year in which there is no shadow economy, and therefore the ratio of $p \cdot T$ to total nominal (official = total) GNP was „normal“ and would have been constant over time, if there had been no shadow economy. This method, too, has several weaknesses: for instance, the assumption of a base year with no shadow economy, and the assumption of a „normal“ ratio of transactions constant over time. Moreover, to obtain reliable shadow economy estimates, precise figures of the total volume of transactions should be available. This availability might be especially difficult to achieve for cash transactions, because they depend, among other factors, on the durability of bank notes, in terms of the quality of the papers on which they are printed.⁴¹⁾

³⁸⁾ A related approach is pursued by Pissarides and Weber (1988), who use micro data from household budget surveys to estimate the extend of income understatement by self-employed. Also in this micro approach more or less the same difficulties arise and the figures calculated for the shadow economies may be crude.

³⁹⁾ Such studies have been made for Italy, see e.g., Contini (1981) and Del Boca (1981); for the United States, see O’Neill (1983), for a survey and critical remarks, see Thomas (1992).

⁴⁰⁾ For an extended description of this approach, see Feige (1996); for a further application for the Netherlands, Boeschoten and Fase (1984), and for Germany, Langfeldt (1984).

⁴¹⁾ For a detailed criticism of the transaction approach see Boeschoten and Fase (1984), Frey and Pommerehne (1984), Kirchgaessner (1984), Tanzi (1982, 1986), Dallago (1990), Thomas (1986, 1992, 1999) and Giles (1999a).

Also, in this approach the assumption is made that all variations in the ratio between the total value of transaction and the officially measured GNP are due to the shadow economy. This means that a considerable amount of data is required in order to eliminate financial transactions from “pure” cross payments, which are totally legal and have nothing to do with the shadow economy. In general, although this approach is theoretically attractive, the empirical requirements necessary to obtain reliable estimates are so difficult to fulfil, that its application may lead to doubtful results.

7.1.2.4 The Currency Demand Approach

The currency demand approach was first used by Cagan (1958), who calculated a correlation of the currency demand and the tax pressure (as one cause of the shadow economy) for the United States over the period 1919 to 1955. 20 years later, Gutmann (1977) used the same approach, but did not use any statistical procedures; instead he „only“ looked at the ratio between currency and demand deposits over the years 1937 to 1976.

Cagan’s approach was further developed by Tanzi (1980, 1983), who econometrically estimated a currency demand function for the United States for the period 1929 to 1980 in order to calculate the shadow economy. His approach assumes that shadow (or hidden) transactions are undertaken in the form of cash payments, so as to leave no observable traces for the authorities. An increase in the size of the shadow economy will therefore increase the demand for currency. To isolate the resulting „excess“ demand for currency, an equation for currency demand is econometrically estimated over time. All conventional possible factors, such as the development of income, payment habits, interest rates, and so on, are controlled for. Additionally, such variables as the direct and indirect tax burden, government regulation and the complexity of the tax system, which are assumed to be the major factors causing people to work in the shadow economy, are included in the estimation equation. The basic regression equation for the currency demand, proposed by Tanzi (1983), is the following:

$$\ln (C / M_2)_t = \beta_0 + \beta_1 \ln (1 + TW)_t + \beta_2 \ln (WS / Y)_t + \beta_3 \ln R_t + \beta_4 \ln (Y / N)_t + u_t$$

with $\beta_1 > 0$, $\beta_2 > 0$, $\beta_3 < 0$, $\beta_4 > 0$

where

\ln denotes natural logarithms,

C / M_2 is the ratio of cash holdings to current and deposit accounts,

TW is a weighted average tax rate (to proxy changes in the size of the shadow economy),

WS / Y is a proportion of wages and salaries in national income (to capture changing payment and money holding patterns),

R is the interest paid on savings deposits (to capture the opportunity cost of holding cash) and
Y / N is the per capita income.⁴²⁾

The „excess“ increase in currency, which is the amount unexplained by the conventional or normal factors (mentioned above) is then attributed to the rising tax burden and the other reasons leading people to work in the shadow economy. Figures for the size and development of the shadow economy can be calculated in a first step by comparing the difference between the development of currency when the direct and indirect tax burden (and government regulations) are held at its lowest value, and the development of currency with the current (much higher) burden of taxation and government regulations. Assuming in a second step the same income velocity for currency used in the shadow economy as for legal M1 in the official economy, the size of the shadow can be computed and compared to the official GDP.

The currency demand approach is one of the most commonly used approaches. It has been applied to many OECD countries,⁴³⁾ but has nevertheless been criticized on various grounds.⁴⁴⁾ The most commonly raised objections to this method are:

- (i) Not all transactions in the shadow economy are paid in cash. Isachsen and Strom (1985) used the survey method to find out that in Norway, in 1980, roughly 80 percent of all transactions in the hidden sector were paid in cash. The size of the total shadow economy (including barter) may thus be even larger than previously estimated.
- (ii) Most studies consider only one particular factor, the tax burden, as a cause of the shadow economy. But others (such as the impact of regulation, taxpayers' attitudes toward the state, „tax morality“ and so on) are not considered, because reliable data for most countries is not available. If, as seems likely, these other factors also have an impact on the extent of the hidden economy, it might again be higher than reported in most studies.⁴⁵⁾

⁴²⁾ The estimation of such a currency demand equation has been criticized by Thomas (1999) but part of this criticism has been considered by the work of Giles (1999a, 1999b) and Bhattacharyya (1999), who both use the latest econometric technics.

⁴³⁾ See Schneider (1997, 1998a), Johnson, Kaufmann and Zoido-Lobaton (1998a), and Williams and Windebank (1995).

⁴⁴⁾ See Thomas (1992, 1999), Feige (1986), and Pozo (1996).

⁴⁵⁾ One (weak) justification for the use of only the tax variable is that this variable has by far the strongest impact on the size of the shadow economy in the studies known to the authors. The only exception is the study by Frey and Weck-Hannemann (1984) where the variable „tax immorality“ has a quantitatively larger and statistically

- (iii) A further weakness of this approach, at least when applied to the United States, is discussed by Garcia (1978), Park (1979), and Feige (1996), who point out that increases in currency demand deposits are due largely to a slowdown in demand deposits rather than to an increase in currency caused by activities in the shadow economy.
- (iv) Blades (1982) and Feige (1986, 1996), criticize Tanzi's studies on the grounds that the US dollar is used as an international currency. Tanzi should have considered (and controlled for) the US dollars, which are used as an international currency and held in cash abroad.⁴⁶⁾ Moreover, Frey and Pommerehne (1984) and Thomas (1986, 1992, 1999) claim that Tanzi's parameter estimates are not very stable.⁴⁷⁾
- (v) Another weak point of this procedure, in most studies, is the assumption of the same velocity of money in both types of economies. As Hill and Kabir (1996) for Canada and Klovland (1984) for the Scandinavian countries argue, there is already considerable uncertainty about the velocity of money in the official economy; the velocity of money in the hidden sector is even more difficult to estimate. Without knowledge about the velocity of currency in the shadow economy, one has to accept the assumption of an „equal“ money velocity in both sectors.
- (vi) Finally, the assumption of no shadow economy in a base year is open to criticism. Relaxing this assumption would again imply an upward adjustment of the figures attained in the bulk of the studies already undertaken.

stronger influence than the direct tax share in the model approach. In the study of Pommerehne and Schneider (1985), for the U.S., besides various tax measures, data for regulation, tax immorality, minimum wage rates are available, the tax variable has a dominating influence and contributes roughly 60-70 percent to the size of the shadow economy. See also Zilberfarb (1986).

⁴⁶⁾ In another study by Tanzi (1982, esp. pp. 110-113) he explicitly deals with this criticism. A very careful investigation of the amount of US-\$ used abroad and the US currency used in the shadow economy and to "classical" crime activities has been undertaken by Rogoff (1998), who concludes that large denomination bills are major driving force for the growth of the shadow economy and classical crime activities due to reduced transactions costs.

⁴⁷⁾ However in studies for European countries Kirchgaessner (1983, 1984) and Schneider (1986) reach the conclusion that the estimation results for Germany, Denmark, Norway and Sweden are quite robust when using the currency demand method. Hill and Kabir (1996) find for Canada that the rise of the shadow economy varies with respect to the tax variable used; they conclude „when the theoretically best tax rates are selected and a range of plausible velocity values is used, this method estimates underground economic growth between 1964 and 1995 at between 3 and 11 percent of GDP.“ (Hill and Kabir [1996, p. 1553]).

7.1.2.5 The Physical Input (Electricity Consumption) Method

(1) The Kaufmann - Kaliberda Method⁴⁸⁾

To measure overall (official and unofficial) economic activity in an economy, Kaufmann and Kaliberda (1996) assume that electric-power consumption is regarded as the single best physical indicator of overall economic activity. Overall (official and unofficial) economic activity and electricity consumption have been empirically observed throughout the world to move in lockstep with an electricity/GDP elasticity usually close to one. By having a proxy measurement for the overall economy and subtracting it from estimates of official GDP, Kaufmann and Kaliberda derive an estimate of unofficial GDP. This means, that Kaufmann and Kaliberda suggest, that the growth of total electricity consumption is an indicator for representing a growth of official and unofficial GDP. According to this approach, the difference between the gross rate of registered (official) GDP and the cross rate of total electricity consumption can be attributed to the growth of the shadow economy. This method is very simple and appealing, however, it can also be criticized on various grounds:

- (i) Not all shadow economy activities require a considerable amount of electricity (e.g. personal services), and other energy sources can be used (gas, oil, coal, etc.), so that only a part of the shadow economy will be captured.
- (ii) Over time, there has been considerable technical progress. Both the production and use of electricity are more efficient than in the past, and that will apply in both official and unofficial uses.
- (iii) There may be considerable differences or changes in the elasticity of electricity/GDP across countries and over time.⁴⁹⁾

(2) The Lackó Method

Lackó (1996, 1998, 1999, 2000) assumes that a certain part of the shadow economy is associated with the household consumption of electricity. It comprises, among others, the so-called household production, do-it-yourself activities, and other non registered production and services. Lackó assumes that in countries where the section of the shadow economy associated with the household electricity consumption is high, the rest of the hidden economy, that is the part Lackó cannot measure, will also be high. Lackó (1996, pp.19 ff.) assumes that

⁴⁸⁾This method was used earlier by Lizzeri (1979), Del Boca and Forte (1982), and then was used much later by Portes (1996), Kaufmann and Kaliberda (1996), Johnson, Kaufmann and Shleifer (1997). For a critique see Lackó (1998).

⁴⁹⁾Johnson, Kaufmann and Shleifer (1997) make an attempt to adjust for changes in the elasticity of electricity/GDP.

in each country a part of the household consumption of electricity is used in the shadow economy.

Lackó's approach (1998, p.133) can be described by the following two equations:

$$\ln E_i = \alpha_1 \ln C_i + \alpha_2 \ln PR_i + \alpha_3 G_i + \alpha_4 Q_i + \alpha_5 H_i + u_i \quad (1)$$

with $\alpha_1 > 0, \alpha_2 < 0, \alpha_3 > 0, \alpha_4 < 0, \alpha_5 > 0$

$$H_i = \beta_1 T_i + \beta_2 (S_i - T_i) + \beta_3 D_i \quad (2)$$

with $\beta_1 > 0, \beta_2 < 0, \beta_3 > 0$

where

i : the number assigned to the country,

E_i : per capita household electricity consumption in country i in Mtoe,

C_i : per capita real consumption of households without the consumption of electricity in country i in US dollars (at purchasing power parity),

PR_i : the real price of consumption of 1 kWh of residential electricity in US dollars (at purchasing power parity),

G_i : the relative frequency of months with the need of heating in houses in country i ,

Q_i : the ratio of energy sources other than electricity energy to all energy sources in household energy consumption,

H_i : the per capita output of the hidden economy,

T_i : the ratio of the sum of paid personal income, corporate profit and taxes on goods and services to GDP,

S_i : the ratio of public social welfare expenditures to GDP, and

D_i : the sum on number of dependants over 14 years and of inactive earners, both per 100 active earners.

In a cross country study, she econometrically estimates equation (1) substituting H_i by equation (2). The econometric estimation results can then be used to establish an ordering of the countries with respect to electricity use in their shadow economies. For the calculation of the actual size (value added) of the shadow economy, Lackó should know how much GDP is produced by one unit of electricity in the shadow economy of each country. Since these data are not known, she takes the result of one of the known shadow economy estimations, that were carried out for a market economy with another approach for the early 1990s, and she applies this proportion to the other countries. Lackó used the shadow economy of the United States as such a base (the shadow economy value of 10.5% of GDP taken from

Morris(1993)), and then she calculates the size of the shadow economy for other countries. Lackó's method is also open to criticism:

- (i) Not all shadow economy activities require a considerable amount of electricity and other energy sources can be used.
- (ii) Shadow economy activities do not take place only in the household sector.
- (iii) It is doubtful whether the ratio of social welfare expenditures can be used as the explanatory factor for the shadow economy, especially in transition and developing countries.

It is questionable which is the most reliable base value of the shadow economy in order to calculate the size of the shadow economy for all other countries, especially, for the transition and developing countries.

7.1.3 The model approach⁵⁰

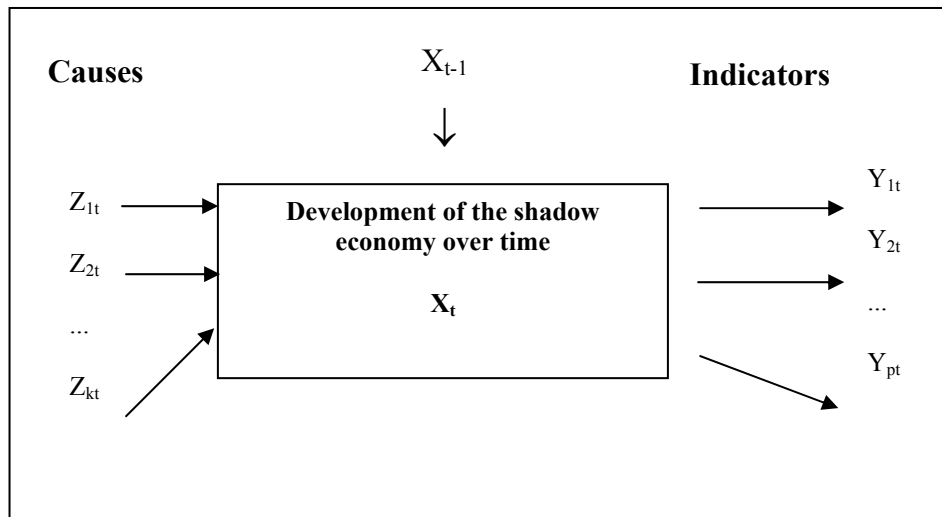
All methods described so far that are designed to estimate the size and development of the shadow economy consider just one indicator that “must” capture all effects of the shadow economy. However, it is obvious that its effects show up simultaneously in the production, labor, and money markets. An even more important critique is that the causes which determine the size of the hidden economy are taken into account only in some of the monetary approach studies which usually consider one cause, the burden of taxation. The model approach explicitly considers multiple causes leading to the existence and growth as well as the multiple effects of the shadow economy over time. The empirical method used is quite different from those used so far. It is based on the statistical theory of unobserved variables, which considers multiple causes and multiple indicators of the phenomenon to be measured. For the estimation, a factor-analytic approach is used to measure the hidden economy as an unobserved variable over time. The unknown coefficients are estimated in a set of structural equations within which the “unobserved” variable cannot be measured directly. The DYMIMIC (dynamic multiple-indicators multiple-causes) model consists in general of two parts, the measurement model links the unobserved variables to observed indicators.⁵¹⁾ The structural equations model specifies causal relationships among the unobserved variables. In this case, there is one unobserved variable, the size of the shadow economy. It is assumed to

⁵⁰⁾This part is a summarized version from a longer study by Aigner, Schneider, and Ghosh (1988, p. 303), applying this approach for the United States over time. The pioneers of this approach are Weck (1983), Frey and Weck-Hannemann (1984), who applied this approach to cross-section data from the 24 OECD countries for various years. Before turning to this approach they developed the concept of „soft modeling“ (Frey, Weck, and Pommerehne (1982), Frey and Weck (1983a and 1983b)), an approach which has been used to provide a ranking of the relative size of the shadow economy in different countries.

⁵¹⁾ One of the latest paper dealing extensively with the DYMIMIC approach, its development and the

be influenced by a set of indicators for the shadow economy's size, thus capturing the structural dependence of the shadow economy on variables that may be useful in predicting its movement and size in the future. The interaction over time between the causes Z_{it} ($i = 1, 2, \dots, k$) the size of the shadow economy X_t , and the indicators Y_{jt} ($j = 1, 2, \dots, p$) is shown in Figure 7.1.

Figure 7.1: Development of the shadow economy over time.



There is a large body of literature⁵²⁾ on the possible causes and indicators of the shadow economy, in which the following three types of causes are distinguished:

Causes

- (i) The burden of direct and indirect taxation, both actual and perceived: a rising burden of taxation provides a strong incentive to work in the shadow economy.
- (ii) The burden of regulation as proxy for all other state activities: it is assumed that increases in the burden of regulation give a strong incentive to enter the shadow economy.
- (iii) The „tax morality“ (citizens' attitudes toward the state), which describes the readiness of individuals (at least partly) to leave their official occupations and enter the shadow economy: it is assumed that a declining tax morality tends to increase the size of the shadow economy.⁵³⁾

weaknesses of it is from Dell'Anno (2003).

⁵²⁾Thomas (1992); Schneider (1994a, 1997, 2003b); Pozo (1996); Johnson, Kaufmann and Zoido-Lobaton (1998a, 1998b); Giles (1999a, 1999b); Giles and Tedds (2002), and Dell'Anno (2003)..

⁵³⁾ When applying this approach for European countries, Frey and Weck-Hannemann (1984) had the difficulty in obtaining reliable data for the cause series, besides the ones of direct and indirect tax burden. Hence, their study was criticized by Helberger and Knepel (1988), who argue that the results were unstable with respect to changing variables in the model and over the years.

Indicators

A change in the size of the shadow economy may be reflected in the following indicators:

- (i) Development of monetary indicators: if activities in the shadow economy rise, additional monetary transactions are required.
- (ii) Development of the labor market: increasing participation of workers in the hidden sector results in a decrease in participation in the official economy. Similarly, increased activities in the hidden sector may be expected to be reflected in shorter working hours in the official economy.
- (iii) Development of the production market: an increase in the shadow economy means that inputs (especially labor) move out of the official economy (at least partly); this displacement might have a depressing effect on the official growth rate of the economy.

The latest use of the model approach has been undertaken by Giles (1999a, 1999b) and by Giles, Linsey and Gupsa (1999), Giles and Tedd (2002), Chatterjee, Chaudhury and Schneider (2002) and Bajada and Schneider (2003). They basically estimate a comprehensive (dynamic) MIMIC model to get a time series index of the hidden/measured output of New Zealand or Canada, and then estimate a separate “cash-demand model” to obtain a benchmark for converting this index into percentage units. Unlike earlier empirical studies of the hidden economy, they paid proper attention to the non-stationary, and possible co-integration of time series data in both models. Again this DYMIMIC model treats hidden output as a latent variable, and uses several (measurable) causal variables and indicator variables. The former include measures of the average and marginal tax rates, inflation, real income and the degree of regulation in the economy. The latter include changes in the (male) labor force participation rate and in the cash/money supply ratio. In their cash-demand equation they allow for different velocities of currency circulation in the hidden and recorded economies. Their cash-demand equation is not used as an input to determine the variation in the hidden economy over time – it is used only to obtain the long-run average value of hidden/measured output, so that the index for this ratio predicted by the DYMIMIC model can be used to calculate a level and the percentage units of the shadow economy. Giles latest combination of the currency demand and DYMIMIC approach clearly shows that some progress in the estimation technique of the shadow economy has been achieved and a number of critical points have been overcome.

7.2 Appendix 2: Data Set and Detailed Estimation result

7.2.1 Countries

The following Table 7.1 presents the 109 countries in the sample and the two data of most interest namely the size of the shadow economy in percent of GDP for the year 2000 and the annual GDP Growth Rate in percent again for the year 2000.

Table 7.1.: List of countries investigated

Country	Shadow Economy 2000	GDP Growth Rate 2000
Albania	33.4	9.15
Algeria	34.1	5.05
Argentina	25.4	1.77
Armenia	46.3	8.16
Australia	15.3	4.21
Austria	10.2	5.34
Azerbaijan	60.6	20.37
Bangladesh	35.6	8.58
Belarus	48.1	8.30
Belgium	23.2	6.13
Benin	45.2	8.42
Bolivia	67.1	5.04
Bosnia and Herzegovina	34.1	0.00
Botswana	33.4	-2.06
Brazil	39.8	7.68
Bulgaria	36.9	9.30
Burkina Faso	38.4	4.66
Cameroon	32.8	8.45
Canada	16.4	6.17
Chile	19.8	8.51
China	13.1	9.92
Colombia	39.1	1.04
Costa Rica	26.2	-0.37
Cote d'Ivoire	39.9	0.77
Croatia	33.4	5.96
Czech Republic	19.1	5.47
Denmark	18.2	6.34
Dominican Republic	32.1	9.86
Ecuador	34.4	3.98
Egypt, Arab Rep.	35.1	7.73
Ethiopia	40.3	8.01
Finland	18.3	7.91
France	15.3	5.32
Georgia	67.3	8.20
Germany	16.3	5.24
Ghana	38.4	7.03
Greece	28.6	7.18
Guatemala	51.5	6.03
Honduras	49.6	6.52
Hong Kong, China	16.6	14.26
Hungary	25.1	7.63

Table 7.1.: List of countries investigated – cont.

Country	Shadow Economy 2000	GDP Growth Rate 2000
India	23.1	6.35
Indonesia	19.4	6.96
Iran, Islamic Rep.	18.9	7.14
Iran, Islamic Rep.	18.9	7.14
Ireland	15.8	15.67
Israel	21.9	10.64
Italy	27.0	5.25
Jamaica	36.4	4.10
Japan	11.3	4.78
Jordan	19.4	4.57
Kazakhstan	43.2	16.14
Kenya	34.3	1.82
Korea, Rep.	27.5	10.43
Kyrgyz Republic	39.8	7.70
Latvia	39.9	7.87
Lebanon	34.1	2.03
Lithuania	30.3	5.52
Madagascar	39.6	8.06
Malawi	40.3	4.25
Malaysia	31.1	14.61
Mali	41.0	6.86
Mexico	30.1	9.09
Moldova	45.1	1.56
Mongolia	18.4	3.88
Morocco	36.4	2.60
Mozambique	40.3	4.89
Nepal	38.4	8.62
Netherlands	13.0	5.94
New Zealand	12.7	4.86
Nicaragua	45.2	7.25
Niger	41.9	2.45
Nigeria	57.9	6.89
Norway	19.1	4.45
Pakistan	36.8	7.05
Panama	64.1	2.27
Peru	59.9	5.31
Philippines	43.4	6.28
Poland	27.6	6.32
Portugal	22.6	6.00
Romania	34.4	3.74
Russian Federation	46.1	8.81
Saudi Arabia	18.4	8.86
Senegal	43.2	8.08
Singapore	13.1	13.76
Slovak Republic	18.9	4.90
Slovenia	27.1	7.24
South Africa	28.4	5.58
Spain	22.6	6.30

Table 7.1.: List of countries investigated – cont.

Country	Shadow Economy 2000	GDP Growth Rate 2000
Sri Lanka	44.6	8.73
Sweden	19.1	6.17
Switzerland	8.8	5.37
Syrian Arab Republic	19.3	7.52
Tanzania	58.3	7.00
Thailand	52.6	5.18
Tunisia	38.4	7.42
Turkey	32.1	10.05
Uganda	43.1	5.90
Ukraine	52.2	8.48
United Arab Emirates	26.4	0.00
United Kingdom	12.6	5.97
United States	8.7	7.44
Uruguay	51.1	1.24
Uzbekistan	34.1	7.86
Venezuela, RB	33.6	5.06
Vietnam	15.6	7.93
Yemen, Rep.	27.4	12.64
Yugoslavia, Fed. Rep.	29.1	0.00
Zambia	48.9	4.86
Zimbabwe	59.4	-5.58

7.2.2 Definition of the Variables

7.2.2.1 General Information

- (1) All calculations and estimations are based on the software package ‘Intercooled Stata 8.0’.
- (2) All growth rates or shares as described in the following section. For example a growth rate of 2 percent is defined as 0.02 instead of 2.0.
- (3) If for some reasons observations for important countries for one year are missing we used the following formula to calculate the average growth rate for these variables:

$$\left(\frac{\text{variable}_{t+n}}{\text{variable}_t} \right)^{\frac{1}{n}} = \emptyset \text{ growth rate} \quad \text{[A.1]}$$

Multiplying the value of the variable from year t with the average growth rate gives the value for t+1. Formally:

$$\emptyset \text{ growth rate} \times \text{variable}_t = \text{variable}_{t+1} \quad \text{[A.2]}$$

(4) In parenthesis the Stata-Labels for the several variables are presented. This is necessary for understanding the regression outputs in detail below in this appendix.

7.2.2.2 Definition of the Variables

(1) GDP per capita on PPP basis [gdpc]

GDP per capita based on purchasing power parity [PPP]. PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over GDP as the U.S. dollar has in the United States. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current international dollars.

Source: World Bank, International Comparison Programme database.

(2) Annual GDP per capita Growth Rate [growgdpc]

Out of this GDP per capita values for the observed 109 countries over the years 1990 to 2000 the dependent variable Annual GDP per capita Growth Rate has been calculated using the formula

$$\text{Per Capita Growth} = \frac{(GDPpc_t - GDPpc_{t-1})}{GDPpc_{t-1}} \quad \text{[A.3]}$$

Source: World Bank, International Comparison Programme database; own calculation by authors.

(3) Shadow Economy [shad]

The variable Shadow Economy is defined as the informal sector [shadow economy] in percent of official GDP. The estimations for the size of the shadow economy are undertaken using the DYMIMIC and the currency demand approaches [see Schneider et al. 2002 and Schneider 2003a und 2003b]. But one has to keep in mind that this variable is only available for three points in time namely the years 1990, 1995 and 2000.

Source: Own calculation by authors.

(4) Shadow Economy Industrialized Countries [shadind]

The variable Shadow Economy Industrialized Countries is defined as the informal sector [shadow economy] in percent of official GDP. It has the value 0 if a country is a developing country [indicated by the value 0 in the Dummy Industrialized Countries] and the value of the shadow economy in percent of GDP if a country is an industrialized country [indicated by the value 1 in the Dummy Industrialized Countries] or a transition country [indicated by the value 1 in the Dummy Transition Countries]. The estimations for the size of the shadow economy are undertaken using the DYMIMIC and the currency demand approaches [see Schneider et al. 2002, Schneider 2003a und 2003b]. But one has to keep in mind that this variable is only available for three points in time namely the years 1990, 1995 and 2000.

Source: Own calculation by authors.

(5) Shadow Economy Developing Countries [shaddev]

The variable Shadow Economy Developing Countries is defined as the informal sector [shadow economy] in percent of official GDP. It has the value 0 if a country is an industrialized country [indicated by the value 1 in the Dummy Industrialized Countries] or a transition country [indicated by the value 1 in the Dummy Transition Countries] and the value of the shadow economy in percent of GDP if a country is a developing country [indicated by the value 0 in the Dummy Industrialized Countries]. The estimations for the size of the shadow economy are undertaken using the DYMIMIC and the currency demand approaches [see Schneider et al. 2002, Schneider 2003a und 2003b]. But one has to keep in mind that this variable is only available for three points in time namely the years 1990, 1995 and 2000.

Source: Own calculation by authors.

(6) Openness [open]

Openness is the sum of exports and imports of goods and services measured as a share of gross domestic product.

Source: World Bank national accounts data, and OECD National Accounts data files.

(7) Inflation Rate [infl]

Inflation as measured by the annual growth rate of the GDP implicit deflator shows the rate of price change in the economy as a whole. The GDP implicit deflator is the ratio of GDP in current local currency to GDP in constant local currency.

Source: World Bank national accounts data, and OECD National Accounts data files.

(8) Inflation Rate Other Countries [inflrest]

Inflation Rate Other Countries is equally defined to Inflation Rate but has the value 0 if a country is a transition country [indicated by the value 1 in the Dummy Transition Countries] and the value of the inflation rate if a country is a non-transition country [indicated by the value 0 in the Dummy Transition Countries].

Source: World Bank national accounts data, and OECD National Accounts data files; own calculation by authors.

(9) Inflation Rate Transition Countries [infltran]

Inflation Rate Transition Countries is equally defined to Inflation Rate but has the value 0 if a country is a non-transition country [indicated by the value 0 in the Dummy Transition Countries] and the value of the inflation rate if a country is a transition country [indicated by the value 1 in the Dummy Transition Countries].

Source: World Bank national accounts data, and OECD National Accounts data files; own calculation by authors.

(10) Government Consumption [gov]

Government Consumption is defined as general government final consumption expenditure (general government consumption) and includes all government current expenditures for purchases of goods and services (including compensation of employees). It also includes most expenditures on national defense and security, but excludes government military expenditures that are part of government capital formation.

Source: World Bank national accounts data, and OECD National Accounts data files.

(11) Lagged GDP per capita Growth Rate [lastgrowth]

This variable is the Annual GDP per capita Growth Rate lagged for one period, thus in our case lagged for one year.

Source: Equal to [growgdpc]; own calculation by authors.

(12) Total Population in millions [pop]

Total population in millions is based on the de facto definition of population, which counts all residents regardless of legal status or citizenship--except for refugees not permanently settled

in the country of asylum, who are generally considered part of the population of their country of origin.

Source: World Bank staff estimates from various sources including the United Nations Statistics Division's Population and Vital Statistics Report, country statistical offices, and Demographic and Health Surveys from national sources and Macro International.

(13) Capital Accumulation Rate [caac]

The Capital Accumulation Rate is the annual growth rate of gross capital formation based on constant local currency. Aggregates are based on constant 1995 U.S. dollars. Gross capital formation (formerly gross domestic investment) consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." According to the 1993 SNA, net acquisitions of valuables are also considered capital formation.

Source: World Bank national accounts data, and OECD National Accounts data files.

(14) Dummy Industrialized Countries [ind]

The variable Dummy Industrialized Countries is a binary variable and takes the value 0 if a country is a developing country and 1 if the country is an industrialized country. "Developing Country" corresponds to high income classification of World Bank Indicators 2002 with per capita income of USD 9,265 or less. The same applies to "Industrialized Countries" which are defined as countries with per capita GDP of USD 9,266 or more.

Source: Own calculation by authors.

(15) Dummy Transition countries [tran]

The variable Dummy Transition Countries is a binary variable and takes the value 1 if a country is a transition country from a centrally planned economy to a market economy and 0 if the country is not.

Source: Own Calculation by authors.

(16) Dummy OECD countries [oecd]

The variable Dummy OECD countries is a binary variable and takes the value 1 if a country is member of the OECD and 0 if the country is not.

Source: Own Calculation by authors.

(17) Foreign Direct Investment [fdi]

Foreign direct investment is net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows in the reporting economy.

Source: International Monetary Fund, International Financial Statistics and Balance of Payments databases, World Bank, Global Development Finance, and World Bank and OECD GDP estimates.

(18) Annual FDI Growth Rate [fdigrowth]

Out of this FDI values for the observed 109 countries over the years 1990 to 2000 the explanatory variable Annual FDI Growth Rate has been calculated using the formula

$$FDI\ Growth\ Rate = \frac{(FDI_t - FDI_{t-1})}{FDI_{t-1}} \quad [A.4]$$

Source: International Monetary Fund, International Financial Statistics and Balance of Payments databases, World Bank, Global Development Finance, and World Bank and OECD GDP estimates, own calculation by authors.

(19) Labour Force [lab]

Total labor force comprises people who meet the International Labour Organization definition of the economically active population: all people who supply labor for the production of goods and services during a specified period. It includes both the employed and the unemployed. While national practices vary in the treatment of such groups as the armed forces and seasonal or part-time workers, in general the labor force includes the armed forces, the unemployed, and first-time job-seekers, but excludes homemakers and other unpaid caregivers and workers in the informal sector.

Source: International Labour Organization, using World Bank population estimates.

(20) Annual Labour Force Growth Rate [labgrowth]

Out of this Labour Force values for the observed 109 countries over the years 1990 to 2000 the explanatory variable Annual Labour Force Growth Rate has been calculated using the formula

$$\text{Labour Force Growth Rate} = \frac{(LAB_t - LAB_{t-1})}{LAB_{t-1}} \quad \text{[A.5]}$$

Source: International Labour Organization, using World Bank population estimates, own calculation by authors.

7.2.3 Regression Outputs in more Detail

In this section of the Appendix the regression outputs are presented in a more detailed way, where several results such a t- or z-statistics, F-tests, R-Squared within, between and overall can be found. Additionally the regression results for Cluster-Regressions are listed in detail.

As already mentioned above all regressions are estimated with 'Intercooled Stata 8.0' using panel regression commands. For general information and econometric details concerning panel regressions see Long (1996), Greene (1997) or Wooldridge (2000).

Panel Regression Total 1990 – 2000 using the Fixed-Effect Approach [fe]

Total Fixed Effects [fe]

Fixed-effects (within) regression	Number of obs	=	193
Group variable (i): id	Number of groups	=	104
R-sq: within = 0.3400	Obs per group: min =		1
between = 0.0375	avg =		1.9
overall = 0.0291	max =		2
	F(9, 80)	=	4.58
corr(u_i, Xb) = -0.9616	Prob > F	=	0.0001

growgdpc	Coef.	Std. Err.	t P> t [90% Conf. Interval]
shadind	.2317538	.3515235	0.66 0.512 -.3532252 .8167327
shaddev	-.3288186	.1867277	-1.76 0.082 -.6395566 -.0180805
open	.0343245	.0332882	1.03 0.306 -.0210711 .0897202
inflrest	-.0064754	.0310026	-0.21 0.835 -.0580676 .0451167
infltran	-.0313483	.0092144	-3.40 0.001 -.0466822 -.0160143
gov	.1020515	.1876892	0.54 0.588 -.2102867 .4143897
lastgrowth	.0442639	.0795051	0.56 0.579 -.0880426 .1765703
pop	-.0004899	.0004327	-1.13 0.261 -.00121 .0002301
caac	.0192958	.0137675	1.40 0.165 -.003615 .0422066
_cons	.0810733	.061764	1.31 0.193 -.0217096 .1838563

sigma_u	.12701133		
sigma_e	.03371631		
rho	.93417041	(fraction of variance due to u_i)	

F test that all u_i=0:	F(103, 80) =	1.14	Prob > F = 0.2703

Regression Output Detail 1 - Source: Own calculation by authors

It shows that the Dummy [ind] and the Dummy [tran] are dropped from the regression with the Fixed-Effect Approach since there is no variation in these variables over time. The next step is to estimate the same equation once more with the Random-Effects Approach and afterwards test with a Hausman-McFadden-Specification Test which of the two model specifications has to be preferred⁵⁴.

H0 states that the Random-Effects model has to be preferred. H1 then suggests the Fixed-Effects Model to be the right specification. Therefore if H0 cannot be rejected at a conventional confidence level, the Random-Effects Model is the correct specification.

**Panel Regression Total 1990 – 2000 using the Random-Effect Approach [re]
Total Random Effects [re]**

Random-effects GLS regression	Number of obs	=	193
Group variable (i): id	Number of groups	=	104
R-sq: within = 0.2662	Obs per group: min =		1
between = 0.4174	avg =		1.9
overall = 0.3436	max =		2
Random effects u_i ~ Gaussian	Wald chi2(9)	=	94.63
corr(u_i, X) = 0 (assumed)	Prob > chi2	=	0.0000

growgdpc	Coef.	Std. Err.	z P> z [90% Conf. Interval]
shadind	.0769996	.0292499	2.63 0.008 .0288878 .1251115
shaddev	-.0516262	.021763	-2.37 0.018 -.0874231 -.0158293
open	.0123984	.0058027	2.14 0.033 .0028538 .021943
inflrest	.0230645	.0174138	1.32 0.185 -.0055786 .0517076
infltran	-.0210372	.0051337	-4.10 0.000 -.0294814 -.012593
gov	-.1806035	.055867	-3.23 0.001 -.2724966 -.0887104
lastgrowth	.153827	.0502364	3.06 0.002 .0711955 .2364584
pop	.000036	.0000174	2.07 0.039 7.39e-06 .0000647
caac	.0185635	.0098691	1.88 0.060 .0023303 .0347967
_cons	.0618808	.0149818	4.13 0.000 .0372379 .0865237

sigma_u	.0087508		
sigma_e	.03371631		
rho	.06311078	(fraction of variance due to u_i)	

Regression Output Detail 2 - Source: Own calculation by authors

The now following Hausman Test shows that H0 cannot be rejected at a conventional level and thus we have to give the Random-Effects model preference over the Fixed-Effects model.

⁵⁴ For more details concerning ‘panel regressions’ and ‘specification tests’ see Wooldridge (2000) and Long (1996).

Hausman-McFadden-Specification Test

---- Coefficients ----			
	Fixed	Random	
growgdpc	Effects	Effects	Difference
shadind	.2317538	.0769996	.1547542
shaddev	-.3288186	-.0516262	-.2771924
open	.0343245	.0123984	.0219262
inflrest	-.0064754	.0230645	-.0295399
infltran	-.0313483	-.0210372	-.0103111
gov	.1020515	-.1806035	.282655
lastgrowth	.0442639	.153827	-.1095631
pop	-.0004899	.000036	-.000526
caac	.0192958	.0185635	.0007323

Test: Ho: difference in coefficients not systematic

chi2(9) = (b-B)'[S⁽⁻¹⁾](b-B), S = (S_{fe} - S_{re})
 = 10.89
 Prob>chi2 = 0.2834

Panel Regression for OECD Countries 1990 - 2000 [oecd==1 and re] OECD Random Effects [re]

Random-effects GLS regression	Number of obs	=	94
Group variable (i): id	Number of groups	=	21
R-sq: within = 0.2128	Obs per group: min =		3
between = 0.7168	avg =		4.5
overall = 0.3700	max =		5
Random effects u _i ~ Gaussian	Wald chi2(6)	=	51.10
corr(u _i , X) = 0 (assumed)	Prob > chi2	=	0.0000

growgdpc	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]
year	-.0031079	.0009262	-3.36	0.001	-.0049231 -.0012926
shad	.0782766	.0380983	2.05	0.040	.0036054 .1529478
open	.0155147	.0062813	2.47	0.014	.0032036 .0278258
caac	.1267053	.0365311	3.47	0.001	.0551056 .198305
fdigrowth	.0042132	.0016938	2.49	0.013	.0008935 .0075329
labgrowth	.9505111	.3891057	2.44	0.015	.1878778 1.713144
_cons	6.205567	1.847538	3.36	0.001	2.584459 9.826674

sigma_u	0
sigma_e	.01887023
rho	0 (fraction of variance due to u _i)

Regression Output Detail 6 - Source: Own calculation by authors

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