

The Dark Side of Global Economy

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Abstract: The paper presents several definitions of the shadow economy and tries to develop its taxonomy. Given the diversity of the hidden activities, it is difficult to formulate a specific definition of the underground economy. The concept of the underground economy is explained taking into account its forms in eastern economies, developing economies and industrialized economies. The term of illegal activity is very well developed by focusing on its arguments of inclusion or exclusion in the national accounts. The author also presents the two faces of global economy in many of its aspects which could explain its duality.

Key words: underground economy, official economy, global economy, illegal activity, national accounts, duality

1. Introduction

Trying to measure the dimension of underground economy is very difficult since the activities that are covered by such a concept are carried out so that they are not recorded and they cannot be detected. Moreover, if one asks a member of the academy, a specialist in the public sector, an economic analyst or a politician about the meaning of underground economy, one may get various answers to this subject. Yet, there is growing worry about this phenomenon and it is linked to a series of factors that should be taken into account when talking about underground economy.

Among the most important factors, we can mention the following:

- increase of fiscal burden together with an “institutional sclerosis” [1] may lead to an increase of the underground economy and implicitly to the erosion of the basis for taxes and social security. The result may be a vicious circle with a rise of budgetary deficit or taxes, and this further leads to a supplementary increase of the underground economy and, eventually, may lead to a weakening of the economic and social basis of collective commitments;

- in the case of an increased underground economy, the economic policy is based on fake “official” indicators (such as unemployment, official labor force, income, consumption) or on indicators with bad magnitude. Because of such uncertain indicators, the measures that are taken to stop underground economy are questionable;

- one should take into account the effects of the rising underground economy over the official economy.

Firstly, an increased underground economy may give powerful incentives to attract local and foreign workers outside the official economy and may cause higher competition for such companies. On the other hand, at least two thirds of the income from the underground economy is spent immediately in the official sector and has a positive effect on the official economy [2]. Since underground economy is a contemporary reality all over the world, many societies are trying to control this activity by a series of measures such as punishment, monitoring, economic increase and education. Statistics referring to the number of people who are involved in underground economy, or to the frequency of such activities and their magnitude are crucial to the effectiveness and efficiency of the decisions that are made about the funding resources that are used to stop this activity. Unfortunately, it is quite difficult to get the exact or the correct information referring to the underground activities, be them from the market for goods or labor force market, because, as mentioned earlier, the individuals who are involved in such activities do not want to be identified. Yet, an estimate of underground economy may be considered a scientific hobby to understand the unknown.

2. The black hole of global economy

Although there are books and articles on underground economy, the topic is still controversial since there are disagreements about the definition of underground economy, about the estimate procedures and about using these estimates in economic analysis. It was noticed that there are elements that indicate an increase of global

underground economy, but little is known about the dimension of this economy both in the developed and in the developing countries.

One of the most frequently-used definitions presents underground economy as “the totality of economic activities that are not recorded as such and contribute to the gross national product (GDP) that is calculated officially” [3]. Roger S. Smith (1994) defines underground economy as production of goods and services, legal or illegal, which escape control in official estimates for the gross domestic product (GDP).

A Romanian dictionary of economic terms, published in 1999, defines underground economy as “the totality of economic activities that are not declared to the institutions that calculate taxes and social securities and that escape statistical recording and national accountancy” [4].

It is a well-known fact that there are a lot of underground activities that are included in planned economy as well as in market economy, no matter if they are developed or developing. The agents, who are involved in underground activities escape, avoid or are excluded from the institutional system of rules, rights, regulations that officially govern those economic actors that are involved in production and exchange [5]. The different types of underground activities may be

distinguished by means of specific institutional rules that are broken. According to this criterion, Edgar Feige identified four specific types of underground economic activities: illegal, unreported, unrecorded and informal [6] (see figure 1):

- Illegal economy refers to the “totality of the revenues that are generated by those economic activities that violate the legal status of legitimate forms of trade”. This category includes activities such as production and distribution of drugs, black market of currency exchange, prostitution and pornography.
- Unreported economy refers to the “totality of economic activities that escape or avoid fiscal rules as they are defined in fiscal codes”. This includes both legal sources and illegal sources of the unreported revenue.
- Unrecorded economy refers to “those activities that avoid institutional conventions that define the necessary requirements for the report to the governmental agencies for statistics”.
- Informal economy includes the “economic activities that avoid costs and are excluded from the rights and benefits that come along with leasing, work contracts, loans and social securities”. It includes that revenue that is generated by economic agents that operate informally.

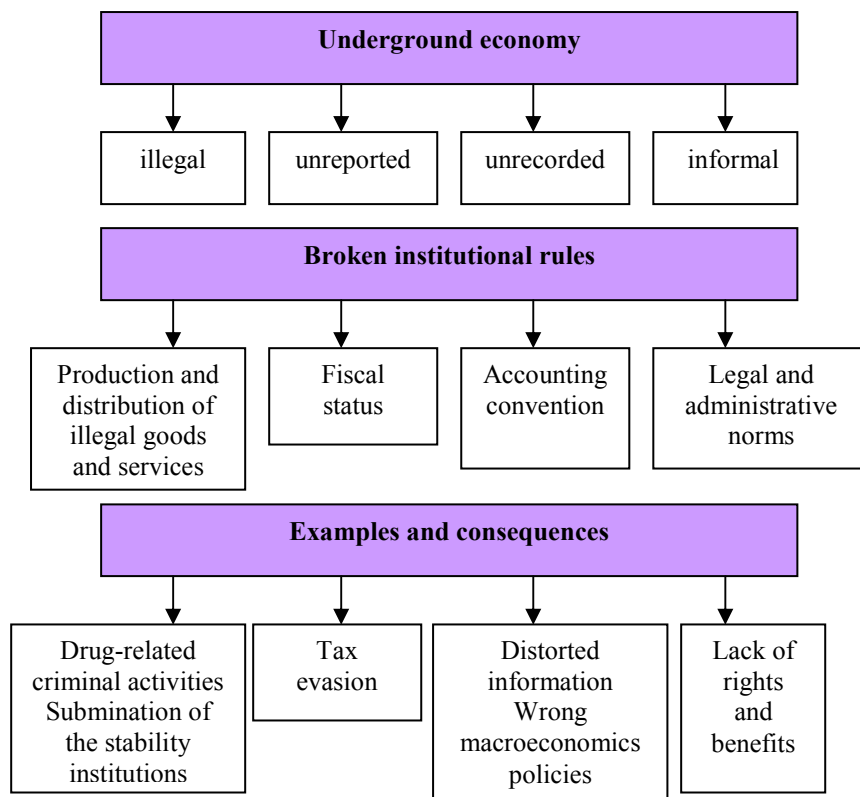


Fig. 1 Classification of underground economy

Source: Edgar L. Feige, *Revised Estimates of the Underground Economy: Implications of US Currency Held Abroad*, in „The Underground Economy: Global Evidence of its Size and Impact”, Owen Lippert, Michael Walker, The Fraser Institute, Vancouver, British Columbia, Canada, 1997

Underground economy may also be divided into the following categories, according to the definition accepted by the United Nations (UN), the Organization for Economic Cooperation and Development (OECD) and by the European Union (EU):

- *Undeclared legal productive activities*, including activities that are not recorded at state level by means of national accountancy and those activities that are not declared at financial administrations;

- *Illicit productive activities* such as drug production and trade, weapons trade etc.

As far as the *illegal* activities are concerned, there have been a lot of controversies about their inclusion in the national accounts or not.

The main arguments in favour of their inclusion are the following [7]:

- *the new version of the National Accountancy System*, signed at the International Convention in 1993, mentions that both illegal and legal activities should be recorded;

- *distortion of aggregates in national accountancy* appears the moment when illegal operations are not recorded in accounts and the result is that the given economic indicators will be false if these accounts are taken into account. For example, if the sums that refer to illegal goods and services are not recorded in accounts, the sum for consumption expenses will be underestimated, while the sum for savings will be overestimated.

- *internal coherence of national accounts* – national accounts are an integrated, complete system. The information referring to a column cannot be modified or excluded unless this action has repercussions on the information referring to important indicators in other columns or accounts.

- *comparability* – the information in national accountancy is used to analyse the evolution of a certain economy in time and to compare it with other economies. The range and importance of illegality in economic activity vary from one country to another. Carrying a thorough comparison of the economic activity in different countries presupposes inclusion of all legal production in the national accounts. The status of numerous goods when compared to the law has changed in time. A valid comparison of the level of economic activity in time is achieved by including the totality of production in accounts. If this is not done, discontinuity appears if the status of a product is altered when the economic situation is not changed (the effective level of production and occupation). The economic information referring to the countries where a high proportion of the active population is involved in illegal activities will be slightly falsified by excluding them.

- *coherence of definitions* – it always starts from the hypothesis that the undeclared legal activity, a component of underground economy, must be integrated in national accountancy. A large part of the underground activities is illegal; thus, not declaring revenue out of fiscal reasons is illegal. One may operate a distinction between the revenue from an illegal operation (such as selling heroin) and the revenue from a legal operation which further leads to a crime (for example, not declaring revenue).

The main arguments in favour of their exclusion are the following:

- *The representatives of several countries agreed that such activities are “bad activities” for the entire economy, in other words, such activities do not have a contribution to the well-being of the society, while the national accounts have as main objective measuring the well-being.* But national accounts do not measure the well-being of a society, but the economic activity. The value of a good is given by its market price or, if own production is involved, by the best approximation of the price. Accounting for an operation does not necessarily mean that it should be tolerated.

- *Some specialists consider that illegal activities should not be taken into account due to the lack of accurate data.* Thus, the implicit hypothesis is that the level of illegal activities is zero, which is obviously a false observation.

The scheme in figure 2 below represents a bird’s eye view on the economic activity. Within productive activities, underground economy includes, on the one hand, the so-called “black economy”, made from unrecorded companies and companies that carry dissimulated activities, and on the other hand, includes the illegal activities, such as drug trade, weapons trade, human trafficking. Unproductive activities include both illegal activities (theft, hostage taking, blackmail etc.) and legal activities (working in private households, charity, and barter) [8].

Consequently, a precise definition is difficult to be formulated, if not quite impossible, and this is mainly due to the complexity of the phenomenon and to the fact that underground economy is “running water”: it easily adapts to the changes within an economic, fiscal, judicial, moral system [9].

As mentioned before, the concept of underground economy covers diverse activities: illegal (trafficking, corruption, and pimpness) and legal, that are not recorded at the level of national accountancy (working home, volunteering) or that are not declared at social and fiscal administration (fiscal fraud, working on the black market). Moreover, the forms of underground economy vary in accordance with the economic systems and other local specificities.

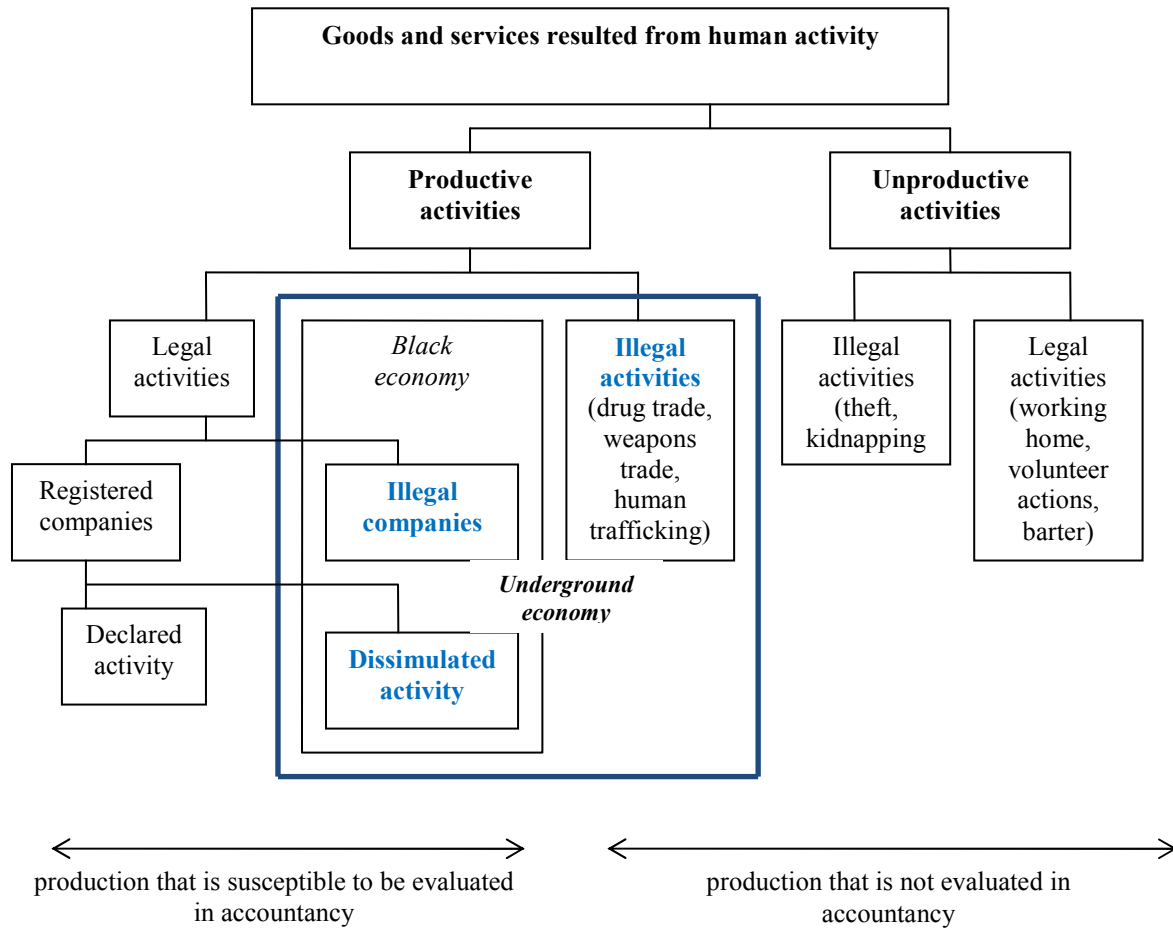


Fig. 2 The place of underground economy
 Source: INSEE – Economie et Statistique nr. 226

Pierre Pestiau, a specialist in this field, considers that underground economy includes the “totality of economic activities that are carried out at the border of criminal law, social and fiscal laws, or that escape the reviews of national accountancy”[10]; in other words, underground economy puts together illegal hidden activities and private activities.

Pierre Rosanvallon suggests another distinction between “occult economy” and “autonomous economy”. The concept of underground economy exceeds the area of domestic activities. It includes the totality of the underground activities that are not dealt on the market, and they are considered “occult”. These phrases suggest that there is a “good” underground economy. One could notice that some goods and services may be obtained more economically from a social point of view if they are produced in a limited area: individual actions, family, volunteering (see figure 3).

The importance and the profile of underground economy differ from one country to another. Yet, one may notice there are some similarities; for example, in the member countries of OECD as far as “black

practices” are concerned ad their motivations (avoidance of direct and indirect taxes and social securities).

Before making the reforms towards a market economy, Eastern countries used to have their own private sector: underground economy. Until the fall of the communist regime and planned economy, these countries witnessed a parallel economy, totally illegal, which Grossman called “secondary economy”. The movements from the end of the ‘80s could not threaten this type of economy. The importance of the Eastern secondary economy cannot be easily measured due to a relative trust of the official statistics on the underground economy, of economic alterations and law uncertainty. Before 1989, state omnipresence and rarity of goods led to a private underground economy that prospered under the shadow of planned economy and was often tolerated. The degree of repression depends on the public power and particularly on the economic situation as long as underground practices have a regulating role of poverty.

Repression also depends on the degree of corruption of local representatives and on the visibility of underground economy.

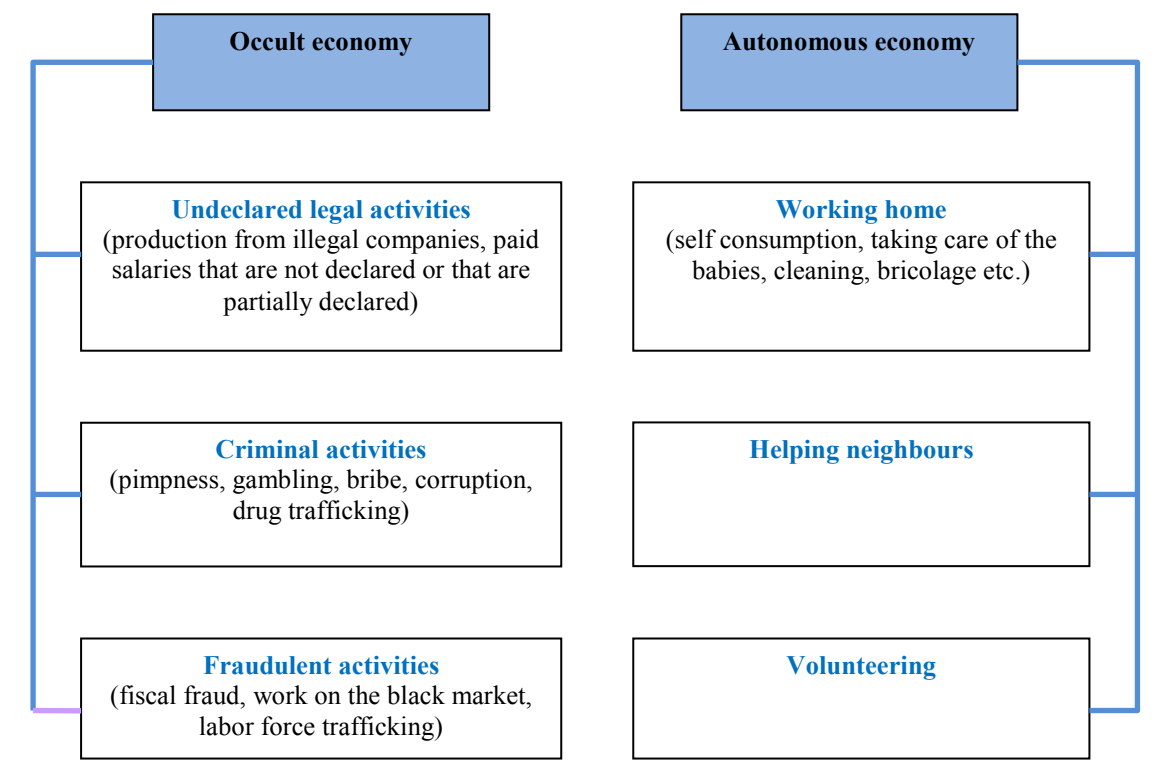


Fig. 3 Comparison between occult economy and autonomous economy
 Source: Marc Debare, *Les milliards de l'ombre de l'économie souterraine*, Hatier, Paris, 1992

Secondary economy is based on the transfer of production from the planned sector to the unofficial sector. Underground economy is thus developed by means of turning into a parasite of the official economy. This type of economy answers the deficiencies and the rigidity of planned economy and answers particularly to poverty, standardization and poor quality of products.

If secondary economy is meant for the production of goods that will be consumed or exchanged on the parallel markets, the underground activities in planned economies have the same varied forms as the ones in the *industrialized countries*.

Transition towards political plurality and market economy in Central and Eastern Europe favoured the temporary development of new illegal activities. Economic alterations limited some forms of parallel activities that are specific to planned economy. Yet, former socialist countries face the development of mafia-like activities.

The general economic situation of *developing countries* is heterogeneous. In these countries, unofficial economy is the dominant way of production and determines the level of development. It is often said that under-developed economies are thought of as being "dual". In these countries, one may distinguish between two fundamental forms of unstructured economy:

- *A primitive form that includes agricultural self production and everything it involves.* It includes

activities that come directly after the domestic activities and it often happens that a border between the two is difficult to be established.

- The other form includes *handicraft, trade or small scale activities*. Their multiplication rate is related to rural exodus and demographic boom which further leads to urban increase. Proliferation of these activities is carried out within the framework of the law and escape state control. Local public authorities tolerate these activities because they absorb the labor force and reduce poverty.

3. Conclusions

Shadow economies are a complex phenomenon which is present to an important extent in developing, transition and developed countries. People are engaged in shadow economy for several reasons. The analysis of causes of the shadow economy shows that an increasing burden of taxation and social security payments are the major driving forces for its growth.

Nevertheless, around the world, there are strong indications for an overall increase of shadow economy. The size and causes are different for all kind of countries, but there are some comparisons that can be made and that might be useful for social scientist and politicians who need to deal with this process.

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