

## The Informal Economy

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### Abstract

*The informal economy can take forms as: fraud or scale evasion, diversion or abuse of advantage scale, moonlighting, fiscal paradises, money laundering, money for drugs and criminal activities, shadow banking, off-shore centers, numbered accounts.*

*The underground economy includes legal business activities carried out outside the eyes of the public authorities.*

*In full swing, the undeclared economy is a big piece of the overall economy, and its impact on the growth of states is not negligible. In Romania, the undeclared economy represents 31,9% of the country's GDP, and it has a significant impact on the growth of the economy.*

**Key words:** the informal economy, the undeclared economy

**J.E.L. classification:** K 42

### 1. Introduction

In its broadest sense, the informal economy concerns all trade in goods and services. Phenomenon growing and worrying, it affects both individuals and legal persons (companies and associations). It affects all economic sectors and is an attack on the principles underlying our economic and social model. However, it doesn't need to be considered as a closed world, disconnected from the formal economy; the two economies - formal and informal - are linked: companies in the formal economy sometimes outsource some of their activities to companies that employ undeclared employees, and so on.

The informal economy can take forms as: fraud or scale evasion, diversion or abuse of advantage scale, moonlighting, fiscal paradises, money laundering, money for drugs and criminal activities, shadow banking, off-shore centers, numbered accounts. These words are the illustration of a world that cheats or plays with legality in order to get rid of taxes, taxes or social contributions, or to maximize its profit (Horodnic et al., 2017).

The claim that it feeds the world of the economy and finance is true, especially as the fraudulent schemes are more complex, as the interministerial circular on the implementation of the European plan to combat illegal work (un.org, 2019). It can be solely local, organized at the national level or rely on international networks sometimes giving it a global dimension. According to the countries, the undeclared economy represents a variable part of the GDP (Godfrey, 2015).

Its consequences are also qualitatively and quantitatively variable depending on the economic and financial structures that prevail: for example, in countries where tax collection is low or social protection doesn't exist, they aren't the same as in those where state revenue is tax-based or high-level social protection. In the European countries, which fall into this second category, with certainly notable variants, the underground economy deprives the public accounts (State, Social Security) of revenues by reducing the tax base, creates situations of unfair competition for businesses, causes individual insecurity and loss of rights as well as legal uncertainty for users or consumers (Cling et al., 2018).

## 2. Theoretical background

The undeclared economy is often defined as a grouping of activities that are either beyond the control of the state in terms of legal obligations or are criminally guilty, that is to say:

- unlawful activities for failing to comply with certain standards such as minimum wage, legal working hours, health and safety conditions or to evade payment of taxes, contributions or compliance with administrative or customs formalities of the police; but also, this is not negligible, to produce an additional subsistence income, in addition to social assistance or low wages (fixed-term, part-time, timesharing). In the latter case, it is not a question of justifying illegal practices, but of explaining or understanding them;

- illegal activities, which include the production of goods or services and selling them, distribution or possession of products which is prohibited by law, money laundering or for financing illegal activities, or the exercise of legal actions as a result of producers who don't have the right (Danielsson, 2018).

The OECD, suggests dividing the *unobserved* economy, which can't be entirely assimilated to the undeclared economy, into four categories:

- underground production which includes activities that are productive and legal, but deliberately removed from the public authorities to avoid paying taxes or complying with specific regulations;

- illegal production: productive activities that generate goods and services prohibited by law or that are illegal when they are carried out by producers who are not authorized to do so;

- production of the informal sector: productive activities carried out by unincorporated enterprises belonging to households, which are not registered or are smaller than a given size in terms of assets and which have a market output;

- household production for own use: productive activities that result in the consumption or accumulation of goods and services by the households that produce them. This phenomenon can't be assimilated to the previous ones (Danielsson, 2018).

More recently, in a study of the underground economy Horodnic et al.(2017) propose the following definition:

"The underground economy includes legal business activities carried out outside the eyes of the public authorities. These activities fall into two categories commonly found in Europe. On the one hand, hidden work includes wages that workers and employers don't declare to public authorities to avoid taxes, contributions or formalities; on the other hand, under-reporting of income to limit taxation. The underground economy does not include illegal activities or domestic crimes or activities that, by law, do not need to be reported."(Schneider, p. 34).

We propose to use this conception, which corresponds to the first category of the OECD manual, or *underground production*, and which is the one on which the European Commission relies (OECD, 2018).

## 3. Evaluation methods

However, the delimitation of the concept doesn't smooth the traditional problems of evaluation of underground production. By the notion, when the enterprise is unknown, or it does an occult activity, it is challenging to carry out evaluations: it is also one of the cases where the legislator has been the most severe since the statute of limitations is increased to 10 years (Boels, 2018).

We distinguish in general:

- the direct methods, based on investigations or controls of the fiscal administration: they allow an in-depth knowledge of the practices and the individual behaviors of the fraudsters, as well as the level of compliance for the laws and the importance of the principal one's influence factors; on the other hand, they are often suspected of diminishing the significance of the phenomenon, and they don't ensure perfect comparability between countries;

- indirect approaches, which are based on the comparison of economic aggregates, such as national accounts, electricity consumption and cash transactions; they generally give an amplified result;

- an ad-hoc method called "Mimic" is based on an analysis of causal factors and the evolution of target indicators (Ledeneva, 2018).

These methods are all based on strong hypotheses, which sometimes are questionable. They give very sophisticated results, which they need a careful analysis; thus, for a given country, estimates can vary. There is no perfect method, even if the direct techniques have the advantage of allowing a more analysis of the behaviors: the main focus is to use them in parallel and comparing the results (Ibid.).

#### **4. Research methodology**

The methods used in the approach of this research are empirical ones. For collecting the data, I used various literature titles and reports regarding the undeclared European economy. The sources which helped me to elaborate this research can be found are mentioned in the references section. The main goal of my research was to evaluate the level of undeclared European economy which can help in the design for new strategies that meant to fight with this form of illegality.

#### **5. Findings**

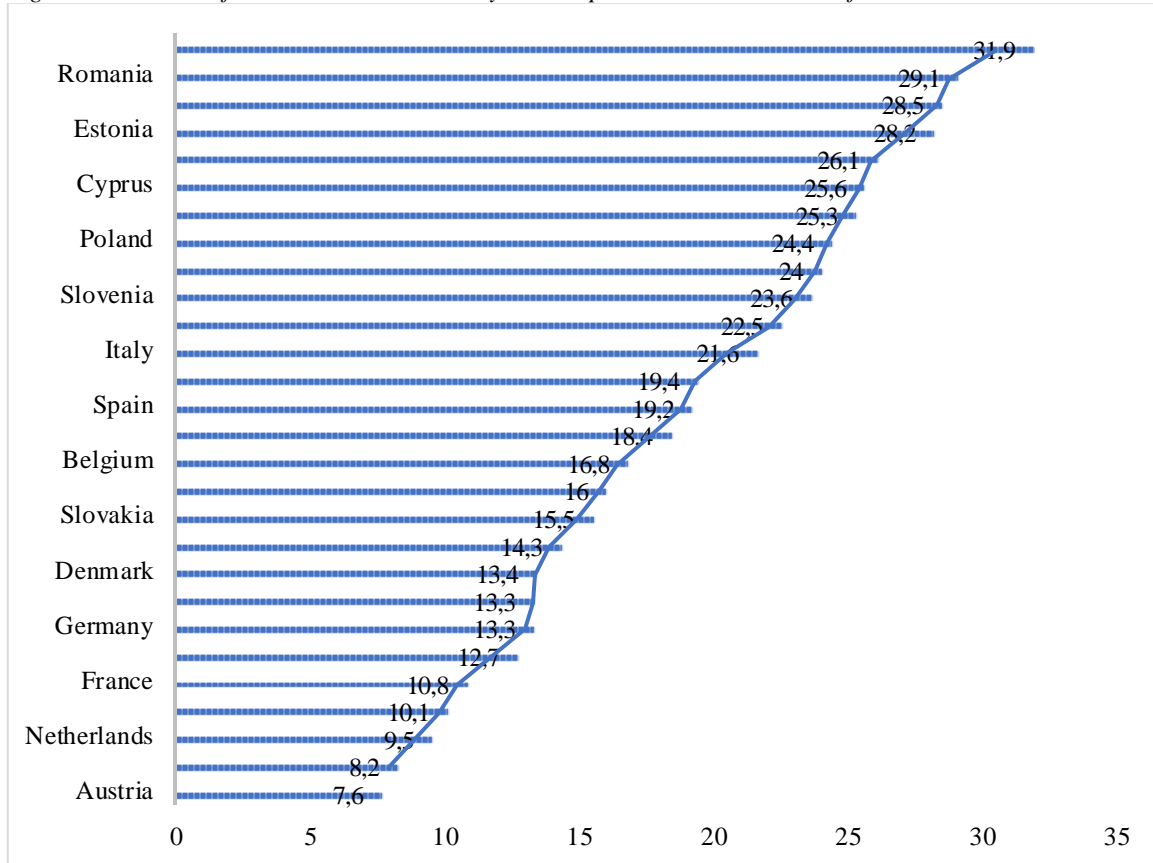
##### **5.1. At European Level**

Concealed work, whether it is *black* that is entirely exempt from reporting obligations, or *gray*, is widespread fraud in Europe. In fact, according to a special issue of Eurobarometer, 4% of Europeans report having carried out undeclared activities outside their employment during the previous year, and 11% acknowledge having bought goods or services *black*. According to the European Commission, the importance of the underground economy would be between 7 to 16% of EU GDP, or 7 to 19% of total declared jobs. In the study cited above, the UN estimates that *moonlighting*, and income concealment corresponds respectively to two-thirds and one-third of the total estimated for the undeclared economy (OECD, 2018).

With the reserves exposed above, in the countries of the European Union, in 2013, the underground economy would represent approximately 18.9% of the activity or 2.1 trillion euros! Austria has the lowest (7.6%) share of the undeclared economy compared with its GDP and Bulgaria has the highest rate (31.9%). Countries like Germany, United Kingdom, and France are on the top of the list of countries with the lowest share of the undeclared economy (among Austria, Netherlands, Ireland, Scandinavian countries), far ahead of the countries where it is the most important (Bulgaria, Romania, Greece, Italy) (Ibid.).

In Italy, the product of the undeclared economy outside the administration scale would be between 255 and 275 billion euros in 2017, between 16.3 and 17.5% of GDP according to an estimate of Eurostat, published in July 2018. We can say that the size of the undeclared economy increases as we move from North-West Europe to South-East Europe. We should underline that Switzerland is a good example because the share of the undeclared economy is representing only 7% of GDP.

Figure nr. 1 Share of the undeclared economy in European countries as a % of GDP in 2018



Source: Eurostat.eu (2019)

## 5.2. At an International Level

The main estimates of the undeclared economy (under tax return and undeclared work) converge to levels that frequently reach 10% of GDP in Western countries, approaching 50% in emerging countries, to exceed this level. It is estimated at the international level that the undeclared economy would weigh slightly less than the US economy. However, it must be recognized that despite international harmonization efforts, particularly within the framework of the so-called Delhi Statistical Group, the statistical data are very easily comparable between countries. According to the OECD, 1.8 billion people worldwide would work without a contract and social security cover.

Over the long term, there has been a trend towards decreasing the weight of the sector in GDP, which notably reflects the introduction of progressively more effective scale governance systems, the development of social protection systems guaranteeing minimum incomes. Not surprisingly, among the European countries most exposed to the underground economy are countries with the highest economic backwardness compared to the EU average.

However, it should be pointed out, that while the trend over the long term is bearish, we are witnessing an influence in the wake of the 2008 crisis. Factors like the slowdown in growth caused by the financial crisis and the austerity policies that followed, the unemployment rise, the stagnation of purchasing power, are all possible explanatory ones.

The development of the social economy, a sign of decomposition of social relations, may then appear as a response to the financial implications of the population in the process of impoverishment.

## 6. Microeconomic Factors

The causes that govern the development of hidden work are well known and the financial aspect remains decisive. Above all, it is a matter of absolute necessity or a desire to increase their resources and, for others, to reduce their expenses. The aim pursued is the reduction of a direct cost (wages, social contributions) or indirect (social or environmental regulations), related to the will to emerge from a legal obligation. From this point of view, the mechanics is the same as that which is set up for the black market: we observe an increase of the black market when regulations are superimposed, whose respect constitutes a disproportionate cost for the company.

The incentive to defraud is strong at both ends of the earnings ladder:

- at the bottom of the scale, both need to increase their earnings and the imperative of avoiding detrimental threshold, lead to privileging the non-declaration of additional gains;
- at the top of the scale, the desire to escape an excessive levy rate can produce similar effects through the under-reporting of earnings.

From this point of view, we can almost distinguish two undeclared economies that are far from being watertight: the first, which is built on the desire to increase its income, to produce at a lower cost by circumventing the legal provisions and the second, which is based on the exploitation of vulnerable people, the unemployed at the end of their rights and illegal migrants.

Therefore, it will be necessary to pay fewer wages contributions and spend fewer taxes, for benefiting from a more significant net gain, or more marginally, to deceive a regulation deemed to be restrictive and therefore expensive:

- provisions to ensure the protection of employees or consumers, standards relating to the quality of products, which may also have health consequences or rules guaranteeing the security of the broader environment, etc.

It should also be noted the consequences of the development of the digital economy, which relies on a large workforce staying in front of a computer:

- young creators are employing more and more trainees around the digital economy in *incubators*, spaces for *co-working*, and there is a specific porosity between legal status and informal status of paid employees, in conditions that don't comply with the regulations. The proliferation of sites that directly link jobs and requests for services (*jobbing*) is also a factor that facilitates the development of the undeclared economy.

## 7. Macroeconomic Factors

Macro-economic factors such as the economic situation, the level of unemployment and the weight of the tax are explaining the emergence and development of the undeclared economy.

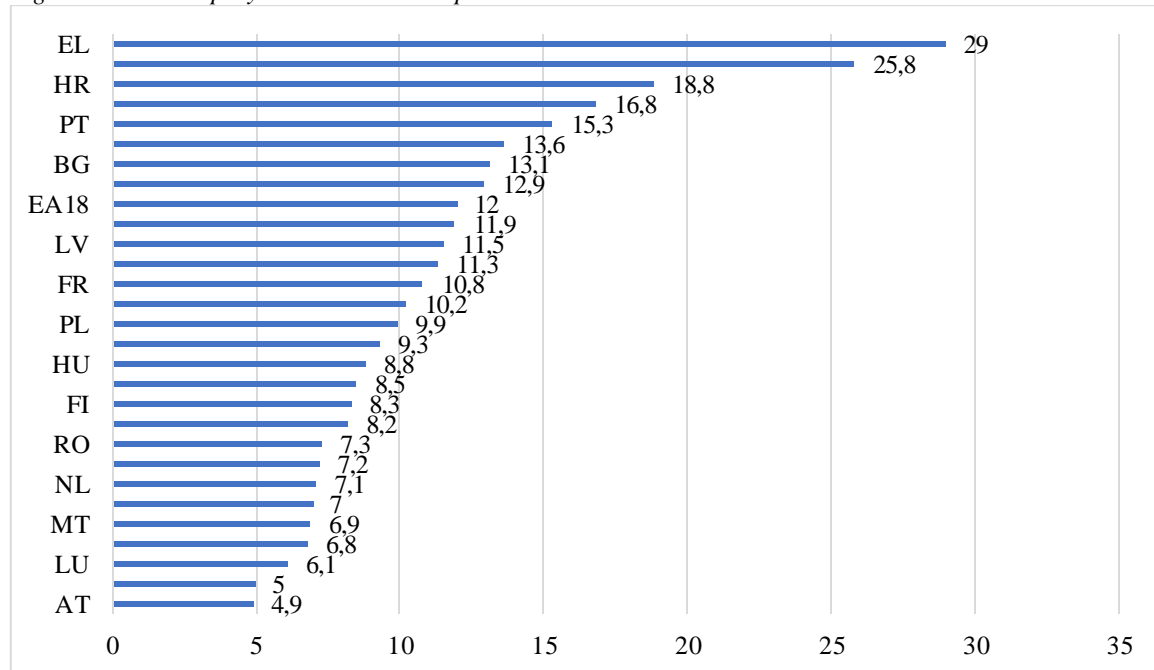
Thus, we will mention in a non-exhaustive way:

- a context of massive unemployment, which creates healthy competition between job seekers and encourages them to be less demanding on working conditions;
- the economic crisis, which depresses activity and obscures the business horizon, creating a need for employers' flexibility ;
- taxes and contributions that increase the cost of labor and reduce earnings for employees, creating a shared financial interest for hidden work;
- poverty which explains the attraction that can constitute a fast and unconstrained income of subsistence;
- the competition that may weigh on the results of the enterprise, or even the globalization of trade and industry, which exacerbates international competition in the unsheltered sectors.

The Eurobarometer survey of March 2019 indicates that the main reasons given for the exercise of an undeclared activity are: the difficulty of finding a declared job (21 %), the high level of taxes and contributions (16%), the non-existence of other sources of income (15%); and the invocation of a common practice in the sector or region that makes it challenging to find an alternative (14%) (eurostat.eu, 2019).

There is also a strong correlation with the unemployment rate under a sustainable level, which cannot surprise: workers experience a loss of income that they are trying to offset, and also, the intense competition between workers on the labor market, allows employers to impose conditions that emerge regulation. At the same time, in the short term, precarious workers are the first to be hit by the economic slowdown and the decline in activity.

Figure no. 2 Unemployment Rate in European countries



Source: Eurostat.eu (2019)

In the 1990s, at the international level, globalization has contributed to the development of an informal workforce. The ILO observes that while globalization creates new jobs and new markets, not all of these jobs are good ones, and these new markets may not provide opportunities for the least advantaged producers (ilo.org, 2019). International competition is changing employer/employee relations and pushing companies to hire low-wage workers or outsource production.

In any case, it is clear that the causes of the underground economy are a function of the ways in which societies are organized. For the industrialized countries, the welfare state and the weight of the seal, while in the developing countries the economic structures are poorly organized.

## 8. Conclusions

In 1983, many countries voted an opinion regarding the shadow economy. The situation has changed little, and the causes remain as well as the consequences even if, on the one hand, the forms taken by the illegal workers have been able to evolve (absence of a preliminary declaration, bargaining, illicit loan of labor, dissimulation of activity, employment of foreigners without a title). Misappropriation of the status of self-entrepreneur, fraudulent implementation of the regulatory framework on the posting of workers, increasingly complex arrangements or even institutionalization of fraud and, on the other hand, the legislative arsenal has been strengthened (responsibility of the chiefs, financial and administrative sanctions, clarification of the duties in control, etc.).

During economic downturns, the importance of the undeclared economy throws a dim light on the social consensus: the quest for profit at any price, refusal to participate in the recovery of public accounts, refusal to take its share in the financing of rights acquired by all. Even if some economists have seen a shock to the crisis, or even the manifestation of a need for flexibility to promote innovation and growth, we cannot ignore that it is part of a withdrawal, a disrespect of the

rights of the other, of a tolerance of the collective conscience too often characteristic of our society. In this respect, it must be fought as it proceeds from the quality of citizen to participate in the financing of the State.

But it must also warn about the complexity of a regulation that can discourage to declare.

Stacking of normative texts does not explain the underground economy as a whole, but it is one of the factors on which the public authorities must act: the work of simplification which has begun, must continue, but must not be the pretext for deregulation or weakening of standards. Stacking of normative texts does not explain the underground economy as a whole, but it is one of the factors on which the public authorities must act: the work of simplification which has begun, must continue, but must not be the pretext for deregulation or weakening standards.

Poverty, exclusion, mass unemployment provide docile labor for unscrupulous employers: the response to the development of the undeclared economy therefore also requires the implementation of inclusive macroeconomic policies. It must also be noted that the undeclared economy is based on cultural practices: adherence to the social model, attachment to individual freedom, and the promotion of work.

Therefore, the fight against the undeclared economy must, combine a better awareness and prevention, a reinforcement and an effective enforcement of sanctions, targeting more of controls and better articulation of the devices between them. At a time when the recovery of public accounts is considered a priority by policy makers, fairness dictates that efforts are properly distributed and in particular, that no one can avoid them by legally reprehensible behaviors.

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