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In the shadows

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The informal economy is neither small nor benign

HAVE you ever paid cash to a builder for the odd home improvement? Or perhaps bought fruit from a street vendor who lacked the required hygiene certificate? Maybe you have employed a maid or a nanny, and have never got round to filing all that paperwork for social security?

If so, then depending on your local laws you may have been participating in what economists call the "informal" or "grey" economy. In essence, the grey economy consists of legal activities whose participants fail to pay tax or comply with regulations. The informal (or "underground" or "parallel" economy) is often taken to mean something broader, including illegal activities such as prostitution and drug dealing as well, although there is no agreed strict definition.

The grey economy is often thought of as something found at the margins of poor countries, such as a hawker stand in Thailand or a roadside vendor in Ghana. But that is misleading. Although it represents a greater share of total output in poor countries, it exists in rich and poor places alike. Recent research suggests that the grey economy is growing. Moreover, a new study suggests that it may be slowing the overall economic growth of developing countries.

Measuring the invisible

By its very nature, the informal economy's size in any country is hard to observe. In a paper published a couple of years ago*, Friedrich Schneider, of the Johannes Kepler University of Linz, exhaustively examined the ways of estimating it. There are two basic approaches. The first is direct: you could ask people whether they dodge taxes, or look at



the results of spot tax-audits. However, people are unlikely to confess to breaking the law, and tax inspectors do not usually check on a random sample of the population. So the second method, indirect detective-work, is better. For example, you might compare data on cash transactions or electricity consumption with official output figures. If the use of cash or electricity is growing much faster than the measured economy, this might indicate that the informal share of total activity is rising.

Using such techniques, Mr Schneider estimated that the informal economy in developing countries in 2000 was equivalent to 41% of their official GDP. In Zimbabwe, the figure was 60%. In Brazil and Turkey, around half of non-farm workers are in the informal sector. In OECD countries the share of the informal economy was lower, but far from negligible, at 18%.

There is little mystery about why the informal economy exists. There are a lot of advantages to operating in the shadows. For a start, there are no income taxes to pay. Avoiding social-security charges, which often drive a chunky wedge between take-home pay and employers' wage bills, can both cut labour costs and thicken wage packets. People can also save a fair bit by ignoring safety, environmental and health rules, not to mention intellectual property rights.

Indeed, in cross-country comparisons, the more expensive and more complicated are taxes and regulations, the bigger is the informal economy as a share of GDP. That explains why, among rich countries, Spain, Greece, Italy and Belgium have some of the largest grey economies and why America, Canada and Switzerland have much smaller ones. In recent years, the growth in the grey market in some poor countries may owe a lot to the International Monetary Fund's austerity programmes, which increase taxes and thus encourage many entrepreneurs to opt out.

A booming grey economy sounds like good news, if only because many of the officially jobless are in fact earning a living. So if the poorest are winning, who loses?

The entire economy does, according to a new study[†] by Diana Farrell of the McKinsey Global Institute, research arm of the consulting firm. The price for having a large grey economy can be much lower productivity. Grey firms tend to be small and want to stay that way lest they come to the attention of the authorities. However, their small scale limits their ability to make the most of new technology and business practices.

In Russia, for example, large supermarkets, which have no choice but to obey the tax inspectors, have a 5% cost advantage over small shops. But informal outlets can save 13% by staying in the shadows. In other words, the productivity benefits of greater scale are swamped by higher tax rates. As a result some industries, especially labour-intensive ones such as retailing, stay fragmented and inefficient.

Ms Farrell estimates that formalising the informal sector could add 0.8 percentage points to Portugal's productivity growth, and 1.5 percentage points in Turkey and Brazil. Brazil's construction industry, for example, would gain because it would have no need to employ

lookouts to tell unregistered workers to scatter when government inspectors turn up.

Broadening the tax base, cutting rates and improving enforcement would help. Ms Farrell notes that, if the Turkish government managed to collect 90% of its value-added-tax revenues instead of the current 64%, it could lower the tax rate from 18% to 13% without sacrificing any income. She also points out that Brazil's government today spends 30% of the country's (official) GDP, a bit more than America's today, and vastly more than the 7% the Americans spent in 1913, when their real GDP per head was roughly the same as Brazil's today. Yet Brazil has only four tax enforcers for every 1m people. If tax rates remain high and the probability of detection low, grey activities will continue to have irresistible appeal.

* ["Size and Measurement of the Informal Economy in 110 Countries Around the World"](#). World Bank Working Paper, July 2002.

† ["The Hidden Dangers of the Informal Economy"](#). *McKinsey Quarterly*, 2004, no 3.

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