

The tax and regulatory causes of the underground economy

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Working "under the table," together with tax fraud and illicit trafficking in various items, has been a focus of debate since the start of the crisis that hit most developed countries. Repressive measures have been implemented or are being discussed at the national and international levels.¹

However, these measures fail to attack the real causes of the underground economy. If it were to decline or disappear without any change in regulations or taxes, this could, paradoxically, end up penalising the official economy. The only lasting solution is to liberate the legal market.

A MULTI-FACETED AND HARD-TO-MEASURE ECONOMY

The concept of an "underground economy" may include, depending on the definition, a wide range of economic activities. But they all have one point in common: they operate outside government control. As one economist notes, it is "that part of the economy where goods and services are produced, exchanged or consumed illegally."²

One of the distinctions is based on the productivity of the activities in question. Trading in stolen goods, for example, is seen as *unproductive* black markets. Other activities are viewed as *productive* when they involve exchanges of goods and services that occur between consenting individuals but that are prohibited (narcotics) or over-regulated (labour, tobacco, alcohol). This "productive" part of the underground economy forms the focus of this study.

Given that this phenomenon, by definition, lies outside government control, it is hard to measure accurately. But various methods are used in attempts to estimate its size, based, for example, on electricity consumption, use of cash in the economy, results of audits and tax adjustments, etc.

According to an estimate by Professor Friedrich Schneider, a specialist on this issue, the shadow economy — primarily involving concealed labour and thus excluding illegal activities in particular — may have accounted in 2012 for 10.8% of GDP in France and 18.9% of European GDP (see Table 1).

Whichever estimates are used,³ the size of the underground economy seems large in absolute terms. For a country like France, for example, it accounts for between 75.1 billion euros⁴ and 219 billion euros (and up to 1.9 trillion euros for the EU as a whole).

Table 1

Estimate of the "shadow" economy in Europe in 2012		
Country	As % of GDP	In billions of euros
Austria	7.6%	23.6
Belgium	16.8%	63.3
Bulgaria	31.9%	12.7
Cyprus	25.6%	4.6
Czech Rep.	16.0%	24.5
Denmark	13.4%	32.7
Estonia	28.2%	4.8
Finland	13.3%	25.9
France	10.8%	219.2
Germany	13.3%	351.6
Greece	24.0%	46.5
Hungary	22.5%	22
Ireland	12.7%	20.8
Italy	21.6%	338.2
Latvia	26.1%	5.8
Lithuania	28.5%	9.3
Luxembourg	8.2%	3.6
Malta	25.3%	1.7
Netherlands	9.5%	57.1
Poland	24.4%	93.1
Portugal	19.4%	32.1
Romania	29.1%	38.3
Slovenia	23.6%	8.4
Spain	19.2%	201.3
Slovakia	15.5%	11.1
Sweden	14.3%	58.4
United Kingdom	10.1%	192
EU-27	18.9%	1902.5

Source: F. Schneider and A. T. Kearney, "The Shadow economy in Europe, 2013," 2013, p. 23.

1. See, among others, the French government's plan for fighting illegal labour, released in November 2012: <http://www.gouvernement.fr/gouvernement/la-lutte-contre-le-travail-illegal>. Also see the report "Tackling undeclared work in the European Union," *European Foundation for the Improvement of Living and Working Conditions*, 2008. As regards the fight against tax evasion, a broad series of measures are under discussion at the national and international levels (such as automatic information exchange or an end to bank secrecy).

2. See Pierre Lemieux, "The Underground Economy: Causes, Extent, Approaches," Montreal Economic Institute, November 2007, available at: http://www.iedm.org/files/cdr_nov07_en.pdf.

3. National statistical agencies in many countries also attempt to keep track of the so-called "unobserved" economy. For example, INSEE in France put it at between 3.7% and 4% of GDP in 2008, rather than 11.1% for that year under the method devised by Friedrich Schneider. See the INSEE report "Les comptes nationaux passent en base 2005," May 2011, p. 4, available at: http://www.insee.fr/fr/indicateurs/cnat_annu/base_2005/methodologie/comptes-nationaux-base-2005.pdf.

4. This matches the extrapolation of INSEE's low estimate for 2008, namely 3.7% of PIB (see Note 3 above). By way of comparison, this is 27.3% more than forecasts of 2013 income tax revenues (59 billion euros). See the 2013 tax law, available at: <http://www.economie.gouv.fr/files/projet-loi-finances-2013-plf-chiffres-cles.pdf>.

If the aim is to fight this phenomenon effectively, it is essential to understand the factors behind it. Economic reasoning and international experience point invariably to common causes that consistently create obstacles to dealings in the official economy: prohibitions, compulsory levies and specific tax measures, as well as fastidious and complex regulations.

PROHIBITION OF COMMON PRODUCTS

The primary cause, and undoubtedly one of the oldest, is the prohibition of some common goods and services. Its effect on the growth of the black market is observed systematically. Why?

While prohibition effectively prevents trading in forbidden products on the legal market, these products generally continue to be desired, sought and demanded by consumers. The absence of a legal supply leaves plenty of latitude for contraband supply to substitute for it. The black market flourishes, and consumption of the product in question hardly disappears.

Examples abound, from "coffee, forbidden under penalty of death by Sultan Amurat II in the 15th century"⁵ to alcohol and tobacco, which are favourite targets of public authorities.

The case of alcohol prohibition in the United States in the 1920s stands as a life-size experience of the consequences of this type of prohibition in terms of black markets and large-scale contraband activities.⁶ Tobacco prohibition in several American states in the 19th century,⁷ and more recently in Bhutan, had similar effects.

It is essential to bear this in mind. While governments in most western countries have given up on total prohibition, the issue has obviously resurfaced in public debate in the last few years.

THE WEIGHT OF TAXATION AND SOCIAL SECURITY CHARGES

This is a primary cause of the underground economy in western countries. Compulsory levies — taxes, social security charges, etc.

— make it profitable, whether for concealed labour or illegal trafficking.

Taxes and social charges, a cause of undeclared work

As noted by two specialists, "In almost all studies, one of the most important causes (...) is the rise of the tax and social security burdens."⁸ The higher these burdens on labour relations and dealings

in the official economy, the less profitable these dealings become and the greater the incentive to trade on the black market.⁹

This incentive exists at several levels. It involves, for instance, escaping income tax or value added tax by buying or selling on the black market. In addition, the existence of social security charges creates a gap between what an employee costs a company on the official labour market and the salary this employee receives. It may then become profitable for both sides to establish a working relationship outside the official economy.

Specific tax measures: a cause of illegal trafficking and parallel markets

The tax burden also explains the contraband trade in certain prod-

ucts, even though these products are permitted on the official market.

As long as taxes account for a high share of the final price, opportunities for profit are provided in the underground economy, which moves in on a long-term basis and comes to account for a significant share of countrywide sales. For example, the contraband sale of alcohol or tobacco products in a country such as the United Kingdom, where excise taxes alone may amount to eight euros for a 70-cl bottle of spirits,¹⁰ the share held by the illicit market was estimated at 13% of the official market in 2010-11.¹¹ For other heavily taxed products, such as beer and cigarettes, this share may reach 14% and 16% respectively, according to official estimates.

Each time the public authorities prohibit a product on the official market, they create opportunities on the black market. And each time they decide to raise taxes or tighten regulations, they make illicit trafficking and the shadow economy more profitable.

5. See Pierre Lemieux, 2007, *op. cit.* p. 9.

6. See Valentin Petkantchin, "Is government control of the liquor trade still justified?," Montreal Economic Institute, 2005, p. 9. See also Mark Thornton, "Alcohol Prohibition Was a Failure," Cato Institute, Policy Analysis 157, July 17, 1991.

7. See Pierre Lemieux, 2007, *op. cit.* See also Valentin Petkantchin, "What if tobacco were simply prohibited?," Economic Note, Institut économique Molinari, January 2012, p. 2, available at: http://www.institutmolinari.org/IMG/pdf/note0112_en.pdf.

8. See Friedrich Schneider et Dominik Enste, "Shadow Economies: Size, Causes, and Consequences," *Journal of Economic Literature*, Vol. XXXVIII, March 2000, p. 82.

9. Another possible reason involves working "under the table" to avoid losing social allowances such as unemployment benefits. This turns black market labour into an undesired result of social welfare and should be regarded as an additional cost of applying social benefits programs.

10. See "UK Excise Duty Rates on Alcohol," The Wine and Spirit Trade Association, 2013, available at: <http://www.wsta.co.uk/images/stats/excisedutyrates.pdf>.

11. Source: HM Revenue & Customs, *Measuring the tax gap*, 2012.

Increasing this tax burden can only increase the disconnection between the real production cost of goods and their price on the official market, to such a degree that consumers begin abandoning the official market on a larger scale.

The example of contraband tobacco in Quebec and across Canada clearly illustrates this process. In the late 1980s and early 1990s, taxes on tobacco rose sharply, causing an upsurge in illicit trafficking, estimated in early 1994 at "65% of the cigarettes purchased in Quebec,"¹² or two cigarettes out of three. In just a few years, official sales collapsed, falling by more than 61%.

The tax burden had to be cut drastically to curb contraband sales and enable the legal market to regain its place (see below).

In France, the parallel trade also took off after sharp tax hikes in 2003-04 led to price increases of about 40%.¹³ It was estimated to hold 20% of the market in 2011. With the legal market penalised, the tax burden — accounting for more than 80% of the final price — ended up lowering the government's tobacco-related revenues. These revenues fell in the first quarter of 2013 for the first time in 10 years, down 2.5% from the same period in 2012. The decline in volume was 8.6%.¹⁴

There can be no mistake: it is not alcohol or cigarettes as such that give rise to this shadow supply. The existence of taxes on various drinks (soda and beer) and food items (sugar, chocolate, ice cream, saturated fat) had the same effect in Denmark: many Danes abandoned the domestic market and stocked up in other countries.¹⁵

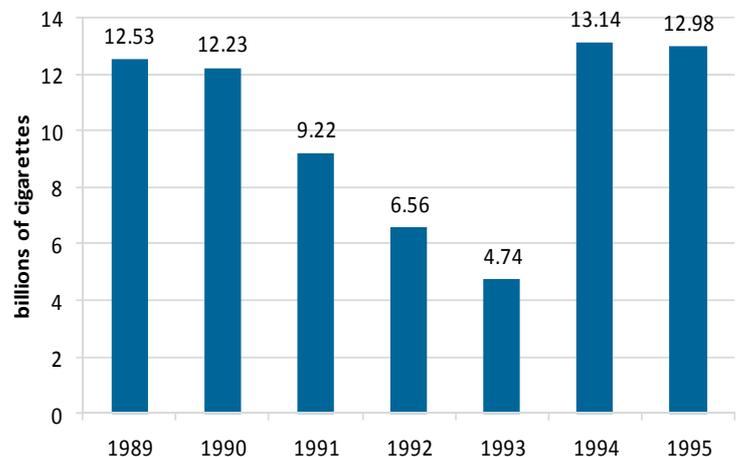
AN OVER-REGULATED OFFICIAL MARKET

The presence of overly restrictive regulations¹⁶ also leads to expansion of the underground economy.

The case of black labour market is typical in this regard. When the labour laws prevent the contracting parties from negotiating freely on a certain number of conditions, they have an incentive to deal under the table. This is true of the minimum wage, which effectively excludes from the legal labour market anyone whose

Figure 1

Collapse in the legal cigarette market in Quebec in the early 1990s



Source: Health Canada, "Cigarette and Fine-Cut Sales in Quebec 1980-2011," 2012.

productivity cannot justify the cost to employers. This makes a portion of the workforce available to the underground economy.

Regulations specific to certain industries or products have the same effects. A study analysing the situation in 75 countries found that "a heavier regulatory burden (...) reduces growth and induces informality."¹⁷

In addition, heavy regulations may result in unnecessary increases in the prices of products on the legal market. Products available on the black market can then be offered to consumers at lower prices, despite the risks involved in illegal dealings.

TOUGHER REPRESSION: A SELF-DEFEATING SOLUTION

Given the scope of the underground economy, public authorities generally suggest toughening the means of repression so as to collect more tax revenues.¹⁸ The justification for this repression remains the same: it would promote the transfer of all under-

12. See "Mémoire présenté à la Commission des finances publiques sur l'étude des mesures pour contrer la consommation de tabac de contrebande," Revenu Québec, September 2011, p. 7.

13. See the evaluation report of the Court of Auditors, "Les politiques de lutte contre le tabagisme," December 2012, p. 136: "it is thought that, prior to this date, only a few departments along the borders, near Andorra or Luxembourg, were affected" (translation).

14. See the AFP report, "Le marché des cigarettes en baisse en valeur, une première depuis 10 ans," April 22, 2013, available at: <http://www.ladepêche.fr/article/2013/04/22/1611665-marche-cigarettes-baisse-valeur-premiere-depuis-10-ans.html>.

15. See Valentin Petkantchin, "Nutrition' taxes: the costs of Denmark's fat tax," Economic Note, Institut économique Molinari, May 2013, available at: <http://www.institutmolinari.org/fiscalite-nutritionnelle-les-couts,1523.html>.

16. A number of studies have found a connection between heavy regulation and a shadow economy (i.e., concealed work). See Schneider and Enste, 2000, *op. cit.*, p. 86, and the references cited there. See also Norman Loayza, Ana Oviedo and Luis Servén, "The impact of regulation on growth and informality: Cross-country evidence," World Bank, Working Paper WPS3623, May 2005, available at: <http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-3623>.

17. See Norman Loayza, Ana Oviedo and Luis Servén, *op. cit.* 2005. According to the authors, "the informal sector comprises (non-criminal) economic activities that go undeclared specifically in order to avoid compliance with costly regulation, ... tax payments and social security contributions" (pp. 5-6).

18. The European Commission evaluates the tax shortfall at one trillion euros. See "Clamping down on tax evasion and avoidance," December 6, 2012, available at: http://europa.eu/rapid/press-release_IP-12-1325_en.htm.

ground activity to the legal market, thereby creating new tax revenues.

Beyond the cost of this repression in terms of resources and bureaucratisation of the economy, this reasoning and the resulting forecasts are erroneous.

Though certain activities may no longer be undertaken in the underground economy, they will not be undertaken in the official economy either — in part or even in whole, depending on the specific case — because of the burden of compulsory levies and regulations. With prices higher, demand for the goods or services concerned will decline. In a 2007 survey, 78% of the Germans questioned indicated that they would not turn to the official market if the shadow market were to disappear.¹⁹

Another way of approaching this issue is to recognize that the underground economy and the official economy are closely linked and are interwoven with one another. Each depends on the value and the purchasing power created in the other. For example, nearly two-thirds of the income earned in the shadow economy is estimated to be spent in the official economy.²⁰

Increased repression by the public authorities, without any change in regulatory and tax frameworks, risks simply destroying economic activities and the associated revenues. The only long-lasting solution for ending the underground economy consists of dealing with the causes that give rise to it and thus to free the

official market from its fiscal and regulatory burdens.

The Danish government made the politically difficult choice of following this solution in the face of parallel trade and the adverse effects caused by tax measures. It abolished its fat tax in 2012 and is preparing to eliminate its tax on soda and beer. Similarly, given the magnitude of contraband tobacco sales in Québec, the tax burden was reduced by nearly 80% in February 1994.²¹ The result was almost instantaneous: a drastic reduction in the black market and "full restoration of the legal market," with legal sales in the two months following the tax reduction tripling compared to the same period in 1993.²²

CONCLUSION

Each time the public authorities prohibit a product on the official market, they create opportunities on the black market. And each time they decide to raise taxes or tighten regulations, they make illicit trafficking and the shadow economy more profitable.

To fight the shadow economy, governments are intensifying repression. But they are leading themselves astray, because this does not deal with the causes of the problem.

The fight against the shadow economy should take a completely different form. It should restore competitiveness and vigour to the official economy and labour market. To achieve this, there is no other choice but to lighten tax and regulatory burdens.

19. See Lars Feld and Friedrich Schneider, "Survey on the Shadow Economy and Undeclared Earnings in OECD Countries," *German Economic Review* 11 (2), p. 122. Some 30% will do the work themselves, and 48% will completely stop requesting the good or service.

20. See Friedrich Schneider, "The Influence of Public Institutions on the Shadow Economy: An Empirical Investigation for OECD Countries," *Review of Law and Economics* 6:3, 2010, p. 457.

21. See Pierre Lemieux, 2007, *op. cit.*, p. 9. With the decline in contraband sales, the public authorities brought back tax increases starting in 1995, leaving room for a return of the black market.

22. See the 1994-1995 *Budget*, Gouvernement du Québec, 1994, p. 18.

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