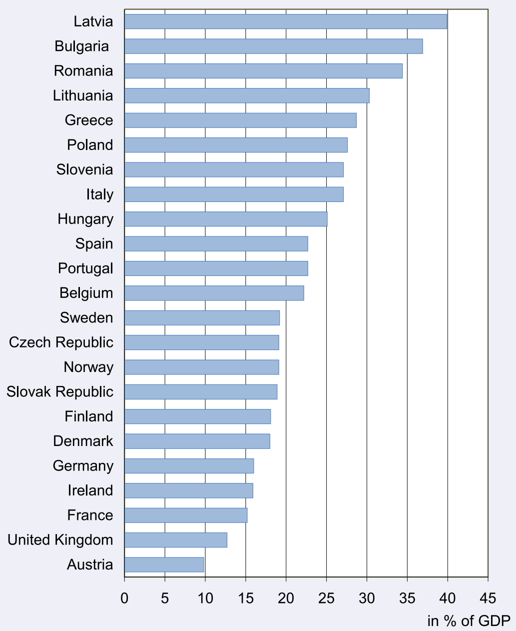
# ACCESSION COUNTRIES IN THE SHADOWS

The subject of the shadow or informal economy is still quite controversial; there are disagreements on the definition, the estimation methods and policy aspects. There is agreement, however, on the importance of the shadow economy for tax revenue and social security contributions collected and other effects on the official economy. Unfortunately, it is very difficult to get accurate information on the size of the shadow economy, as the actors involved are not eager to discuss their illegal or unreported activities. In a recent paper, F. Schneider and R. Klinglmair (February 2004) presented estimates on the size of the shadow economy in 110 countries. According to their findings, the shadow economy represents a greater share of total output in poor countries, but it exists in rich places too. And it is growing.

In several EU accession countries the shadow economy is much larger than in Western Europe. This is not surprising, considering the difficult times faced by many people after the breakdown of their Communist regimes. Many who had worked in the run-down state-owned enterprises became unemployed with no new jobs in sight. The lack of social security benefits left only the way into the shadow economy.

SIZE OF THE SHADOW ECONOMY 1999/2000




Source: Schneider/Klinglmair 2004.

Still, big differences exist between the accession countries in this respect too. Whereas the shadow economies in the Czech and Slovak Republics amounted to only 19 percent of GDP in 1999/2000 and thus less than in Italy or Greece, it was 40 percent in Latvia.

There is little mystery about why the shadow economy exists. Besides the special problems of the people between Riga and Sofia, there are a lot of advantages to operating in the shadows. Avoiding income and value added taxes as well as social security contributions, which often drive a big wedge between take-home pay and employers' wage bills, cuts labour costs and leaves more in the pay packets. People can also save costs by ignoring safety, environmental and health rules, not to mention intellectual property rights. Thus taxes, especially the marginal tax rate, and the density of regulation are the major driving factors.

While operating in the shadow economy has advantages for the individual employee or firm, it has big disadvantages for the economy as a whole.

By leading to reduced tax revenues, growth in the shadow economy reduces the quantity and quality of public goods and services. Ultimately this can result in an increase of tax rates for firms and individuals in the official economy. And a large shadow economy also has the price of leading to much lower productivity (McKinsey Quarterly 2004, no. 3). Informal firms tend to be small lest they come to the attention of the authorities. However, their small scale limits their ability to make use of new technology and business practices.

Those countries will have smaller shadow economies that have higher tax revenues achieved at lower tax rates, fewer laws and regulations and less bribery and corruption.

Transition countries have higher levels of regulation leading to a significantly higher incidence of bribery; they have higher effective tax rates and a large discretionary framework of regulation and hence a larger shadow economy. Broadening the tax base, cutting rates and improving enforcement would help.

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