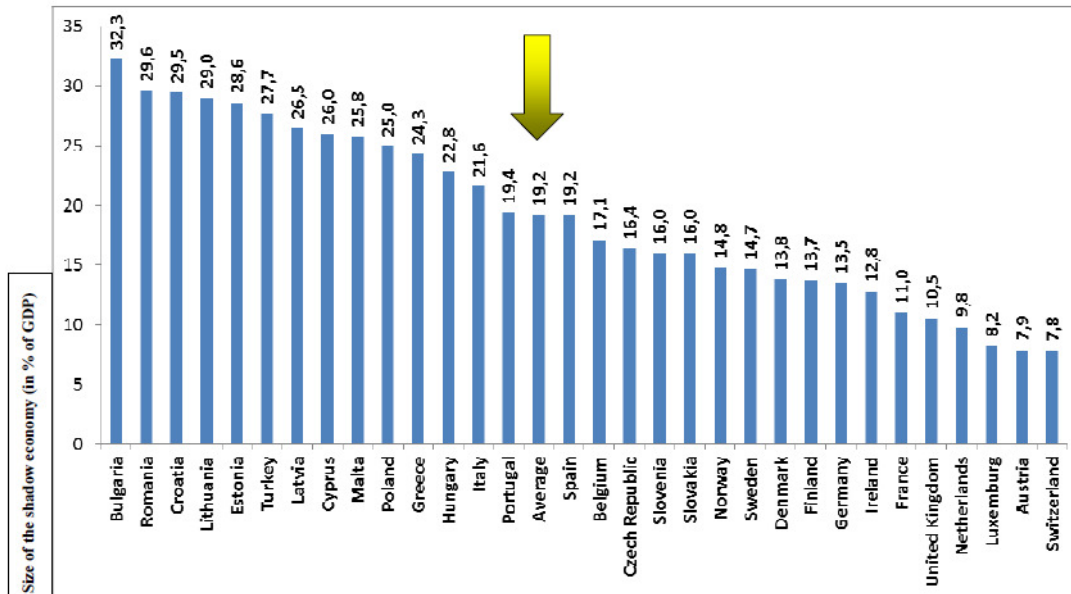


SHADOW ECONOMY

The shadow economy includes those economic activities and the income derived thereof that circumvent or avoid government regulation or taxation. The major component (about two thirds) is undeclared work, which refers to the wages that workers and business don't declare to avoid taxes or documentation. The rest is represented by business underreporting profits to avoid tax regulation.¹

1. Key statistic indicators

Figure 1: Size of the shadow economy of 31 European Countries in 2012, % of GDP



Source: Schneider, F. (2011), "Size and development of the Shadow Economy from 2003 to 2012: some new facts".

The fact that undeclared work is not observed or registered, and it may be defined differently in national legislation, makes it difficult to obtain reliable estimates of how widespread it is across Member States. But assessing the extent and features of undeclared work is indispensable in order to put in place appropriate policy measures.

As stated in the COM(2007)628: "Undeclared work can be measured both directly and indirectly. Indirect methods are based on the comparison of macroeconomic aggregates (such as national accounts, electricity consumption, cash transactions). Indirect (especially monetary) methods often over-estimate the level of undeclared work and say little about its socio-economic characteristics. Direct methods, on the contrary, are based on statistical surveys and have advantages in terms of comparability and detail, but tend to under-report the extent of undeclared work."

Caution has to be taken when using indirect methods as there is wide agreement among experts that they over-estimate undeclared work and measure the whole shadow economy. Prof Schneider's data are based on indirect methods, but they can give an idea in international comparison; the numbers are updated and widely recognised. The results of the estimates differ a lot depending on the methodology used, and e.g. in case of Estonia vary from 4% (estimate of the national Statistical Office) to almost 30% in Schneider (2011).

¹ Schneider (2011), The Shadow Economy in Europe 2011.

Therefore the results of the work should be viewed against the policy settings in Member States that could set more or less favourable conditions for shadow economy.

2. Assessment of the main challenges in the Member States

Shadow economy and undeclared work have negative implications which affect macro-economic objectives as well as quality and productivity at work and social cohesion. From a macroeconomic perspective, they decrease tax revenues (income tax or VAT) and undermine the financing of social security systems. From a microeconomic perspective, undeclared work tends to distort fair competition among firms, paving the way for social dumping inhibiting the creation of regular employment with full social protection. It also causes productive inefficiencies, as informal businesses typically avoid access to formal services and inputs (e.g. credit) and companies do not grow.

The transformation of undeclared work (UDW) into formal work is an important issue for the current employment policy of the European Commission, and represents an important step towards the fulfilment of the employment targets of the Europe 2020 strategy.

The 2011 Annual Growth Survey (AGS) set as a priority that Member States should step up their efforts to reduce undeclared work by strengthening the enforcement of existing rules and reviewing tax benefit systems.

The 2012 AGS proposed that Member States should reinforce measures to encourage moves from informal or undeclared work to regular employment. Furthermore, enhanced tax compliance would increase government revenues.

A number of factors have contributed concerns over a growing scope for undeclared work:

- the growing demand for household and care services as a result of socio-demographic changes, possibly in combination with working time reduction;
- the trend towards smaller and less hierarchical working relationships with more flexible pay systems or time accounting;
- self-employment (including false self-employment) and sub-contracting and, more generally, flexible contracts and on-call work, when they are misused for non-declaration of part of the revenue;
- the growing ease of setting up cross-border groupings of enterprises, which require efficient international cooperation between monitoring and enforcement bodies and/or systems.

The situation of the official economy also plays a crucial role in people's decision to work in the shadow economy. In a booming economy, people have a lot of opportunities to earn a good salary and "extra money" in the official economy. This is not the case in an economy during a recession; when more people might try to compensate their income losses through additional shadow economy activities.

Based on the Schneider study, shadow economy has been decreasing since the highest level of 23.2% in 2003. This decrease would seem to be due to the fact of the recovery from the world wide economic and financial crises. The only exception is Greece, where the recession of the official economy is so strong, that it even reduced the demand of the shadow economy activities due to the severe income losses.

Table 2: Size of the shadow economy of 31 European countries over 2003 – 2012, % of off. GDP

Country / Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Austria	10.8	11	10.3	9.7	9.4	8.1	8.47	8.2	7.9	7.6
Belgium	21.4	20.7	20.1	19.2	18.3	17.5	17.8	17.4	17.1	16.8
Bulgaria	35.9	35.3	34.4	34	32.7	32.1	32.5	32.6	32.3	31.9
Cyprus	28.7	28.3	28.1	27.9	26.5	26	26.5	26.2	26	25.6
Czech Republic	19.5	19.1	18.5	18.1	17	16.6	16.9	16.7	16.4	16.0
Denmark	17.4	17.1	16.5	15.4	14.8	13.9	14.3	14	13.8	13.4
Estonia	30.7	30.8	30.2	29.6	29.5	29	29.6	29.3	28.6	28.2
Finland	17.6	17.2	16.6	15.3	14.5	13.8	14.2	14	13.7	13.3
France	14.7	14.3	13.8	12.4	11.8	11.1	11.6	11.3	11	10.8
Germany	17.1	16.1	15.4	15	14.7	14.2	14.6	13.9	13.7	13.3
Greece	28.2	28.1	27.6	26.2	25.1	24.3	25	25.4	24.3	24.0
Hungary	25	24.7	24.5	24.4	23.7	23	23.5	23.3	22.8	22.5
Ireland	15.4	15.2	14.8	13.4	12.7	12.2	13.1	13	12.8	12.7
Italy	26.1	25.2	24.4	23.2	22.3	21.4	22	21.8	21.2	21.6
Latvia	30.4	30	29.5	29	27.5	26.5	27.1	27.3	26.5	26.1
Lithuania	32	31.7	31.1	30.6	29.7	29.1	29.6	29.7	29.0	28.5
Luxemburg (Grand-Duché)	9.8	9.8	9.9	10	9.4	8.5	8.8	8.4	8.2	8.2
Malta	26.7	26.7	26.9	27.2	26.4	25.8	25.9	26	25.8	25.3
Netherlands	12.7	12.5	12	10.9	10.1	9.6	10.2	10	9.8	9.5
Poland	27.7	27.4	27.1	26.8	26	25.3	25.9	25.4	25	24.4
Portugal	22.2	21.7	21.2	20.1	19.2	18.7	19.5	19.2	19.4	19.4
Romania	33.6	32.5	32.2	31.4	30.2	29.4	29.4	29.8	29.6	29.1
Slovenia	26.7	26.5	26	25.8	24.7	24	24.6	24.3	24.1	23.6
Spain	22.2	21.9	21.3	20.2	19.3	18.4	19.5	19.4	19.2	19.2
Slovakia	18.4	18.2	17.6	17.3	16.8	16	16.8	16.4	16	15.5
Sweden	18.6	18.1	17.5	16.2	15.6	14.9	15.4	15	14.7	14.3
United Kingdom	12.2	12.3	12	11.1	10.6	10.1	10.9	10.7	10.5	10.1
27 EU-Countries / Average	22.3	21.9	21.5	20.8	19.9	19.3	19.8	19.5	19.2	18.4

Source: Schneider, F. (2011), "Size and development of the Shadow Economy from 2003 to 2012: some new facts" .

(1) The World Bank's research on informal workers² suggests a similar picture although the numbers are not directly comparable (the focus is on paid work without legal contract and not so much on undeclared work). Bulgaria, Romania, Lithuania, Estonia, Latvia, Poland) are estimated to have the highest levels of shadow economy, with levels ranging from 25% in Poland to 32.3% in Bulgaria. In addition, Cyprus, Greece, Italy, Malta and Portugal also have above average levels of shadow economy, with levels ranging from 19.4% in Portugal to 26% in Cyprus)

3. Horizontal issues

The size of the shadow economy can be reduced by:

- Reducing the financial attractiveness of undeclared work through better design of tax and benefit systems, and stricter controls in the social protection system with regard to the performing of undeclared work:
 - ensuring adequate levels of income support, recognition of the link between rights and contributions, by controls on welfare beneficiaries and adequate financial sanctions for tax and social security fraud;
 - areas to watch include (i) the taxation of overtime, (ii) the respect of minimum wages or wages set by collective agreements and their possible role as levels of reference for envelope wages, (iii) tax distortions between the status of employee and self-employed, and (iv) the reduction of fiscal burden on low skilled jobs.

² WB's research working paper 5912 on "Informal Workers across Europe": Michails Hazans, December 2011

- Administrative reform and simplification, with a view to reducing the cost of compliance with regulations:
 - further improvement of labour law and administrative systems to better cope with short-term needs and shortages in the labour market;
 - sector-specific approaches to transform undeclared work into regular work (especially in hotels and restaurants, agriculture, home services);
 - enforcement of the Community *acquis* on the free movement of workers;
 - further exploiting the possibilities of e-government, on-line registration and exchange of information between administrative databases
- Strengthening the surveillance and sanction mechanisms, with the involvement of labour inspectorates, tax offices and social partners:
 - exemptions from the practice of written labour contracts should be limited to the minimum;
 - sector-specific solutions to control and regularise undeclared work with the involvement of the social partners;
 - cooperation between the various bodies in charge of tax, labour, and immigration, as well as on the enforcement of legislation and sanctions.
- Trans-national cooperation between Member States, and
- Awareness raising activities:
 - increasing awareness among the public on the risks and costs to society linked to undeclared work, particularly as far as sanctions are concerned; social partners have a key role to play in this respect;
 - informing citizens about the positive effects of full payment of taxes and about the insurance nature of social security contributions.