

# How To Manage Underground Economy-Related Issues

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**Abstract:** *The aim of the paper is to reveal the main causes and consequences of the underground economy, seen as a mix between the shadow economy, reflecting the officially unreported monetary transactions, and the black economy, consisting in the criminal monetary transactions associated with the latter. Given that the underground economy, as a whole, can stand for and/or deepen the budgetary deficit of any country, by diminishing the level of revenues to the state budget, leading, as a consequence, to restrictions as to the public spending volume, thereby adversely influencing the living standard of its population, the focus of the study is related to laying, to a reasonable extent, the general framework, for limiting, via well-grounded macroeconomic fiscal policies and other related, targeted measures, the negative effects of the same.*

**Keywords:** underground economy, shadow economy, black economy, budgetary deficit, macroeconomic policies

**JEL Classification:** E26, E61, H62

## 1. Introduction

The underground economy, with its miscellaneous meanings, perceived from different perspectives and being, therefore, more or less comprehensive, as we can see hereinafter, has, without any doubt, a significant, unfavourable impact on the economic well-being of a nation.

As any issue affecting the normal evolution of the real economy should be carefully approached in order to identify the appropriate, specific targeted measures to be taken via the existing instruments at hand, so as to create the pattern for a favourable settlement, to the largest possible extent, of the same, we undertook to render in this paper several important elements, relating to both its causes and the consequences.

Topic of interest and frequently considered by specialists in social and economic sciences all over the world, treated from various points of view in terms of impact at social and economic level, it remains, however, incompletely rendered and decrypted, aspect revealed by the significant level of such economy in relation with the gross domestic product registered by each and every country on the globe.

The same as in the case of indirect competitors which, unlike the direct ones, are difficult to detect, due to the fact that they are less visible, the underground economy, or, otherwise called, the hidden economy, raises various problems related to its true capturing, therefore imposing trials in terms of making decisions and implementing the same, most of them resulting, unfortunately, in partial or total failures in solving the problem.

Given the below-depicted multiple faces of the underground economy, the most important is to set disparate measures for its

distinctive composing elements, considering their particular features and the specificity of the generating related contexts and to enforce them individually, well targeted, hoping for an extended annihilation of such practices and/or, at least, for a reasonable covering of the resulting unwanted effects.

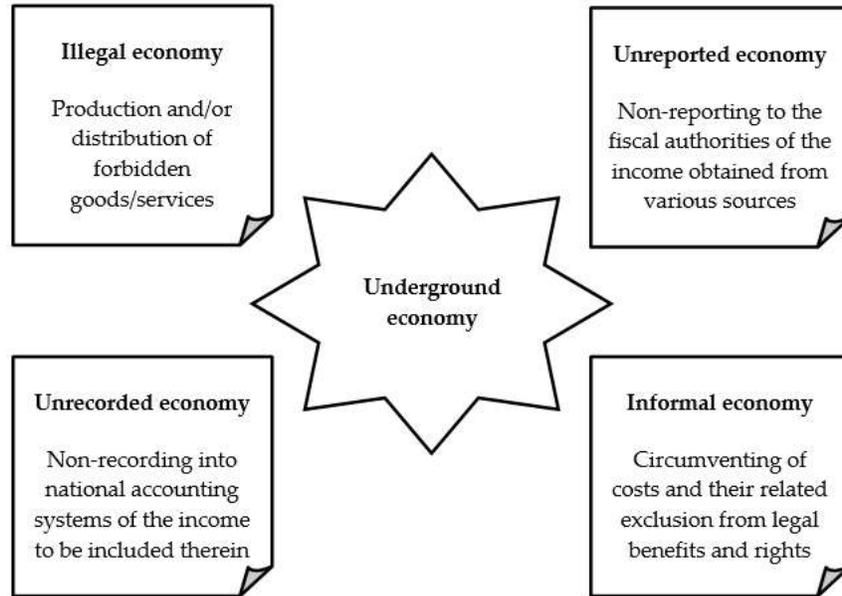
## 2. Overview on the underground economy

As above-mentioned, in Introduction, the underground economy is encountered in the literature, despite its main specific meaning, with many variations in terms of its extension or, more specific, in terms of its composing elements.

Thus, Investopedia provides us with a definition of a comprehensive underground economy referring to any illegal economic activity, either it is about an illegal provided product or about a legally unreported transaction, such economy being also identified as shadow economy, black market or informal economy.

Although highly comprehensive, the term of underground economy is not perceived in the vision of Feige (1990, 2016), as being identifiable with the informal economy, as defined in Investopedia, the latter being just an element thereof. More exactly, the underground economy is seen as consisting of four sub-components, namely: the illegal economy, the unreported economy, the unrecorded economy and the informal economy, as revealed by Figure 1.

Figure 1. Author's representation of Feiges's underground economy classification



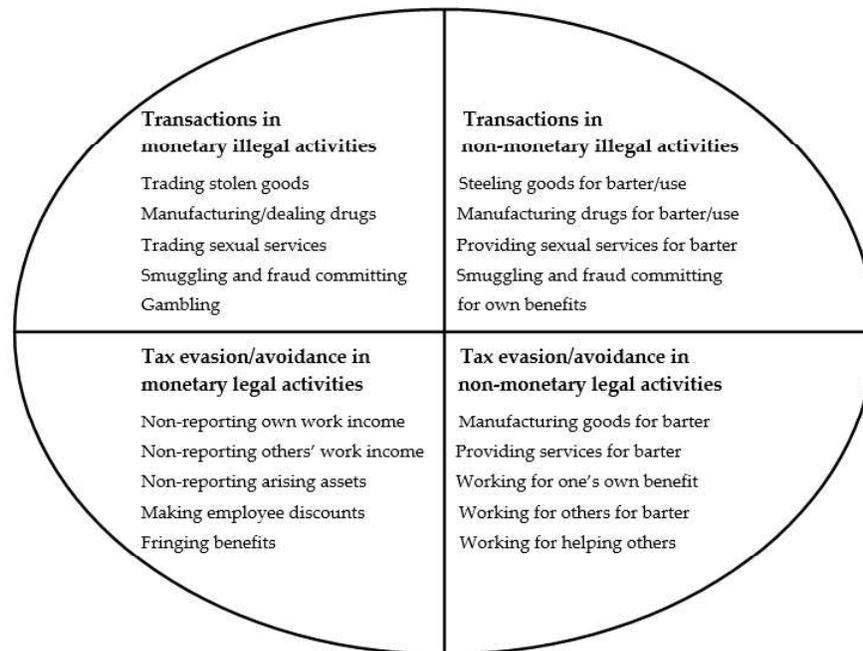
The Business Dictionary suggests us that the underground economy is an alternative term for designating the black economy, the parallel economy or the shadow economy and encompasses everything relating to transactions not being subject to taxation, therefore not included in the gross domestic product, to, usually, cash transactions recorded in officially invisible account books.

The same superposition of the underground economy, black economy or shadow economy term is encountered in Wikipedia, where this one stands for a clandestine type of market, for transactions characterised by

illegality or by breach of institutional rules.

Schneider and Enste (2000) assimilate the underground economy with the shadow economy, defining it, starting from the taxonomy of Mirus and Smith (1997), by splitting the same into four element-based matrix: transactions in monetary illegal activities, transactions in non-monetary illegal activities, tax evasion/avoidance in monetary legal activities and tax evasion/avoidance in non-monetary legal activities, as rendered in Figure 2.

Figure 2. Author's representation of Schneider and Enste's underground economy classification



Therefore, we encounter as many, more or less accurate and complete, definitions, as related inspirational sources, because, as well suggested by Mogensen et al. (1995), the shadow economy, used by the said author as a synonym for the underground economy, evolves based on the running water principle, adjusting itself to tax-related changes, to tax authority imposed sanctions or to general moral attitudes.

In order to simplify things, however without letting aside the above-mentioned related information, we would consider hereinafter the underground economy as being made of two specific sub-forms of economies, taken from this point on as stand-alone entities, relating to two main blocks of monetary transactions:

- the shadow economy, rendering officially unreported monetary transactions, such as:

- unreported incomes from self-employment or other activities

- unreported wages, in part or in full, from official or unofficial use of the labour of others

- unreported profits

- unreported tips of any kind

- etc.

- the black economy, reflecting the criminal monetary transactions, like:

- trading drugs

- trading weapons

- making traffic with organs

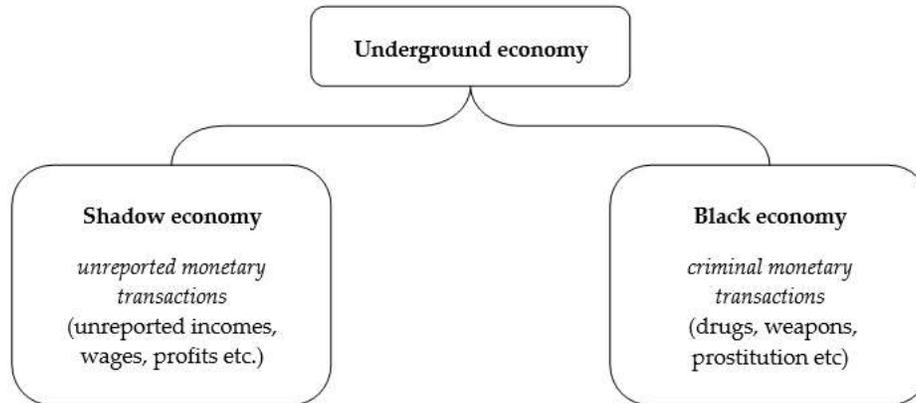
- prostitution

- gambling

- etc.

In such case, we eliminate the idea of synonymy between underground economy, shadow economy and black economy, the last two elements being just items sheltered by the underground economy under its bigger umbrella (Figure 3).

Figure 3. Author's representation of the underground economy classification



**3. Causes and effects of the underground economy**

Dealing with the underground economy indubitably involves dealing with its generating causes and arising effects.

Approaching, in terms of causes, the underground economy, without making the distinction between its main components, the shadow economy and the black economy, would not be recommended because, as above-mentioned, such important issue with major impact at macro-level should be well-targeted, therefore each and every specific items should be captured in its individuality for a subsequent thorough analysis of the same.

The causes for the occurrence and deepening, in some cases, of the underground economy are various, some of them still analysed by specialists in economic sciences, sociology or physiology (Table 1).

In the case of the shadow economy, we could identify, as causes, first of all, the desire of producers to minimise their costs and the one of consumers to have some

(additional) income from the labour provided to others, partly or fully unofficially reported in terms of wages, or from the labour used for their own for getting (higher) benefits, this mainly originating in lower living standard contexts, revealing:

- an overwhelming level of taxation of any kind, impeding companies to survive on the market and people to have minimum subsistence / reasonable existence means
- an impossibility to officially employ people considering the sometimes too restrictive regulations in the matter
- an impossibility of getting a job in official conditions, given the age, level of qualification and so on
- etc.

Beyond financial-related temptations the black economy is also related to other, more powerful reasons revealing the desire of power and dominance, vices or other assimilated features that characterise, after all, people with particular, more specific psychological patterns.

Table 1. Causes being at the basis of the underground economy

Shadow economy	Black economy
<ul style="list-style-type: none"> <li>➤ The excessive taxation level, generating:               <ul style="list-style-type: none"> <li>• the impossibility of producers to carry out their activities in compliance with the existing laws</li> <li>• the impossibility of consumers to legally procure their minimum subsistence means / reasonable existence means</li> <li>• etc.</li> </ul> </li> <li>➤ The restrictions associated with the existing regulations, determining:               <ul style="list-style-type: none"> <li>• the difficulty of investors to set up legal businesses, due to entry barriers, bureaucracy and so on</li> <li>• the difficulty of companies to legally employ people, in certain conditions, given by the minimum wage, level of contributions, work conditions to be provided and other related benefits</li> <li>• the difficulty of available active individuals to officially get a job</li> <li>• etc.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>➤ The excessive taxation level, generating:               <ul style="list-style-type: none"> <li>• the impossibility of producers to carry out their activities in compliance with the existing laws</li> <li>• the impossibility of consumers to legally procure their minimum subsistence means / reasonable existence means</li> <li>• etc.</li> </ul> </li> <li>➤ The restrictions associated with the existing regulations, determining:               <ul style="list-style-type: none"> <li>• the difficulty of investors to set up legal businesses, especially in certain fields of activity, due to entry barriers, bureaucracy or due to the refusal to legalise certain activities (like prostitution or gambling)</li> <li>• the difficulty of companies to legally employ people, in certain conditions, given by the minimum wage, level of contributions, work conditions to be provided and other related benefits</li> <li>• the difficulty of available active individuals to officially get a job</li> <li>• etc.</li> </ul> </li> <li>➤ The specific psychological pattern of certain individuals, revealing:               <ul style="list-style-type: none"> <li>• the desire of power</li> <li>• the desire of control</li> <li>• vices</li> <li>• etc.</li> </ul> </li> </ul>

Relating to the main effects determined by the underground economy, the same distinction should be made between the shadow economy and the black economy. While the first one may reveal, maybe unexpectedly, some positive aspects for the real economic

life, the black economy would be certainly regarded in a different way.

Talking about the shadow economy, we can see that everything related to it results in a given amount of money received by an economic agent, be it represented by

an individual, as part of a household, or by a company, therefore discussing about different forms of incomes collected by the same and officially unreported.

Irrespective of the economic agent we take into consideration, the following:

- wages paid by companies and received by employees and partly unreported (for an officially provided work, with declared wage level below its actual level) or fully unreported (for unofficially provided work)

- income got from partially unreported assets (as result of the rendering of official activities the outcome of which is undervaluated in statements) or from fully unreported assets (by the rendering of unofficial activities)

- profits of individuals or firms partly or fully unreported (by avoiding, to a lesser or larger extent, to declare and/or to register in the accounting books certain specific outputs)

and so on, reflect the increase of the overall purchasing power for the same, this determining the general increase of the demand for consumption and/or investment goods, therefore an increase of the aggregate demand and, as a chain effect, the increase of gross domestic product.

However, given that unreported incomes translate into less revenue to the state budget, we understand that what is added to private consumption and investments is cut, with a tax-related percent, from the public consumption and investments, which are restricted given the gap created by the diminishing governmental revenue, therefore decreasing to a certain extent the before-mentioned gross domestic product.

Besides, other negatives issues are to be mentioned, such as the uncertainty, at micro-level as for:

- the quality and safety of products got under the related circumstances, in most

cases not accompanied by warranty certificates, as well as the risk of losing the acquired illegal products, in certain circumstances etc. (for consumers)

- the quality and safety of the work conditions, the social security-related benefits being incomplete if not, as in most cases, completely absent, as well as the risk of suddenly losing the job, in certain circumstances etc. (for employees)

- the risk of losing the right to go on with the business, various more or less destabilising sanctions, losing of the created products etc.

or, at micro-level as for:

- the accuracy of the indicators provided (such as consumption, gross domestic product, unemployment etc.), that can generate serious misleading effects as concerns the policies adopted by the macroeconomic entitled organisms.

Going forward, to the black economy, any potential positive issue is completely absorbed, besides its destructive economic impact, also partially captured when discussing about the shadow economy, by the totally harmful effect this one has on the health and life of individuals and, thereby on both the social and economic life of a nation:

- the decrease of the quality of life (drugs, prostitution, gambling etc.)

- the risk of disease or injury (prostitution, weapons etc.)

- the risk of death (drugs, weapons etc.)

- the losing of freedom, by imprisonment, sometimes for life (for all of them)

Therefore, if the shadow economy makes us distinguish some light, despite the large range of negative effects on the real social and economic life, the black economy erases even the most insignificant hope for it, as clearly revealed above and synthesised in Table 2.

Table 2. Effects of the underground economy on the social and economic life

	Positive effects	Negative effects
<b>Shadow economy</b>	<p>➤ The augmentation of the purchasing power for certain categories of economic agents, causing :</p> <ul style="list-style-type: none"> <li>• the increase of the living standard for the same</li> <li>• the indirect increase of the GDP level, to a certain extent</li> <li>• etc.</li> </ul>	<p>➤ The decrease of the revenue to the state budget, generating:</p> <ul style="list-style-type: none"> <li>• the decrease of the budgetary surplus / the creation of a budgetary deficit / the deepening of the budgetary deficit</li> <li>• the decrease of the living standard for most individuals (public sector employees, those frequently using and highly dependent on the national infrastructure and so on.)</li> <li>• etc.</li> </ul> <p>➤ The increase of the uncertainties and risks associated with:</p> <ul style="list-style-type: none"> <li>• the quality / safety of the acquired products</li> <li>• the quality / safety of the work conditions</li> <li>• the safety of some businesses as a whole</li> <li>• etc.</li> </ul> <p>➤ The inaccuracy of some basic macroeconomic statistical indicators, misleading the entitled authorities as for the decision to be made and the policies to be adopted.</p>
<b>Black economy</b>	<p>➤ The augmentation of the purchasing power for certain categories of individuals, causing :</p> <ul style="list-style-type: none"> <li>• the increase of the living standard for the same</li> <li>• the indirect increase of the GDP level, to a certain extent</li> <li>• etc.</li> </ul>	<p>➤ The decrease of the revenue to the state budget, generating:</p> <ul style="list-style-type: none"> <li>• the decrease of the budgetary surplus / the creation of a budgetary deficit / the deepening of the budgetary deficit</li> <li>• the decrease of the living standard for most individuals (public sector employees, those frequently using and highly dependent on the national infrastructure and so on.)</li> <li>• etc.</li> </ul> <p>➤ The decrease of the living standard for certain categories, directly or indirectly involved in the business or otherwise affected by the same, by:</p> <ul style="list-style-type: none"> <li>• the increase of the risk of disease, injury or death</li> <li>• the increase of the risk of imprisonment</li> <li>• etc.</li> </ul> <p>➤ The inaccuracy of some basic macroeconomic statistical indicators, misleading the entitled authorities as for the decision to be made and the policies to be adopted</p>

#### 4. Managing the underground economy-related issues

Finding the most appropriate means to manage the underground economy-related issues is neither simple nor always possible. This takes time and involves a successive range of targeted analyses, decision-making processes and implementations thereof, followed by adequate and timely corrections depending on the arising results.

It is, certainly, obvious that the level of development of a country, its overall welfare, will cause the diminishment of the underground economy level in total economy, as it is also obvious that, as in the case on the natural or normal rate of unemployment, here too, we deal with a certain rate of underground economy that cannot ever be covered, irrespective of the measures we would make to annihilate it.

However, undertaking to keep the underground economy to the minimum possible level should be the desideratum of any national authority, as such undesirable form of economy deeply affects, both socially and economically, the nation as a whole.

In line with the above-mentioned, beside some common measures applicable to any underground economy form, we will target, hereinafter, specific measures for each of its composing elements, namely the shadow economy and the black one, as in Figure 4.

For the shadow economy, the following steps are to be considered:

- the adoption, by the fiscal authorities, of an expansionary fiscal policy, reflected in the decrease of the tax level, thereby diminishing the related burden to be borne by private economic agents, or in the increase of the subsidies granted in certain conditions, thus socially supporting certain categories of such agents

- the release of certain barriers to entry for companies in certain fields or sub-fields

of activity, as well as the adoption of various specific measures, apart from the subsidy-related ones, meant for encouraging the official set up of businesses (to encourage entrepreneurship)

- the increase of the evasion tax and/or, as the case may be, the deepening of the punitive measures, including, without limitation, imprisonment, sanctioning thereby, in a more severe way, the non-compliance with the legal reporting requirements related to the income obtained, to the jobs provided or taken, and so on.

- Save for some measures rendered-above, also applicable to the black economy, we encounter herein elements exclusively characterising this criminal transaction-related economic form:

- the increase of the control oriented towards certain individuals / groups of individuals more likely to resort to such activities

- the provision of social and psychological support for individuals in need from such point of view

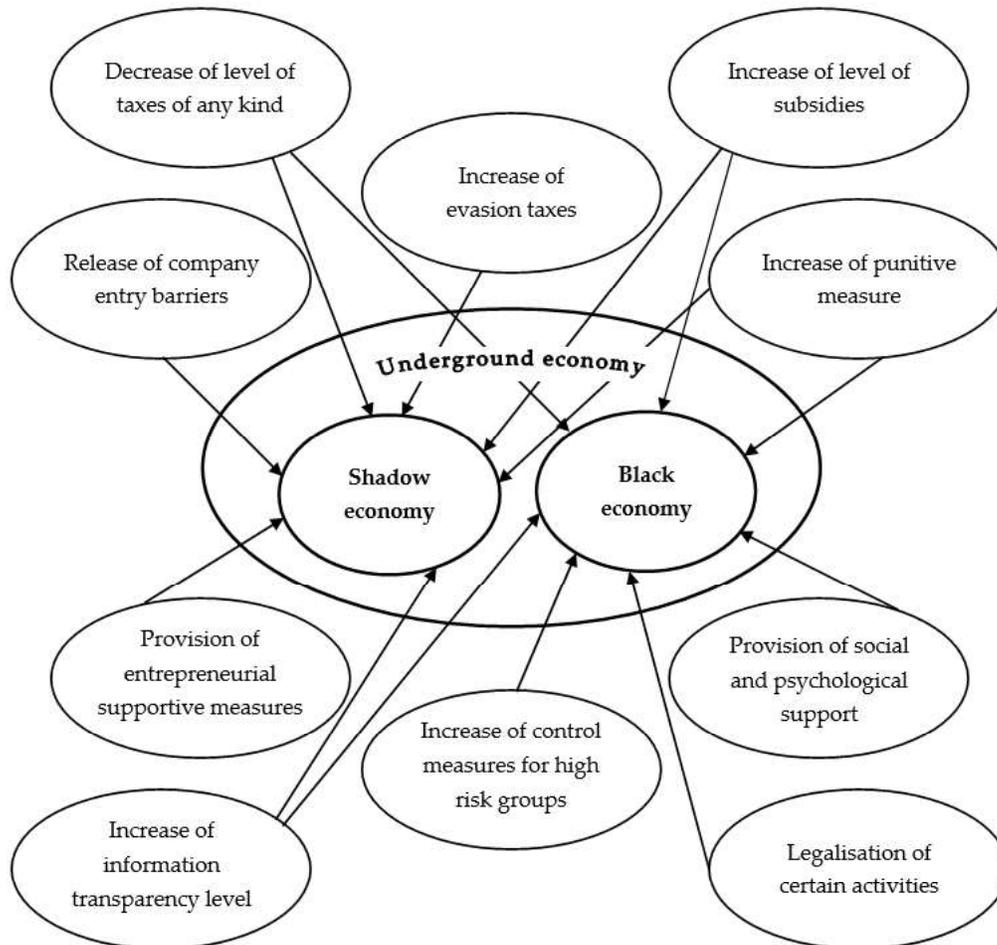
- the increase of the related punitive measures, including imprisonment for long periods of time for certain, highly dangerous criminal activities

- the legalisation some activities like prostitution or gambling, as the case may be

- etc.

Overall, the rendered measures should be gradually applied, checking for any visible improvement in the considered context, this being mainly reflected in a decrease of the underground economy weight in real economy, transposed, in time, into better living standards for the population, with their subsequent chain effect related to the diminishment of the temptation of people to get involved in such illegal processes.

Figure 4. Measures necessary for managing the underground economy-related issues



## 5. Conclusions

The present paper is meant to lay down the general framework relating to the underground economy, by clarifying the activities contained therein, by rendering the main causes susceptible to lead to its occurrence and extension, by depicting the mainly significant negative effects that this one might generate, thereby affecting the welfare of an entire nation, and, as a consequence, by raising questions as for the decisions to be taken and implemented so as to reduce as much as possible such unfavourable outcomes.

Although this is a global problem, affecting also the strongest developed countries of the world, it subsisting and manifesting anyway, at a minimum, natural level, even in most unattractive circumstances for the same, some countries, succeeded, by adequate measures undertaken by their macroeconomic authorities, in finding the necessary means for keeping it under control, therefore making serious steps, to be also followed by other fellows, in order to create a more healthier and safe environment both from a social and economic perspective.

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