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A Review of the informal economy
in the European Community
by Adrian Smith*

Internal paper



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The Directorate-General for Economic and Financial Affairs,
Commission of the European Communities,
200, rue de la Loi
1049 Brussels, Belgium

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*Economic adviser in the Directorate General for Economic
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ABSTRACT

This article sets out to review the concepts and existing evidence on the informal economy in the European Community. It covers firstly the various approaches to the question - national accounts, employment, fiscal and monetary; secondly, it provides a range of estimates; thirdly, it suggests reasons for the phenomenon; and fourthly, it discusses the implications. A critique of the evidence and concepts is then made and finally some conclusions and recommendations are offered.

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I. INTRODUCTION

A nascent economic phenomenon

This article sets out to review the concepts and existing evidence on the informal economy in the European Community, it also looks at relevant American papers. The informal economy has many other names, e.g, underground, hidden, parallel, irregular, black, dual, cash, moonlight, submerged, twilight economies, etc, or le travail noir or Schattenwirtschaft or lavoro sommerso, but in this article just one expression - the informal economy - will be used. It needs to be distinguished from both the formal and household economies; it also appears to have as many definitions as names, but coverage also differs. In this paper, the definition used of the informal economy is "GNP that because of unreporting or under-reporting is not measured by official statistics"; this equates with the definition used by the IMF. A selected bibliography appears at the end of the article.

The informal economy has always existed because of convention and measurement difficulties. Some informal activity is already included in national statistics to varying degrees and recent upward revisions of economic statistics in many countries have permitted the inclusion of some activities not previously embraced in official statistics. This article aims to concentrate on those activities still outside and excluded from official statistics.

A consequence of the present social and technological stage of development is the transfer of particular spheres of production between the formal and informal sectors of the economy. The informal economy is regarded by many as not only increasing but of growing importance and significance, and in various countries it has reached a different point in its progress ranging from nascency through to institutionalisation. The British view has been epitomised by successive Chairmen of the Board of Inland Revenue in their evidence to House of Commons Committees when the subject was regarded as of "very considerable importance". Official German sources have seen undeclared employment as a steadily growing problem for their own world tax authorities. In Italy illegal and unrecorded work were regarded as a major development and contributing to their economic

recovery, whilst in France the "Conseil des Impôts" reckon that the understatement of income is a widespread phenomenon and the existence of the informal economy has been regarded as a response to widespread demand. In Belgium it is reckoned that fiscal fraud has doubled in the last five years. In the USA the informal economy has been reported as steadily rising because inflation creates strong incentives to avoid taxes. On an international basis, an IMF survey took the view that the informal economy had now "come in out of the cold" and worked its way towards the centre stage of public and official attention.

The eminent American economist, Professor Milton Friedman, regarded the informal economy as an important safety net, but it is seen as an inequitable one by others. It exists in both the Western and Eastern bloc world and can be seen as a response to social and cultural demands or as an aspect of Socialist society as a safety valve against autocracy. One commentator has identified six types of market in Russia, of which five contain some degree of illegality or informality.

The informal economy has probably been highlighted most of all by its relationship to tax avoidance and evasion. Whilst there are some reports of such behaviour reaching epidemic proportions, there is also some acknowledgement of the growth of the informal economy by the increase in the policy reaction against it. For instance, UK, France, Netherlands, Germany, Belgium, and USA are now all mounting campaigns against the informal economy, although it is difficult to envisage any dramatic changes in enforcement.

But it needs to be noted that one authoritative source, albeit not European, namely the US Internal Revenue Service, was unable recently to find reliable evidence of any trends to indicate whether or in what direction the relative amount of unreported income was changing. However, the balance of opinion is undoubtedly towards a view that the informal economy is growing in real volume and significance. It appears a nascent economic phenomenon upon which relatively little public economic or social research has so far been carried out.

Definitional problems

There have been many definitions of the informal economy; a number differ because of the varying degrees of coverage. The one that is preferred and used here (q.v) is: "GNP that because of unreporting or underreporting is not measured by official statistics". Other sources have used other definitions, and it is perhaps worthwhile to look at a few so as to be able to appreciate the width and depth of the range. The US Internal Revenue Service refers only to unreported legal and illegal income, whilst the US General Accounting Office looks at cash activities which escape measurement and taxation. The Federal Reserve Board prefers illegal transactions which the participant wishes to hide. In the UK, the Inland Revenue (BIR) refers to income undeclared for tax, Department of Employment (DE) to concealed transactions to evade tax and the CSO use income not estimated from regular statistical sources for compiling GDP on an income basis. OECD's definition is activities not measured in economic statistics and that of Deutsche Bundesbank is services provided for without tax and social security contributions and paid for in cash. French theories are concerned with work outside of, or in the margin of legislation.

It can therefore be observed that whilst there is a general theme, some definitions are concerned with the legality and illegality, others with reporting and non-reporting, some with concealing and non-concealing, and others with measurement and non-measurement. One group of definitions refers to a gross concept, whilst another has a net concept in mind; for example, some would include all expenditure on illegal drugs and gambling, whilst others would concentrate only upon the net income derived from these activities; in the USA, income tax is heavily concentrated upon, whilst in Europe sales taxes and social security contributions also figure. The definition chosen in this paper is based on grounds of simplicity and convenience. Use of the preferred definition does have its disadvantages, but in this field where the order of the day, by definition, is for extensive non-reporting and camouflage, one is not seeking a highly precise and accurate statistical answer, but as robust a view as possible as

to the order of magnitude. In conclusion here, it might be worthwhile reflecting on a two centuries old maxim of Adam Smith, who said in 1750 that "the tax which each individual ought to pay ought to be certain and not arbitrary". This suggests that the problem is not at all new and has been around for some while.

II. VARIOUS APPROACHES TO THE QUESTION

National accounts

There are various approaches which can be used in an assessment of the informal economy. The first approach to be appraised involves the framework of national accounts. Most of the evidence from this standpoint comes from the UK, principally its Central Statistical Office (CSO, 1980) and also from OECD (1981).

The CSO definition of the informal economy is very relevant in such an appraisal; this is "economic activity generating factor income, that is wages, salaries and gross trading profits arising from the production of goods and services, which cannot be estimated from regular statistical sources used to compile income measures of GDP". It may be noted that GDP is conventionally derived from a compromise of three GDP estimates using income, expenditure and output; only the UK and Belgium in the Community publishes its results of all three methods - it would be of assistance if others did also. It is from the publication of these three estimates of GDP that it is possible to observe some differences, though part may be due to time lags. Up to 1979 the expenditure method generally yielded a GDP in excess of the income method, and this long term tendency has been cited as a "prima facie" evidence for the informal economy; however it would be useful to have more knowledge about this gap.

The CSO study concentrated upon the initial residual differences, namely that part of GDP which is not recorded income; this can also be defined as concealed factor incomes, both included in and excluded from national accounts, including concealed income-in-kind and concealed expenditure, and incorporating a residual error (which can be positive or negative). The CSO's emphasis on the initial residual difference stresses the three activities forming the

hardcore of the informal economy, namely the undervaluation element for receipt of goods or services greater than the value for tax purposes (e.g, fringe benefits), incorrect or insufficient tax declarations (e.g, income from a second job) - the largest factor - and fraud in the production of goods or services in the formal economy (e.g, shoplifting). The initial residual differences do not fully represent all concealed factor income, it is necessary also to include concealed income-in-kind (e.g, condoned private office telephone calls) and concealed expenditure (e.g, drugs).

Unadjusted estimates of GDP for the UK have shown a significant gap between GDP (income) and GDP (expenditure) estimates, which is thought to be attributable to the hardcore group of activities referred to earlier. An adjustment of 2 1/2% is made for this hardcore group and a little more is added on for the concealed personal income in kind to produce a revised GDP (income) estimate; no adjustment is made to profits. This, according to CSO, may be broadly evaluated by the size of the average annual initial residual differences over the year 1974-78 of about 3 1/2%. The CSO, with their emphasis on missing factor income, conclude that the informal economy has shown some growth in the past, but it has been unspectacular. The construction of industrial production accounts as a refinement of the national accounts approach has been suggested, whereby income and expenditure discrepancies should be eliminated. Alternatively, expenditure surveys, possibly by family, may also remove such discrepancies.

A valuable survey by OECD (1981) suggests a range of under 1% to nearly 5% of GDP for the informal economy and supports the general national accounts approach put forward by the British CSO. It needs to be emphasised that this approach is in search of greater accuracy generally in national accounts statistics, rather than any other specific objective, e.g, tax evasion, employment statistics, monetary policy, and should be looked at from a general statistical standpoint.

Employment

The second approach to be reviewed is that within an employment framework. The main national evidence to be considered here is from Italy (Censis, 1979; Contini, 1979 and Pettinati, 1979).

This approach centres around the labour market and particularly the possibility of its inadequate or incorrect data and statistics. OECD reckon that the informal economy is more prevalent in its less industrialised and more agricultural members - these broadly border the Mediterranean - Italy, Greece, Spain, etc. though there is some evidence that it also prevails amongst the non-indigenous in the more industrialised countries. It is in Italy that most of the research has been concentrated using a model of decentralised production and activity rate analysis. In Italy surveys as to how people use their time are being proposed and may ascertain involvement in the informal economy and double-jobbing. France, and also Japan, have allocation of time budget series; possibly the European Labour Force Survey could incorporate this aspect. Some evidence also points to use of child labour, particularly in Italy, on an illegal basis and subject to "Mafia" type controls. Double jobbing, defined as where the second job produces an income of at least 25% of the gross income of the principal job, is also a significant factor which has principally been studied in Ireland and UK. However, all double jobbing is not in the informal economy. In an Irish study (A.F. Ryan, 1979) 60% of double job holders paid tax on their earnings, 40% were insured and 50% of the second jobs were known to the principal employer; in UK about 3% of the work force have second jobs.

The informal economy possesses its own allocative and distributive properties and so has an effect on a variety of economic aspects of the labour market, including output, productivity, productive potential, employment, unemployment, prices, costs, structure, etc. The opportunities and incentives for labour to join the informal economy have been growing in the recent past. The desire for tax offsets, low economic growth, rising unemployment, a change in social and moral attitudes and the increasing number of part-time jobs can be cited. In short, the opportunity is there and in a true market sense, it is thereby seized upon.

Inaccurate data and statistics could lead to unsuitable labour market policies being followed. For instance, is registered unemployment too low relative to employment and labour supply because some

registered unemployed are actually supplementing their benefit by working in the informal economy?

There appears to be a trade-off between the cost of ignoring informal activities and the cost of wrong policy decisions, particularly taking account of the OECD (1980) view that the size of the informal economy may be larger than originally thought, and that the unemployment rate can no longer be regarded as a good policy indicator. Decentralised production models and time use surveys may offer a future clue. The employment approach to the informal economy, therefore, contains many valid and pertinent aspects relevant to today's economic policies.

Fiscal

The third approach to be considered is that of a fiscal framework. This is linked with a monetary approach and also has close association with social security systems, which have certain analogies to taxation. It is principally concerned with tax avoidance and evasion whereby there is an incentive to work outside the fiscal system so that there are no tax deductions or liabilities or payments received and these can be in a legal way (avoidance) or illegal way (evasion).

A fiscal approach to the informal economy needs to be seen against a background of the usual objectives of fiscal policy, namely the simultaneous raising of revenue for public expenditure and the re-distribution of income; it is the latter that is becoming more difficult to practice when the rate of taxation is relatively high, and acts itself as an incentive for evasion. However, if avoidance and evasion prevail to a significant degree, public revenue can fall to an extent which either cuts public expenditure or raises the public borrowing requirement so that a particular expenditure programme is maintained - in the latter case, interest rates would need to rise. In such a way, macro-economic policies can be affected by developments in the informal economy.

Whilst most of the theoretical work on the fiscal aspect has been of British or American origin, the research methodology has been developed mostly in Belgium (M. Frank, 1976 and 1979) where a com-

parison of actual tax revenues with the national accounts and input/output statistics has revealed not only a considerable degree of evasion, but a rapidly rising one - doubling in volume in the past five years. This has been verified by sample surveys and evasion losses have been drawn up by type of tax and recipient income group with a firm bias of evasion by the higher income groups. The US Internal Revenue Service (1979) drawing upon extensive audits under its Taxpayer Compliance Management Programme, estimates around 6%-8% of incomes went unreported. Further national research in this area could be useful.

Other research methods have been to determine what is not implausible by working back from a hypothetical level of evasion equating to a percentage of GDP, to the implicit evaded income for each worker, separating employees and self-employed. Additionally, the information already available on evasion by the self-employed can be extended on broad assumptions to provide the average amounts evaded by employees. It is then a matter for the taxman's judgment if a certain level is not implausible. As an alternative, income and expenditure at a disaggregated level have been compared in UK in the direction of disaggregation for the individual using household expenditure (and income) surveys (A. Dilnot and C.N. Morris, 1981). Further research methods have included an analysis of tax authorities retrospective payments in order to obtain characteristics of evaders, and the use of expenditure surveys to ascertain informal expenditure. The fiscal approach to the informal economy, with its linked monetary and social security aspects, is therefore one which can emphasise both its incentives and possible macro-economic implications.

Monetary

The fourth and final approach to the question is in a monetary framework, where most of the economic research has been concentrated in the USA (N.N. Bowsher, 1980; USA Comptroller General, 1979; E.L. Feige, 1979; P.M. Gutmann, 1977; USA Internal Revenue Service, 1979; IMF, 1979; R.D. Laurent, 1979 and R.D. Porter, 1979). The reasons for concern from this particular standpoint are that the intended impact of monetary policies could be upset by the size of the informal economy and that monetary statistics may provide some clues as to measurement of the informal economy.

The different monetary methods invoked are somewhat inter-related and one method used (P.M. Gutmann, 1977) was to review the relationship between currency stock and demand deposits over a long period on the hypothesis that any unexplained growth in currency might be explained by illegal or unrecorded activities. This method takes the 1937:1941 currency/demand deposits (M1) relationship as normal, and postulates that the difference between this and recent - e.g: 1976 - values of the same ratio are a measure of the amount of currency held for informal activities. An estimate of around 10% of GDP is then arrived at for the USA.

Such a postulation has been challenged from various stand-points. Firstly, a one-third decline on the velocity of circulation appeared to be ignored, as was the five fold rise in deposits. These would, by themselves, explain the increased currency ratio; such a conclusion was, in fact, backed by the US Internal Revenue Service. Secondly, Cagan in his classic article (1965) on the stock of money suggested that over time the ratio of currency to demand deposits could be effected by many variables (other than informal activity), such as expectations, retail sales, incomes, bank failures, urbanisation and travel. Thirdly, the choice of the base year is critical; in a parallel British example it is possible by juggling the base years to arrive at a negative informal economy. These strong criticisms stress the difficulties in this type of study and emphasise their "ad hoc" nature. This hypothesis has been tested for a variety of countries over 20 years and if American experience were to be repeated, it could be expected that currency growth would exceed that for demand deposits, but with limited exceptions, this is not borne out. In European major industrialised countries - Germany, France, Italy, UK - the evidence is, in fact, to the opposite effect. A shortening of the time period to 10 years gives the same negative result. However, in the other major industrialised nations - Japan - a very slight inclination towards the US example emerges, but over a much shorter time period. However, this original study was stimulating enough for its hypothesis to be tested both elsewhere and with different variables.

A second methodology (R.D. Laurent, 1979) is derived from the quantity theory of money and is to appraise currency transfers and demand deposits and to concentrate on turnover rates. The hypothesis here is that the use of currency should fall because of the growth in the number of credit cards, the rising security risk of holding cash and the move towards higher long term interest rates; the informal economy is seen as mitigating against such a decline. The trend towards a cashless society consequently involves much lower turnover rates. A detailed analysis of demand deposit stocks, turnover, and transfers and currency stocks, turnover and transfers in the USA concluded by indicating that the proportion of economic activity associated with currency has, in total, fallen substantially in the past 40 years and that, whilst acknowledging the role and growth of the informal economy, it was unlikely that it at present accounts for as much as 1/10th of GNP.

A third technique (IMF, 1979) was to derive an estimate of the informal economy by using equations for currency demand where use of currency is shown to depend on a few key variables, particularly taxes. This particular approach concentrated upon the analysis of the individuals choice between currency and demand deposits in the USA between 1929 and 1976, with the choice being determined by various factors, one of which was taxation. Higher taxes were seen as leading to the development of the informal economy fuelled by currency held for tax evasion purposes. Various statistical regressions using the currency ratio (currency holdings: demand deposits) and personal income statistics, tax rates and brackets, real per capita income etc, indicated that the informal income was between 4% and 5% of GNP.

A fourth scheme (E.L. Feige, 1979) involved considering the ratio of the value of dollar transactions to GDP over a long time period. This scheme attempted to measure unrecorded activities, both legal and illegal, in the USA, by comparing the ratio of the value of transactions to GDP over the period 1939/78 on the basis of Irving Fisher's long standing monetary theory, namely $MV = PT$ (money times the velocity it circulates at equals prices times volume of transactions). From a pre-war base when it was assumed that no informal

economy existed, any unexplained growth in transactions was attributed to the informal economy. This study concluded that in 1976 these amounted to 19% of GDP rising to 27% in 1978. This approach which has produced the highest estimates for USA has met with technical criticism principally relating to the methodology. It has been pointed out that such a procedure would produce negative estimates of the informal economy in the USA for each year from 1940 to 1972; the assumption of a zero informal economy in the base year (1939) has been challenged; the positive results from 1973 have been seen as solely due to demand deposits and not transfers.

A fifth way which emanated from Germany (Deutsche Bundesbank) stressed the relevance of the (income) velocity of circulation (relationship between money-stock and GNP) to monetary policy and the need to distinguish any effect of the informal economy on monetary aggregates, and whether developments in the velocity of circulation are permanent or temporary. This approach is the only example to hand of any original European thoughts in this field - more could be beneficial - and here the Deutsche Bundesbank concentrate on reviewing its significance rather than any quantification.

III. MEASUREMENT

Range of estimates

From a national accounts standpoint the informal economy (on varying definitions) has been estimated in the UK (A. Dilnot and C.N. Morris, 1981; House of Commons, 1979 and K. Macafee, 1980) at between 2% and 7 1/2%; on a different basis (P. Seguin, 1979) the French informal economy was put at 10%; an Italian study (B. Contini, 1979) provides an estimate of 15%, and an OECD paper (1981) reckoned for USA the estimate would be around 3%. On an employment basis, estimates range from 800,000/1,500,000 (about 3/6% of labour force in Italy (P. Pettenati, 1979) to 20 million (25% labour force) (E.L. Feige, 1979) in USA. A Danish source indicates that around 10% of the labour force might well be engaged in informal activities. In a monetary context, with all examples being drawn from USA, estimates (E.L. Feige, 1979; P.M. Gutmann, 1977; IMF, 1979 and R.D. Laurent, 1979) reached were 4 1/2% of GDP, through less than 10%, 10% to 27%.

On a fiscal foundation Belgian Treasury losses were put (M. Frank, 1979) at FB 200,000 million per year (= USD 3,000 million) in 1979 and similar French losses at FF 4.5 billion as far back as 1971 (= USD 1,000 million); in USA the range was from USD 2 billion through USD 13/17 billion (USA Internal Revenue Service, 1979)(to which could be added a further USD 6/9 billion for extra tax losses on criminal activities) to USD 100 billion. British tax losses have been estimated (House of Commons, 1980) at UKL3-3 1/2 billion per year with theft, pilferage, etc, amounting to around 2% of GDP (plus a further UKL60 million for "offshore" tax evaders), other British sources on a fiscal basis suggest around 2.1% to 3.1% of GDP. In Ireland it has been estimated (A.F. Ryan, 1979) that 5% of the labour force has a second job and half of these are unrecorded which would total around 30,000. A summary is shown in table 1.

These attempts at quantification can be seen to demonstrate a very wide range of indicators no matter which basis is taken. The existence of the informal economy is not questioned - the difficulties arise in identification, classification and quantification. The significance of the range from even such a small volume of evidence does indicate a fairly high degree of uncertainty in what is an uncharted area.

IV. REASONS FOR THE PHENOMENON

Natural

In turning to review the reasons for the phenomenon of the informal economy, the first point that needs to be made is that its development over time can be regarded as a natural reaction to events. The same theme, put another way, would be to see it as occurring directly as a result of market forces. There is some danger that stricter controls over the informal economy would only result in the market functioning to such an extent that new ways around would still be found so that the informal sector still continued to prosper. There is some danger in regarding the formal sector as the sole representative of the market as many standard economic models do.

Under this heading the dual economy theme needs to be noted, which can also be seen as a technological reason for the phenomena. A highly efficient, internationally competitive, export oriented, high wage sector is now being seen as becoming more evident alongside the development of a low productivity, labour intensive, low labour cost, small scale sector, thus playing a useful role in the restructuring of an economy. This needs to be viewed in a context of a slowing down of world economic and trade growth rates. The informal economy can also be seen as one of the main trends in economic evolution today, and emphasising the continuous shrinkage, in terms of relative employment and value added, of material production and the corresponding growth of recorded employment in the service sector. Over the last two centuries, the aggregate effect has been a shift from the household economy to the formal economy, but in future there may well be a move away from the formal to the informal economy. More work on this concept could be revealing. The natural, or market, reaction to the present economic slowdown and restructuring, accordingly, has been to accelerate the growth of the informal sector in a dual economy context.

High taxation

Moves towards more progressive and higher taxes - e.g, in Italy - have given some impetus to fiscal avoidance and evasion, and recent years have seen a revolt against high taxation, culminating perhaps in "Proposition 13" in California recently, where electors voted to cut state taxes and services by approximately half. However, whilst a later similar proposition on the same theme has been rejected there by local electors, there is much evidence pointing to rising taxation as leading to activities avoiding such high rates. Although it needs to be here that in the highest taxed nation in the West - Sweden - the informal economy appears to be in relative infancy; though the relationship between the individual and government is important here. The increased use generally of banknotes and coins, and particularly those of high value, can be seen as a means used to avoid records and offering safety in participation in the informal economy. In Ireland a desire to recoup tax paid in taking an untaxed second job has been noted and a preference for a second (untaxed) job

as compared with overtime (taxed) was also noted. But the formal sector is becoming less dominant than in the past and there is a need to encompass the informal economy in any decision-making.

Social security

A similar line of reasoning to high tax rates applies to social security contributions. In Italy, for example, hourly social security costs are now reckoned to exceed average hourly wages whilst in France, Netherlands, Belgium and Germany security costs range between 41% and 44% of total costs. As with taxation, social security contributions have been growing of late in most countries in order to meet the cost of rising standards and coverage of social services. However, any correlation between the size of the informal economy and the height of social security costs is not evident. But, the point has now been reached where it may be worthwhile to avoid these costs and in doing so, one does not necessarily lose the opportunity to obtain social security benefits.

As social security contributions have risen, so have benefits. The rise and increased coverage of these, which are generally untaxed benefits, could have made it relatively attractive to obtain these whilst remaining "technically" unemployed and so, in fact, receive two sources of income - both untaxed. Some benefits are income determined and it is therefore worthwhile to lower one's official income in order to receive benefits. Increased welfare payments can shift the labour supply curve upwards, thus cutting back the formal supply. There is also the concept of the "Why Work Syndrome", where an attitude against (formal) work has been developing. Social security policies, both from a contributor and recipient standpoint, can thus serve to fuel the informal economy, but social security costs can indeed be high as in Germany when all the evidence points to a relatively small sized informal economy.

Labour

High labour costs have influenced employers, both large and small, to search for cheaper sources of labour and to look for a sector of the labour market that is less rigid, more mobile, less union-

ised and easier and cheaper to make redundant if necessary. Growing employment protection legislation is also a particular driving force in the growth of the informal economy. Such a supply normally exists and can take the shape of such disguised workers as housewives and domestic helps, pensioners, students and immigrants - a group which may be regarded as disadvantaged in some way or other. This is not a new feature - female and child informal labour was significant in Italy in 1971.

The availability of part-time jobs has risen in order to meet this new labour supply with its inherently lower costs. The general trend towards shorter working hours in one job, accentuated in certain climatic conditions, enables another job to be undertaken with the second being in the informal economy. Dissatisfaction with the income or content of a principal job has been cited as a reason for taking a second job located in the informal economy. It is however not unknown for wages in the informal economy to exceed those in formal economy; here, of course, several additional costs are evaded. The continual rise in real labour costs can be said to have contributed to the informal economy as employers - large and small - and employees, have been induced to look elsewhere than the formal labour market.

Immigrants

Immigrants who have arrived from poorer countries, and also poorer regions of an individual country, in search of employment naturally drift in to lower paid unofficial work because of their need to survive in an alien country or region. Some will have arrived illegally and will not be anxious to make contact with authority at all, and consequently be only too willing to accept employment in the informal economy. At times of high unemployment in the host nation or region, it becomes even more difficult for them to enter the formal sector. Immigration is not a new factor in the European Community, but the numbers - legal and illegal - appear to be rising as communications, etc. improve and the North/South relative income gap widens.

Social and criminal

Finally, social and criminal aspects are to be turned to. Some see a change in social attitudes as making the informal economy more visible and acceptable as increased use is made of it. Put another way, new social relationships could be being built whereby the dual economy co-exists. This line of approach can be extended into what is becoming known as incivisme, namely the acceptance or encouragement of an attitude of indifference towards public obligation and responsibility. A deep mythology might in fact already exist; it is possible to trace a general air of consent to some degree despite official campaigns against the informal economy.

Where participation in the informal economy involves the taking of a second job, this can be an alternative to a wife working. Concealed income in kind (e.g, using office telephones for private reasons) and concealed expenditure (e.g, on illegal drugs) and the increased opportunities for these to occur, can be seen as a factor in the present development of the informal economy. Though these may be condoned, they are not fully recorded by being unauthorised and consequently should be regarded as part of the informal sector. Table 2 shows the results of an official Italian survey on the unauthorised or extra-mural activities of Italian civil servants and suggests a significant involvement in the informal economy.

Whether any such change in social attitudes or any increase of indifference to responsibility would be extended to include acceptance of outright criminal activities is another matter. There have been few attempts to assess the income elements in these criminal sectors, but one estimate for the USA in 1976 put it at around USD 30 billion (1 1/2% of GDP) on which USD 7 billion tax had not been paid. Another for the UK provided an estimate of about 1.8% of GDP in 1974. However, criminal statistics are known to be under-estimates and uncertain and that any evaluation of the criminal economy and statistics has not inconsiderable difficulties. Changes in social attitude and rising criminal activity have no doubt contributed to the growth in the informal economy to some uncertain degree.

Precision in this field is exceptionally difficult. The role the authorities can play can be important and the authorities now may need to recognise fully the existence of the informal economy and live with it. It appears unlikely to go away. Some adjustment may be called for in order that the state can adopt a more facilitative role than at present. Any prohibitive interventionist action seems in danger of being circumvented in one way or another and possibly only accelerate the development of the informal economy. There appears to be a need to comprehend more about the nature of the informal economy in view of its apparently increasing size.

V. IMPLICATIONS

Macro-economic

The first implication of the informal economy to be considered is the overall macro-economic element. Incorrect and misleading economic statistics, particularly those relating to such aggregate indicators as GDP can significantly underrecord true growth and overestimate inflation; this has led some to the view that the data base is so distorted that economic realities can be misconceived and render any diagnosis incorrect. The economic situation today need not necessarily be as depressing as it appears; the alleged faster growth of the informal economy as compared to the formal alleviates this aspect. Standard econometric models turn heavily on the formal sector as representing the market; it needs to be recognised that such models are usually biased by being dependent on formal statistics only and rational behaviour and expectations theory naturally assume correct data. Recent macro-economic forecasting failures, or inaccuracies, could be attributable to misleading data rather than any fundamental flaws in economic concepts and doctrines. However, it is not impossible to argue here that where the informal economy is significant, e.g, Italy, there could be grounds for ascribing any economic success, or an economic recovery, primarily to activity in the informal sector, even although the present deep recession could be affecting even the informal economy there.

A further macro-economic implication stems from the volume of tax losses. In the UK tax losses have been estimated at UKL 3 1/2 billion which equates with approximately a third of the British Government's present public sector borrowing requirement. A cardinal feature of British economic policy now is to significantly reduce borrowing, and when this has been achieved, other economic policy initiatives can then follow. A considerable reduction in tax losses could therefore be one way of leading to changed economic policies. It is not too difficult to extend this argument across the board in a European Community context where most governments are now concerned as to their high borrowing.

Productivity and competitiveness

Inaccurate statistics of price, output and employment levels would render any derived productivity and competitiveness statistics somewhat dubious. The particular deduced critical indicators which would be affected and which are very relevant in economic forecasting are: unit labour costs, activity rates, annual productivity rates, productivity/head, productive potential and capital/output ratios. Some of the basic statistics are already corrected to a limited degree to allow for the informal economy by national accounts statisticians and occasionally there are major revisions such as that which occurred to Italian employment levels in 1977 when the overall activity rate was raised by 3% and so created a new series. It is thought possible that productivity levels in the informal economy are not only higher than in the formal, but also growing rapidly.

Monetary policy

The question has been postulated in the USA: "Is the underground economy undermining monetary policy?" With the emphasis on monetary policy in the management of major world economies today, this question is perhaps the most important to be posed in this paper. Much of the evidence is American and a study (N.N. Bowsher, 1980) by the Federal Reserve Bank of St. Louis shows the crucial ratio of currency to demand deposits has risen from 0.21 in 1939 through 0.25 in 1959 to 0.28 in 1969 and then accelerating to 0.38 in 1979. It also notes evidence that increased use of dollar bills

is linked with a growth in the unrecorded or illegal activities and that growth in the volume of unrecorded transactions exceeds that for recorded transactions against a general background of rising incentives in the form of increases in taxations and other restrictions. However, this experience has not been repeated in France or UK.

Another aspect of concern to central banks is the velocity of circulation, defined as the relationship between GNP and money stock. Deutsche Bundesbank (1979) have highlighted the possible significance of the informal economy and its relevance to the velocity of circulation. If money stock expands rapidly at a time of sluggish economic activity, the inverse of velocity of circulation rises correspondingly and the crucial question for monetary policy is whether any change in velocity of circulation is permanent and long term or purely cyclical. A substantial rise in society's cash payments (in the informal economy) could cause a long run change in the velocity of circulation. It should be noted here that there is some dispute as to the precise velocity of circulation statistic to be used in such calculations; here the income velocity as compared to the transactions velocity is used. Further information on the velocity of circulation of currency (notes and coins) as compared to total money stock - M1 or M3 - could be beneficial.

It has been argued by a Federal Reserve Bank of Chicago Study (R.D. Laurent, 1979) that currency use should, a priori, fall with the growth of credit cards, the high security risk of carrying cash, and the sacrifice of high interest rates. But this has not occurred in the USA; the evidence there does not deny that the informal economy is growing, leading to an increase in currency holdings. However, this study reveals that currency turnover, observed through dollar bill redemptions and destructions, has actually slowed down over the past 40 years, yet this could be due to higher quality notes. An interpretation offered for the combination of the speeding up in demand deposit turnover and the slowing down in currency turnover observed is in two distinct trends. The first trend is a move towards a cashless society with

currency performing a smaller and smaller proportion of transfers in the economy, aided by credit cards, etc. The second trend is the growing use of currency as a store of value, with much lower turnover rates and a rapid increase in outstanding high denomination notes. The Chicago analysis concluded that on balance the proportion of total economic activities associated with currency has declined substantially over the past forty years and it seemed unlikely that the informal economy accounted for 10% of GNP.

Any increase in liquidity caused by a rise in the currency: demand deposits ratio would heighten the risk of providing scope for inflation rising as the money stock growth would exceed that for GNP. Put simply, more money would be chasing the same goods. On the other hand, as an alleviating factor, any price level in the informal sector would naturally be below that in the formal sector. So as the informal economy grows in size there are two countervailing factors, namely increasing liquidity fuelling official inflation and the emergence of a lower priced market. The principal monetary implications therefore are of significance, bearing in mind the emphasis given to monetary policy today.

Fiscal policy

The fiscal aspects of modern economic policy have three main objectives mentioned earlier, namely to raise revenue for public expenditure, to assist redistribution of income and wealth and, as one means, of controlling the overall level of demand. The implications for each of these aspects of fiscal policy of the informal economy will be considered in turn.

Firstly, much activity in the informal economy takes place purely and simply to avoid or evade taxes in some form or another. The pertinent factor is the importance of the tax base and not the tax rate; this thus emphasises coverage of taxation rather than any high rates.

Secondly, in appraising the raising of revenue for public expenditure, the major factor is that there is a straight loss of potential revenue to government on the basis that if informal

activities paid their legal taxes, revenue would rise. Such a loss of revenue could mean less public expenditure than otherwise affecting a whole range of possibilities in the public sector. Put another way, it is not implausible in the British example that income undeclared for tax purposes amounts to 7 1/2% of GDP which equates with 3/4 of total social security expenditure or around 20% of total public expenditure - a not insignificant sum. It should be noted that experience has shown that potential tax losses differ by type of tax. In Belgium, for instance, death duties (otherwise known as succession taxes or capital transfer taxes) easily rank highest for losses, followed by personal income taxes and property taxes. Tax evasion in Belgium and USA is seen as greater at the top and bottom of income distributions and lower in the middle zones of income. Whilst these aspects might be expected to differ country by country, there could be indications here of the emphasis to be put on a particular pursuance policy. Very high returns - up to 600% - have been quoted for additional marginal resources devoted to fiscal frauds.

Thirdly, fiscal policy is aimed to achieve ends in the direction of a redistribution of wealth and income. This theoretically occurs through a transfer from one group of society to another, usually from the rich to the poor. The informal economy acts, in effect, as a random tax subsidy by providing price reductions to some, but not all. Whilst fiscal policy has achieved some considerable success in raising public revenue, it has not been seen as successful in its redistribution objectives.

Fourthly, the use of fiscal policy in controlling the overall demand level may need reviewing. Tax losses, whether potential or actual, can contribute to increases in borrowing requirements and public deficits, and as such, cause the economy to be run at a lower level than otherwise. However, such a lower level may be the one appearing in the official statistics and not the actual or real level which would include the informal element. It is very difficult indeed here to disentangle the real effects.

There are also a few other pertinent points. In some countries, e.g, the USA, there is a voluntary system of self-assessment and some delinquency stemming from the informal economy over compliance is seen by the authorities as inevitable in a free democratic society. Within this context though there is a call for more resources to pursue unreported cash incomes in particular; here a rate of return over 600% is quoted for such additional marginal resources. The present limited resources of the revenue authorities are often quoted as reasons for revenue losses.

The conclusion that can be reached on the implications for fiscal policy is that in the case of raising revenue and, to a lesser degree of certainty, controlling the overall level of demand, the informal economy can have significant implications and cause problems. As to redistribution of income and wealth, any general lack of success of taxes in this direction seriously dilutes any real effect the informal economy might otherwise have had.

Sectoral

The informal economy affects the various sectors of the economy in different countries in dissimilar ways; it is not the traditional shift between the public and private sectors. Only a very limited and indirect impact, if any, is felt in areas where the informal economy does not exist, which is mainly the public sector. It is in the private sector and within this, some parts of manufacturing and particularly the service sector, where the implications are felt, and which specific private sectors are affected is determined by the particular situation for a specific industry in any one country. The size of the enterprise appears important as much of the informal activity seems to be concentrated in small size firms which need no technological barriers to expand, but are very adaptable to changing markets. Small firms because of their informality can offset any technological disadvantage by having lower costs.

In Italy, small scale manufactured goods (e.g, leather, footwear, clothing, timber) which are capable of being produced at home by family units and outworkers including child labour, have a high informal content. In the UK, Germany and France, building, household, electrical and car repairs figure prominently, whilst in Belgium and USA it is professional services that have a significant proportion of "informality". In Ireland, double jobbing which figures significantly in the informal economy is particularly evident in the leisure sector. Small firms in these sectors are not seen as affected by changes in the international division of labour, though the sectors in some countries, e.g, Italy, where the informal economy is significant, produce those goods where competition from the developing or newly industrialised nations is strengthening.

Employment and immigration

The first implication of the informal economy on employment and immigration that needs to be noted is that, as by definition, the informal economy is generally unrecorded, and official labour market records and statistics are consequently incorrect. In particular, the unemployment rate should no longer be regarded as a good policy indicator. However, it should not be thought that unemployment disappears into the informal economy - it is merely somewhat diluted and remains as a real problem.

The second employment implication concerns the self-employed, especially in the small firms sector, who naturally have the best opportunity to participate in the informal economy. Over a long period self-employed persons have been regarded as notoriously low income declarers. When this is linked with low overall activity rates, as in Italy and Holland, questions naturally arise about the size of the informal sector. In Italy, some evidence points to growing numbers of unrecorded self-employed, amounting in some cases to whole villages.

The third employment implication relates to social security in all forms. Some social insurance schemes, e.g, Casa Integrazione Guadagni of Italy, are seen as, in effect, promoting the informal

economy. Under this scheme a laid-off worker continues to receive 93% of his past income provided he does not return to (formal) work. As such, the scheme is conducive to any laid-off worker moving in the direction of the informal economy. Furthermore, a high burden of social security contributions is regarded as a rationale for employers turning to the informal labour market in order to reduce costs. High contributions are necessary to finance high benefits and this factor points to social security beneficiaries possibly working clandestinely. In the UK the unemployment benefit regulations have been regarded as only a limited sanction towards participation in the informal economy, whereas supplementary benefit regulations are somewhat tighter. In terms of real value in the UK, unemployment and supplementary benefits have kept pace with real income levels but will not in future - only retirement pensions are expected to. This would tend a little to gradually deflate, over time, the real value of social security benefits. The question therefore of whether the link between work and reward has been distorted by the social security system does appear to have some validity; additional marginal resources devoted to social security frauds could - as in the fiscal field - yield good returns. However, on the other hand, the worker who operates outside the illegal system would not receive the benefit of any recent employment protection legislation, but this would not be too relevant in a second job context.

The fourth employment implication would be that of the dual economy mentioned earlier and epitomised here by the "Do-It-Yourself" trend (J.E. Gershuny, 1977 and 1979). A movement away from expenditure on services towards goods can be observed with more and more of the final production of services being done in the home and thus a wide range of services once in the formal economy are now done informally in the home or are on a self-service basis.

The fifth implication concerns immigration, youth and child labour. A large number of immigrants and youths, unable to compete in the local labour market tend to drift to the informal economy in order to obtain any type of work available. Irregular labour markets have grown in the lesser industrialised parts of Europe, e.g, Southern Italy, Greece, and it could be a problem in the European

Community applicant countries of Spain and Portugal. It is seen to be mainly an urban area problem for men outside the prime age groups, women and those with limited education - a flexible and marginal force. But it also exists in the more industrialised belts of Northern Europe where the emphasis is on the mundane unskilled tasks - construction, home maintenance, gardening, leisure, catering, domestic work, etc. where the student population is evident.

The sixth and final implication for employment is the relationship between the informal economy and economic growth; this is seen as 'U' shaped in some countries, e.g, UK, namely that the informal economy is at its peak when the economy is in a full boom or full recession state. In other countries, e.g, Germany, this impression is not so strong. The informal economy could be proportionally more important when either a recession, because of income reduction, forces labour to seek irregular employment, that is demand induced, or a boom causes employers to seek marginal labour, or otherwise supply induced.

The informal economy does have considerable implications for employment and immigration and perhaps one of the more important policy implications for the future is the development of the dual economy which has naturally occurred as a combination of both market forces and government intervention.

VI. CRITIQUE

National accounts

Prior to drawing towards a conclusion and recommendations it would be incomplete in a survey of this nature to close without introducing an element of critique of the various methodologies reviewed here.

The national accounts standpoint involves the use of aggregate statistics and there is always a worry about the comprehensiveness and accuracy of aggregate data; there is a good case for any aggregate-based analysis being supported where possible by

an appraisal from disaggregated data. On the UK national accounts basis this has now been done (A. Dilnot and C.N. Morris, 1981) and has provided broad supporting evidence. In looking at aggregates there are difficulties in concentrating upon residuals in any relationship; much of the work from a national accounts standpoint has been carried out this way and the results can be easily swayed by changes in one factor in the equation not under direct consideration. This, in fact, happened in the UK when a revised figure for company profits resulted in a 1/3rd change in the estimate of the size of the informal economy.

In such an analysis of GDP constructed on various bases - income, expenditure and output, there is a need to take account of both timing differences of the various bases and changes in time lags. Such an assessment has its perplexities when time lags are suspected of changing exogenously.

OECD (1981) have highlighted the definitional problems in any national accounts based assessment of the informal economy by distinguishing between undeclared legal transactions, production of illegal goods and theft; the exclusion of household activities is emphasised. Often in each of these sectors there is a grey area of uncertainty as to classification and also in international comparisons there are differences in national laws - what may be legal in one country is illegal in another and classifications of the same transaction would consequently be at variance.

Employment

Any assessment of the informal economy on an employment basis requires use of labour market statistics. It is this very data that suffers from some inaccuracy because of the informal economy and consequently can influence any concomitant assessment to an unknown quantity. Participation in the informal economy involves a degree of camouflage which results in employment statistics being incorrect; high levels and loose regulations for social security benefits can augment such a tendency.

The alternative approaches suggested in this paper of decentralised production models, time surveys and activity rate analyses also have the weakness of being somewhat dependant on labour market response and data. In countries where the informal economy is suspected of being higher than in others the degree of inaccuracy can rise.

A possible solution is to aim for greater precision in employment statistics and a warning should be sounded of the dangers of relying solely on employment data for economic and social decisions, including those relating directly to the informal economy.

Fiscal

As with the employment viewpoint the paramount desire for secrecy and confidentiality prevail and thus any fiscal statistics used here need to be treated with some caution.

The approach which compares groups of data for national accounts with input/output statistics suffers to varying degrees from this deficiency (earlier national accounts arguments apply here also); the amount by which each group of statistics is incorrect is of course unknown but the possible differences in accuracy for each group raises further problems when used on a comparative basis. The US Taxpayer Compliance Management Programme of strict audits for a selected sample appears to offer the possibility of a high degree of accuracy, as does a British system of disaggregated personal data analysis because at some stage in each a precise explanation (though sought for other reasons) can be available.

However, some delinquency in this area must be expected; some would regard it as part of the price to pay for a democratic society.

Monetary

From the monetary viewpoint it is possible to make a more thorough critique than for others; this is not necessarily because there are more criticisms of principle to be levied at this approach

but since it is in the area that the research has been documented in more detail thus enabling more extensive comment than elsewhere to be possible. Certain specific criticisms have already been made earlier in the text when the individual monetary approaches were discussed. At this juncture therefore only general criticisms will be covered.

It is reckoned to be extremely difficult to derive estimates of the informal economy from changes in a single ratio (namely, total USD transactions to GNP in current USD) over the long term. This criticism is augmented when it is recognised that the USD is an international and reserve currency and there is high risk of error if any domestic comparative denomination is used.

Newer forms of financial mechanisms have reduced the proportion of financial transactions attributable to currency and the total stock of money at any one time is due to a variety of changing factors, particularly expectations, retail sales and income levels. It is consequently doubtful if the impact of the informal economy is not well submerged amongst these other factors.

A crucial element used in estimating the size of the informal economy is the assumption on the number of times a dollar bill is exchanged, or changes hands. This statistic is extremely hard to substantiate, yet is a crucial assumption. Furthermore, the positive results obtained for the USA since 1973 now appear to be due to the growth in demand deposits and not transfers; it is the latter that has an "informal" linkage. Also, the decline in the velocity of circulation in the USA appears to have been ignored. Attempts to repeat American research results in Europe have not, to date, proved very successful (A. Dilnot and C.N. Morris, 1981, and M. O'Higgins, 1980).

In some research it has been assumed that there was no informal economy prior to World War 2; on reflection, this now looks rather dubious, especially when the "Prohibition" era was in full swing at that time.

Summary

This section has presented a general critique of the methodologies used in the various approaches. Some criticisms appear strong, others less so. But one needs to recognise that such criticisms do exist and are thought to have a certain degree of validation.

But this is a very grey area by definition, and if the answer looks still unclear, then the best course would appear to be to recognise and build on the work done to date and to continue with the research against a background which recognises the existence of the informal economy and our lack of precise knowledge of it.

VI. CONCLUSIONS AND RECOMMENDATIONS

In completing a review of such a topical subject as the informal economy, a strong temptation emerges to draw firm and strong, and possibly heroic, conclusions so as to entice policy makers towards positive action now. But a certain degree of academic integrity should prevail. It cannot be emphasised too strongly that this is a field in which it is more than usually difficult to obtain information, which is, by definition or desire, hidden, submerged or camouflaged in some form or other. A brief reminder, at this juncture, of the range of estimates contained in this review may be pertinent. The informal economy has been judged in individual countries, inter alia, at:

- amounting to between 3% and 27% of a nation's GDP - in USA;
- involving among 10% and 35% of a nation's labour force - in Italy;
- resulting in about UKL3 1/2 million of annual tax losses - in UK.

The present evidence strongly suggests that the informal economy is a growing phenomenon which has still to be fully recognised by the authorities in Europe, whilst its potential appears already to be well appreciated by its participants. However, some recognition is now developing and there are indications that the

problem is somewhat larger than originally envisaged. But it remains doubtful if, under any stricter controls, whether the formal economy would grow at the expense of the informal.

Bearing in mind particularly the overstatement of inflation and understatement of employment in present day economic indicators, it is quite possible that European economies are now not as depressed as made out to be; consequently unsuitable policy remedies could be being taken. This policy problem is further exacerbated as the informal economy is alleged to be growing at a dissimilar faster rate than its formal companion; the totality may therefore require policies of a rather different nature.

A concluding suggestion therefore would be that the time is now most appropriate for further thoughts relating to research prior to any major economic policy recommendations. On the available evidence it would be injudicious to suggest any firm economic policy action now, only procedural or statistical changes should be proposed at this stage, such as:-

- a) the introduction of time use surveys in the European Community, possibly using the existing Labour Force Survey;
- b) the devotion of more resources nationally to fiscal and social security fraud detection because of their high returns;
- c) the publication in the Community of all three methods of estimating GDP (except in the UK and Belgium where it is already done);
- d) the development of statistics for the velocity of circulation of currency (notes and coins) as compared with money (M1 or M3).

The specific areas of economic research where activity might be usefully concentrated upon now in Community countries would appear to be:-

- a) into the implications for employment policy by drawing up decentralised production models involving the local informal economies (as in Italy);
- b) into the inferences for fiscal policy and losses in Community countries through a comparison of input/output data with revenue statistics (as in Belgium);
- c) into the possible undermining of monetary policy by use of certain American monetary techniques (as in USA);
- d) a full appraisal of the dual economy concepts and its implications for industrial restructuring.

Each of these can, of course, be enlarged upon to provide a full scale research project.

It might also be worthwhile mounting some form of international conference where all these issues could be usefully ventilated.

TABLE 1 : SUMMARY OF MEASUREMENTS OF INFORMAL ECONOMY BY APPROACH BY COUNTRY

Approach	Country	Measure	Measurement
1. National Accounts	U.K.	GDP	2/3 1/2%
	U.S.A.	GDP	3/8%
2. Employment	France	(Employment (% Labour force	800,000/1,500,000 3/6%
	Italy	(Employment (% Labour force (GDP	2/7 million 10/35% 15%
	Denmark	(% Labour force	11%
	U.S.A.	(Employment (% Labour force	20 million 25%
	Ireland	(% Labour force with unrecorded second job	2 1/2%
3. Fiscal	U.K.	Tax losses	UKL3/3 1/2 billion p.a.
	U.K.	GDP	2/7 1/2%
	France	Tax losses	FF 4.5 billion p.a.
	Belgium	Tax losses	FB 200,000 million p.a.
	U.S.A.	Tax losses	USD 2 billion p.a.
	U.S.A.	Tax losses	USD 13/17 billion p.a.
	U.S.A.	Tax losses	USD 50 billion p.a.
4. Monetary	U.S.A.	GDP	4 1/2%
	U.S.A.	GDP	under 10%
	U.S.A.	GDP	10%
	U.S.A.	GDP	19/27%

TABLE 2

SURVEY OF EXTRA MURAL ACTIVITIES OF ITALIAN CIVIL SERVANTS, 1980

	% of total
Those with second job	54
Those often absent from duty because of few checks made.	45
Those selling goods within Ministries during working time.	33
Those taking early or late holidays (and thus a longer holiday because of superiors absence at main holiday time).	30
Those available for small jobs outside in official working time.	27
Those who hardly ever report for work because no checks made.	19

Source: Centro Studi Investimenti Sociali (CENSIS), Rome, quoted in "Il Messaggero", Rome, 13/10/80.

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