

UNDERGROUND ECONOMY: IT IS AN ECONOMIC PROBLEM A SOLUTION?

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Abstract

Underground economy one of the most complained issues for the government officials hence it's an inevitable phenomenon which is as old as government itself. Underground economic activities can be defined as unrecorded economic activities by the tax officials. The motivation of underground activities comes from license requirements and repressive government regulations on economic activities.

Underground economic activities cause tax evasion. The government sustains enormous revenue losses which it directly affects its debt level and jeopardize its capacity to provide services and fund programs. Growing underground economic activities dominates the official economy. Thus for the legitimate business enterprises, it's impossible to compete with underground firms. With its bustling and indistinguishable nature, underground economy blurs the macroeconomic outlook, so it prevents us to make effective economic and politic decisions. But for some economists, underground economic activities are "the inalienable right to life and property, which comprises the right to sustain both life and property through honest work".

Keywords: underground economy, unregistered economy, black economy, tax evasion, underground employment

Introduction

There is a common agreement that a considerable and rising share of economic activities take place outside the official economy. This holds, in particular, for developing and transition but also for high income economies. These economic activities had not recorded by the system of national income accounting. There would be three major concerns about the underground economic activities: First, underground economic activities cause tax evasion. Secondly, it's impossible to compete for a legitimate

business enterprise in a country which holds underground economic activities. Finally, with its bustling and indistinguishable nature, underground economy blurs the macroeconomic outlook, so it prevents us to make effective economic and politic decisions.

1- Definition of Underground Economy

There is wide spread of definitions for underground economy, such as: shadow economy, informal economy, black economy, unregistered economy, hidden economy, clandestine economy etc... Underground economy can be defined shortly as, unrecorded and therefore uncontrolled activities by government officials. In other aspect underground economy is economic activities which cannot be predicted by the national accounts estimation techniques. (Derdiyok,1993: s.54). In the concept of taxation, underground economy is the economic activities which have been kept secret from government by the motivation of tax evasion or tax avoidance (Altuğ,1994: 15).

There are three main schools of thought regarding the relationship between the formal and informal economies (Chen, 2002):

- **The dualists:** the informal economy is a separate marginal economy not directly linked to the formal economy, providing income or a safety net for the poor.
- **The structuralists:** the informal economy is subordinated to the formal economy. In order to reduce costs, privileged capitalists seek to subordinate petty producers and traders.
- **The legalists:** informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies.

2- Relationship Between Underground Economy and Illegal Economy

Illegal economic activities are the government-restricted activities which seen by society as harmful and immoral. Naturally, activities which are forbidden to run as registered economical activities are unregistered activities as well (Sarılı, 2002). Thus undergrounding of some economic activities with various reasons causes undergrounding of taxable resources.

Earned money from illegal economic activities called as “black money”, legalization of this money called as “money laundering”. Essentially, exchanging money, cheque, bond, security etc. which earned with illegal ways, to other currencies or derivatives is illegal as well. And it’s very common in countries which hold underground economy (Çolak, 2001: 196). Many countries count money laundering as a crime also.

But according to Sehnholz (1984), whether government officials put on a par underground economy with illegal economy, underground economy has to be distinguished from illegal economy. In fact both groups are knowingly violating laws and regulations. However they differ radically in the role they play in society. The illegal economy comprises criminals who are committing acts of bribery, fraud, and racketeering, and willfully inflicting wrongs on society. The underground economy involves otherwise law-abiding citizens who are seeking refuge from the wrongs inflicted on them by government. They are

employers and employees who are rendering valuable services without a license or inspection sticker, or failing to report their productive activities to the political authorities.

3- Types of Underground Activities

Underground activities can be grouped into four main categories (Sehnholz, 1984):

- Economic activity yielding income that is not reported to the tax authorities.
- Economic production that violates one or several other mandates, such as compulsory government licensing and rate making, inspection and label laws, labor laws, government regulations of agriculture, export and import controls, government control over money and banking, governmental control of energy production and distribution, and countless others. Violators may or may not evade taxes, but they all work illegally, hiding from swarms of government inspectors.
- Productive activity by transfer beneficiaries who draw Social Security benefits or receive public assistance. Their freedom to work is severely restricted.
- Productive activity by illegal aliens without residence status. They may pay income taxes and other taxes, but must remain underground for fear of deportation.

4- Pros and Cons of Underground Economy

Advantages of the underground economy can be classified as; bringing in competitive power to economy, increasing employment, having a multiplying effect on economy, providing resource to official economy, bringing dynamism to economy and being the assurance of socio-economic system.

On the other hand, underground economy has various negative effects on economy. First, growth of underground economy means shrinkage of official economy and it causes tax losses. In that case government has two options. First one is going into debt. After going into debt, government attracts efficient private sector investments to itself and it would be affect private sector investments negatively with crowding out effect. Besides, this will increase the bond prices and the interest rates. After that mechanism, inflation rates will increase and country faces so many problems. The second option of the government would be coinage but it had no different effect than the one mentioned above. Underground economy's the other negative effect on economy is related with competition. The underground firms pay no tax or less tax than the other firms so they gain competitive power and it will be an unfair competition (Kildiş, 2000).

Finally, underground economy causes unreliable statistical data. In that case it would be impossible to determine the size of the economy and the economic distributions. Once them cannot be determined properly, economic policy decisions cannot be determined properly as well.

Recent empirical studies on underground economy in Turkey classified in Table 1.

Table1: Summaries of Empirical Studies on Underground Economy in Turkey

Researcher	Approaches	Period	Underground Economy as Percent of GDP (%)
Altuğ	Underground Wage Approach	1992	35,0
Derdiyok	Monetarist Approach	1991	26,2
	Tax Loss Approach	1991	40,4
İlgin	Cash Ratio Approach	1993	54,3
	Econometric Approach	1992	45,3-53,9
	Fixed Ratio Approach	1968-2001	31,0-84,0
	Tax Loss Approach	1985-2001	26,0-184,0
Kasnakoğlu	Monetarist Approach	1997	7,0-9,0
	Cash Ratio Approach	1997	30,0-61,0
	Econometric Approach	1997	9,0-13,0
Özsoylu	GDP Approach	1990	7,5
	Fixed Ratio Approach	1991	11,5
	Trading Volume Approach	1990	11,5
Temel, Yazıcı, Timtek,	Expenditure Approach	1991	1,5
		1991	16,4
	Tax Loss Approach	1991	1,9-7,8
	Monetarist Approach		
Aktürk	Econometric Approach	2002	16,2
Koçoğlu	Sensitivity Approach	1987	19,6-26,5
Orçun, Kuşcuoğlu, Karaca, Derin	VAT Loss Approach	1998-2003	35,4-23,5

Source: Ministry of Finance Tax Inspectors Board & TOBB, **Türk Vergi Sistemi-Sorunlar-Çözüm Önerileri**, Ekim 2002, s.105

Conclusion

As we mentioned before, underground economy has many definitions. But no matter what we define it, it's obvious that underground economy is a very important phenomenon. First it's impossible to us to see the big picture of the economy. Secondly, tax evasion causes significant financial losses. However it's impossible to say that, underground economy is completely pernicious. It has some positive effects on economy such as; social balancing and providing economic activity. Anyway, one must not dismiss from his/her mind that; though underground economy sustains cost reduction or competitive power, it has negative effects such as levying more tax from the very same elaborates. Needless to say, struggling with underground economy is the most important job of the government. But some steps to be taken first:

- Debureaucratization and simplification of tax system with a tax reform.
- Establishing an effective auditing system with a tax administration reform.
- More frequent tax audits and heavier penalties for tax evasion .
- Showing elaborates that their taxes returning to society as public service.
- Expanding the taxation to the whole sections of the society and reducing the tax burden on elaborates.
- Reducing the tax on the input prices such as energy, oil, natural gas etc., which constituting the cost in Turkey, to the level of rival countries.
- Reducing the institutions current 70% burden on employment to the 25%, which the level of European Union.
- Motivating the agricultural sector to corporatization with an agricultural reform.

With the vast developments in information and communication technology it is not impossible to control the underground economy. But it must be assessed with our suggestions and within a program framework. If not, registering the underground economy would not be constructive, on the contrary it would have cause economic downturn. Therefore underground economy must be assessed with both its positive and negative sides but “realistically”.

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