

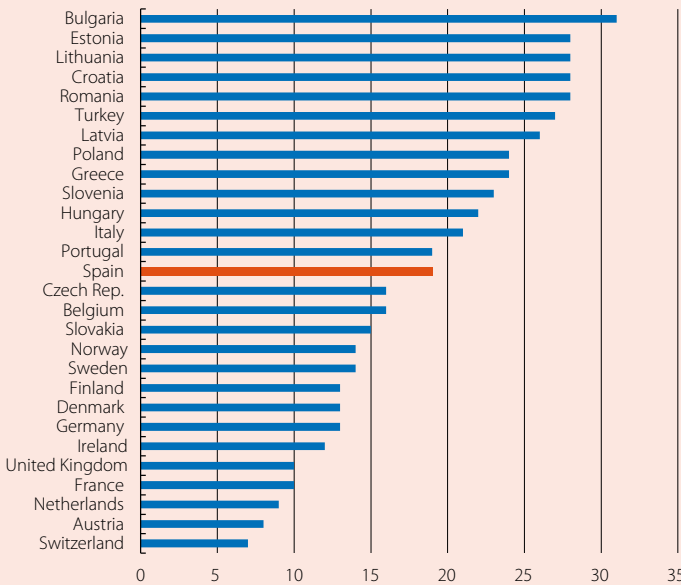
The shadow economy: too great a burden

When looking at taxation in Spain, it is inevitable to examine tax fraud and therefore the eternal problem of the shadow economy, also called the underground or black economy, as well as a host of other similar names. This comes as no surprise because a black economy (the series of productive activities that are often legal but deliberately hidden from the public authorities to avoid certain fiscal costs or legislative requirements) not only makes it difficult to estimate the true size of the economy but also significantly reduces fiscal efficiency and economic growth per se. So how can it be minimized?

Firstly: by quantifying the extent of the problem; not an easy or precise task (due to the hidden nature of what needs to be measured) but one based on more or less reliable estimates. In this respect, one basic reference is the report drawn up every year by Friedrich Schneider which, in 2013, estimates that Spain's shadow economy, including undeclared employment and the inadequate registration of income from sales or services, would represent 18.6% of GDP.⁽¹⁾ Although this is almost the same as the European average (18.5%), it greatly exceeds the figure recorded in benchmark countries such as Germany (13%), France or the United Kingdom (10%). Of note in Spain is the relatively high proportion of employment fraud within the shadow economy, estimated at around 8% of GDP or equivalent to hiding one million full-time jobs.⁽²⁾

Spain's shadow economy: too far from the benchmark countries

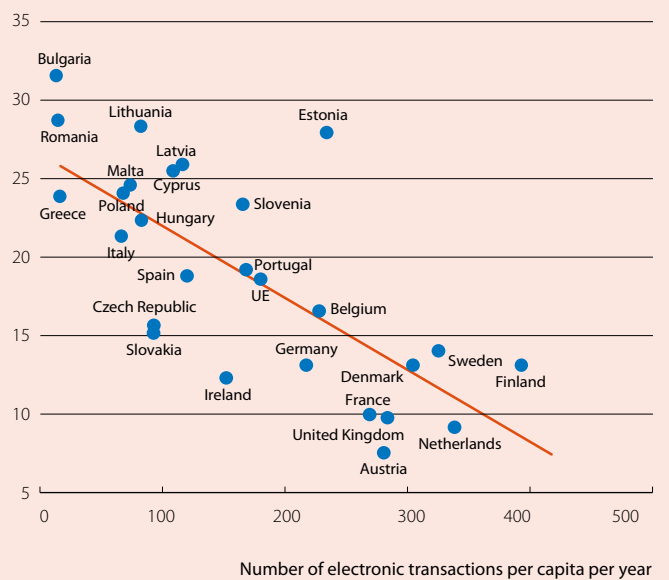
(% of GDP)



Source: Schneider, 2013.

More electronic transactions, smaller shadow economy

Relative weight of the shadow economy (% of GDP)



Sources: Schneider (2013), ECB and "la Caixa" Research.

Given the economic relevance of this phenomenon, it is not surprising that its impact in terms of lost fiscal revenue is also appreciable. It is calculated that eradicating the shadow economy would result in an increase in tax revenue of between 60 and 80 billion euros, a notable sum if we remember that, in 2012, the total tax and social security paid in Spain was 347 billion. Assuming a more realistic correction such as a reduction in the relative weight of the shadow economy to the level of Germany, this would result in extra revenue of around 18-20 billion euros.⁽³⁾ This would undoubtedly help to cut the distance with the euro area in terms of fiscal revenue as a percentage of GDP: in 2012, 33% of GDP vs. 42% for the EMU average. Within a context of economic crisis and with the urgent need for fiscal consolidation, it is evident that this lower fiscal revenue resulting from the large shadow economy is hindering Spain's economy. In fact, within a recessionary context, increasing revenue through tax hikes is much more harmful for growth than achieving the same end through a larger taxable base, bringing out hidden activities or ensuring greater compliance of existing fiscal requirements.

(1) See Schneider, Friedrich. 2013. The Shadow Economy in Europe. Visa Europe, AT Kearney.

(2) Data for 2008. See Jiménez, Alfredo and Martínez-Pardo del Valle, Ramiro. 2013. «La economía sumergida en España». Working document 4, Fundación de Estudios Financieros.

(3) For details on these estimates, see the aforementioned study by Jiménez, Alfredo and Martínez-Pardo del Valle, Ramiro, 2013.

Given the importance of the shadow economy, and before proposing possible solutions, we must examine why it is so prevalent. From an individual point of view (company, worker or consumer), the reasons for hiding economic activities are to avoid paying tax and social security contributions or to avoid having to comply with legal standards (minimum wage, maximum working day, etc.) as well as administrative obligations. Consequently, two crucial factors determining the extent of the shadow economy will be the fiscal burden in all its forms and the country's regulatory intensity. This practice will also be more or less likely depending on three additional factors: the likelihood of the activity being detected and penalized, the degree of social acceptance of hidden practices and the ease of incurring in such practices. Regarding this last aspect, it should be noted that this is easier, for example, in an economy with little use of electronic transactions (see the graph) and in industries such as construction or retail where, unlike other sectors such as financial services or supplies, have a greater tendency to use cash in commercial transactions.

Which of these factors are the most relevant in Spain's case? One of the few empirical studies available (Schneider and Buehn, 2012) associates the relatively large size of Spain's shadow economy with excessive and inefficient regulation in a highly specific area: the labour market.⁽⁴⁾ At quite a distance from this over-regulation of employment they also identify the level of indirect tax and personal tax (they have not studied the impact of corporate tax) as factors that encourage the shadow economy in Spain. They have also established that the degree of social acceptance of fraudulent practices is a relevant factor, although much less so than the labour and fiscal variables.⁽⁵⁾ Schneider and Buehn have not analyzed the ease and likelihood of detection.

With this diagnosis, can strategies be designed to unearth the shadow economy in Spain and thereby increase fiscal revenue? The origin of the problem suggests that general government needs to focus on two broad methods: increase the costs of hiding such activities (discouragement) and reduce the benefits (encouragement). In terms of discouragement, actions usually fall into one of two categories, both aimed at increasing the risk perceived by the offender: actions aimed at increasing the capacity to detect undeclared activities and those aimed at increasing the punishment once detected. The lower the probability of being detected or the greater the cost of maximizing this probability, the more effective it will be, as a discouragement, to opt for a penalty that acts as a deterrent when an offence is detected. Spain's current National Reform Plan tends towards more tax inspections, especially in the area of hotels, restaurants and construction, as an explicit measure to reduce the shadow economy.

Regarding encouragement, there are usually two strategies adopted: on the one hand, encouraging people to move from the shadow economy to the official economy, including the different variations of «fiscal amnesty», with their reputational advantages and disadvantages; on the other hand, attempting to stop people from moving from the official to the shadow economy. In this second area, preventative in nature, there are three key actions to be carried out: simplifying administration and regulation, encouraging financial inclusion and generating greater social awareness. Although the explicit motivation behind this is often not to combat the shadow economy, it seems undeniable that simplifying administrative and tax bureaucracy reduces the incentive to carry out unregulated activity. In this respect, both in Spain and in the countries around us, the aim is to simplify, with more or less success, the legal environment for business activity. With regard to financial inclusion, the most common measures are linking certain social benefits with being registered or promoting the use of different means of payment other than cash (on average, a 10% rise in the use of electronic payment methods is associated with a 5 point reduction in the shadow economy relative to GDP). In this area, one of the most frequent ways is to limit cash transactions to relatively small amounts. Between 2011 and 2013, Belgium, Bulgaria, Denmark, Slovakia, Spain, France, Greece, Italy and Romania have all either adopted or announced plans to adopt this line of action. With regard to social awareness, greater development would help to create awareness that fiscal fraud is detrimental to the quality of public services or involves a significantly greater fiscal effort, something which could be as or even more effective than increasing inspections or fines.

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(4) See Schneider, Friedrich and Buehn, Andreas. 2012. «Shadow Economies in highly developed OECD countries: What are the driving forces?». Institute for the Study of Labor Discussion Paper, no. 6891.

(5) These conclusions are similar to those presented in the aforementioned study by the Fundación de Estudios Financieros, highlighting the following among the causes of Spain's large shadow economy: the greater fiscal burden, its role as an escape valve at times of economic recession, the lack of fiscal awareness among citizens, over-regulation and a rigid labour market.