

Economics and “underground” economy theory

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Abstract. *Following examination of the theory underlying "underground" economy study I concluded that a good knowledge of the economic thought history is a must for any paper of economic analysis. Subject is sufficiently dramatic by its nature; so I consider it is necessary to bring the scientific perspective. In addition, "underground" economy is an unavoidable ingredient of any economy, the most profitable component of the economy being the "underground" one. Lack of consideration for this component can lead to severe shortfalls of economic analysis leading to the adoption of unrealistic strategies. I support since the beginning of this paper that not the quantitative side will be essentially concerned but epistemic logic. In this paper I propose to elaborate a theory that will mark the right of “underground” economy to exist as a sub-branch of economics. The main argument supporting the need for such an analysis consists of time evidence that shows that "underground" economy is a source of development, subsistence and even escape from the periphery zone for some underdeveloped economies.*

Keywords: “underground” economy; economics; economic development; globalization.

JEL Codes: A14, B22, H26.

REL Codes: 13I, 14K.

Introduction

In this paper I propose to elaborate a theory to mark the "underground" economy right to exist as a sub-branch of economics. The main argument supporting the need for such an analysis lies in the time evidence that "underground" economy is a source of development, subsistence and even escape from the periphery to underdeveloped economies. In addition, "underground" economy is an inevitable ingredient of a country's economy. The most profitable part of the economy is the "underground" part. Lack of consideration of this component can lead to severe shortfalls of economic analysis leading to the adoption of unrealistic strategies. Following examination of the theory underlying the "underground" economic study, I concluded that knowledge of the history of economic thought is a must for any work of economic analysis, such that the subject is sufficiently spectacular by its nature that I consider necessary to approximate the scientific perspective.

Methods used in economic analysis aim at highlighting the "underground" as a source of subsistence and even escape from the periphery underdeveloped economies, trying also to increase the chances of theoretical type breakthroughs in the field of scientific interest. For completeness, in the analysis for each goal I will choose an instrument. The methodology nature is deductive and what I propose to base economic theory is called "underground". This is the systemic analysis, comparative and comprehensive approach to the topic investigated, according to the endpoint and the stage considered. It will use specific tools such as classification, synthesis, static and dynamic comparative analysis, correlation analysis, methods of induction and deduction, the graphical representation of events and phenomena investigated. There is a need for this approach because of the nature of the topic investigated, so we can say that the investigation of economic phenomena may have a quantitative resonance only if scientific instruments are accompanied by an ongoing analytical deductive healthy logic.

Research results are to develop a theory of "underground" economy based on a map of arguments that come to support the need for such a scientific approach, especially since there are consistent proofs that the "underground" economy is a source of development, support and even escape from the periphery to underdeveloped economies.

To meet the above requirements, in a fair, uncorrupted way from a scientifically point of view, I passed a series of relevant researches to the topic, as can be seen in the reference list, of which I recall, the following priority: Marin Dinu, *Economia de dictionary. Exerciții de îndemânare epistemică*, Editura Economică, București, 2010, and Emil Dinga, *Studii de economie. Contribuții de analiză logică epistemologică și metodologică*, Editura Economică, București, 2009.

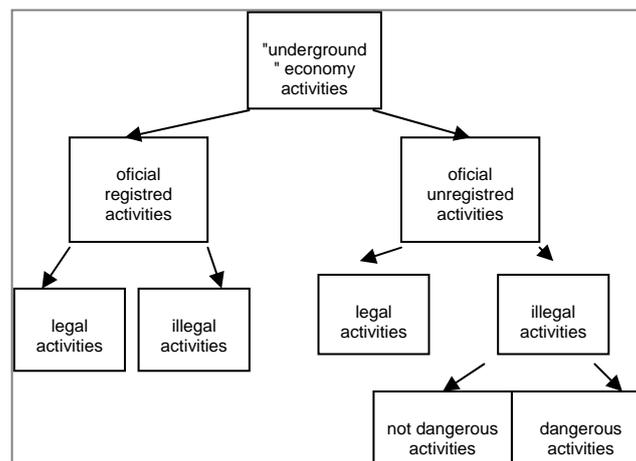
Getting close to "underground" economy by knowledge

Conceptual identifying "underground" economy is the first and most important step to be made for knowledge "underground" economy. This step is already marked by previous scientific efforts; I will go on to close the "underground" economic phenomenon by its definition and delimitation of its area of coverage.

→ How do I define "underground" economy?

Starting with the obvious purpose of "underground" economic activities and to maximize income regardless of means and methods to be used for this, and heterogeneous activities attracted in its scope, the staff of the Department of Economics and Economic Policy accepted definition of "underground" economics as it means all organized economic activities, in violation of social norms and economic laws, aiming to generate revenues that cannot be controlled by the state.

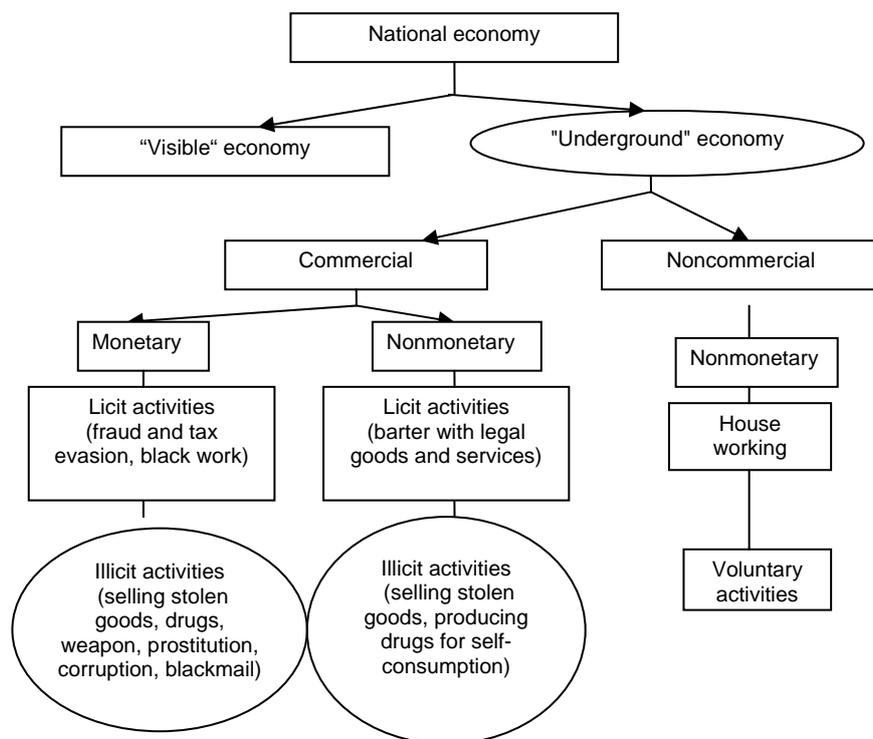
I think that this definition may assume in addition the economic activities that require self-consumption, self-consumption economy and nonmonetary economic activities, respectively nonmonetary economy. Worldwide, the two entities are approved as components of the "underground" economy because this is beyond fiscal records, generating the income that cannot be controlled by the state, as the above definition requests. When trying to define the "underground" economy, borders are very difficult to park and sometimes differences are imperceptible. "Underground" economy is the product of some general and specific factors, therefore can bear the structure shown below:



Source: The structure of "underground" economy shown in the above figure is the author proposal.

Figure 1. *The structure of "underground" economy*

A different view of researchers presents a parallel analysis of "underground" economy and "visible" economy, or in other words of informal economy and formal economy. The natural conclusion to be drawn is that we cannot speak of two types of economy because the economy is only one. The relationship that I think to be true, according to the basic principles of logic, is that between "visible" and "underground" economy there can be a relation as a part to a part, together forming a country's real economy as a whole, as can be seen from Figure 2.



Source: Figure 2 is the adaptation of the author after the scheme of Pierre Pestieau in his paper "L'Economie Soutteraine".

Figure 2. *The structure of real economy*

The definition which I consider appropriate to describe correctly and completely the phenomenon is that the "underground" economy represents all informal economic activities, commercial or noncommercial, conducted in an organized form, are not officially recorded, legal or illegal dangerous or hazardous economic and civil society.

If global concerns for understanding the phenomena that lead to the perpetuation and development of "underground" economy dating from the '70s, similar studies in transition economies are scarce, estimates vary from one author to another, and data from official statistical institutes are questioned. This is because there is no unified methodology to estimate the "underground" component in economy and because of the lack of uniform definitions globally. I believe that the "underground" economy is the product of general factors and some specific.

Two types of economy as are presented in the literature, which have identical composition does not make sense to operate separately and be analyzed in place of rivalry. Both economies are part of real economic life, both are due to people's real needs, both are capable of meeting a set of their real needs. More important and necessary is to consider this component as macroeconomic policies are grounded today only for a part of a country's economic activity namely that of indicators such as GDP, inflation, unemployment rate, and so on; they take into account only the activities declared and recorded. The remaining existing value-added activities, which take considerable share of the world economies, are being left alone and not taken into account when determining strategies and macro-economic recovery strategies. This disability makes difficult the action of macroeconomic decision-makers and therefore the adopted policies don't have resonance in a country's economy.

How do I justify the existence of "underground" economy?

The need for a new explanatory model of the economy "underground" feels no doubt. "Underground" economy should be treated as part of the economy of any country, which exists with or without our will. I believe we do not have to start by searching for solutions to fight but rather seeking to understand and know the solutions. Therefore, knowledge and understanding of a phenomenon is the main way to use it for purposes beneficial to the economy.

→ What is "underground" economy?

The question "Why *underground* economy exists?" is one that very few have tried to find an answer. Trying a few responses we claim that the "underground" economy has its root in the incapacity of market agents and the inability of state representatives: 1. "Underground" economy exists because it provides economic goods which meet the real needs of society. Without the existence of component demand, bidders in the "underground" market do not exist, 2. "Underground" economy exists because there is proved to be an effective method for controlling the global powers. Global power control is achieved more easily through hidden and corrupt operations, 3. "Underground"

economy that provides opportunities exists for entrepreneurship event in a market economy. Entrepreneurship, needed by any economy that wants to be a developed market economy, is inhibited by tax burden and bureaucratic cluster in a country, 4. "Underground" economy exists because it can exist and is encouraged for that purpose. Lack of a very well thought control allows developing economic "underground" activities and the emergence of new ones, 5. "Underground" economy exists to provide those to whom the gates are closed by state authorities. Coercion is the mother of ideas, with which barriers are bypassed by the authorities, 6. "Underground" economy exists because there is a real source of development, and subsistence and even escape from the periphery to underdeveloped economies.

→ **How does "underground" economy works?**

"Underground" economy has shown a functional economic system in history. At any time and in any economy, regardless of level of development, "underground" economy was felt in different proportions. According to an article in the publication "The Economist" in 2008 most countries with high vulnerability to corruption are new entrants in EU countries: Romania and Bulgaria. Although the growth rate is shown to be strong during 2008, threats do not slow to appear, so that Bulgaria's current account deficit stood at the end of 2008 the level of 24%. Bank loans will exhibit very poor banking system failures, so it will arise the question how much from external assistance will benefit the two countries. The Baltic countries are also recognized for high levels of corruption, in this case due to inability or unwillingness authorities to control such activities.

In the context of globalization it is essentially necessary to analyze the issue of corruption. It has to be taken into account that once economy obeyed to globalization orders, corruption travels at the speed of cold air currents surrounding the planet. If we analyze the remarkable work about corruption of Susan Rose-Ackerman (1999), we find that three of the four chapters are based on consideration of corruption as "an economic problem, cultural or political one". Friedrich Schneider, Austrian expert in the field of "underground" economy, discussed the existing gap between the interests of private entrepreneurs to engage, in illegal way, immigrants as a survival strategy in the context of increasingly competitive global economy and feelings of community citizens who see their jobs threatened by unfair competition, all these in addition to the requirements of own governments to increase budgetary contributions to the funds.

To limit the development of "underground" economy there are required, along with establishing new enforcement measures and increased penalties for existing ones, enhancing economic measures that are designed to promote economic growth, to reduce the tax burden and achieve a real legislative stability.

Arguments map that explain the existence of "underground" economy

I wanted to build a map of economic arguments to explain the presence of "underground" economy in the economic structure of any country, so that I can prove that this component is a source of development, subsistence and even source to escape from the periphery for underdeveloped economies.

→ The natural liberty of Adam Smith in "underground" economy

The system proposed by Adam Smith is one in which every individual pursues his own interests to benefit the entire society. Human powers, their weaknesses, affects and provisions are given by God. Smith's project was to determine the natural principles that govern human behavior. He tried to elucidate the natural laws governing moral laws.

→ Tax burden awakes in us a sense of property

Psychological studies on the behavior of tax payer showed a considerable increase tax evasion charge only if that is perceived to be incorrect. If the citizen is aware that the fee is the result of an expressed agreement and not an arbitrary one, conscience will urge him to pay the debt to the state. This behavior, sustained by the majority, is a truth long known, so that Adam Smith in his paper "Wealth of Nations", wrote: "In those corrupted governments where there is at least a suspicion on unnecessary expenditure or misuse of public revenue, the laws are not fully respected". From here we trace the following conclusion: if the perception is general suspicious about the use of public revenue, the laws will be less respected.

→ Egoism vs. altruism

Circumvent phenomenon is not only an economic phenomenon, but rather a social one, with strong psychological implications. Economic literature has found out by the following argument: "it is human nature to gather and to avoid as much as possible parts of disposal of wealth" or "man always has an adverse reaction to authority, they are trying to deceive" or "Individualism is a trait of human behavior stronger than collectivism" (Le Bars, 1979). To protect from extreme ideological games, I felt the need to analyze by comparing selfish type and altruism type. Common understanding for selfish person expresses that person who with priority is pursuing personal interests and don't want to share the wealth or achievement with community. According to sociological studies of Anthony Giddens, which present detailed evolutionary stages of the human species, through the studies of Charles Darwin, we conclude that the human species is prone "natural selection" like animals in the same area fighting for supremacy (Giddens, 2000, p. 27). This means that to survive and perpetuate the species, human beings participate in the selection. Since the first evolutionary steps, the man has proved to be more individualist rather than

collectivist, the results from self-defense instinct. Comparing the two types of behaviors, animal's world and the human species; we can draw the following conclusion: animals attack only if they are abused intervening defense instinct, and animals are not being evil by nature and human beings as their defense instinct triggers he feels assaulted by the state, which comes to his income diminishment and discourage entrepreneurship. The conclusion is that man is not born evil, but has a highly developed sense of defense, which allows it to "perpetuate the species" in time and space, instinct without which humans would be doomed to perdition. Man is born with a default individualistic and selfish side developed, and living in the community can teach him to be altruist.

→ **Private property vs. public property**

The conclusion is that private property can lead to isolation, distancing us from social cohesion and sometimes cooperation, all of these characteristics of European model that our country embraced. Private property sense is one that stirs rush fortune. The desire to have more wealth individuals will be tempted to circumvent state contributions and contributor to such tax evasion, especially if it feels that the effort put into community service is not rewarded accordingly.

→ **Tax fraud: between property sense and awareness of private property**

Following the analysis performed on data collected through questionnaire and after consulting the literature, I concluded that there are at least two reasons that justify the opposite perception of the two categories of "underground" economic trend in Romania. The first reason is that private respondents are less confident in government's ability to provide a package of measures that may lead to the sphere of "underground" activities to pass the barrier to business written, recorded, given that they believes that tax fraud is the main component of the "underground" economy. The second reason is that the "underground" economy activities are coming from the sphere of private activities in connection with the state and as long as state institutions will not guarantee private property and will not use resources responsibly raised, "underground" economy will continue to grow.

→ **The existence of "underground" market**

"Underground" economy market has a globalized market structure in which the property is guaranteed, competition is fierce, the price is free by confronting supply and demand, free enterprise is at home and even labor division is functioning more efficient that on the visible market. To defend the values of collectivism and altruism, world entities are trying to control demonstration intervention in economic harm of "underground" economy to humanity.

The main tools are, in my opinion, the creation of coherent legislation and make citizens more responsible with the authorities that should protect us. This may be possible with high attention for the role of the Government or the institution of national security as a prerequisite for a society in continuous development.

→ **Implications of taxation level on aggregate supply and demand on "underground" economy market**

In terms of human behavior regarding taxation is that, if the tax rate increases and citizens must allocate a higher amount of payment, here comes the instinct to defend the property. Natural questions which arise here are the following: 1. Which is the optimal taxation rate and how to determine it? 2. Under what conditions reduced taxation would be benefic for Romania? Conclusion is that the benefic results of the new tax will benefit people with incomes just above average, which represents a very small percentage of Romanian population. It is certain that an increase in aggregate demand far exceeds potential GDP growth, given that labor productivity is increasing slightly. Therefore, on long term, tax revenues collected to the state budget, from the increased base of taxation, is growing with a much lower rate than the rate of decrease in budget revenues as a result of tax flat, increase the budget deficit, strong inflationary pressures appear and on long term will increase inflation. With *ceteris paribus*, a high level of current consumption means that fewer resources are available to be invested in productive capital.

→ **Will succeed a lower tax rate to unearth the "underground" economy?**

Statistics show that the taxation base has not increased in recent years, which confirms that there is no reaction of taxpayers to the tax incentive. Do you think that Romanian entrepreneur will be determined to declare income merely because the tax rate decreased by 9 percentage points? This seems impossible while the Romanian mentality is to win as much in a short time, and the responsibility to weaken rules on the day the action of distorting and destabilizing the government decision.

→ **Flat tax implications on the Romanian "underground" economy**

I believe that research on flat tax adopted by Romania in 2005 should, at least, refer to two key issues that it covers. Adoption of flat tax in Romania has brought two important changes. The first change is that it was adopted a uniform tax, eliminating the tax discrimination. Thus competitive businesses will not feel the punishment in a progressive taxation system where so does not feel rewarded. A second change is the reduction of tax from 25% to 16%. This means that 9% of the achievements will remain in the pocket of the taxpayer. A large number of studies support that: tax flat of 16% to be in company's

advantage, but not to big gains for modest employee and also deepens macroeconomic imbalances.

→ **State credibility contributes significantly to the applicability of a theory**

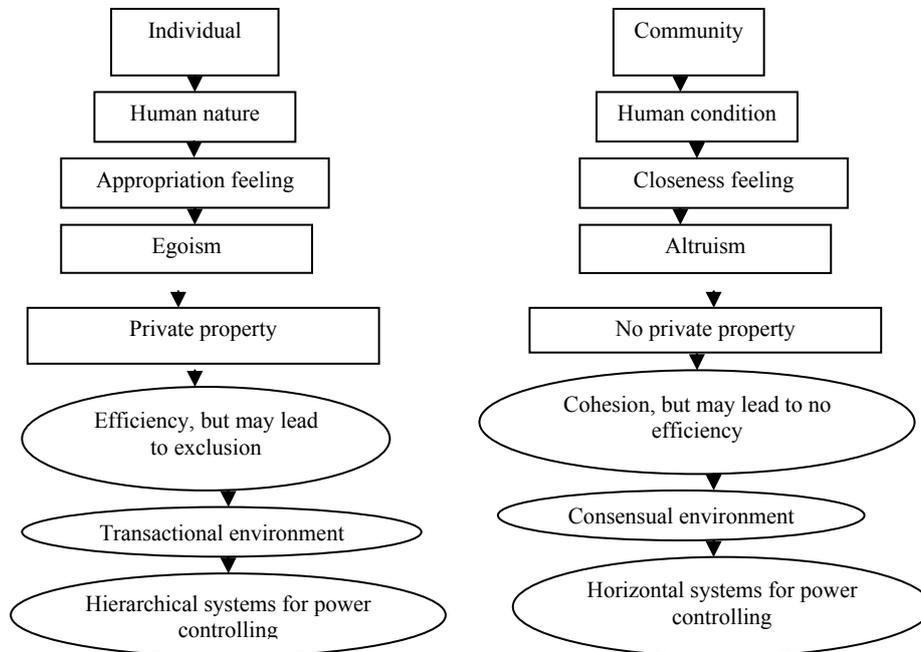
The question that arouses here is how much from Romanian "underground" economy will be unearthed due to the introduction of the flat tax? The answer varies from one source to another, trying to provide estimates for a situation which I have already shown that there is no quantitative evidence domain. If there were or were not effects on the component of Romanian "underground" economy is less relevant. Important is that this decision is not sufficient to cause the taxpayer to comply with taxation. I think that this decision should be accompanied by efforts to rebuild the responsibility to norms and institutions.

→ **Successful implementation of a theory must take into account the specificities of a nation**

Reducing corporate tax and income tax were not sufficient to significantly increase the degree of voluntary compliance. An important part of the market did not react and continued with the old behavior. The reasons are not too many, but I think there are important primarily for high levels of social contributions. Thus, individualism is at the service of public property and generates mostly "underground" economy. The fundamental cause is the attraction for wealth that people have generated from the fact that man is born individualist, selfish.

Therefore, I think that selfishness in the service of private property often generate efficiency. Communitarianism placed into service of private property generates cohesion, but may lead to inefficiency. "Underground" economy can be generated by any of us and especially by those whose altruistic feelings were not developed harmoniously in society. Selfishness, fundamental human trait, placed in service of no private property generates often corruption, the more the system is permissive and has a fragile structure.

I think the map below play its descriptive role, helping to justify the existence of "underground" economy but it should be noted that scientific analysis of the economy "underground" can be considered only in relation to the human condition since human nature is unknowable and we could not develop a model since we cannot identify a predictable behavior.



Source: Author's scheme is made based on their reasoning presented throughout this paper.

Figure 3. Arguments map that explain the existence of "underground" economy

Is "underground" economy source of economic development?

"Underground" economy explains the economic and social phenomena hard to imagine. Therefore the current problems may have resonance in the treatment of implications related to "underground" economy. The current economic system is run by a small number of people, as many believe today, it is based on a "concept that has become accepted as the last word: any growth is the benefit of mankind and higher this increase, the more popular are its benefits "(Perkins, 2007, p. 14). This belief spread the ideas that who contributes to economic growth have to be rewarded and idolized, and those who are born poor be exploited at the pleasure of those who control. The concept described above is completely wrong. As is known in most parts of the world, only a small part of the population benefits from economic growth while millions of families live with the care of tomorrow. United States spend over 87 billion dollars to carry the war in Iraq while the United Nations estimates that if we use less than half that amount, we could provide clean water, nutrition, sanitation and basic education each inhabitant of the planet.

Globalism, in view of Marin Dinu, expresses a stage in the evolution of interdependence in which an actor of international life has a role in the management of Planet resources (economic, cultural, military, scientific, political, etc...). Order resulting from the principle of polarization produces adversity (economic, ideological), closed political systems (state borders guarded by geographic, economic, ideological, and racial) or cooperation undermined national sovereignty (the divergent interests of states). Stage where we are in has a part (state) which controls the whole (world), managing discretionary global powers, exercises unilateralism and facilitates decisions leveling diversity (including cultural). It is obviously an architectural formula of life and the international regime reached by peaceful means (Dinu, 2008). Reducing extreme poverty by half till 2015 is just a wishful thinking, as beautiful as it is unattainable, because, as noted in the last decade of last century, rather than reduce poverty continued to grow, despite global income was increasing and, on the other hand, even this rate of only 0.7% of GDP of donor countries, as official aid dedicated to development, was not attained. Only five developed countries have reached and exceeded this figure in 2000, while the US contribution, the most powerful country in the world, was of only 0.24% Development Fund (Soros, 2002). The gap between rich and poor is growing both in absolute terms, the top global rich developed countries and millions of poor in less developed countries and in the relative mode in developing countries between elites and the majority made up of agricultural workers. In this respect some data are relevant: 1% of the richest people in the world as much as 57% of the poorest. Over one billion people live on less than a dollar a day. Nearly one billion lack access to safe water and 826 million suffer from malnutrition.

→ **Who is widening gap between rich and poor, between developed and developing countries?**

Similar data are supported by international bodies. UNDP Human Development Report of 1999 stated: 'With 30 years ago the gap between the fifth of the world's rich and poor world was 30-1 in 1990 he reached 60-1, and in 1999-82 to 1. Endorses the richest fifth 86% of the world and the poorest fifth only 1%.' From the few references to help promised by international institutions we find that the benefits of globalization for developing countries are small and the price paid is too large, both in the financial report and the economic and social imbalances, the deteriorating environment, reaching even to violence. During this landscape "underground" economy finds its deserved place as long as governments are unable to offer people more of their living.

Conclusions

Researchers suggest strongly that "underground" economy can be beneficial, as long as it serves to the proper functioning of the economic environment responding to the demand for urban and small craftsmen. From this point of view the "underground" economy provides entrepreneurship that can lead to increased competition, increased efficiency and strong barriers to government activities that facilitate or inhibit the manifestation of market instruments. "Underground" sector can help create markets, increase financial resources, enhance entrepreneurship and provide reservoirs for economic and social institutions. Natural selection between formal and informal, described above, may provide greater potential for growth, leading to a positive relationship between growth and "underground" sector growth. There are obvious beneficial effect of these expenditures on economic growth and income tax. Given all the above I consider that the right of "underground" economy to exist among the other sub-branches of economics is won, and the main argument consists in the evidence that "underground" economy is a source of development, support and even escape from the periphery for underdeveloped economies.

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