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UC Merced Undergraduate Research Journal

Title

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Permalink

<https://escholarship.org/uc/item/2352m70q>

Journal

UC Merced Undergraduate Research Journal, 10(1)

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Publication Date

2017

DOI

10.5070/M4101037224

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Undergraduate

GDP and Underground Economy (UE):

A Literature Review on the Mistaken Significance of Underground Economies

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Author Note

This paper was prepared for Writing 100, Section 01, taught by Professor Varnot.

Abstract

The significance of underground economies relative to a country's calculation of GDP was further examined under the assumption of the inclusion of them when performing this computation. Challenging the current methodology of GDP and how it's calculated, as done traditionally through assessing and measuring the following sectors of a country's economy: private consumption, gross investment, government investment, government spending, and net exports, the underground economy proves to be a worthy cause of further analysis, as it's assignment to any one sector may not be appropriate. Though illicit activities constituting the underground economy prove hard to examine with any level of certainty, the substantial benefits of inclusion deliver great advantages to a country. It is from these findings that have surfaced a greater issue with what is standard practice when calculating GDP. Though the underground economy is filled with a great level of uncertainty, findings suggest including it in the measure of GDP, but done so with caution, as there are risks of jumping to conclusions.

GDP Defined and Measured

To determine the true essence of where a country stands economically, economists have kept a standard of performing a single computation comprised of many sets of accumulated data. “The monetary value of all finished goods and services produced within a country’s borders in a specific time period,” according to (Investopedia.com), is what GDP is defined to be. Though this ideology may not be apparent to many, it’s an everyday reality for those who take on the responsibility of gathering such data. The extent of obtaining a single numerical value, GDP, poses to be quite a tedious process. Though the equation of GDP itself, stated in (1), may appear to be simplistic, it’s rather a very complicated process. It is within this equation, where consumer spending (C), government spending (G), a country’s investments (I), and net exports (NX) are accounted for. Things such as purchasing a new home, having social security, or buying a “Made in China” product, are all accounted for when carrying out this calculation. It is of great interest to many economists, to have a GDP that is of high value, however that desire isn’t one that can be achieved fully.

$$(1) \quad \text{GDP} = C + G + I + NX$$

Though the result of equation (1) gives economists a distinct numerical value, that might make believe to be representative of a country’s economy, it’s rather just an approximation. It is not a question of whether we can calculate a GDP, but rather coming to terms of how this might be an understatement in the works. By means of

observation, the largest market that exists, but remains unknown, is the underground economy. Yet, it’s position within GDP remains unclear, as researchers continue to explicate what currently exists already in regard to the UE.

This literature review will further discuss and analyze the significance that the UE has on a country’s GDP and overall well-being. Furthermore, from addressing the significance of the UE on a country’s GDP and overall well-being, possible indications become uprooted from founded significance, of why an established understanding needs to be developed in terms of the presence of government within a country.

Beneficial Means of the Underground Economy

Though a large majority of illicit activities (i.e. drug trade, prostitution, etc...), constitute the underground economy, there’s a positive side to this illegality. Activities that appear to be illegal and harmful, such as prostitution and drug trades, may be beneficial and helpful instead. Multiple studies conducted have comprised results in which an indication was formed about the underground economy proving to be beneficial to a country’s GDP despite activities being illegal. Existent from multiple attempts and estimations of an all-included UE GDP, the overlying founding was that GDP would increase by a significant amount (Dell’ Anno, 2016; Dobre, Alexandru, Lepas, 2010; Feige & Urban, 2008; Zumbun, 2014). According to these findings, it’s believed that there would be a greater benefit to the overall well-being

of a country. However, what's needed first is to obtain confidence in the accuracy of how we calculate the total economic activity, as there needs to be some convergence of information between the observed and unobserved portions of the economy (Feige & Urban, 2008). Disparities between the observed and unobserved are great, however, once convergence is established by economists, the future beneficial prospects from doing so may be more attainable. Aside from the benefit of having a country's GDP increase, there are many other counterparts of an economy that will thrive. Zumbrun (2014), who has analyzed the U.K. in regard to the UE, finds that a country will have a better grasp at keeping their nation's debt levels low or in accordance to set targets prescribed by the country itself. From levels of national debt being lowered, the ability to provide more public goods into the official sector then becomes possible, especially in countries such as Russia, where there is a heavy reliance of government assistance as poverty rates are continuously soaring (Timofeyev, 2013). It is within countries as such that have developed a dependency on the UE, where a mass creation of untracked and untaxed revenue exists. Schneider (2005), agreeing with this ideology, emphasizes that if we successfully address the UE by identifying its components, a reduction can then be made in the UE sector itself, creating an increase in tax revenues, government spending (i.e. public goods, services, etc.), and stimulating GDP to grow. By enacting the UE to be accounted for when measuring GDP, findings have indicated that the risk of measuring the

unknowns in a country may prove to be more beneficial than harmful to the country. However, even with this consensus of the UE being a greater cause to analyze, as it proves to have some beneficial effect to GDP, the computational means of UE in GDP is anything but easy to do, as the current methodology of GDP is the complete opposite.

Methodological Issues Encountered

Known by many economists, is the typical methodology of GDP where the four components, C, G, I, and NX are identified and measured. However, categorizing UE activities under these distinct subjects remains a complicated procedure to carry out successfully. With basic data collection on observable activities, given traceable numbers and statistics, GDP computation becomes an easy task to do. Feige & Urban (2008), disagree on the matter of treating UE calculations in consideration of traditional computations of GDP, where basic data collection programs would serve little purpose on illegal and informal activities examined. Because the UE is commonly stigmatized by activities such as prostitution, drug trades, etc., Zumbrun (2014) finds that some economists question whether measuring it would be any good to do so, because the practice itself challenges commonly held merits and methods that have been instilled in practice. Whether economists are ready to accept this refinement of measuring GDP, remains questionable, considering that a common rule of running a business it to remain a legal entity. Zumbrun (2014) furthermore finds that measuring the UE may end up

making GDP measures less accurate due to many temptations and risks of getting too theoretical or having high levels of skepticism. What remains, if UE is included, is an uncertainty that would be limitless. Dell'Anno (2016) believes otherwise, understanding that even with an uncertainty being present, there should still be a computation done, but done so with a great level of caution. Because there is no available or set data for the UE, every single figure that's calculated should always be considered an approximation, because there are many beliefs, disagreements, and inferences derived (Dell'Anno, 2016; Dobre, Alexandru and Lepas, 2010; Schneider, 2005; Zumbun, 2014). To ensure that a calculated GDP is more accurate, the convergence of new and old methods of measuring economic performance becomes a necessity to establishing new insights of the UE impacting GDP (Feige and Urban, 2008). What remains as a resolution to achieving this order, is to challenge the current methodology of GDP, relying upon being retrospective in analyzing the components that comprise GDP itself. Yet with great effort to include the UE, an ultimate distinction needs to be made between taking in as much information as you can, and the accuracy of the information obtained (Zumbun, 2014).

Current Methodology – An Understatement

The current methodology of GDP, through the observation of the observed in an economy serves as an understatement of what's going on in a country. Rather than tell us what's unknown in the economy, a

reinstatement is provided on the breakdown of activities within the official sector. Feige & Urban (2008), report that because key national currencies are instead held beyond domestic borders, we don't know how much money is in circulation or where domestic currency is currently at. Within the current methodology of GDP, measured through four observable components, C, I, G, and NX, many activities are unapparent or overlooked in the computational process. With these overlooked activities, issues such as unemployment and poverty rates may not be properly addressed, as the UE gives a reason as to why these issues arise (Timofeyev, 2013). Dobre, Alexandru, and Lepas (2010), also report that there is a direct relationship in the unemployment rates and the UE of a country. Thus, while the UE serves almost as a "haven" for those who have a dependency on it as a means of survival, as such in transition and developing countries, it's been found that an increase in inequality, increases the size of the shadow economy (Dobre, Alexandru, and Lepas, 2010). The challenges of measuring the UE may not be the biggest challenge of all, but rather a challenge within a bigger challenge. Findings have revealed that the growth of the UE is rather very much interconnected to the role and presence of government, where things such as foreign investments, taxes, and social security burdens, and especially the enforcement of laws and regulations, pose as indicators of a growing UE (Dell'Anno, 2016; Dobre, Alexandru and Lepas, 2010; Schneider, 2005; Timofeyev, 2013). Based off all these studies, the underlying significance to accounting for UE in

computing GDP may prove to be far more accurate than the current method in place, as then there will be more insight into what's happening in a country and from there, may reveal in great level of detail, long-term issues that have been existent or known, but never truly identified to a greater means.

Conclusion

The significance of measuring a country's GDP proves to serve as a measure of well-being, as it supposedly includes all final goods and services produced within a country's borders. However, patterns have shown researchers having trouble establishing and accepting this commonly held belief, as the underground economy remains questionable in terms of acceptability and validity. Although the many activities associated with the underground economy are illicit activities,

it's been found by researchers that the possible inclusion of these in a nation's GDP may prove to be beneficial to a country. From increasing a country's GDP to generating a greater influx of cash for use, there exists further development and expansion of a country's operations and management. Yet, because of traditional practices of performing a GDP calculation, the issue of UE inclusion in a GDP, continues to be of question. Findings indicate that the UE should be included in a country's GDP, as there serves an importance of doing so, especially for transition and developing countries. Thus, though the computation of a UE estimation may prove to be a tedious process, the benefits that come out from doing so, may outweigh the troubles of doing so, as this will ultimately lessen the gap of inequality, improve the presence of government in society, and increase GDP overall.

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