Talking point

Shadow economy defies crisis – year-end note with a wry pitch

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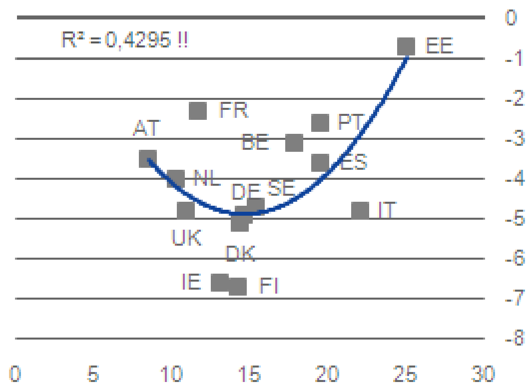
Germans simply cannot make up their minds. With close to 15% of its GDP being generated in the shadow economy, Germany muddles along at the European average. Germans are neither impeccably honest in their work ethic, like the Austrians, nor do they expend so much effort in circumventing the state as, for instance, the Greeks. One reaps what one sows: the economic crisis hit the indecisive Germans particularly hard with a 5% contraction of GDP. Going forward, there's probably only one solution: regardless of whether it is "good" or "bad", Germans should decide on one approach and stick with it.

The unofficial sector, the so-called "shadow economy", covers all economic activities performed beyond the cognizance of government authorities. These include both illegal activities (e.g. drug dealing) as well as the deployment of materials or labour (moonlighting) without an invoice. Moonlighting applies both to blue-collar tradespeople demanding cash for work performed without an invoice, and thereby avoiding paying taxes and social-security contributions, as well as to private tutors who also get paid in cash and whose activities are unknown to the authorities.

Impact of shadow economy on GDP growth in Europe



Horizontal: GDP generated in the shadow economy (%), 2009
Vertical: GDP growth (% yoy), 2009
Sources: University of Linz, DB Research

Since the end of the new economy crisis in 2003 the share of the shadow economy has decreased steadily in Germany, from just under 17% to 14.2% of official GDP. This year, the shadow economy is set to grow again for the first time since 2003, to as much as 14.6% of GDP according to researchers at the University of Linz. For Germany, this reading corresponds to EUR 352 billion worth of output being generated outside the scope of the official national accounts and thus of the tax office. In theory, it is simply a toss-up whether the shadow economy gains significance in a crisis. And it is equally a toss-up whether a large shadow economy fundamentally mitigates or exacerbates the vulnerability of the official economy to crises. Empirically, though, it seems quite obvious: countries with a very high or very low share of activity in the shadow economy appear to be much less affected by growth fluctuations in the world economy than countries displaying a more or less average intensity of shadow market activity. For instance, the GDP of countries with a particularly honest (in the sense of "large official") working population (such as Austria, France or the Netherlands) is down this year by merely 2-4% yoy. The reading is even better in countries such as Greece or Portugal where additional production equal to nearly one-quarter of official output comes from the shadow economy. The GDP of these countries has shrunk this year by only around 0.7% and 2.6%, respectively. By contrast, countries in which the population cannot really decide whether it wants to offer its labour "honestly" in the official economy or rigorously off-record are hit particularly hard. This includes Germany, Ireland and some Scandinavian countries whose shadow economies equal around 15% of GDP. These countries have seen their GDP plunge by around 5% in 2009, and in the case of Ireland and Finland by over 6.5% in fact. Our chart shows that the most unfavourable level of shadow market activity is 14.3318% of official GDP. So, at 14.6%, Germany is virtually on the brink of the worst-case scenario.

This apparent relationship suggests several conclusions may be drawn. First of all, it looks absolutely advisable to decide for one side of the coin or the other: Germans should either all join the official workforce as of today, virtuously paying their taxes and social-security contributions on wages obtained or paid, or they should follow the example of such successful countries as Greece (in this case not just employing a moonlighting painter to do the living room, but instead to build the entire house without government involvement). In any event we should, by way of exception, not gear our conduct to Europe's model players such as Sweden, Denmark or Finland.

Which path of the two is the right one for Germany, though? The answer is simpler than one might expect: honest work does pay off! For one thing, people should have learned from the economic crisis that only morals and decency are the key to sustainable business activity. For this reason alone, Germans should exhibit a greater degree of honesty vis-à-vis their tax officials. For another, the foregoing analysis makes one thing quite clear: had Germans generated a negligibly small share of GDP in the shadow economy to the degree that the performance of France, Austria and the Netherlands paled in comparison, Germany would presumably not have fallen into recession. On this note, may you have a Merry Christmas!

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