

Econbrowser

Analysis of current economic conditions and policy

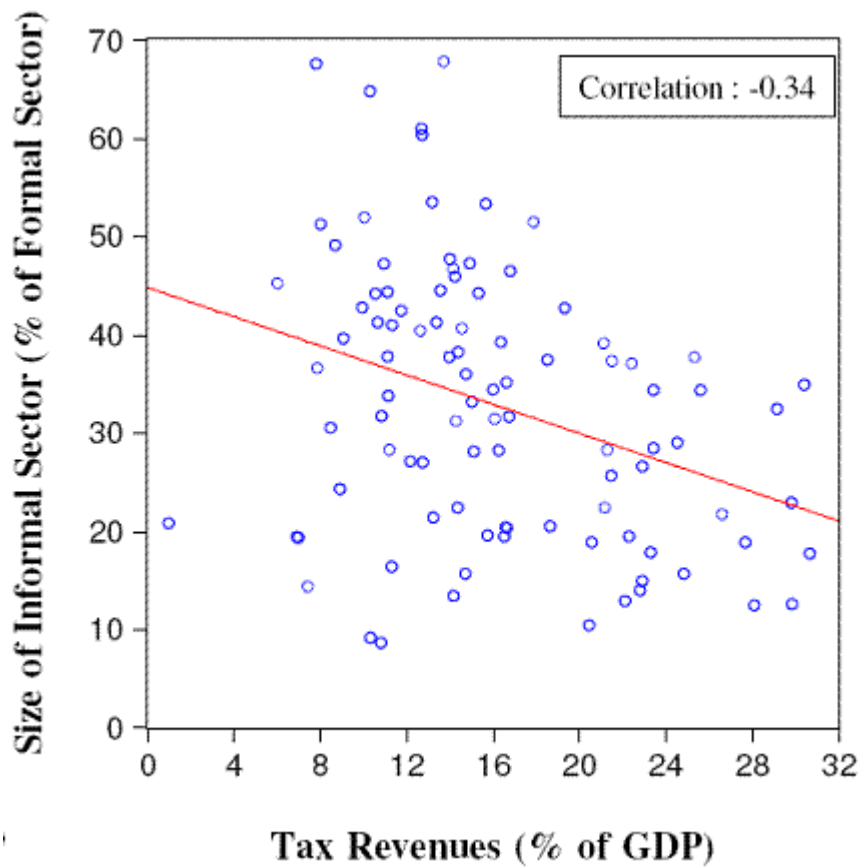
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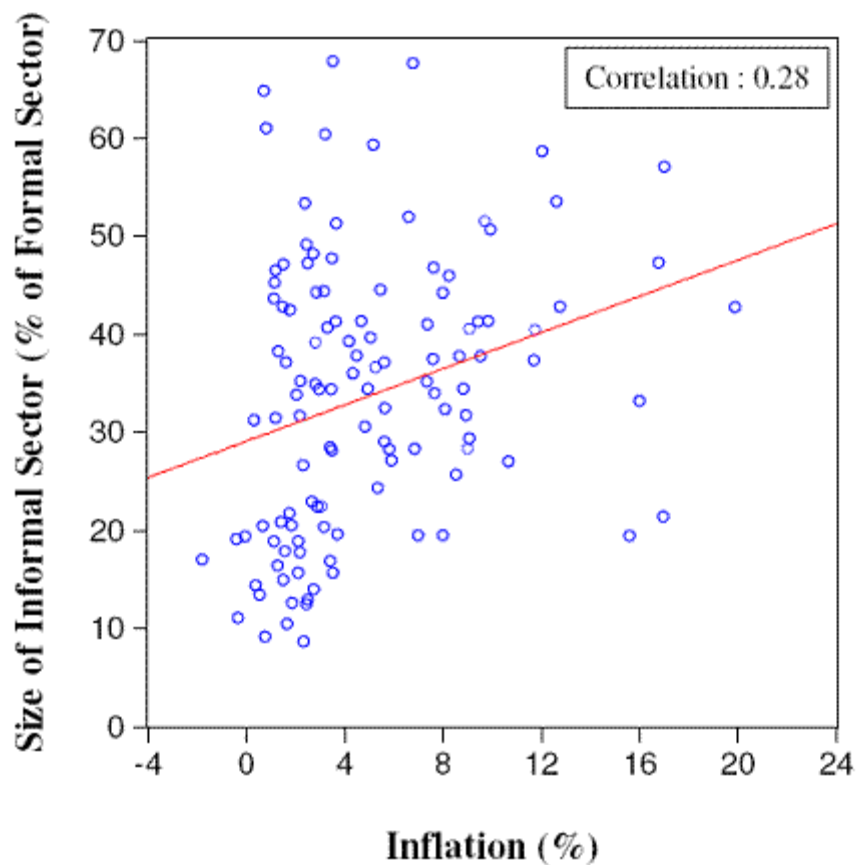
May 16, 2010

Inflation, taxation, and the underground economy

University of Maryland Professor Boragan Aruoba (of the [Aruoba-Diebold-Scotti Business Conditions Index](#) fame) has an [interesting new paper](#) that offers another perspective on the challenges facing Europe.

[Aruoba's paper](#) notes some interesting regularities in a data set of 118 different countries. One measure he looks at is the size of the underground economy in different countries. If you carry out your business in the underground economy, you will benefit by avoiding taxation, but you lose the legal and contract protection that you would have had if you'd instead been working in the formal sector. If only the first effect mattered, you'd expect to see countries with higher tax rates have a greater role for the informal sector. But Aruoba finds just the opposite-- the bigger the informal sector, the lower tax receipts as a percent of formal-sector GDP. Aruoba attributes this to the fact that in countries with better legal institutions, the benefits of conducting business above board outweigh the taxation costs, and the governments can afford to raise more of their revenue through traditional taxation.

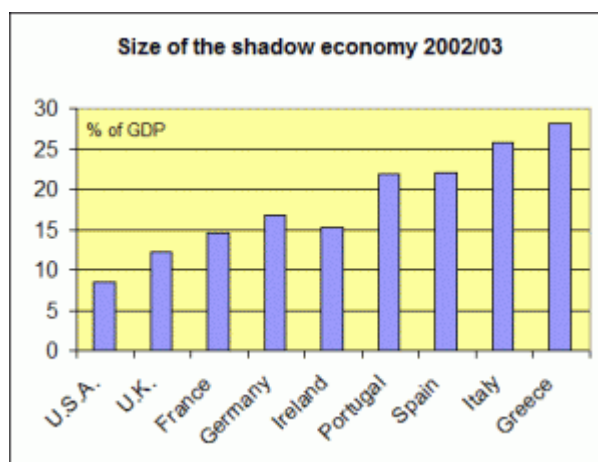




Source: [Aruoba \(2010\)](#)

Aruoba's interpretation is that the weaker a country's institutions, the greater the attractiveness of the informal sector, and the more the government is likely to rely on inflation rather than standard taxes to raise revenue.

I was thinking about these correlations as we all ponder the storm clouds over Europe. Joining a common currency unit means losing the ability to adapt monetary policy to your own country's cyclical conditions. But it also means surrendering to your neighbors' long-run mix of formal-sector taxes rather than inflation as a source of government revenue. Here's an estimate of how the size of the informal sector differs across the countries in the news at the moment.



Source: [Multiplier effect](#)

[Tyler Cowen](#) thinks those bars look unsettlingly like dominoes.

Posted by James Hamilton at May 16, 2010 06:37 AM

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When looking at the convergence report of the ECB

"Over the 12-month reference period from April 2009 to March 2010, inflation was very low in the EU as a result of negative global price shocks and the significant downturn in economic activity in most countries. In line with the approach followed in previous reports, the inflation rate for Ireland has been considered an outlier and has therefore been excluded from the calculation of the reference value. Over the reference period average HICP inflation rates were below the reference value in the Czech Republic, Estonia and Latvia, whereas in the other six countries inflation was above the reference value, with the largest deviations being observed in Romania, Hungary and Poland."

Or P !9 prices

<http://www.ecb.int/pub/pdf/stapobo/spb201005en.pdf>

Should you try to retrieve the inflation statistics, from the Bank of England please follow the instruction and payment request as hereunder:

<http://www.bankofengland.co.uk/publications/inflationreport/prices.pdf>

Not to omit that one should have first perused this thread so much alike the ECB

<http://www.bankofengland.co.uk/publications/inflationreport/index.htm>

Suspecting that the last official reported inflation as of April 2010 was around 3.4% shall we conclude that there is :

An underreported underground economy in UK and in Ireland
and underreported inflation in Europe?

Posted by: [ppcm](#) at May 16, 2010 07:59 AM
