

NEW ESTIMATES OF THE BLACK ECONOMY: UNDER-REPORTING OF INCOME BY THE SELF-EMPLOYED IS OVER 10% OF UK GDP

'Black economy' activities by self-employed people in the UK amount to 10.6% of GDP, according to new research by **Panayiota Lyssirotou**, **Panos Pashardes** and **Thanasis Stengos**, published in the July 2004 *Economic Journal*.

Their analysis of under-reporting of income by the self-employed suggests that:

- Households whose heads are in blue-collar occupations on average report only 46% of their income.
- Households whose heads are in white-collar occupations on average report only 61% of their income.

Estimating the size of the black economy is important for assessing the seriousness of the problem and for the correct measurement of GDP and employment. In general, empirical approaches to estimating the size of black economy activities rely on economic relationships thought to contain information about such activities.

This study uses the relationship between demand for goods and the level of household income estimated from data drawn from the Family Expenditure Survey (FES). To the extent that certain household groups – such as the self-employed – under-report their income, their expenditure pattern would resemble the expenditure pattern of better off households known to report their income correctly – such as civil servants.

The method this study uses to estimate the size of the black economy improves on previously used methods mainly because it safeguards against wrongly attributing to under-reporting of income the observed differences in spending behaviour that are caused by differences in household preferences. The researchers show that failing to account for this can understate the size of the black economy.

The results indicate that self-employment income reported by blue collar households needs to be scaled up by a factor of 2.18 to correct for under-reporting; whereas the corresponding figure for self-employment income reported by white collar households is 1.64.

Considering that reported self-employment income is around 12% of GDP and that blue collar households account for nearly 46% of reported self-employment income and white collar households for over 54%, the estimates suggest that self-employment related black economy activities in the UK amount to 10.6% of GDP.

The researchers note that the black economy, broadly defined as the economic activities that are hidden from public authorities to avoid taxation, undermines the financing of public goods and social protection.

At the same time, a country trying to curtail the loss of tax revenue by raising tax rates can create a vicious cycle, as this reinforces the incentive not to declare economic activities to the public authorities.

There can also be distorting effects due to unequal opportunities and willingness to evade in different sectors of the economy and because individuals working in the black economy may be unwilling to move from one job to another.

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Note for Editors: 'Estimates of the Black Economy Based on Consumer Demand Approaches' by Panayiota Lyssiotou, Panos Pashardes and Thanasis Stengos is published in the July 2004 issue of the *Economic Journal*.

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