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Economic crisis and "white informal economy" – a slippery slope

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Abstract

Purpose – The purpose of this paper is to demonstrate the importance of studying the quasi-legal forms of informal economic behaviour that we know as the white informal economy. The paper also sheds light on the role of the informal economy in the financial crisis that started in 2008. Finally, the aim of the paper is also to encourage empirical research about these concepts.
Design/methodology/approach – The paper is theoretical and based on a literature review.
Findings – The paper implies that when discussing about informal economy, different sub-categories should continue to be used in order to distinguish the various forms of informal economic practices. There is a particular need for research on practices of economic activities that are legal but not always moral, yet severely damaging. For such activities, the authors propose the term/categorisation the "white informal economy". Additionally, the authors argue that in the causal links of events that brought about the financial crisis the role of the white informal economy was significant.
Practical implications – The paper wishes to encourage further research on the topic of (white) informal economy that in turn would also create the scenario for proper policy development for tackling tax avoidance, tax evasion and future financial crises.
Originality/value – The paper adds to scholarship that takes a critical standpoint towards the financial crisis and to scholarship on the informal economy. It presents an attempt to stimulate further discussion about the connectivity of the informal economy and the financial crisis.

Keywords Economic crisis, Informal economy, Tax avoidance, White informal economy

Paper type Literature review

Defining the concepts

In order to stimulate recovery from the recent economic crisis, States began to search for funds that would end the liquidity crisis. In this, they turned to austerity policies and started tackling informal economy even more strongly (Schneider and Buehn, 2012; see also Keeler, 2009). Taking "a step backwards", the issue that we wish to address in this paper is whether the informal economy actually played any part in the events that caused the crisis itself and whether it is prolonging it.

Two main terms are key to our argument. These are the (white) informal economy and economic crises, the latter of which is almost interchangeably used with the term financial crisis. The latter Aizenman (2009, p. 424) defined as "a rapid financial disintermediation due to financial panic. In practice, this involves a 'flight to quality', where savers attempt to liquidate assets in financial institutions due to a sudden increase in their perceived risk, moving their savings to safer assets, such as foreign currency and foreign bonds in open economies, or currency, gold, and government bonds in closed economies. The ultimate

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manifestation of financial crises includes bank failures, stock market crashes, and currency crises, occasionally leading to deep recessions". This came true in the post-2008 era where the world was plunged into recession especially due to lack of trust in the banking sector. The public discourse in some States showed that informal practices (such as keeping funds "hidden in a drawer of socks") are seen as better than risky formal institutions ("keeping funds in banks, which play with our money").

The recession and austerity also stimulated the perception that the informal economy would increase in these times (see Colombo *et al.*, 2014). The research conducted by Schneider and Buehn (2012) shows that in some countries the shadow economy actually did increase in times of crisis, but in others it has fallen. This is logical, as the driving forces that they discovered (such as unemployment, taxes, etc.) that have a positive effect on the informal economy usually strengthen in such times (Schneider and Buehn, 2012). Yet on the other hand, due to austerity, less commodities and services can be afforded even if purchased "off the record". A variety of terms have been used for the informal economy, e.g. hidden economy, grey economy, black economy, unreported economy, shadow economy, etc. (Gërxhani and Feige, 1999; Henry and Sills, 2006; Schneider, 2011)[1]. This in a way indicates the ambiguity of the concept. Some authors see the informal economy as comprised of otherwise legal activities and profits from these activities, but which are hidden from State authorities and so are unregulated (see Gërxhani and Feige, 1999; Cross, 2001; Rutherford, 2007). Other authors also include illegal activities and profits from such activities. That is, they include the so-called "criminal economy" (see Ruggiero (2000) on the criminal economy). We share such views, since funds always travel from one sphere of the economy to the other. Its logical that criminals would use part of the profit to buy legal goods such as food, cars, pay rents, etc., just as it is logical that average working people would buy counterfeit goods or pay for sexual services with money that they have earned in their legitimate jobs (see van Duyne, 1996; Selinšek, 2006).

The informal economy is nowadays often (but wrongly) seen as a place where only low-skilled work is done, where payment is made with cash, etc., and which in general presents a safety net for the poorest. However, several scholars (e.g. Gërxhani and Feige, 1999; Schneider, 2008) have shown that the informal economy appears in both less-developed and highly developed countries and that it is a tactic for enriching (or hiding) funds and not merely a method for earning funds for survival[2]. The lack of consensus and perceived complexity of the spheres of the (in)formal economy motivates us to provide a model that will categorise these different views. After some analyses (Dobovšek and Slak, 2016b), we propose a model of the informal economy which consists of white, grey and black segments. The comparison and differences between the segments can be seen in Table I.

The table is for illustrative purposes only and it should be kept in mind that the boundaries among categories are extremely blurred, especially because there are further questions about the informal economy that need to be addressed in the future[3]. Since black and grey segments are fairly common in the discussions about the (in)formal economic spheres, the white segment deserves some more attention. As argued in Dobovšek and Slak (2016b), the white segment of the informal economy is similar to Henry and Sills's (2006, p. 264) "informal unofficial economic activity"[4]. The crucial point is that activities or profits derived from these activities are legitimate in all ways, yet the latter are protected from taxes, confiscation or just further enriched with various questionable yet not illegal creative financial (accounting) measures (Dobovšek and Slak, 2016b). Examples range from cases of simple methods of hiding funds against confiscation (by e.g. transferring them to close relatives) to complex but legal schemes used for tax avoidance. The latter is a particularly pertinent example as to why the white informal economy deserves special attention since the funds involved are usually not that small.

Segment of informal economy	Examples	Legality of activities from which funds originate	Regulation	Taxes
Black[a]	Profits from drug trafficking; or prostitution and other crimes	Illegal	Non-regulative	Unreported
Grey	Off-the-record car repairs; tax evasion	Legal	Striving towards regulation	Unreported
White	Tax avoidance[b]; funds concealment	Legal	Week regulation	Semi-reported (as includes tax oases and creative accounting)

Notes: [a]In the literature this would often be labelled as within the criminal economy; [b]we agree with the definition of tax avoidance given by Richardson *et al.* (2015, p. 44) who see tax avoidance as "tax planning activities that are considered to be aggressive in that they are designed to actively reduce taxable income by exploiting uncertainties or variability in the interpretation of the tax law, taking advantage of areas of the tax law that may fall into the gray area, undertaking arrangements or schemes designed to actively reduce corporate tax liabilities in addition to activities that are illegal"

Table I.
Comparison of the segments of the informal economy

The Tax Justice network (2015) has shown that the losses due to tax avoidance are up to three-digit billions.

The grey sub-category of the informal economy is undoubtedly the broadest category and activities that fall in this category are the most frequently occurring. They range from off the record (with cash-in-hand payment) of house or car repairs, or personal tutoring, to off-the-record production of goods or services (Losby *et al.*, 2002). Yet it is the white sub-category of the informal economy where losses to the state budget are biggest. Besides the considerable financial losses, the fact that there is an even stronger lack of political interest in these issues, lack of investigative knowledge and lack of proper legislation in regard to dealing with these issues of the white informal economy can present a motivational factor for perpetration of these acts that are financially very rewarding for the perpetrators. The debate we wish to encourage is somewhat similar to that started by Keen *et al.* (2010) or Palan *et al.* (2010) on the role of taxes in crisis. Keen *et al.* (2010) writes that tax distortions have had an impact on the financial crisis as taxes were a strong background factor influencing the behaviour of financial institutions and actors. The similar discussion by Palan *et al.* (2010) also showed that tax havens and offshore funds (and experts employed there) have significantly helped in the whole questionable securitisation process as their flexibility has speeded up legislation or actually enabled the processes. There are even some politicians who have voiced their "concerns" that shadow banking and tax havens have played a part in the course of events that brought about the financial crisis (Keeler, 2009).

The role of the white informal economy in the crisis

Several factors have been seen as responsible for the crisis that started in 2008. From the irresponsible financial behaviour of US households, or the thrift of exporting countries, "the bankers who took the upside and left the downside to the taxpayer; the politicians who tried to expand their vote banks by extending homeownership to even those who could not afford it; the markets that tolerated high leverage in the boom only to become risk averse in the bust […] The list goes on." (Rajan, 2009, p. 400). However the lack of regulation has more recently been found to be the most crucial cause (Ferguson, 2010; Fisher *et al.*, 2011; Keeler, 2009; Mitchell, 2011; Pontell, 2005; Tomasic, 2011; Willett, 2010)[5].

In the post-1930s depression in the USA, the Keynesian economic policies and the Glass-Steagall legislation presented a solid framework to safeguard society from the irresponsible behaviour of financial power players. Regulation guarded against moral hazard which, unstopped, often leads to financial crisis (Aizenman, 2009). When economies returned to a somewhat stable state after they collapsed in 1929, the framework was again being slowly demoted, most strongly with the emergence of neoliberalism.

We – and here we agree with Plehwe *et al.* (2006) – see neoliberalism as a set of ideas (perhaps even philosophies) that state that self-regulating competitive markets and a rational *homo economicus* who strives to serve his/her own interest are also best for the whole society itself (see also Golob *et al.*, 2009; Harvey, 2007 for discussion on neoliberalism). The role of the state is to enable free markets or even to create markets where there are as yet none "such as land, water, education, health care, social security, or environmental pollution" (Harvey, 2007, p. 2) and to liberate the economic and financial sectors from the "shackles of regulation". And though the economic crisis showed that regulation must be present, the neoliberal ideology continues to dominate as an economic policy. Regulation is therefore the first connection of informal economy with the crisis. The neoliberal view that regulation is a hindrance to financialisation (securitisation) and economic development (Hetzer, 2012; Sikka, 2015) motivated the desire to repeal regulation and this action eventually led to the financial crisis of 2008. Similarly regulation is seen as one of the reasons why actors engage in the informal economy (Jones *et al.*, 2006; Schneider, 2008). The similarities do not stop there. For instance, both with the informal economy and for actors that caused the financial crisis, there is a frequent usage of "subsidiaries" or legal missing trades/straw firms that are located in tax havens. One scheme for tax avoidance is selling patent rights using subsidiaries of which some are located in tax havens (Bowers, 2014; Fisher, 2014). And so prominent banks and financial institutions used "subsidiaries", hedge funds and other business entries located in tax havens for their trading in Collateralized Debt Obligations "products" (Keeler, 2009; Palan *et al.*, 2010), the products that were at the heart of the problem that caused the crisis. Using derivatives and other methods for masking risk and debt that occurred prior to the 2008 crisis (Sikka, 2015) is also similar to creative accounting techniques used in the informal economy, indicating that (white) informal economy techniques were used. And at the end, if not earlier, informal economy mechanisms came into play after the events, when funds that during the crisis involved actors had earned needed to be enriched or protected against confiscation[6]. Funds were moved to tax havens where they remained safely in waiting for the re-use by perpetrators (or their families) (see Palan *et al.*, 2010). We see the existence of such tax havens jointly with other complex financial methods of doing business as a form of incentive, as facilitating factors (or decreasing deterrence) as discussed in various criminological theories.

Moreover, to what degree would funds from the informal economy (e.g. funds hidden in tax havens) loosen austerity measures? It is logical that they might do so, and what Saraç and Başar (2014) have shown is that the countries with a larger extent of the informal economy have suffered the greatest damage through the crisis. The evidence shows that the financial crisis has stimulated tax avoidance to an even greater extent, because the financial crisis has had a negative impact on firms as well, so firms have become even more motivated to engage in tax avoidance (Richardson *et al.*, 2015), and so damaged state budgets. In this circle, due to austerity, buyers buy less of products/services of some firms that engaged in tax avoidance, causing a further loss of profit exactly because in the first place firms did not pay their share of taxes. Given this loss, States are forced to recalculate their budgets and raise taxes, leading to further austerity, cutbacks, etc., and this again motivates people and institutions to engage in informal economic practices.

We then can see that the informal economy had dual roles when it came to the crisis. First, informal economy schemes (e.g. those including tax havens and offshore centres) were used to acquire actual funds and second in some cases were later on used for laundering or hiding money gained in deviant, delinquent or even criminal acts (Hudson, 2013).

This can be somewhat attributed to the consensus that the informal economy provides a hidden funds reserve which has (at least politically and at a first glance) motivated the global fight against the informal economy, tax havens, etc. That such big funds really are hidden in tax havens is evidenced in research and from investigative journalism. For instance the International Consortium of Investigative Journalists (2015) has developed an interesting database in regard to world money trails that showed how the biggest companies avoided taxes[7]. These sources indicate that funds are so extensive that in some cases taxation of these funds would end austerity altogether. Admittedly, the secrecy around these centres and actors makes it very difficult to have an accurate assessment of these funds.

The question here of course is if corporations actually have any social responsibilities, rather than just having business-oriented (profit maximisation) goals (see Fisher, 2014). Views about the role of the economy and social effects on the economy (see Golob *et al.*, 2009 for an interesting discussion of the social economy) are usually a reflection of the economic theory that one believes is applicable. In our opinion, corporations should be held accountable for some social responsibilities. They use state infrastructure, gain employees with know-how obtained in state colleges, use medical services in case of accidents or if their employees have (health) problems due to the nature of the work. They exploit the environment even though perhaps they own a part of the land this exploitation pollutes the nearby air, waters and lands, etc. Several other products and services built and funded from the state's budget are also used in the course of private firm production. And though the presence of a strong business enables employment and has certain financial benefits to the region, the question is always whether these businesses give back enough to the region? Here a common idea is to lower taxes to attract more business, yet the mere presence of strong businesses in a country with low corporate taxes does not always positively reflect on the well-being of the population, as the cases of Ireland and Cyprus have shown.

Epilogue

We can conclude that the white informal economy is continually escaping control. So tackling the white informal economy would also mean tackling tax havens, tax avoidance and even tax evasion. And these are all possible because of weak regulation, lack of transparency and control. Yet we must be careful with regard to exercising control. If one invests only in repressive measures (fiscal and regulatory policies in a formal economy), the greater is the incentive for companies to relocate their assets to the informal economy and to use corruption to grease the development of legislation in their favour. Proper post-crisis responses (e.g. proper taxation of the richest, proper bank legislation, etc. (see George, 2015) or shaming of tax avoiding companies (Fisher, 2014)) are measures equally possible for tackling the white informal economy, yet these measures sound radical in the ears of most economists and politicians. Nevertheless, they seem to be common sense and a guarantee against exploitation of loopholes by too-big-to-fail or other power structures[8]. We therefore propose that more light needs to be shed on the issue(s) of the white segment of informal economy. Financial, accounting and other economically themed schemes from this segment are connected to financial crises, tax evasion, tax avoidance, etc. and proper knowledge and understanding could help to develop preventive measures or to show why proper policy development is lacking. If nothing else it would give investigative journalists some more tools to use in their investigations. We do however know that such research will be difficult since even the grey and black segments of informal economy lack global consensus, and even a proper agreed definition. In our discussion, we have left out the issues of classical crimes done by those that were involved in the events that caused the financial crisis. These crimes ranged from crimes perpetrated to earn capital for entry into the securitisation market, predatory lending, Ponzi schemes, bribes, etc. We have also omitted discussion in relation to how funds that were earned were used in the black informal economy (for instance to buy high-end escort or prostitution services, cocaine, etc.), all of which are issues that also need research attention.

Notes

1. The work of Gërxhani and Feige (1999), Frey and Schneider (2000), Schneider (2008, 2011) and Schneider and Buehn (2009) are very informative on the informal economy. For a short summary see also Saraç and Başar (2014).
2. Kuehn's (2014) work shows that in high-income countries, tax evasion is a significant motivator for engaging in the informal economy.
3. Some questions that need prompt attention are, first, how to characterise the profits that occur in the "twilight zone between licit and illicit. For example, illicit white cigarettes, which are legally produced in one country and illegally smuggled to othe/ […]; or firearm replicas which, when manipulated, can become illicit firearms" (Savona and Riccardi, 2015, p. 10). Second, there is the situation where cases of formal businesses employing homeworkers or sole proprietorship businesses fall into the informal economy in order to cut operational costs (see Cross, 2001). Should help among neighbours that beneficially contribute to social ties among people be considered a part of the informal economy? If so, to which segment do they belong? We agree that some of these questions were at least partly answered in discussions on the grey and black informal economies (see Gërxhani and Feige, 1999 or Schneider and Enste, 2000) yet there is still a need for more consensus.
4. Aimed as "to get around rules and processes typically not using money but favours, privileges and perks as a means of exchange. They are not parasitic, nor illegal, but not a formal part of policy or practices of an organization" (Henry and Sills, 2006, p. 264).
5. Risky behaviours of top (too-big-to-fail) economic players have occurred (and been encouraged) under the presumption that the state will cover the loss (Aizenman, 2009). As it was discovered after the crisis of 2008 began, economic behaviour in the crisis involved actors and their business practices that presented a factor in a causative chain of events that as it moved into the crisis showed signs of typical white-collar criminality and corruption (Geis, 2011). But also present was conflict of interests (Ferguson, 2010; Federal Bureau of Investigation, 2011), irresponsibility (Brown *et al.*, 2010) and other various types of damaging behaviours (see Dobovšek *et al.*, 2015; Dobovšek and Slak, 2016a). Some even go so far as to characterise the whole mortgage bubble and securitisation market as a Ponzi-scheme (Mah-Hui, 2008; Patterson and Koller, 2011; United States Senate, 2011).
6. Bernie Madoff, one of the most successful Ponzi-schemers, was exposed due to the crisis as the liquidity shortage and run on funds of his "investors" caused the scheme to collapse. According to Hudson (2013), financial institutions turned a blind eye towards Madoff's questionable business practices, some of which were connected to tax havens. Madoff was not the only one who has been prosecuted for financial crimes that were revealed due to liquidity problems (see Freeman, 2010; Tomasic, 2011 for some additional information).
7. See also Bowers (2014) and Palan *et al.* (2010).
8. As Sikka (2015) noticed, the lack of regulation enabled the development of such too-big-to-fail institutions. Due to light touch regulation banks and other institutions dealing with financial products accumulated extensive capital, and became centres of country stability since they gained ownership of many important firms and by that, also gained informal influence, etc.

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