

NEW ESTIMATES FOR THE SRI LANKAN SHADOW ECONOMY, 1990-2015

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Shadow economy reflects a part of economic activities involving goods and services which are paid for by cash but not declared for either taxes or government regulations. It distorts and undermines the true picture of public finance and discourages the labor force who works in the formal economy. This study attempts to refine both theoretical and methodological paths of estimating the size of the shadow economy in a developing country. A theoretical model has been developed adapting the models by Hall (1979) and Dell'Anno and Solomon (2008). The investigation has observed and justified the possibility of using the rate of underemployment as a newfangled determinant to estimate the size of shadow economy. Further it reveals that the relative magnitudes of job finding rate (f) and a damage/devaluation of job separation rate (f^*) can change the nature of relationship between the rate of underemployment and the size of shadow economy. Empirical investigations used Multiple Indicator Multiple Cause (MIMIC) models to estimate the size of shadow economy in Sri Lanka. Two fitted MIMIC models (MIMIC 5-1-2a and MIMIC 7-1-2) are used for 'Benchmark' calculations and derive a series of average values for Sri Lankan shadow economy for the period 1990-2015. Calculations for both models vary around 40 percent of GDP with a decreasing trend. Further comparisons reveal a strong positive relationship between shadow economy with both underemployment and self-employment. Significant improvement of self-employment; especially in informal market, it strengthens people to avoid government tax collectors. 'Invisible underemployment' stimulates people to work with shadow economy. Moreover, taxes on goods and services (indirect taxes) are given a significant positive relationship due to higher burden levied on peoples' purchasing power parity. The contemporary conditions of Sri Lankan labour market imply a decreasing trend of the rate of underemployment. The government can maintain this trend to decrease intensity on people for becoming a part of shadow economy. On the other hand, government should continue their framework to decrease the number of self-employed people from the informal sector and to encourage them to engage with formal, regulated market economy. At the same time, self-employed people from official economy should be clearly accounted under the government tax collectors. Therefore, while giving further concern on the reasons and setting of the unobserved economy, government can find alternatives to improve their tax revenue without burdening consumers' dignity with rigid tax rates.

Keywords: Shadow economy, Underemployment, Structural relationship, MIMIC models, Benchmark calculations