

## **UNEMPLOYMENT, OFFICIAL ECONOMY AND DIMENSIONS OF THE SHADOW ECONOMY: AN EMPIRICAL ANALYSIS FOR SRI LANKA USING SEM APPROACH**

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Economists and policy makers confront a series of issues when accounting all unobserved market fractions in a challenging market economy. These challenges have become worse within complex market structures in developing economies. One of these challenges is the expansion of unobserved and unofficial economic activities which is generally known as the 'Shadow Economy'. This study basically attempts to estimate the Sri Lankan shadow economic activities as a percentage of official estimates, while revolving the wheel of non-clarified zones and market functions through overstepping the traditional official estimates.

Objectives of the study are addressed through three equally important portions. Initial portion intend to choose and develop suitable, fitted MIMIC (Multiple Indicator Multiple Cause) models while using the structural relationship between the unemployment rate and shadow economy to estimate the size of the shadow economy in Sri Lanka. Then the following portion is to estimate shadow economy for each fitted model through benchmark calculations. Finally, to examine if estimated models and their calculations are accepted by re-examination of Okun's law and to contrast estimated results in growth terms to the growth of official estimates (GDP) of the economy. Therefore, the methodology involves the estimation of structural equation models, which analyses a set of causes of the shadow economy while simultaneously taking in to account its influence upon a series of indicators. This study introduces three MIMIC models through the analysis that are MIMIC 5-1-2a, MIMIC 4-1-2b and MIMIC 3-1-3a. Then the benchmark calculations for each model derives a series of average values for the Sri Lankan shadow economy from 1990-2012. Calculations for MIMIC 5-1-2a vary between 91% and 32% from 1990 to 2012 with a decreasing trend. On the other hand, calculations for MIMIC 4-1-2b and MIMIC 3-1-3a demonstrate the average size of shadow economy between 14% and 52% with an increasing trend.

Further discussions, therefore, reveal the fact that, the effect from tax on goods and services to the government revenue and the effect from public employment tend to undermine the increasing pattern of shadow economy in Sri Lanka. Since unemployment rate and private employment plays a major role in economy, shadow economy tends to increase. Eradicating the workplace enforcement crisis and underemployment issues may hinder the increasing pattern. Ultimately, the results from re-examination of Okun's law give a hint that the growth of shadow economy and official economy are not interdependent and have a parallel growth with shifting stages in market functions.