EU Twinning Project JO/13/ENP/ST/23
Component 1: National Account

Underground Economy Informal and Illegal sector
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Summary

1. General framework
2. Informal enterprises
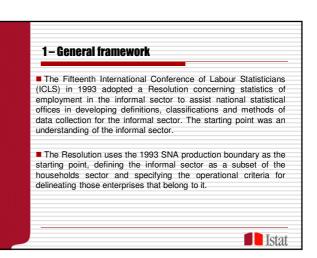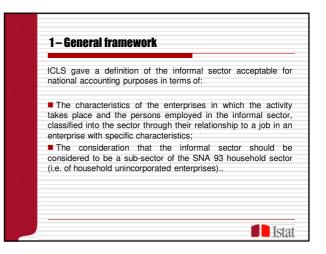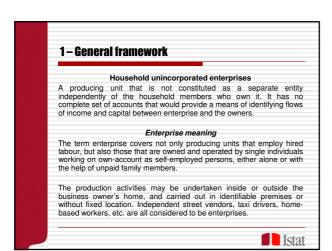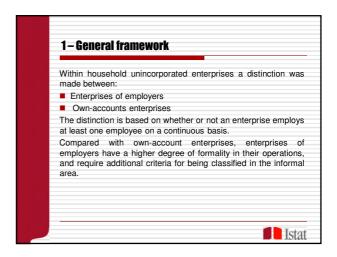3. Own use

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1 – General framework

It represents an important part of the economy mainly in the developing countries and plays a role in the employment creation, production and income generation.

According to SNA93, an independent account can be compiled using the same principles and procedures as for household sector account elaborated in United Nations (2000).
The vast majority of informal activities are perfectly legal.

Some underground production is originated from enterprises which belong to the informal sector. But although informal sector and underground activities may overlap, the concept of informal sector is different for the concept of underground production.
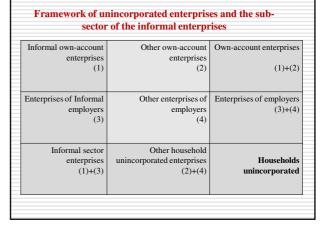
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1 – General framework

■ The Fifteenth International Conference of Labour Statisticians (ICLS) in 1993 adopted a Resolution concerning statistics of employment in the informal sector to assist national statistical offices in developing definitions, classifications and methods of data collection for the informal sector. The starting point was an understanding of the informal sector.

■ The Resolution uses the 1993 SNA production boundary as the starting point, defining the informal sector as a subset of the households sector and specifying the operational criteria for delineating those enterprises that belong to it.

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1 – General framework

■ The ICLS resolution recognised also the activities excluded from the scope of the informal sector were not necessarily formal.

■ Examples are the household non-market production of goods, small-scale agriculture, paid domestic services, and activities falling outside SNA 93 boundaries, such as domestic or personal services provided by unpaid households members and volunteer services rendered to the community. It was recommended that such activities should be identified as belonging to a separate category.

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1 – General framework

ICLS gave a definition of the informal sector acceptable for national accounting purposes in terms of:

■ The characteristics of the enterprises in which the activity takes place and the persons employed in the informal sector, classified into the sector through their relationship to a job in an enterprise with specific characteristics;
■ The consideration that the informal sector should be considered to be a sub-sector of the SNA 93 household sector (i.e. of household unincorporated enterprises)..

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1 – General framework

Household unincorporated enterprises

A producing unit that is not constituted as a separate entity independently of the household members who own it. It has no complete set of accounts that would provide a means of identifying flows of income and capital between enterprise and the owners.

Enterprise meaning

The term enterprise covers not only producing units that employ hired labour, but also those that are owned and operated by single individuals working on own-account as self-employed persons, either alone or with the help of unpaid family members.

The production activities may be undertaken inside or outside the business owner's home, and carried out in identifiable premises or without fixed location. Independent street vendors, taxi drivers, home-based workers, etc. are all considered to be enterprises.

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1 – General framework

Within household unincorporated enterprises a distinction was made between:

- Enterprises of employers
- Own-accounts enterprises

The distinction is based on whether or not an enterprise employs at least one employee on a continuous basis.

Compared with own-account enterprises, enterprises of employers have a higher degree of formality in their operations, and require additional criteria for being classified in the informal area.
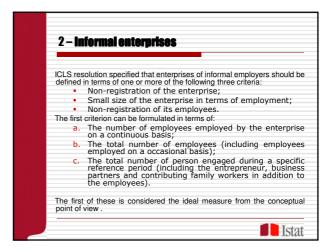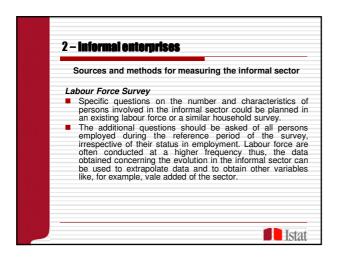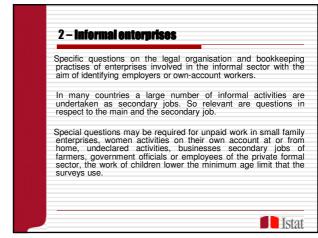
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1 – General framework

The definition finally adopted at the 15th ICLS incorporates two different points of view:

❖ Enterprises in relation to the legal and administrative registration in force; an intrinsic relation between non-registration and notion of informality is assumed;

❖ Employment size has to be used as criteria for distinguish informal sector enterprises from other household unincorporated enterprises.

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Framework of unincorporated enterprises and the sub-sector of the informal enterprises

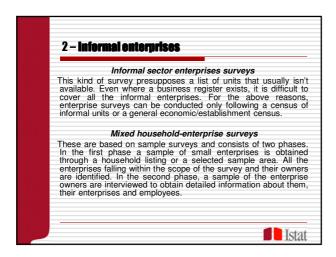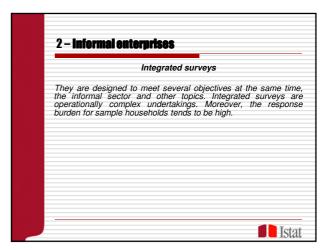| Informal own-account enterprises (1)	Other own-account enterprises (2)	Own-account enterprises (1)+(2)
Enterprises of Informal employers (3)	Other enterprises of employers (4)	Enterprises of employers (3)+(4)
Informal sector enterprises (1)+(3)	Other household unincorporated enterprises (2)+(4)	**Households unincorporated**

2 – Informal enterprises

Depending on national circumstances, either all own-account enterprises should be considered informal, or only those that are not registered under specific forms of national legislation. The legislation includes factories' and commercial acts, tax and social security laws, professional acts, laws or regulations established by national legislation bodies.

Regulation enacted by local authorities are excluded because their enforcement may vary considerably from one country to another and over the time, or between different reasons.

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2 – Informal enterprises

ICLS resolution specified that enterprises of informal employers should be defined in terms of one or more of the following three criteria:

- Non-registration of the enterprise;
- Small size of the enterprise in terms of employment;
- Non-registration of its employees.

The first criterion can be formulated in terms of:

a. The number of employees employed by the enterprise on a continuous basis;
b. The total number of employees (including employees employed on a occasional basis);
c. The total number of person engaged during a specific reference period (including the entrepreneur, business partners and contributing family workers in addition to the employees).

The first of these is considered the ideal measure from the conceptual point of view.

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2 – Informal enterprises

Sources and methods for measuring the informal sector

Labour Force Survey

- Specific questions on the number and characteristics of persons involved in the informal sector could be planned in an existing labour force or a similar household survey.
- The additional questions should be asked of all persons employed during the reference period of the survey, irrespective of their status in employment. Labour force are often conducted at a higher frequency thus, the data obtained concerning the evolution in the informal sector can be used to extrapolate data and to obtain other variables like, for example, vale added of the sector.

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2 – Informal enterprises

Specific questions on the legal organisation and bookkeeping practises of enterprises involved in the informal sector with the aim of identifying employers or own-account workers.

In many countries a large number of informal activities are undertaken as secondary jobs. So relevant are questions in respect to the main and the secondary job.

Special questions may be required for unpaid work in small family enterprises, women activities on their own account at or from home, undeclared activities, businesses secondary jobs of farmers, government officials or employees of the private formal sector, the work of children lower the minimum age limit that the surveys use.

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2 – Informal enterprises

Informal sector enterprises surveys

This kind of survey presupposes a list of units that usually isn't available. Even where a business register exists, it is difficult to cover all the informal enterprises. For the above reasons, enterprise surveys can be conducted only following a census of informal units or a general economic/establishment census.

Mixed household-enterprise surveys

These are based on sample surveys and consists of two phases. In the first phase a sample of small enterprises is obtained through a household listing or a selected sample area. All the enterprises falling within the scope of the survey and their owners are identified. In the second phase, a sample of the enterprise owners are interviewed to obtain detailed information about them, their enterprises and employees.

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2 – Informal enterprises

Integrated surveys

They are designed to meet several objectives at the same time, the informal sector and other topics. Integrated surveys are operationally complex undertakings. Moreover, the response burden for sample households tends to be high.

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3 – Own use

Household production for own use

1. Household production of goods for own final use, including crops and livestock, production of other goods for own consumption, and own-fixed capital formation
2. Owner-occupied dwelling services
3. Paid domestic services (i.e. paid domestic staff)

Goods for own final use

According SNA 93, the production of a good for own final use should be measured when the amount produced is believed to be quantitatively important in relation to the supply of the good in the country

Services for own final use

- Household production of services for own final use is outside the SNA production boundary with two exceptions:
- Paid domestic services
- Owner occupied dwellings services

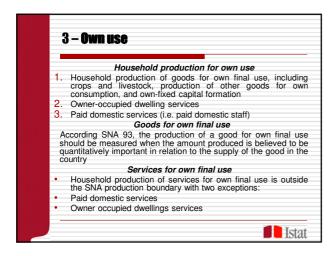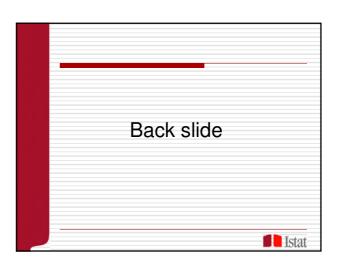**Istat**

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Illegal activities

- According to 1993 SNA, illegal activities that have the characteristics of transactions (mutual agreement between parties) are treated the same way as legal actions; therefore, they should be recorded in the accounts (§ 3.54-56).

- Lack of recording causes *discrepancies*, as incomes earned from illegal production are largely spent on the purchase of legal goods and services, on the acquisition of legal fixed or financial assets or other legal transactions. There is inevitably a discrepancy between supply and uses if illegal activities are not recorded (§ 3.54)

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2 – Illegal activities

- In addition to *consistency* of the overall system, *comparability* of national accounts figures *between countries* and *over time* is another major reason for inclusion of illegal activities
- Some activities (as production/distribution of alcohol or prostitution) may be illegal in one country and legal in another: exclusion may bias international comparisons
- Distortions over time can also emerge if some activities switch from being illegal to be legal, or conversely (for example, production and distribution of alcohol during prohibition in the USA)

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Illegal activities

- There are '...*obvious practical difficulties in obtaining data on illegal production..*' (1993 SNA, §6.30), and in countries where illegal activities are quantitatively insignificant, efforts are better directed to reducing the amount of other NOE components

- The *NOE OECD Handbook* has provided more examples of illegal activities and proposed further guidelines on *theft* and *fencing*, *bribery*, *extortion* and *money laundering*

- The explanation of illegal activities in the 1993 SNA should be further clarified by providing examples based on, or references to, those in the NOE Handbook

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1. Production and distribution of illegal goods (i.e. banned drugs or pornographic material)	6. Theft and fencing (re-sale) of stolen goods
2. Production of illegal services, such as prostitution (in countries where this is illegal)	7. Bribery
3. Production activities which are usually legal but which become illegal when carried out by unauthorized producers (i.e. unlicensed medical practices, unlicensed gambling activities, unlicensed production of alcohol and poaching)	8. Money laundering
4. Production and sale of counterfeited products (i.e. watches and other products with false trade-marks and unauthorized copies of artistic originals, such as software, CDs and videos)	9. Forgery of banknotes, contract murders, espionage, etc. (generally of minor importance for NA)
5. Smuggling, in particular of tobacco, weapons, alcohol, food, people, both wholesale and retail	

Illegal activities: Estimation issue

By their nature, illegal activities are very difficult to measure. People involved in illegal transactions have obvious reasons to hide their involvement

However, there are sometimes quite reasonable if unconventional data sources and methods to measure various types of illegal activity. The quality of these estimates is subject to more discussion than that of estimates for activities that are well covered in regular surveys

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Illegal activities: Estimation issue

Parts of some illegal activities may be implicitly included in the system of NA (double counting problem), e.g. prostitution. Income from prostitution may be declared as income from legal 'personal care' services and expenditure on prostitution may be declared, but similarly disguised, by the purchaser

However, in most cases usual sources for NA will not have information on illegal activities, thus direct methods for compiling estimates are to be preferred

Probably the most useful approach is to use the basic identity:

domestic output + imports = intermediate consumption + final consumption + capital formation + exports

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Illegal activities: Data sources

Several source can be used for estimation of illegal activities, among these:

- ✓ police and survey data on criminal activities
- ✓ health care institutions and charities may also provide useful information, *e.g.* on the number of addicts in the case of drugs, or the number of prostitutes
- ✓ more conventional data sources for the compilation of NA, *e.g.* labour force surveys and other household surveys
- ✓ special studies by universities and research institutes, although often not concerned with the money flows involved
- ✓ the last resort is to conduct a survey focusing on those aspects of illegal production for which it seems feasible to try and collect data

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Illegal activities: the EC activities

- In 2001, a Task Force on illegal activities was set up by the GNI Committee (Committee of the MS chaired by Eurostat with a regulatory power). It identified three areas of illegal activities (trafficking of drugs, prostitution and smuggling of alcohol and tobacco).
- In 2003, Eurostat asked NSI of Members States to provide some first estimates on the above illegal areas
- The aim was to verify how sources and methods to estimate illegal activities might be reliable and accurate to be included in GDP
- Istat has provided to Eurostat some first experimental estimates on the above illegal areas.

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Conclusions (1/2)

❑ Measurement problems are the core question to be solved for NA: 1) availability of reliable sources; 2) accuracy of the estimates; 3) risks of double counting of production and expenditure when adding explicit estimates of illegal activities.

❑ The statistical basis for estimates for purpose of NA is weak: limited or not suitable data sources are available, a large number of assumptions are necessary and most of these assumptions are difficult to verify.

❑ Estimates from the supply side (production) are weak for the following reasons: chain distribution is too short (one importer, one trader and one consumer) while a consistent number are those ones who work in that kind of markets (specialized pushers, prostitutes, illegal foreign, etc.).

❑ Estimates obtained from the demand side (consumption) are affected by the complementary of substances (for example, legal and illegal drugs), the hidden population of consumers as on the hypothesis of their consumption behaviours.

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Conclusions (2/2)

❑ In view of the approaches experimented by most MS and difficult data situation Eurostat is going to suggest to base the estimates on the consumption side only, in particular on drugs transactions.

❑ At the meantime, as the error of the estimates seem to be quite high, an application of the supply side approach (production) could be useful too.

❑ In order to develop data quality, exchange of best practices on sources and methods from the various countries at the European level is going on.

❑ The work on the above issue will be improved by the Italian national accountants in the next future. The experimental phase should be concluded in 2010.

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