

Unclassified

STD/CSTAT/WPNA(2011)8

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

17-Oct-2011

English - Or. English

STATISTICS DIRECTORATE
COMMITTEE ON STATISTICS

Working Party on National Accounts

MEASURING THE NON-OBSERVED AND INFORMAL ECONOMY

To be held on 27-28 October 2011
OECD Conference Centre
Beginning at 2:30 p.m. on the first day

This document has been prepared by Nadim Ahmad (OECD - Statistics Directorate) and will be presented under item 4 of the draft agenda

At its June 2011 meeting the OECD's Committee on Statistics endorsed the development and circulation of a survey on the Non-Observed and Informal Economy. This document describes and explains the motivation for the survey.

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JT03309201

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MEASURING THE NON-OBSERVED AND INFORMAL ECONOMY

1. Introduction

1. At the March 2011 meeting of the OECD Economic Policy Committee's Working Party 1 (WP1), a research proposal was put to Delegates to engage in a detailed study on what was referred to as the *informal economy*: focusing in particular on activities related to underground production.

2. Working Party 1 representatives recognised the importance of the project but felt that before the study went ahead it would be necessary to have a clearer idea of the size and importance of these phenomena across OECD countries.

3. The Statistics Directorate has therefore been asked by WP1 to approach the Committee on Statistics with a view to conducting such a survey amongst OECD countries, and indeed amongst Enhanced Engagement countries.

2. Background

4. In 2002 the OECD, in collaboration with the IMF, ILO and the Interstate Statistical Committee of the Commonwealth of Independent States, published a Handbook on the measurement of the Non-Observed Economy (NOE)¹ that categorised the NOE into what it described as five *problem areas* that could impact on the exhaustiveness of GDP:

- *Underground production*, defined as those activities that are productive and legal but are deliberately concealed from public authorities to avoid payment of taxes or compliance with regulations.
- *Illegal production*, defined as those productive activities that generate goods and services forbidden by law or that are unlawful when carried out by unauthorised procedures.
- *Informal sector production*, defined as those productive activities conducted by unincorporated enterprises in the household sector or other units that are unregistered and/or less than a specified size in terms of employment, and that have some market production.
- *Production of households for own-final use*, defined as those productive activities that result in goods or services consumed or capitalised by the households that produced them.
- *Statistical underground*, defined as all productive activities that should be accounted for in basic data collection programmes but are missed due to deficiencies in the statistical system.

5. The purpose of the Handbook was to provide countries with guidance and examples of 'best practice' used in countries to counteract these problems, and was partly in response to a misunderstanding by some users of how, and whether, the non-observed economy was included in official estimates of GDP.

6. To some extent the Handbook has successfully met these objectives; certainly it has been instrumental in improving the exhaustiveness of GDP estimates in a number of countries (generally outside

¹ *Measuring the Non-Observed Economy, A Handbook*, 2002, OECD

of the OECD) and has also increased awareness amongst users of the fact that 'non-observed' does not necessarily equate with 'non-measured'.

7. However, the increased awareness has also led to increased demand for the estimates that statistics offices make for the NOE and its components; particularly in studies interested in the tax-evasive part of the NOE and in studies interested in informal employment.

8. Unfortunately very little internationally comparable information is publicly available for OECD countries, certainly in the context of the NOE components, which can satisfactorily respond to user requests. Indeed, increasingly, these requests are coming from within the OECD itself. At the March 2011 meeting of the OECD Economic Policy Committee's Working Party 1 (WP1) meeting, a research proposal was put to delegates to engage in a detailed study on what was referred to as the *informal economy*, focusing in particular on activities related to underground production.

9. The proposal saw the measurement of the informal economy as central to the development of a number of important policy perspectives, including:

- *Social protection and insurance*: in the context of the higher levels of insecurity and vulnerability faced by informal workers, in particular after they retire.
- *Growth and productivity*: even if underground production is accurately measured in official estimates of GDP it impacts on growth and productivity estimates in a number of ways. Production in the informal sector often generates inefficiencies because firms may limit their size to below their optimal efficiency scale in order to avoid detection; they may use backward production technologies, partly reflecting their sub-optimal size; or they may have greater difficulty in accessing finance leading to possible under investment in innovative assets and workers. At the same time, the relative cost advantages enjoyed by informal firms through tax avoidance and avoiding the costs of regulatory compliance may give rise to unfair competition. Equally, if start-up costs are excessive, the informal sector may be a necessary channel for small entrepreneurial firms, which, subsequently, go on to be successful formal sector firms.
- *Erosion of tax revenues*: all else being equal, a high degree of informality implies that a given level of public spending will require higher tax rates on the income and profits of formal businesses.
- *Integrity and trust in public institutions*: non-compliance with tax collection and market-supporting regulation erodes the rule of law and the integrity of public institutions. This can limit a society's ability to address collective needs and undermine social norms, increasing the cost of enforcing the law. The resulting loss of social capita and social trust may also reduce the ease and certainty of doing business and adversely affect growth.
- *Economic measurement*: there remains uncertainty about how well official estimates of GDP capture the informal economy across countries, which could impact on comparability across countries and on a number of economic policy decisions.

10. Working Party 1 representatives recognised the importance of the project and the policy objectives but felt that before the study went ahead it would be necessary to have a clearer idea of the size and importance of these phenomena across OECD.

11. In response to this, at the June 2011 meeting of the OECD's Statistics Committee the Statistics Directorate proposed and received approval from delegates for a survey to be developed and circulated to OECD and Enhanced Engagement countries. The survey, which is attached as an annex to this note, was circulated in September 2011.

3. The Survey

12. Before describing the survey it is instructive to say a few words on the nature of the ‘problem areas’ described in the NOE Handbook. The primary purpose of the handbook was not to facilitate international comparisons of the NOE; rather it was for national accountants to be fully cognisant of all the transactions needed to measure GDP comprehensively and consistently across countries. In this sense, it is important to note that the problem areas are not defined in a mutually exclusive way, the same phenomena might, for example, be recordable in more than one of the ‘problem areas’. Indeed it is fair to say that international comparisons of the size of the NOE may not be particularly meaningful. One country for example might define its informal sector as all unincorporated enterprises with less than 5 employees (whether on the statistical business register or not) whilst another might record only those unincorporated enterprises not on the statistical business register. All other things equal, estimates of the NOE for these two cases will therefore be different but estimates of GDP will be the same.

13. This reflects, in large part, the fact that the NOE comprises two phenomena – one statistical (e.g. the coverage of statistical business registers) and one economic (e.g. underground production). Note also that firms not appearing on the statistical business register may appear on an administrative register, such as a tax or labour force register, and also that, in many countries, many unincorporated enterprises are below the revenue thresholds needed for tax purposes, meaning that one cannot take estimates of the informal sector say as being necessarily related to tax avoidance. This is why great care is needed when comparisons using a thematic approach as described above are made.

OECD SURVEY ON MEASURING THE NON-OBSERVED ECONOMY

At the March 2011 meeting the OECD Economic Policy Committee's Working Party 1 (WP1) recommended that the OECD's Statistics Directorate approach the OECD's Committee on Statistics to conduct a survey amongst OECD and Enhanced Engagement countries to conduct a survey on the *informal economy*.

This survey is the outcome of a proposal made to, and approved by, the OECD's Committee on Statistics at its June 2011.

The survey is designed to achieve two immediate objectives:

- The first is to achieve a better understanding of the size of the Non-Observed Economy (NOE) across OECD Member and Enhanced Engagement countries and, in particular, the size of its key components, such as those that relate to fiscal and regulatory evasion.
- The second is to achieve a better understanding of the methods used by countries to estimate these phenomena, with a view to encouraging the sharing of best-practice across countries.

The Survey/Questionnaire is based on Eurostat's Tabular Approach to measuring the exhaustiveness of GDP estimates.

Table S1 below provides the main basis of the Questionnaire. It requests two breakdowns of the NOE. The first requests a breakdown by institutional sector. The second requests a breakdown by activity, with, where possible, additional breakdowns by size class. Information should be provided for the most recent year in which a comprehensive response can be provided.

For both the institutional sector breakdown and the activity based breakdown, the NOE is broken down into seven NOE-types. Table A1 provides explanatory information on each of these NOE Types (referred to as N1 to N7). Figure 1 provides a simple schematic illustrative tool that aids Table A1.

The preference is for activity information broken down by ISIC Sections but other classification systems, including national classification systems, can be used (especially if a correspondence table between the national classification and ISIC Rev 3 or 4 can be provided). Equally, ISIC Section information should be viewed as a minimum. If you are able to provide information at a more disaggregated level, such as 2 or 3 digit ISIC level, you are strongly encouraged to do so.

The table additionally requests breakdowns by size-class: *Self-Employed*; *Other Micro*; *Small*; *Medium* and *Large*. For convenience, no attempt is made to define thresholds for these categories in the generic questionnaire. You are invited to define the categories in a way that is best-suited to the available data in your country. It is recognised up-front that it may not be possible to provide this information in all, or indeed, any industries. In such cases you are strongly encouraged to consider whether similar information could be provided using different dis-aggregations, for example incorporated versus unincorporated enterprises or less disaggregated breakdowns, such as self-employed and other.

For each of the adjustments made in Table S1 below it is essential that some descriptive commentary is provided in Table S2 that describes the approach, method, sources etc used to estimate that particular activity, broken down where relevant by the particular exhaustiveness type N1 to N7.

Please indicate alongside the appropriate cell in the questionnaire whether the data used is confidential by marking a 'C' alongside the entry. The OECD will not disseminate any confidential information outside of the organisation. Please also stipulate in the accompanying methodological table, S2, whether the methods and approaches used to estimate a particular cell should also remain confidential.

The tables are produced below in this document for convenience but are accompanied by corresponding Excel files. Table S1 should be completed as an Excel attachment or equivalent. Table S2 can be completed in a form of your convenience.

The OECD would appreciate responses to this questionnaire by no later than **31 March 2012**

For any assistance in completing the form please contact Nadim Ahmad at nadim.ahmad@oecd.org to whom completed forms should also be returned.

Question 1:

Please describe below in general terms the approach you use to ensure that GDP captures all NOE activities.

Table S1: Country ZZZZZZ Reference Year XXXXX Currency YYYYY

Adjustment number	Sectors /ISIC Groups	GVA Adjustments by Type							Total NOE Adjustments		Total Adjusted data including NOE estimates	
		N1	N2	N3	N4	N5	N6	N7	Absolute data	% of GVA	Absolute data	% of GDP
1	Non Financial Corporations											
2	Financial Corporations											
3	General Government											
4	Households											
5	NPISH											
6	ISIC X											
7	<i>Self-Employed</i>											
8	<i>Other Micro</i>											
9	<i>Small</i>											
10	<i>Medium</i>											
11	<i>Large</i>											
12	ISIC XX											
13	<i>Self-Employed</i>											
14	<i>Other Micro</i>											
15	<i>Small</i>											
16	<i>Medium</i>											
17	<i>Large</i>											
18	ISIC XXX											
19	<i>Self-Employed</i>											
20	<i>Other Micro</i>											
21	<i>Small</i>											
22	<i>Medium</i>											
23	<i>Large</i>											
24 etc	ISIC XXXX continued..... broken down by enterprise- establishment size											
	Total											
	% of total adjustments											
	% of total GVA											

Table S2

Adjustment Number (from Table S1)	Description of Method and approach used to estimate the adjustment broken down, where relevant by exhaustiveness type N1-N7. Please describe the survey sources used.	Is the method confidential, if yes mark 'C'
1		
2		
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21		
22		
23		
24 etc		

Please describe below the size-class or equivalent information that you have used to break down industrial categories:

Size-class or equivalent categories used (the categories included below are for illustration please describe the actual categories used in your completed Table S1)	Numbers of employees-employment/other (please specify)
<i>Self-Employed</i>	
<i>Other Micro</i>	
<i>Small</i>	
<i>Medium</i>	
<i>Large</i>	

Table A1: Non Exhaustiveness Types

N1	Producer should have registered (underground producer)	<ul style="list-style-type: none"> ➤ Producer fails to register in order to avoid tax & social security obligations. These are often small producers with turnovers which exceed the thresholds above which they should register their income. ➤ Type N1 does not include producers that fail to register because they are engaged in illegal activities.
N2	Illegal producer that fails to register	<ul style="list-style-type: none"> ➤ N2 covers activities of producers that avoid registration entirely. ➤ N2 excludes illegal activities by registered legal entities or entrepreneurs that report (or misreport) their activities under legal activity codes.
N3	Producer is not obliged to register	<ul style="list-style-type: none"> ➤ Producer is not required to register because it has no market output. Typically, these are non-market household producers involved in: (a) production of goods for own consumption or for own fixed capital formation, and (b) construction of and repairs to dwellings. ➤ Producer has some market output but it is below the level at which the producer is expected to register as an entrepreneur.
N4	Registered legal person is not included in statistics	<ul style="list-style-type: none"> ➤ The legal person may not be included in the statistics for a variety of reasons. Eg, the business register is out of date or updating procedures are inadequate; the classification data (activity, size or geographic codes) are incorrect; the legal person is excluded from the survey frame because its size is below a certain threshold; etc.
N5	Registered entrepreneur is not included in statistics	<ul style="list-style-type: none"> ➤ A registered entrepreneur may not be included in the statistics for many reasons. Eg, the administrative source with lists of registered entrepreneurs may not always pass on complete or up to date lists to the statistical office. ➤ Even if there is a regular flow of accurate and comprehensive information from the administrative source to the statistical office, the registered entrepreneur may not be included in the business register for several reasons (see those given under N4).
N6	Mis-reporting by the producer	<ul style="list-style-type: none"> ➤ Mis-reporting invariably means that gross output is under-reported and intermediate consumption is over-reported in order to evade (or reduce) income tax, value added tax or social security contributions. ➤ Mis-reporting often involves: the maintenance of two sets of books; payments of <i>envelope salaries</i> which are recorded as intermediate consumption; payments in cash without receipts; and VAT fraud.
N7	Statistical deficiencies in the data	<ul style="list-style-type: none"> ➤ N7 is sub-divided between N7a - data that is incomplete, not collected or not directly collectable, and N7b - data that is incorrectly handled, processed or compiled by statisticians. This distinction is useful because it helps one to better understand the huge variety of possible statistical deficiencies. However, in practice, N7a and N7b cannot always be easily separated. ➤ Statistical deficiencies: the following list is not comprehensive but these topics should be investigated for non-exhaustiveness:- Handling of non-response; Production for own final use by market producers; Tips; Wages & salaries in kind; Secondary activities.

FIGURE 1

