

Spotlight C: Israel's Shadow Economy

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The severe economic problems experienced by a number of European countries in conjunction with the recent global recession have illuminated problems that are shared with Israel – even though Israel has thus far weathered the recession much better than most countries. However, as Yashiv points out (Yashiv, 2011), there is a need to distinguish between the current bright situation and the much darker long-term picture that underlies it.

Large underground economies in Greece and Italy seriously limit the ability of these countries to garner urgently needed domestic resources for dealing with their predicaments – and do not provide much of an incentive for the citizens of other European Union partner countries to grant financial support drawn from the taxes that they pay. Israel, which also receives extraordinary financial assistance from abroad, should be aware of the parallels that may one day be drawn in this regard.

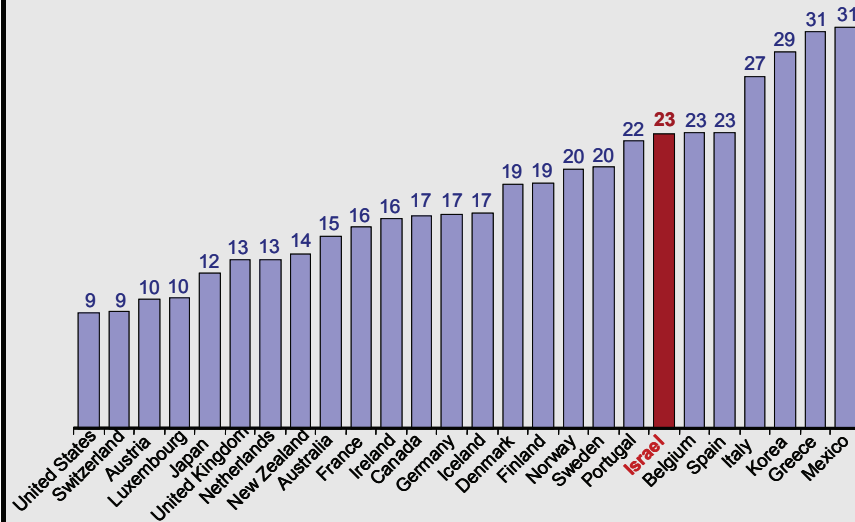
The extremely high rates of non-employment in Israel reflect not only problematic work habits by a large and growing segment of the population, but also what would appear to be – from an anecdotal perspective – quite extensive levels of tax evasion. The severity of non-compliance with the country's laws is very difficult to gauge, but its pervasiveness in some sectors of the population and business sectors is also difficult to ignore.

How large is Israel's shadow economy and how does it compare with other countries? A recent World Bank study by Schneider, Buehn and Montenegro (2010) provides a glimpse – albeit a very rough approximation – based on multiple indicators including currency demand. They rank 151 countries according to the size of their shadow economies. Figure 15 looks at a subset of these and shows how Israel compares to 25 OECD countries.

Figure 15

Shadow economy as share of GDP*

Israel and 25 OECD countries, in percent, 2007



* based on multiple indicators including currency demand.

Source: Dan Ben-David, Taub Center and Tel-Aviv University.**Data:** Schneider, Buehn and Montenegro – World Bank 2010.

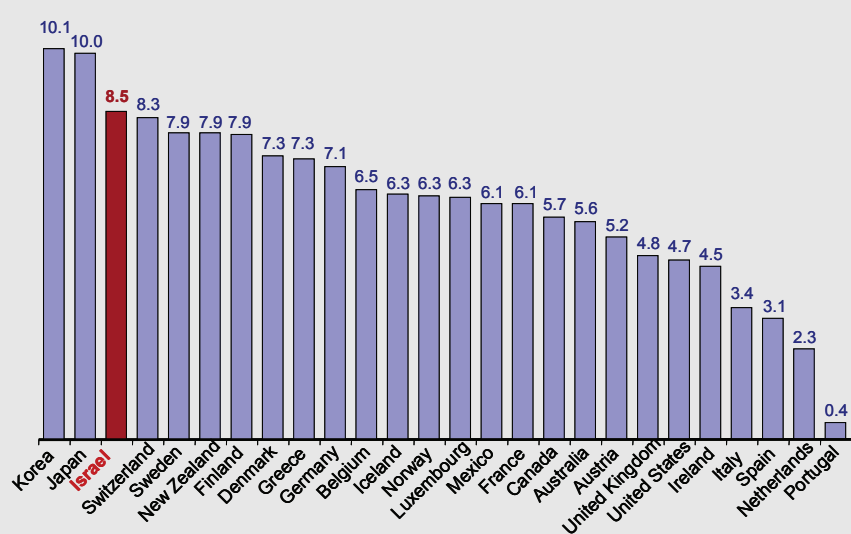
While the apparent problems of Greece and Italy eclipse Israel's as far as shadow economies are concerned, Israel, nonetheless, has some substantial economic activity that is hidden from the eye of the tax authorities. According to Schneider, Buehn and Montenegro, the size of Israel's shadow economy reached 23 percent of its GDP in 2007. This is considerably greater than Germany (16.7 percent), the United Kingdom (13.2 percent), Japan (12.1 percent), and the United States (9.0 percent).

The problem is not only in the size of the country's shadow economy, but also that its share of GDP is growing at a faster rate than in nearly all of the other countries (Figure 16). Since 1999, the shadow economy share of GDP has grown by six percent on average for the 25 OECD countries in the figure.⁹ The growth of Israel's underground economy (8.5 percent) was faster than in 23 of the other countries, with only two countries showing even faster growth rates, Japan and Korea.

Figure 16

Changes in share of shadow economy out of GDP

Israel and 25 OECD countries, in percent, 1999-2007*



* based on multiple indicators including currency demand.

Source: Dan Ben-David, Taub Center and Tel-Aviv University.

Data: Schneider, Buehn and Montenegro – World Bank 2010.

⁹ Note that this refers to the percent change in the shadow economy share of GDP and not to a change in percentage points.

Even if one assumes that the shadow share of GDP in 2010 was similar and not greater to that of 2007, this still implies an enormous amount of economic activity that is taking place outside of the formal public eye – a sum of NIS 187 billion in 2010 alone. Such an extensive shadow economy skews the shouldering of the public burden in a substantial manner, leading to high tax burdens on some portions of the population while other segments of the population who work – while formally appearing not to do so – not only do not bear their share, they actually artificially inflate the burden further by receiving welfare assistance and subsidies since they appear to be much poorer than they actually are.

With underground activity at this scale, one has to wonder how cost-effective it would be to increase substantially the level of law enforcement in Israel to rein in this activity.