MARKET CONSUMPTION
AND HIDDEN CONSUMPTION. A TEST FOR
SUBSTITUTABILITY

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A TEST FOR SUBSTITUTABILITY.

Bruno Chiarini and Elisabetta Marzano

1. Introduction

This paper analyzes the implications that a large and growing underground economy can have on private consumption. In particular, we perform an empirical analysis on the relationship between aggregate private consumption and the hidden consumption component for the Italian case. There are several reasons why we are concerned about this investigation. First, like most Southern European countries, Italy has a sizeable underground sector, between 24-30% of the GDP. Second, polls and microeconomic studies stress that almost all the income earned in the hidden sector is immediately spent, producing an interesting effect on consumer behaviour. Third, a recent estimation of the underground economy for this country uncovers some interesting cyclical properties. A time series plot of the output of these two

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1 Here, we refer to those activities which are not taxed or registered. There exists a vast literature on this issue. See also Thomas (1992), Feige (1994), Lubell (1991), and the papers in The Economic Journal symposium (1999) among others. The methods of estimating the size of the underground economy have recently been surveyed by Schneider and Enste (2000).
Abstract

In this paper we perform an empirical analysis on the relationship between private consumption and underground economy for the Italian case. We find that private market consumption and underground (or hidden) consumption may be defined as "complementary goods": an increase in underground consumption tends to rise family market consumption and increase its marginal utility. An implication of this result is that the nonmarket sector does not offer hedging opportunities to the consumer-worker as stressed in Busato and Chiarini (2004) artificial economy. Moreover, wealth effects associated with a change in underground consumption are negative. A statistical model confirms this structural interpretation.

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sectors for Italy is presented in Figure 1. Casual inspection suggests that these sectors give rise to two distinct cycles. The figure reports the Hodrick-Prescott filtered series of the market and the underground components, stressing the countercyclical nature of the hidden component, and leads one to draw interesting conclusions regarding the smoothing behaviour of agents and the volatility of consumption and income.

The cyclical features of the underground economy have led Busato and Chiarini (2004) to introduce this sector in a dynamic general equilibrium framework. They show that it provides a new degree of freedom for enriching the analysis and producing a better understanding of business cycle dynamics and policy implications. In this economy, the hidden consumption (the underground sector) provides an insurance scheme to insure agents against idiosyncratic risk. Informal markets may be an essential feature in explaining consumption allocations over states of nature. This insurance channel, alternative to financial markets, is available to people that face, for instance, liquidity constraints.

The goal of this paper is, therefore, to test whether or not the nonmarket sector may offer hedging opportunities to the consumer-worker. The test may reflect a representative agent who distributes labor supply and income in the two sectors. Alternatively, it may be consistent with the existence of a contract signed by different family members according to which total income and total labor supply are allocated between the two sectors. To this end we use a partial-equilibrium model of consumer choice and test the hypothesis of
substitutability for describing the relationship between private and underground consumption. We perform this test estimating a structural model (Euler equation) and a statistical model (VAR cointegrated).

The paper is organized as follows: Section 2 provides a consumer choice model, stressing the role of marginal utility dynamics determined by the effects of the two consumption (private and hidden) components. This section derives the Euler equation to be estimated. Section 3 describes the data source and presents the econometric results for two alternative models: the Euler equation-structural model and a reduced-form statistical model. Section 4 analyzes the main implications of the findings in terms of wealth effects. Conclusions are provided in the final section.

Figure 1: Filtered Series. Sources: Istat and Bovi (1999)
2. A Simple Model

This section describes a partial-equilibrium model of consumer choice in the presence of an underground consumption good. The representative individual inelastically supplies one unit of labor every period. We may assume that the consumer allocates a share of the total labor to market production and the remaining, working hours to the underground sector. As usual, tastes are represented by the following utility function:

\[ U_t = E \sum_{i=0}^{\infty} \beta^i u(C^T_{i+1}) \]  

where \( C^T \) denotes the level of the "effective" consumption, \( \beta \) is a constant rate of time preference and \( u(\cdot) \) is a time-invariant concave utility function. In an underground economy, the consumer derives utility from market consumption, \( C^m \), and from underground produced consumption \( C^u \). The two consumption goods may be conveniently defined as a linear combination of "market" private consumption and hidden consumption\(^2\):

\[ C^T_i = C^m_i + \lambda C^u_i \]  

Equation (2) implies that a unit of underground goods and services provides the

\(^2\)In the subsequent econometric analysis we will assume that the underground economy only produces consumption goods, and, mostly, that underground revenues are only employed to buy consumption goods. The consequence is that underground consumption can be either defined as consumption goods produced in the underground sector or as consumption goods which are bought using underground revenue.
same utility as $\lambda$ units of private market consumption. The parameter $\lambda$ is therefore a measure of the substitutability between the two consumption goods. The greater the parameter $\lambda$, the more closely underground consumption substitute for a unit of contemporaneous private market consumption. The substitution parameter defines the derivative of the marginal utility of $C_m^t$ with respect to $C_u^t$. This value may be positive or negative. A negative value implies that increases in hidden consumption raise the marginal utility of $C_m^t$. That is, the two consumption aggregates are complementary goods. Thus, when the hidden consumption rises, the consumers are willing to raise market consumption. This interpretation, consumption aggregates are not rivals, is not consistent with the stylized facts reported above. On the contrary, a positive value of $\lambda$ implies that an increase in $C_u^t$ reduces the marginal utility of market consumption.

The dynamics of the individual's assets take the following form:

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$^3$We follow Barro (1989) and Christiano and Eichenbaum (1992) who define a relationship between consumption services and public consumption, and generalize the expected lifetime utility function (1) adding an extra-term $\phi(C_u^t)$ where $\phi$ is a concave function. With $\phi(C_u^t) > 0$, the consumer does not necessarily feel worse off when $C_u^t$ is increased. Notice that $\phi(C_u^t)$ enters separably in (1) and, therefore, this term has no bearing on consumers' choices of consumption: $C_u^t$ is modelled as an exogenous variable. See also Aschauer (1985) and Karras (1994).
The representative agent holds only a single asset (or a portfolio), $A_{t+1}$ at the beginning of the period, and $w_t^m + w_t^u$ is the sum in wage rate he receives within the market and the underground sector. We assume, for simplicity, that the consumer earns a constant real return $r$. Replacing $C_t^m$ by $C_t^T - \lambda C_t^u$ in the flow budget constraint, the optimization problem for the representative consumer is to maximize,

$$U_0 = E_0 \sum_{t=0}^{\infty} \beta^t \left( \frac{1}{1-\eta} \right) \varphi(C_t^m, C_t^u)^{1-\eta}$$

subject to (3).\(^4\) When the utility function features constant relative risk aversion, the first order conditions for optimality give:

$$\frac{(C_{t+1}^T)^{-\eta}}{E_t(C_t^T)^{-\eta}} = (1 + r)\beta$$

It is straightforward to show that the Euler equation along with definition (2)

\(^4\)Here $\varphi(\cdot)$ is the linearly homogeneous aggregator of the two consumption goods.
provides the following estimable equation:

\[ C_t^m = \nu C_{t-1}^m - \lambda C_t^u + \nu \lambda C_{t-1}^u + \lambda (C_t^u - E_{t-1} C_t^u) + (C_t^m - E_{t-1} C_t^m) \]  \hspace{1cm} (5)

where \( \nu = \beta(1 + r)^\eta \). Below we report the empirical analysis using official data for the consumption component and estimates for the underground consumption.

3. Estimation

In this section, to test the degree of substitutability between private consumption and hidden consumption, we estimate the structural model developed above and a statistical model (reduced-form) for the variable involved. The empirical specifications are tested using data from Istat (National Accounts) for 1970-96. The private consumption data are an annual series on total family expenditures in real terms \( C_t^m \) (exclusive of public consumption \( C_t^p \) and underground consumption \( C_t^u \)). The GDP deflator \( P_t \) has been used to generate real consumption aggregates. All the variables are in log terms.

3.1 Underground Estimates

Although a large literature exists on many issues of the underground economy, a set of alternative estimates for Italy is lacking. Disagreement about definitions and estimation procedures is still strong and at the moment there exist few time series for the hidden component of the GDP. In this study, to measure the relative size of the hidden consumption, we adopt two different
series generated by Bovi (1999) and Chiarini and Marzano (2004). Bovi has, in his works, generated and updated annual estimates of aggregate underground economy (1970-1997) based on the currency demand approach. In particular, the unrecorded economy is generated by a modified version of Tanzi's approach (1980; 1983) to better depict some features of the Italian economy, using a dynamical but unequational specification.\(^5\) Chiarini and Marzano's series, as well, are generated using a modified version of the Tanzi's approach, in which the characteristics of non stationarity of the basic series are exploited through cointegration techniques to generate a quarterly estimation of the Italian size of the underground economy (1975-1999).

The National Statistic Institute (Istat) is starting to calculate the size of the underground sector. However, at moment, it is not available a time series but only annual data for few years (1992 to 2000).

Naturally, there are other possible measures of the hidden economy: disparate estimates based on questionnaires or experiments or, in some cases, official information on aggregate income-tax-evasion data. However, these data for the unrecorded economy are not revised or updated and cannot be used in a time series model.

No one of the available estimations of the underground economy, including the official estimates by ISTAT, allow to distinguish, inside the

\(^5\)See also Bovi and Castellucci (1998). Two additional methods for estimating the underground economy based on the labor market statistics are reported in Castellucci and Bovi (1999).
aggregate size of the underground production/revenue, the share allocated to consumption or investment. Two possible definitions of the underground consumption are available:

1. consumption goods bought using underground income;
2. consumption goods produced in the underground sector.

Nonetheless, to proceed in the empirical analysis, and to get data about the aggregate underground consumption, some further assumptions about its the size are necessary; following Adam and Ginsburgh (1985) the possible options are:

- total underground output is equal to underground consumption, so that the two definitions are equivalent;
- a fixed share of the irregular income/output is consumed/produced by the private sector, which, again, allows to use both the definitions;
- the average propensity to consume is identical in the regular and irregular sector, which fits better with the first definition.

In the proceeding of the paper we adopt the first assumption, that is the correspondence between the income generated/earned in the underground economy and consumption. This adjustment is crude and, moreover, many

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6In general, the lack of micro-data on the features of the underground economy is a well known problem, and very few studies are available (see for instance Lemieux, Fortin and Frechette, 1994; Fortin, Lacroix and Montmarquette, 2000).
goods included in the underground consumption would have durable or investment characteristics. Nonetheless, this is coherent with data reported in Schneider and Enste (2000) as well as in Fortin, Lacroix and Montmarquette (2000), and also with the intuition which is the basis of the currency demand approach (and Tanzi’s approach as well). Actually, the series of the underground economy estimated by Bovi is founded on an estimation of the excess of demand of currency, and it is plausible to assume that the estimated excess of currency is mostly used to allow the trade of consumption goods.

Summing up, the variable definitions and statistical sources are:

$C^m_t$ = private real consumption expenditure (durable and non-durable goods and services). Sources: Istat.

$C^u_t$ = total income of the underground economy. In this paper we use the overall income figures of the Italian underground economy as consumption series. Of course, this is a first approximation and it reflects the fact that at least two-thirds of the income earned in the underground economy is immediately spent. The figure derives from polls of some European countries. Sources: Bovi (1999)’s estimation.

All the other variables (the GDP deflator $P_t$ and public consumption expenditure $C^p_t$) are taken from the Istat/OECD database.

3.2 Structural Estimates

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7 See Schneider and Enste (2000) and the works quoted therein.
First note that market and non-market consumption variables are not stationary series\(^8\). In this case we know that \( C^T \) has a unit root and therefore we have \( \nu = 1 \). The equation (5) can be estimated under this restriction and, therefore, may be written in terms of stationary variables \( \Delta C^m_t \) and \( \Delta C^u_t \). Notice that the underground consumption should be endogenously determined and, of course, it is measured with error. These facts make the right-hand side variable correlated with disturbances. We use Two Stage Least Square regression to eliminate the correlation between the underground consumption and the disturbances. The estimator used is:

\[
\hat{\lambda}_{tsls} = [X'Z(Z'Z)^{-1}(Z'X)]^{-1}X'Z(Z'Z)^{-1}Z'y
\]  

(6)

with the estimated covariance matrix \( \Omega_{tsls} = s^2[X'Z(Z'Z)^{-1}(Z'X)]^{-1} \), where \( s^2 \) is the estimated residual variance, \( y \) is the dependent variable, \( Z \) the matrix of instrument and \( X \) a vector of explanatory variables.

Furthermore, the use of annual series imposes some time aggregation on (5). In this case, the regression error is not white noise, but it may follow an MA(1) process. The basic point is the same as that discussed in the literature on

\(^8\)The \( ADF \) test for Private Consumption is -2.17 whereas, for the Underground Consumption data, the \( ADF \) statistic is -1.1348. Critical values at 1% and 5% are, respectively, -3.72 and -2.985.
the "timing of consumption" (see Deaton 1992, Attanasio 1999): this is based on the fact that we have no grounds for supposing that the annual data that we use here correspond to the period over which consumers make their decisions. The planning interval may be shorter than the data interval. This problem, "induce spurious correlations for adjacent observations of a series that has been first-differenced". Notice also that the error term has one-period memory we cannot use variables dated before $t-2$.

The parameters estimated for the model $\Delta C_t^m = \gamma - \lambda \Delta C_t^u + \lambda \varepsilon_t + \xi_t$, with $\varepsilon_t = (C_t^u - E_{t-1}C_t^u)$ and $\xi_t = (C_t^m - E_{t-1}C_t^m)$, are reported in Table 1. For the first three models (models1-3), we do not consider any particular structure for the regression error. The fourth model reports the parameter estimates after considering the MA(1) process. Order and rank conditions for identification are satisfied$^9$.

None of the Jarque-Bera statistic for testing normality (distributed as $\chi^2(2)$), rejects the null hypothesis of normally distributed errors. For instance, in the estimated model (5) in the table, the $JB$ statistic is 0.0958 with an associated probability value of 0.953 and a Kurtosis value of 3.1. In the estimated equations, the Breusch-Godfrey test for second order serial correlation ($p-values$ in parentheses) does not indicate a significant presence

$^9$See, among others, Davidson and MacKinnon (1993).
of this phenomenon. Notice that imposing an MA(1) process on the error term does not improve the stochastic properties of the residuals.

The most interesting result from the table is the robustness of the estimates of \( \lambda \). The estimated parameter is negative, statistically significant and ranges from .37 to .48. The estimates indicate that private market consumption and underground consumption may be defined as "complementary", which is to say, an increase in underground consumption tends to raise the family market consumption and increase its marginal utility.

These findings do not seem to imply the existence of informal markets in which consumers can insure against idiosyncratic income shocks. This result may be due to the fact that in good times progressive tax rates in the market economy become higher and boost the underground economy, introducing a procyclical component into \( C_u \). A further element should be assessed. Italy and many others Southern European countries, have a high degree of institutionalization of the traditional family model. A situation where different generations are brought together in the same household. This family structure has the advantage of offering everyone a sort of protection.\(^{10}\) In this context, family's members works in different markets and with a different status and

\(^{10}\)See the papers in Gallie and Paugam (2000) and the works quoted therein.
some of them are willing to accept any kind of job in any market. When the underground earnings increase, the family's income as a whole, increases pushing up its consumption.

Table 1 TSLS Estimates of $\Delta C_m = \gamma - \lambda \Delta C_u + \lambda \varepsilon + \xi$

<table>
<thead>
<tr>
<th>Models</th>
<th>$\gamma$</th>
<th>$\lambda$</th>
<th>MA(1)</th>
<th>Adjusted R$^2$</th>
<th>S.E.</th>
<th>DW</th>
<th>LM(p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.036</td>
<td>-4.84</td>
<td></td>
<td>0.80</td>
<td>0.0243</td>
<td>1.96</td>
<td>0.318</td>
</tr>
<tr>
<td>Instruments</td>
<td>$\Delta C_{m,t-2}, \Delta C_{u,t-2}, \Delta C_{p,t-2}, \Delta P_{t-2}, \varepsilon$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>0.034</td>
<td>-0.481</td>
<td></td>
<td>0.76</td>
<td>0.0266</td>
<td>2.29</td>
<td>1.62</td>
</tr>
<tr>
<td>Instruments</td>
<td>$\Delta C_{m,t-2}, \Delta C_{u,t-2}, \Delta C_{p,t-2}, \Delta P_{t-2}, \text{Dummy}_{81}, \varepsilon$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>0.035</td>
<td>-0.379</td>
<td></td>
<td>0.80</td>
<td>0.0240</td>
<td>1.52</td>
<td>0.257</td>
</tr>
<tr>
<td>Instruments</td>
<td>$\Delta C_{m,t-2}, \Delta C_{u,t-2}, \Delta C_{p,t-2}, \Delta P_{t-2}, \text{Dummy}_{75}, \varepsilon$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>0.036</td>
<td>-0.484</td>
<td>0.0015</td>
<td>0.79</td>
<td>0.0249</td>
<td>1.96</td>
<td>2.89</td>
</tr>
<tr>
<td>Instruments</td>
<td>$\Delta C_{m,t-2}, \Delta C_{u,t-2}, \Delta C_{p,t-2}, \Delta P_{t-2}, \Delta C_{m,t-3}, \Delta C_{u,t-3}, \Delta C_{p,t-3}, \Delta P_{t-3}, \varepsilon$</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>5</td>
<td>0.032</td>
<td>-0.371</td>
<td></td>
<td>0.81</td>
<td>0.0215</td>
<td>1.72</td>
<td>0.559</td>
</tr>
<tr>
<td>Instruments</td>
<td>$\Delta C_{m,t-2}, \Delta C_{u,t-2}, \Delta C_{p,t-2}, \Delta P_{t-2}, \Delta C_{m,t-3}, \Delta C_{u,t-3}, \Delta C_{p,t-3}, \Delta P_{t-3}, \varepsilon$</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Estimated standard errors in parentheses; sample 1970-1996.
S.E.=standard error of regression; LM=Breusch-Godfrey serial correlation LM test of order 2; Dummy$_{81}$=1:1981; Dummy$_{75}$=1:1975.

3.3 Reduced Form Estimates
If the random variables are unit root nonstationary and are cointegrated, we can use a statistical model to fit the data generation mechanism. To this end,
the VEC (vector error correction model) is widely used. This representation always exists when the variables are cointegrated. Although there have been some attempts to recover structural parameters from these models, imposing particular restrictions (see Ogaki and Park 1998 and Ogaki 1999), the VEC is a reduced form model and, therefore, it better describes the process of generating data. Here we use Johansen's (1988; 1995) Maximum Likelihood method to estimate the model and provide the impulse-response functions.

The vector error correction model estimated is a bivariate restricted VAR that has a cointegration vector restriction built into the specification:

$$\Delta y_t = \Pi y_{t-1} + \sum_{i=1}^{2} \Gamma \Delta y_{t-1} + B x_t + \epsilon_t$$

(7)

where the model follows the standard notation. For our case, $y$ is a 2-vector of nonstationary $I(1)$ variables, $x$ is a vector of deterministic variables and $\epsilon$ is a vector of innovations. The coefficient matrix $\Pi$ has reduced rank $r < 2$, with $2 \cdot r$ matrices $\alpha$ and $\beta$ with rank $r$ such that $\Pi = \alpha \beta'$ is stationary.

In particular, our VEC specification assumes that there are linear trends in the series and a constant in the cointegrating equation. The assumption made on the deterministic trends follows one of the possibilities defined by Johansen (1995):
\[ H(r) : \Pi y_{t-1} + Bx_t = \alpha(\beta' y_{t-1} + \rho_0 + \rho_1 t) + \alpha \perp \rho_0 \] (8)

That is, both the series \( y \) and the cointegrating equation have linear trends. The LR test statistic (trace statistic) rejects the hypothesis of no cointegration but not the hypothesis of at most one cointegration relation: \( LR = 21.33 \) (critical values: 15.4 at 5% and 20.1 at 1%).

The lag order of the VEC is 2 and is estimated for the period 1970-1996 and consists of changes in private consumption \( \Delta C^m_t \) and hidden consumption \( \Delta C^u_t \), both in real terms. The model is conditioned upon a dummy variable for 1975 to account for an outlier and the public consumption expenditure in real terms\(^{11}\).

The residual covariance matrix shows that the innovations in different variables are quite independent (they are orthogonal):

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\(^{11}\) Maximum likelihood assumes that the errors are multivariate normal. The Jarque-Bera statistic does not reject the hypothesis of normal distribution for the two equations of the model: for the \( \Delta C^m_t \) equation the statistic is 0.262, with a \( p \)-value of 0.877 (with a Kurtosis value of 3.2) while for the \( \Delta C^u_t \) equation, the \( J.B. \) is 0.29 (0.864) and the Kurtosis value is 2.62. The first equation yields an adjusted \( R^2 = 0.855 \) and a standard error of regression \( S.E. = 0.029 \). The second equation yields, respectively, \( R^2 = 0.811 \) and \( S.E. = 0.081 \).
This ensures that changing the order of the equation does not dramatically change the impulse responses. Figures 2-6 report the impulse responses of the two consumption models. The first is a stable bivariate VEC model, where $y$ is a 2-vector of nonstationary I(1) variables $C^m_t$ and $C^u_t$, whereas in the second model, public consumption expenditure $C^p_t$ enters as a further endogenous variable.

Although the dynamics are affected, they yield very similar results. After the disturbance in hidden consumption (a standard deviation shock), the private consumption raises below its preshock level (Figures 2 and 3). In Figures 4-6 the consumption innovations induce the two consumption components to react asymmetrically. In Figure 4 private consumption responds positively to a one standard innovation in hidden consumption and public expenditure consumption whereas underground consumption reduces to a one standard deviation innovation in private consumption. These findings appear to be robust to different specifications and do not seem to depend on the ordering of

\[
\Omega_c = \begin{bmatrix}
0.000547 & -0.00109 \\
-0.00109 & 0.0040
\end{bmatrix}
\]

12As a consequence of the unit root in the model the impulse response function does not return to zero. The estimated responses of private consumption in first differences taper off to their initial level. See Lutkepohl (1993).
equations.
Figure 3: Model C(m), C(u)

Figure 4: Response of Private Consumption

- C(m)
- C(u)
- C(p)
Forecast error variance decompositions of the two variables are reported
in Table 2. The table presents the percentage of the variance of each series explained by innovations in $\Delta C^m$ (first part of the panel) and the percentage of $\Delta C^m$ variance explained by the shocks in $\Delta C^u$ (second part of the panel). The column S.E. is the forecast error of the variable for each forecast horizon. This error is determined by the changes in the values of the innovations to each variable in the model. About 43% of the 1-step forecast error variance of hidden consumption is accounted for by its own innovations and about 56% is accounted for by private consumption innovations. For 10-step forecast, 86% and 14% of the error variance is accounted for by hidden and private consumption, respectively. Thus, for a short forecast horizon, private consumption innovations contribute substantially to the forecast error variance of underground consumption. Furthermore, the importance of the hidden consumption shocks increases over the horizon of the simulation: a remarkable and increasing fraction, from 33% to 79%, of the forecast error variance of private consumption is accounted for by innovations in the hidden consumption. The $\Delta C^u$ innovations explain more than 67% of the 4-step-ahead forecasting error variance for the private consumption. These results confirm that private and underground consumption are well defined as complementary goods.

Both the impulse response analysis and the variance decomposition show that the dynamic of the private consumption aggregate is strongly determined by the hidden consumption innovations.
Table 2 Variance Decomposition

<table>
<thead>
<tr>
<th>Period</th>
<th>S.E.</th>
<th>$\Delta C^m_t$</th>
<th>$\Delta C^u_t$</th>
<th>Period</th>
<th>S.E.</th>
<th>$\Delta C^m_t$</th>
<th>$\Delta C^u_t$</th>
</tr>
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<tr>
<td>1</td>
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<td>100.0</td>
<td>0.00</td>
<td>1</td>
<td>0.06430</td>
<td>56.41</td>
<td>43.59</td>
</tr>
<tr>
<td>2</td>
<td>0.02879</td>
<td>66.83</td>
<td>33.16</td>
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<td>0.07458</td>
<td>43.07</td>
<td>56.92</td>
</tr>
<tr>
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<td>0.04177</td>
<td>32.81</td>
<td>67.19</td>
<td>3</td>
<td>0.10922</td>
<td>20.70</td>
<td>79.30</td>
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<tr>
<td>4</td>
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<td>32.92</td>
<td>67.08</td>
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<td>0.12089</td>
<td>20.80</td>
<td>79.20</td>
</tr>
<tr>
<td>5</td>
<td>0.04581</td>
<td>32.32</td>
<td>66.68</td>
<td>5</td>
<td>0.12193</td>
<td>21.41</td>
<td>78.59</td>
</tr>
<tr>
<td>6</td>
<td>0.05064</td>
<td>27.42</td>
<td>72.57</td>
<td>6</td>
<td>0.13372</td>
<td>17.82</td>
<td>82.18</td>
</tr>
<tr>
<td>7</td>
<td>0.05381</td>
<td>25.46</td>
<td>74.54</td>
<td>7</td>
<td>0.14377</td>
<td>16.36</td>
<td>83.63</td>
</tr>
<tr>
<td>8</td>
<td>0.05440</td>
<td>25.54</td>
<td>76.46</td>
<td>8</td>
<td>0.14677</td>
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<td>76.45</td>
<td>9</td>
<td>0.15335</td>
<td>15.09</td>
<td>84.91</td>
</tr>
<tr>
<td>10</td>
<td>0.05925</td>
<td>21.92</td>
<td>78.81</td>
<td>10</td>
<td>0.16128</td>
<td>14.02</td>
<td>85.98</td>
</tr>
</tbody>
</table>

4. Wealth Effects

Using equation (3) for each period starting from $t=1$, we may write the budget constraint in present value form:

$$A_t + \sum_{j=0}^{\infty} \beta^j w_{ij}^m + \sum_{j=0}^{\infty} \beta^j w_{ij}^u = \sum_{j=0}^{\infty} \beta^j C^m_{ij} + \sum_{j=0}^{\infty} \beta^j C^u_{ij} + (1 - \lambda) \sum_{j=0}^{\infty} \beta^j C^u_{ij}$$

(9)

Forward substitution in equation (3) shows that the present discounted value of total consumption is constrained by the level of wealth $A_t$ plus the present discounted value of labor earnings in the two sectors of the economy, plus $(1 - \lambda)$ time the present discounted value of underground consumption.
If $|\lambda| < 1$, the underground consumption may impose a negative (positive) wealth effect on the representative consumer as long as $\lambda < (>) 0$. With a constant interest rate and $\lambda > 0$, an increase of underground labor income from 0 to $w_u$ provides an increase in wealth in accordance with the budget constraint. However, our estimations yield a negative value of $\lambda$. In this case, an increase in $w_u$ and $C_u$ will produce a wealth loss.\footnote{Notice that wealth may fall and utility may rise because of the $\phi(.)$ term. See footnote n.2 and Barro (1989).} This result implies that a country with a large underground economy tends to have a low private saving ratio.

5. Conclusions

In this paper we have presented empirical evidence on the importance of the hidden consumption for a country with a large underground economy. Using both a structural model (Euler equation) and a statistical model (VEC), we show that in Italy, aggregate hidden consumption is not a rival good for aggregate family private spending. The models are estimated using official (NA) aggregate data, whereas the underground economy used in the paper has been generated by a model based on the currency demand approach (Tanzi's approach). Thus, notwithstanding the robustness of our results, the unofficial
character of the underground variable utilized requires some caution in interpreting these findings.

Busato and Chiarini (2004) using an artificial economy characterized by a stochastic growth model, show that the relationship between private consumption and hidden consumption is relevant to the consumption insurance issue. In an economy with a large underground sector, consumers might be insured by this alternative (or additional) market and therefore able to smooth aggregate consumption over states of nature.¹⁴ Using a two sector model in general equilibrium framework, the quoted authors show that this smoothing out is achieved by switching employment, production and consumption between the market and underground sectors. In this paper using econometric techniques in a partial equilibrium framework, we stress that in economies with a sizeable underground sector, private and underground consumption are complementary and therefore they tend to change together. Moreover, the presence of a sizeable underground consumption component produces negative wealth effects.

Our results indicate that, for economies with a sizeable underground sector, a consumption model that does not explicitly incorporate this sector may be seriously compromised. Indeed, there exists a substantial difference between empirical consumption patterns and theoretical predictions (for instance

¹⁴For this issue, see for instance, Cochrane (1991).
Attanasio 1999), and this issue can be reasonably tied to the presence of a nonmarket sector, at least in those countries where this phenomenon is relevant.

Since the underground economy is an increasingly important phenomenon that arises in all countries, the evidence of this paper suggests that additional research in this area is justified, and can be extended in a variety of ways: the models (both the structural models and statistical models) might be extended to other variables, and the research should provide alternative estimations of the underground series. With unofficial data, it is desirable to carry out comparative analyses.

These findings may, to a large extent, due to the underground estimations, the selection of the variables in the VEC, the imposed exogeneity in the Euler equation, or the cointegration analysis. The structural form is specified on the basis of a priori knowledge on the structure of the relationship between the variables of interest, while a major limitation of our reduced form systems is the potential incompleteness. We work with low-dimensional VAR systems with potential omitted variables in the innovations.

6. References


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