

# **From shadow to green: Linking environmental fiscal reforms and the informal economy**

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## **Abstract**

In the past few decades many papers have analysed in some depth different environmental tax reforms and the double dividend hypothesis, i.e. the possibility of improving not only the environment but also the economy through the reduction of distortions in the tax system. However, such studies have not modelled the effects of the presence of a shadow economy, even though informal markets account for a significant and growing part of GDP in many developed economies. This paper analyses this important link using a Computable General Equilibrium model for the case of Spain, with historically high unemployment rates and a large informal economy. Since the informal labour is not taxed, when the green tax is introduced and the tax on formal labour is reduced, the pre-existing non-environment-related inefficiency of the tax system is remarkably reduced. Our analysis shows that if the distortions created by the shadow economy are considered, the case for an environmental tax reform where revenues are used to reduce labour taxes is strengthened and the possibility to find a double dividend is more likely. Our sensitivity analysis also shows that these results can also be extrapolated to some extent to other countries with different sizes of the shadow economy or different labour market conditions.