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# **The theoretical remarks about the shadow economy**

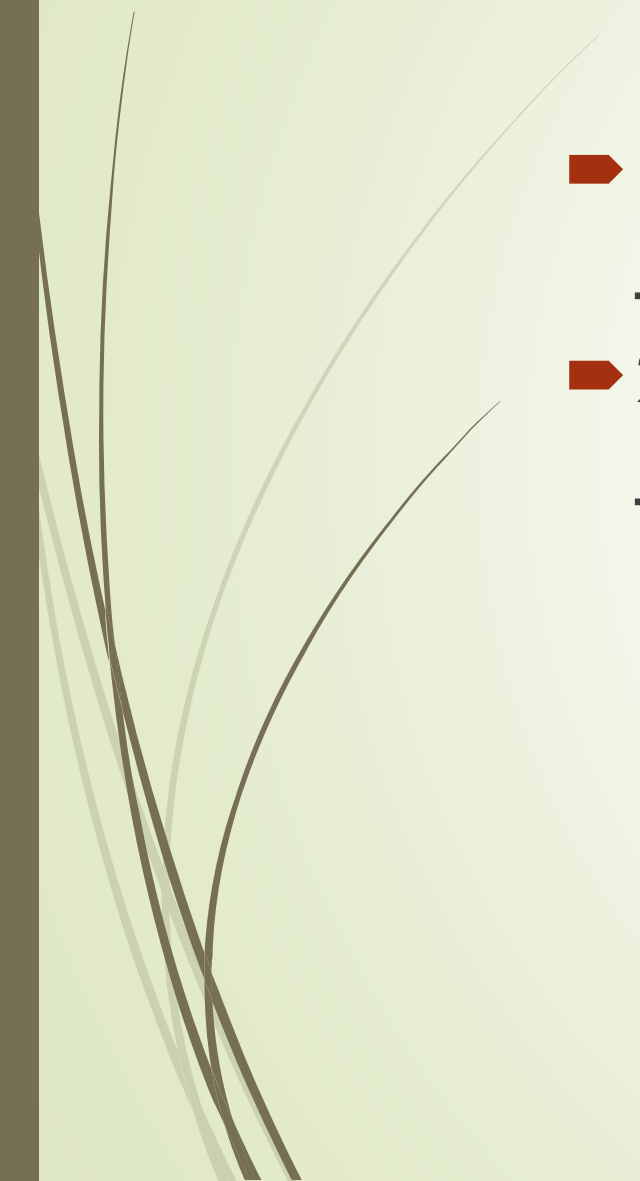
Part IV



# MAIN APPROACHES TO THE STUDY OF THE PHENOMENON OF THE SHADOW ECONOMY



# Outline

- **1. THE BASIC APPROACHES TO THE STUDY OF THE PHENOMENON**
  - **2. MAIN FACTORS OF THE DYNAMICS OF PROGRESSIVE SHADOW PROCESSES**
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# ***Goal of this lecture:***

- Considering the economic approach to the study shadow economy
- Considering the legal approach to the study shadow economy
- Considering the accounting and statistical approach to the study shadow economy
- Considering the criminological approach to the study shadow economy
- Considering the an integrated approach to the study shadow economy
- Considering the cybernetic approach to the study shadow economy
- Analyzing the main five theoretical factors of progressive shadow activity



# **1. The basic approaches to the study of the phenomenon**

- 1. The economic approach,**
- 2. The legal approach,**
- 3. Accounting and statistical approach,**
- 4. Criminological approach,**
- 5. An integrated approach,**
- 6. Cybernetic approach.**



# The economic approach

- ▶ The peculiarity of the economic approach is the study of the influence of the shadow economy on the effectiveness of economic policy, the distribution and use of economic resources, the development of reliable methods for its evaluation and measurement.
- ▶ Three levels of economic approach:
- ▶ Macro- level
- ▶ Micro- level
- ▶ Institutional level



# The economic approach

- ▶ At the macro level, shadow economic activity is analyzed from the point of view of its influence on the structure of the economy, production, distribution, redistribution and consumption of the gross domestic product, employment, inflation, economic growth and other macroeconomic processes.
- ▶ At the micro level, attention is focused on the study of economic behaviour and decision-making by the participants of the shadow economy, business enterprises, and examining individual illegal markets.
- ▶ The institutional level focused on the centre socio-economic institutions of the shadow economy, that is, a system of formal and informal rules of conduct, the sanction mechanism, the patterns of their development.



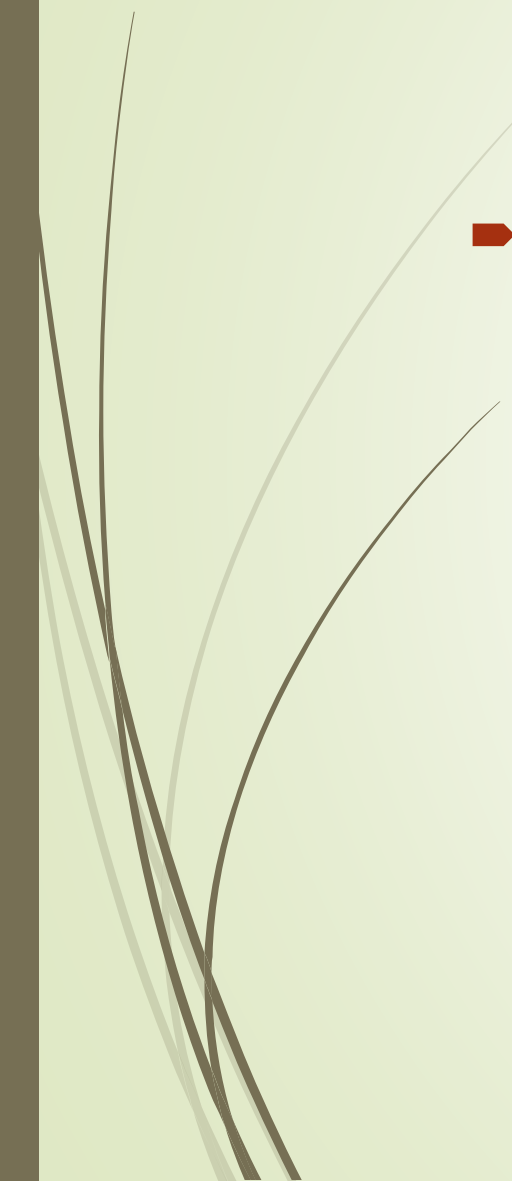


# The legal approach

- As a key criterion for the separation of shadow economic phenomena is the attitude to the regulatory system of regulation. Specific criteria are evasion from official or state registration, from state control; illegal nature.
- B. Dallago define the shadow economic processes by using the notion of "irregular economy", which refers to the activities of economic agents that do not follow regular rules and laws or are hidden in some way from public authorities and control



# Accounting and statistical approach

- ▶ With the accounting and statistical approach, the main criterion for the allocation of shadow economic relations is their unreadability, that is, the lack of fixation by official statistics. The most consistent and developed is the accounting and statistical approach based on the methodology of the System of National Accounts (SNA). The concept of shadow economy is determined on the basis of the main objective of the SNA - the most accurate accounting of all types of economic activity that ensure a real contribution to the production of gross domestic product (GDP).
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# Accounting and statistical approach

- ▶ According to the SNA methodology, all the manifestations of the shadow economy are divided into two groups:
- ▶ a) productive activities, the results of which are included in GDP;
- ▶ b) crimes against the person and property not included in the GDP and fixed in a special account to reduce statistical errors.

# Accounting and statistical approach

- The structure of the productive part of the shadow economy, to be included in GDP, includes the following elements:
- 1. Indicators of legitimate activities concealed or diminished by producers in order to evade taxes or fulfill other obligations.
- 2. Indicators of informal (unofficial legal) activity, including:
  - the activities of unincorporated (that is, directly owned by one owner, often family) enterprises working for their own needs, that is, the production of goods and services produced in households and consumed by them;
  - the activities of unincorporated enterprises with informal employment (temporary brigades of builders, etc.).

# Accounting and statistical approach

- ▶ The structure of the productive part of the shadow economy, to be included in GDP, includes the following elements:
- ▶ 3. Indicators of informal illegal activities, including:
  - legal activities that are dealt with illegally (for example, without licenses and special permits);
  - Illegal activities, which are prohibited by law production and distribution of goods and services for which there is effective market demand (production and distribution of drugs, prostitution, smuggling).




# Criminological approach

- Criminological approach considers the harm to society.
- In the frame of this approach criterion of public harm (hazard) is used.
- criterion of *destructiveness* - harm to society and its members, appropriation of unearned income





# An integrated approach

- Under this approach, various concepts (legal, statistical, economic, social, ethical) and groups of criteria are involved, which collectively reflect the essential aspects of reality and realize the possibility of their fruitful synthesis.
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# Characteristics of types of shadow economy

	<b>The criminal economy</b>	<b>Forced illegal economy</b>
Subjects	Traditional crime, the mafia, oligarchs, corrupt officials, large and medium-sized businesses	Small and medium-sized entrepreneurs, self-employed, household
Nature of activities by purpose and motives	Intentional, aimed at personal enrichment	Forced, associated with survival
Methods of unfair competition	Non-payment of taxes, collusion in the market, bribery of state officials, physical impact on competitors	Non-payment of taxes
The nature of the activity on the consequences and extent of damage	Strongly expressed antisocial, criminal	The illegal, not carrying a serious threat to society
Attitude of population	Negative	Sympathetic, tolerant



# Cybernetic approach

- ▶ Within the framework of the cybernetic concept, the shadow economy is viewed as a self-regulating and controlled system. In a purpose to forecast a future illegal activity in a country and to know laws of its development and interaction with the official sector there can be developed the economical and mathematical models of forecasting and management of the shadow economy.



# MAIN FACTORS OF THE DYNAMICS OF PROGRESSIVE SHADOW PROCESSES

## Why Rapid Growth of Informal Economy?

- Jobless growth
- Labour market flexibility
- Reduction in public sector jobs
- De-industrialization
- Economic crises
- Greater “outsourcing”
- Household survival strategies



# MAIN FACTORS OF THE DYNAMICS OF PROGRESSIVE SHADOW PROCESSES

- ▶ Anthropological factors
  - ▶ Economic factors
  - ▶ Legal factors
  - ▶ Socio-political factors
  - ▶ Administrative factors
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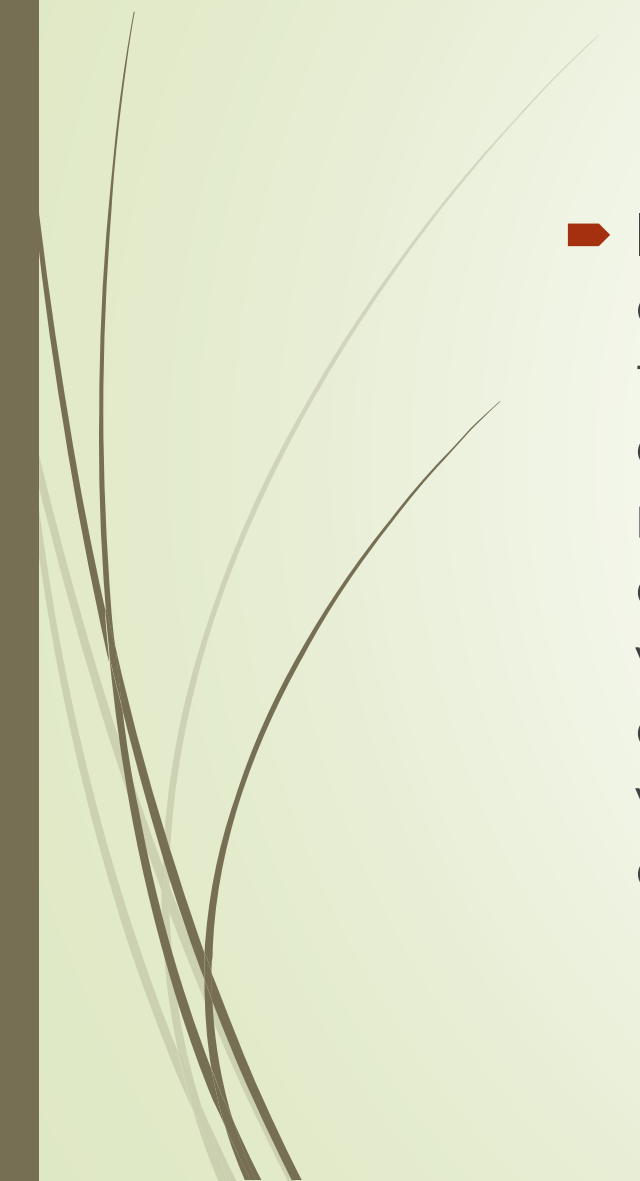


# Anthropological factors

- ▶ This factors are associated with the contradictory nature of human. Modern psychology and anthropology have scientifically confirmed the basic postulates of religious teachings about the dual nature of human: human is the arena of the struggle between good and evil, while good does not always win. Man consists of two opposites; in it there is a struggle between light and black, good and evil. He is characterized by honesty and deceit, self-sacrifice and selfishness, generosity and greed. One of the basic postulates of all religions is that human is sinful by nature.




# Anthropological factors

- ▶ Intrapersonal conflict between good and evil is resolved depending on the existing system of social relations: historical traditions, legislation, moral and moral foundations of society, etc. A man has a tendency to get more, with less effort. Its nature can not be changed; it can be influenced by the environment, upbringing, education. In the absence or weakness of restrictors, rationalism encourages a person to engage in shadow activities. Thus, the shadow component will always be present in one way or another in its economic activities.
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# Economic factors

- Economic factors are associated with distortions in the state tax policy, an inadequate degree of supporting of the market with goods and services, imbalances between various spheres and sectors of the national economy, and the low purchasing power of the population.
  - Institutionalism defined "Price obedience to the law" of economic actions.
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# Economic factors

- ▶ "Price obedience to the law" consists from:
- ▶ access to the law (costs for registration of a legal entity, for obtaining a license, for opening a bank account, for obtaining a legal address and performing other formalities);
- ▶ continuation of activities within the law (payment of taxes, compliance with the requirements of the law in the field of labor relations, payment of court costs in resolving conflicts within the legal system).



# Economic factors

- Thus, there is a direct relationship between the high price of obedience to the law and the scale of the shadow economy. The decision on whether an economic entity chooses a legal or non-legal institutional environment for its business is determined by comparing the transaction costs that arise when transactions are made in the first and second cases. Incentives for voluntary submission to the law appear in the individual only on the condition that the state is able to promote the realization of its interests through the reduction of transaction costs in the legal sector of the economy



# Economic factors

- **1. Tax and Social Security Contribution Burdens**

Since taxes affect labour-leisure choices, and also stimulate labour supply in the shadow economy, the distortion of the overall tax burden is a major concern for economists. The bigger the difference between the total cost of labour in the official economy and the after-tax earnings (from work), the greater is the incentive to avoid this difference and to work in the shadow economy

- **2. Intensity of Regulations**

Increased intensity of regulations is another important factor which reduces the freedom (of choice) for individuals engaged in the official economy / labour market regulations, trade barriers, and labour restrictions for foreigners./



# Economic factors

- ▶ Public Sector Services

An increase of the shadow economy can lead to reduced state revenues which in turn reduce the quality and quantity of publicly provided goods and services.

Ultimately, this can lead to an increase in the tax rates for firms and individuals in the official sector, quite often combined with a deterioration in the quality of the public goods (such as the public infrastructure) and of the administration, with the consequence of even stronger incentives to participate in the shadow economy.

Important note: Countries with more general regulation of their economies tend to have a higher share of the unofficial economy in total GDP, is found in their empirical analysis.



# Economic factors

1. **Smaller shadow economies appear in countries with higher tax revenues if achieved by lower tax rates, fewer laws and regulations and less bribery facing enterprises. Countries with a better rule of law, which is financed by tax revenues, also have smaller shadow economies.**
2. **Transition countries have higher levels of regulation leading to a significantly higher incidence of bribery, higher effective taxes on official activities and a large discretionary framework of regulations and consequently a higher shadow economy.**



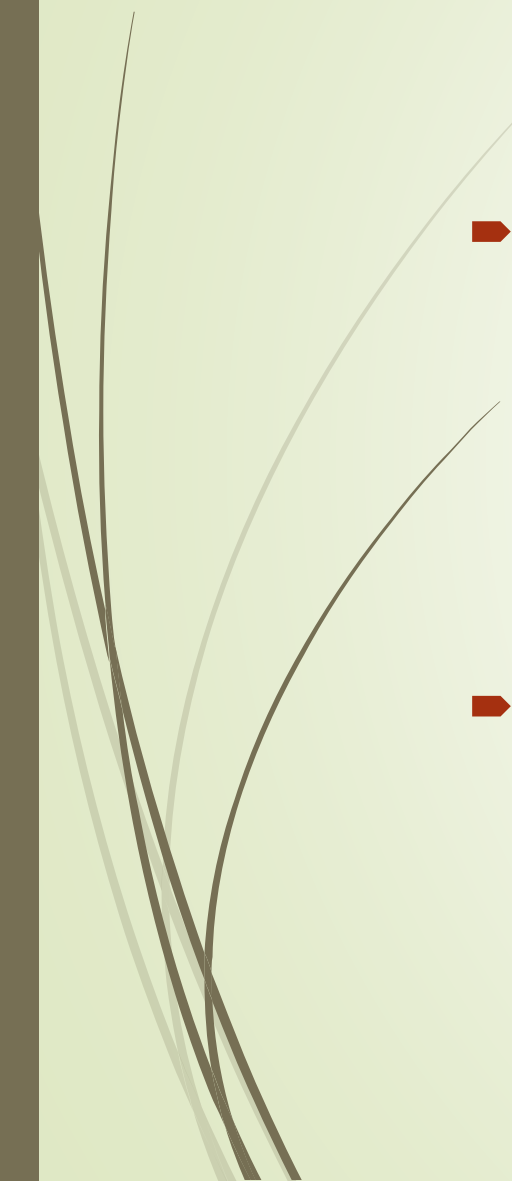
# Legal factors

- ▶ The third group of reasons include legal factors related to the imperfection of the legislative framework and the mechanism for coordinating the fight against economic crime, ineffective activity of law enforcement agencies in suppressing illegal and criminal economic activities.
- ▶ The improvement of the legal framework is endless. Contradictions between the rapidly changing conditions of the market economy and the existing legislative base allow the subjects of the shadow economy to use those "gaps" that are formed in the legal sphere, and quickly rush there.





# Socio-political factors

- The fourth group of reasons explaining the phenomenon of the shadow economy, we include socio-political factors. They are associated with a rather low authority of the state power among the population, violation of the social orientation obligations on the part of the state, the presence in society of socio-psychological sentiments and landmarks, the degree of resolution of the social and economic problems of society.
  - Experience shows: as soon as this system collapses or malfunctions, the shadow economy receives additional motives for development. The contradictions between the needs of economic development and the conduct of state policy also have a significant impact on the process of formation of the shadow economy.
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# Social factors

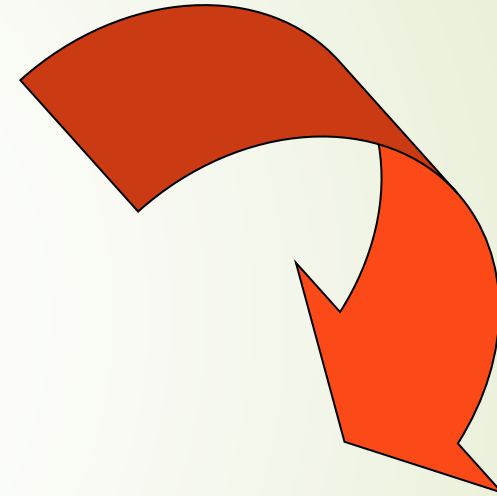
- ▶ Poverty and underground economy are serious problems with corrosive effects facing many countries. Poverty is currently one of the most serious problems in the World. As poverty increases in countries of the world, there also appears a strong indication about the increasing rates of underground economy around the world. One therefore wonders whether there is a kind of linkage between the two concepts. Poverty has been perceived by many as not just lack of money, food and assets but also as lack of access to education and health care and lack of security, dignity and independence (Elijah and Uffort, 2007). Sen 1981 asserted that poverty is not only low income, but also deprivation of essential capabilities. The deprivation itself is a relative concept which can have different definitions in various places and times. Sen believed that relative deprivation is the core factor of poverty.



# Inequality hinders growth and increases poverty



Poverty



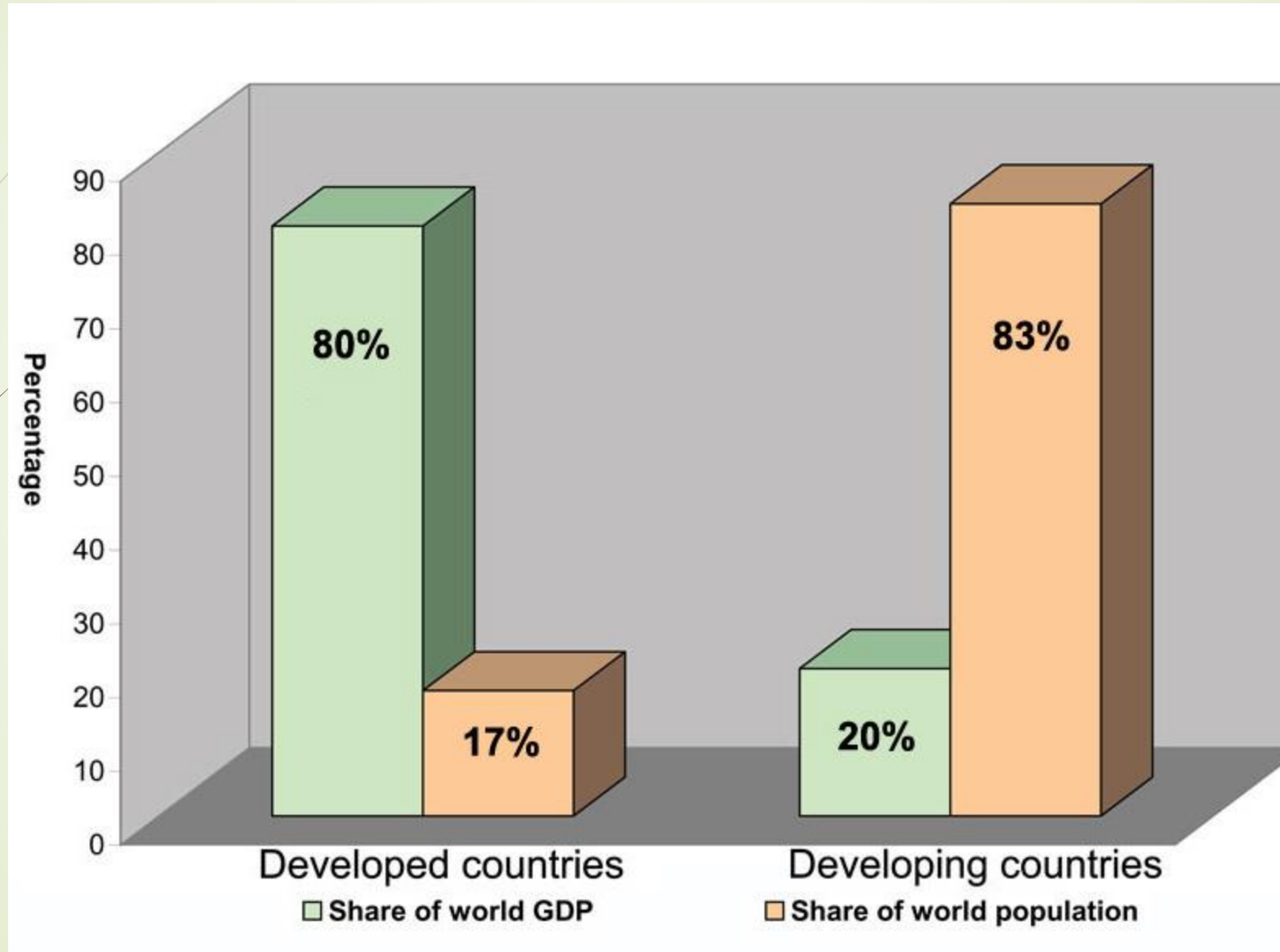
**Lack of economic power**

- Low income
- Low assets

**Lack of socio-political power**

- Denial of human rights
- Discrimination

# Unequal GDP distribution






## Informal economy share of Gross National Income, 2015

- Developing countries: 41%
- Transition economies: 38%
- OECD Countries: 18%

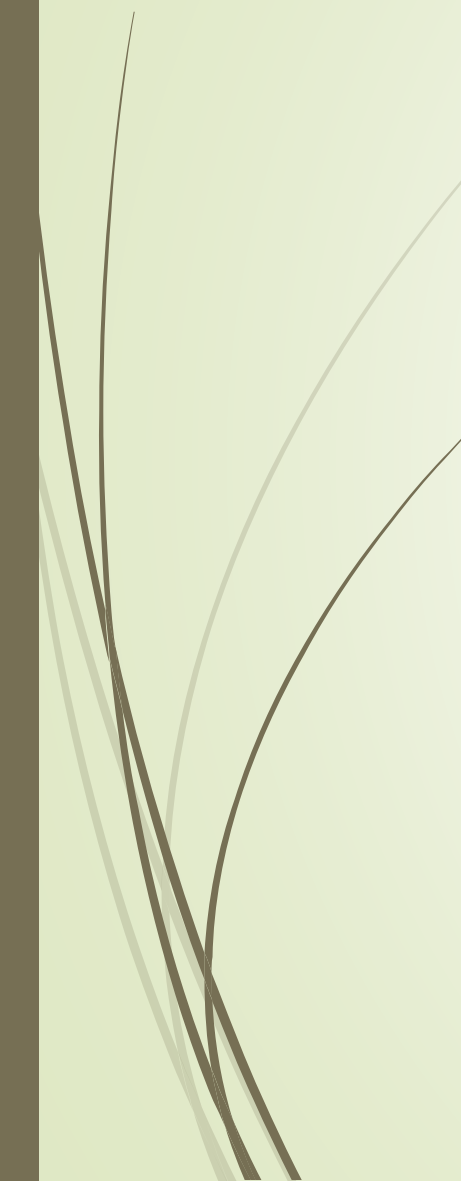


# Health Inequalities

- ▶ Great differences between and within countries
    - ▶ Access to healthcare
    - ▶ Life expectancy
    - ▶ Under-five mortality
  - ▶ Intellectual Property Rights and Patent Monopolies
    - ▶ High drug prices
    - ▶ Unequal access
    - ▶ Compromised capacity to react to crises
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# HIV/AIDS

- Highly unequal global and regional impacts
  - Lowers growth, increases dependencies
  - Worsens existing inequalities between women and men
  - Depletes human resources, threatening stability, security and development
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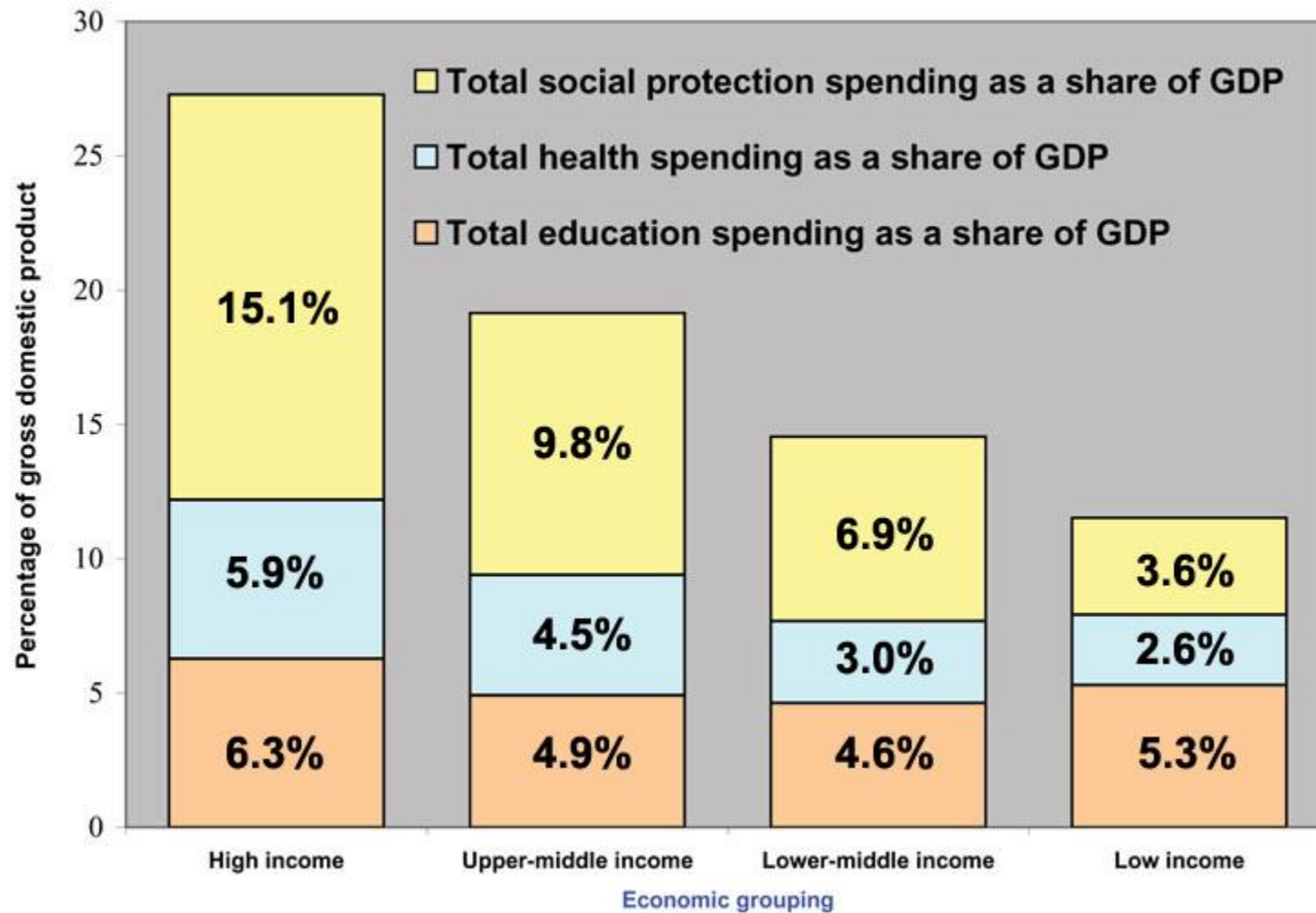
# Education, 2014

Despite progress, substantial inequities exist by region

<i>Indicator</i>	<i>Highest</i>	<i>Lowest</i>
Net Primary Enrolment Ratio	<b>95.7%</b> Latin America & Caribbean	<b>62.8%</b> Sub Saharan Africa
Net Secondary Enrolment Ratio	<b>89.2%</b> N. America & W. Europe	<b>21.3%</b> Sub Saharan Africa
Girls Primary Enrolment per 100 boys	<b>99-100</b> CIS, Europe, E. Asia	<b>76</b> Southern Asia
Girls Secondary Enrolment per 100 boys	<b>107</b> Latin America & Caribbean	<b>79</b> Southern Asia



# Government Spending Priorities



High-income countries spend *2½ times* more of national wealth for health, education and welfare than low income countries.



# Administrative factors

- ▶ lack of an effective state vertical management, covering all spheres of the economy;
- ▶ excessive administrative barriers that impede the development of legal business;
- ▶ irresponsibility and incompetence of the state administrative apparatus, absence of dependence of a payment of the official on concrete results of his work on development of legal market relations in economy;
- ▶ high unofficial "charity" burden on entrepreneurs.



Thank  
you

