



Saltanat Kondybayeva, PhD

Al-Farabi Kazakh National University

saltanatkondybayeva@gmail.com



The theoretical remarks about the shadow economy

Part V



SOCIO-ECONOMIC CONSEQUENCES OF SHADOW ECONOMIC ACTIVITY



Outline

- **1. INTRODUCTION**
 - **2. CLASSIFICATION AND FACTORS**
 - **3. POSITIVE AND NEGATIVE EFFECTS OF INFORMAL ECONOMY**
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Goal of this lecture:

- ▶ Considering the illegal (underground) activities
- ▶ Considering the evolution of the meaning “shadow economy”
- ▶ Analyzing the main factors of progressive shadow activity
- ▶ Identification of the determinants that increase the scope of illegal economic activity
- ▶ Analyzing statistic data
- ▶ Defining positive and negative impact of shadow activity



Introduction

The positive or negative influence of the underground economy is an ample phenomenon, mainly stated, that the underground economy effects are usually negative, but on the other hand there are also positive effects as the refreshment of the economic branches, elimination of the stiffness or the increase in the state stability.

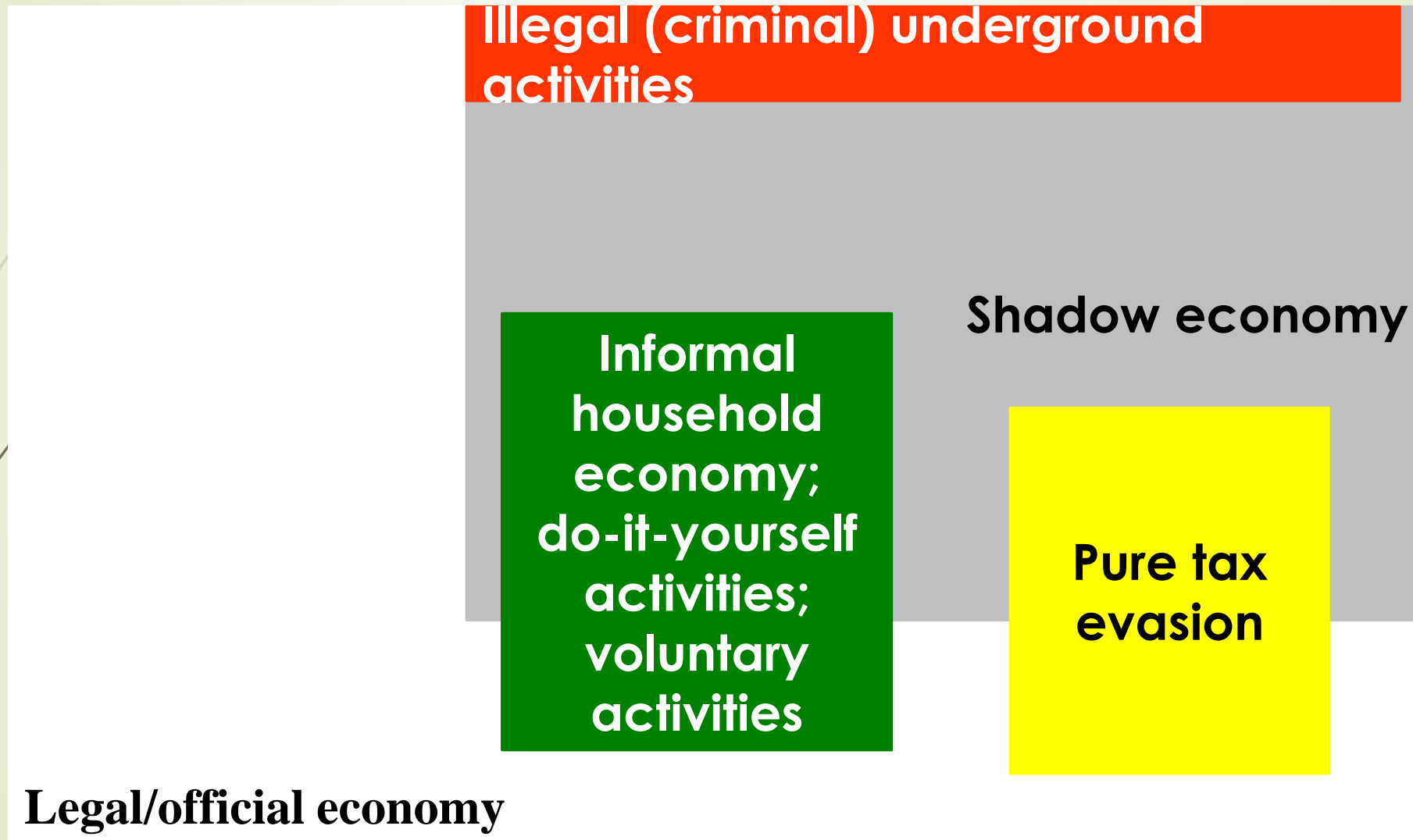
According to the Fraser Institute studies, a growing underground economy is the sign that the democracy works bad, citizens condemning governments policies through an economic behavior, protesting to the law and regulations. The efforts to limit the underground economy, are considered a manifestation of totalitarianism, the informal economy represents a real democratic process

CLASIFFICATION AND FACTORS

- 1. Definitions: different criteria and concepts
- /black, shadow, underground, hidden economy/;
- 2. Three sectors of the hidden economy:
 - Informal /legal/;
 - Grey /semi legal /;
 - Black / illegal /;
- 3. Segmentation of the labour market in the IE
- 4. Factors for the IE growth:
 - Global;
 - Intraregional;
 - National;
 - Neo liberal reforms;

Defining the Shadow Economy

Figure 1: Legal, shadow, illegal and informal economy and tax evasion






Evolution of meanings

Important message:

Informal Economy /IE/ is not a temporary, transitional phenomenon , as it used to be described in the theory and practice



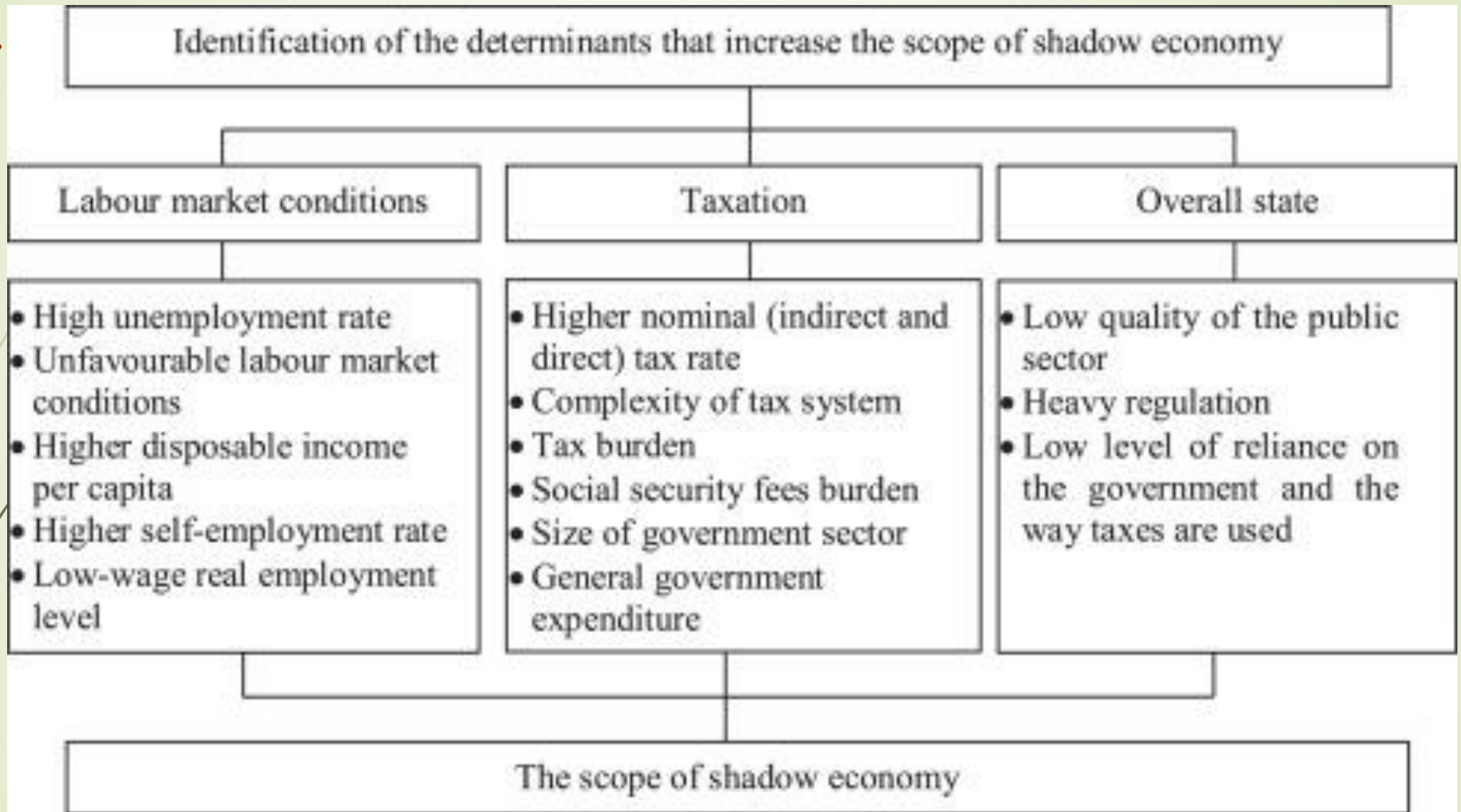
The shadow economy may be present in all sectors of the economy, which can generate extremely difficult situations for the general development of the economy itself. The main causes of the underground economy are considered:

- excessive taxation - tax system has been identified as one of the main factors for the emergence and development of the economy;
- government regulations for certain types of activities - increase in the intensity of legal regulations, often measured by their number, reduces freedom of action of individuals employed in the formal economy, thus leading to a significant increase in labor cost in the formal economy, costs it is the true incentive to work in the informal economy;
- weak legal system - as long as it works on the principle of rule of law leaves enough loopholes to get away with specific operating businesses in the economy.
- fear of losing some welfare benefits provided by the state;
- much flexibility in the use of labor;



The economic literature distinguishes three types of causes of the shadow economy (Schneider, 2009):

- (1) The burden of direct and indirect taxation, both actual and perceived: a rising burden of taxation provides a strong incentive to work in the shadow economy;
- (2) The burden of regulation as proxy for all other state activities. It is assumed that increases in the burden of regulation give a strong incentive to enter the shadow economy;
- (3) The tax morality (citizens' attitudes toward the state), which describes the readiness of individuals (at least partly) to leave their official occupations and enter the shadow economy: it is assumed that a declining tax morality tends to increase the size of the shadow economy.



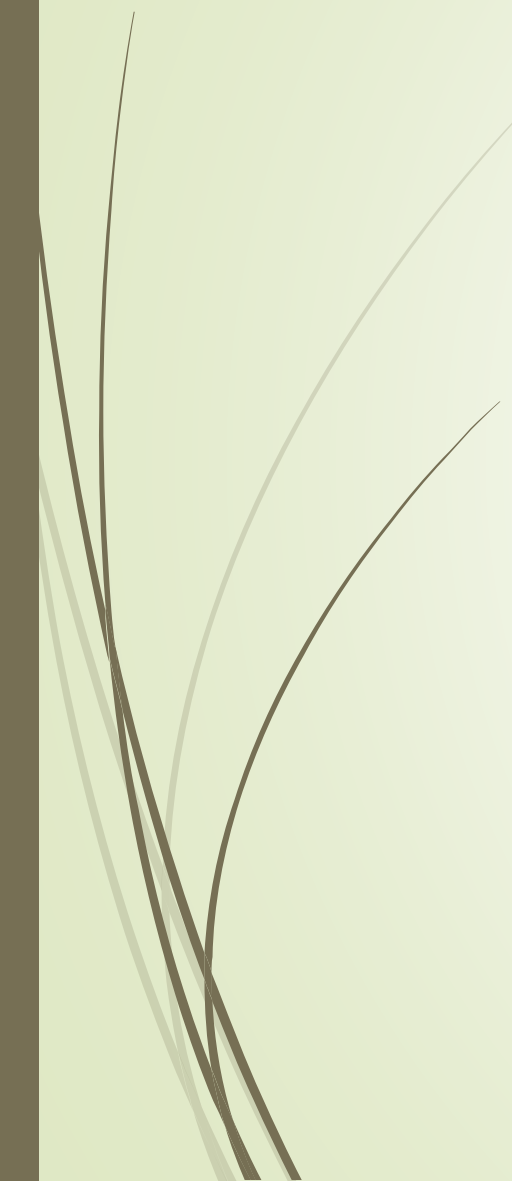


Past significance

- Initial considerations of Informal Economy /IE/ were related to imaging it, as just an adjunct to the official economy.
- Gradually IE marked a certain growth. It involved c branches and regions, thus, engaging numerous in figures and sustainable in time, labor and business groups.
- It transformed from a safe-way for unemployed and low-income groups, into a factor, adding to the overall economic growth.



Present importance

- Today, informal work parallels labor, applied in the formal economy; and thus, informal employment turns into a significant source of primary and/or secondary (marginal) incomes for individuals. This process happens, primarily in the developing countries.
 - National economies, especially in times of crisis, evolve to new economic equilibrium and dynamics, rooted at two inter-dependent economic sectors: the formal and informal one.
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IE size in the transition countries

Region / Countries	Share of Employed in Informal Economy
Central Europe	15%-20%
Baltic Region, Bulgaria, Romania, Croatia	20%-35%
ex-Yugoslavia	40%-50%
ex-USSR Asian countries	50%-80%

- ▶ The share of informal sector in Central Europe is estimated at 15%-20% of the total number of employed. Percentage levels of this share in the Baltic Region, Bulgaria, Romania, and Croatia vary in between 20% and 35%. However, in two territorially distant regions, flourishing of informal economic activity is observed. For instance, in the states of ex-Yugoslavia, this percentage range is 40%-50%, and in the Asian territories of the ex-USSR, this is a range of 50% to 80% of all employed.

4. Results of the Size of the Austrian, Czech, German, Polish and Slovakian Shadow Economies

Table 2: Size and development of the shadow economies in countries over 2005 to 2015

Countries/ Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	10.3	9.7	9.4	8.1	8.5	8.2	7.9	7.6	7.5	7.8	8.2
Czech Republic	18.5	18.1	17.0	16.6	16.9	16.7	16.4	16.0	15.5	15.3	15.1
Germany	15.4	15.0	14.7	14.2	14.6	13.9	13.2	12.9	12.4	12.2	12.2
Poland	27.1	26.8	26.0	25.3	25.9	25.4	25.0	24.4	23.8	23.5	23.3
Slovakia	17.6	17.3	16.8	16.0	16.8	16.4	16.0	15.5	15.0	14.6	14.1

Source: Calculation by Friedrich Schneider, University of Linz, Austria, January 2015.

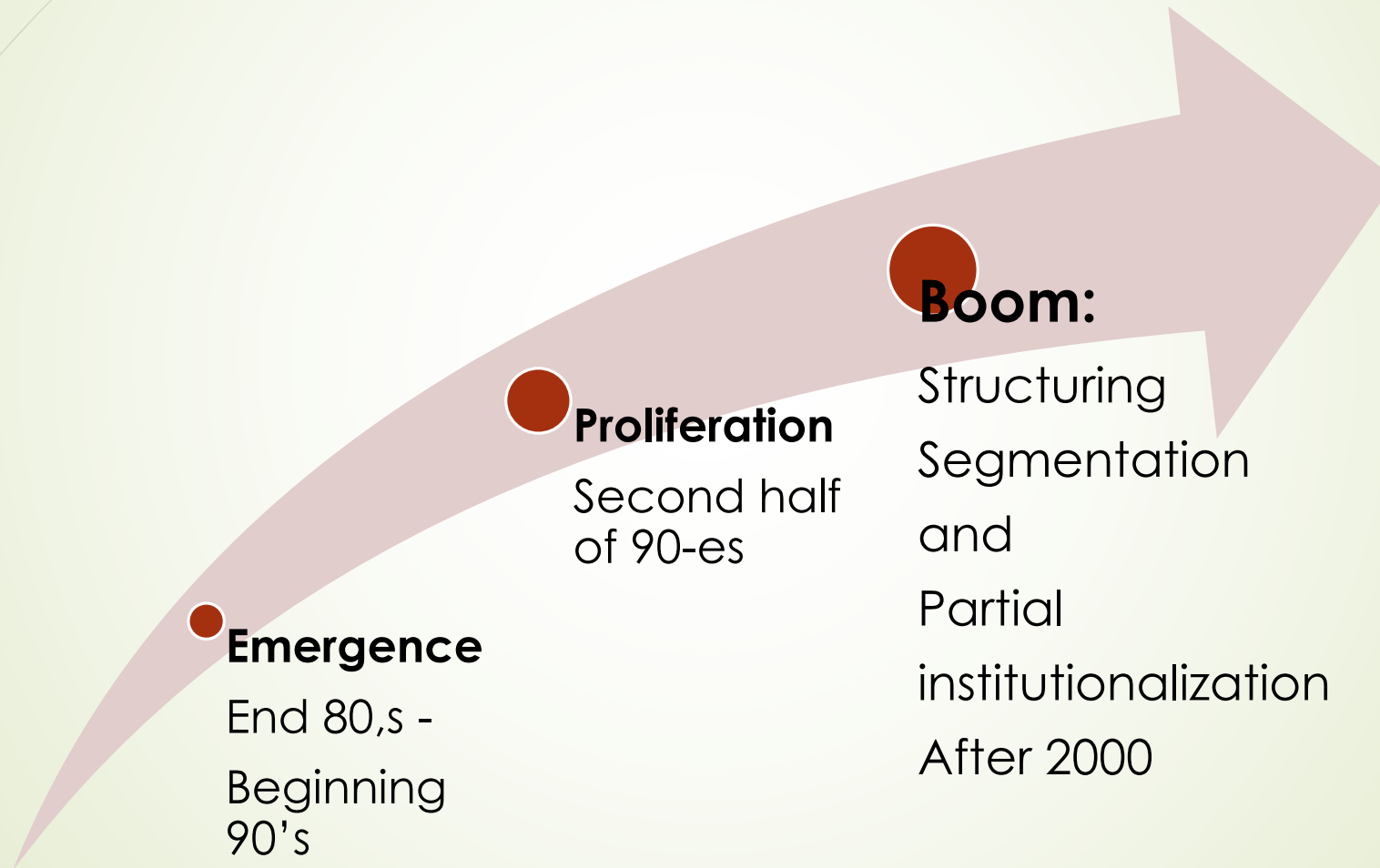
Results of the Size of the Austrian, Czech, German, Polish and Slovakian Shadow Economies

Table 3: Average relative impact of the causal variables on the shadow economy in the countries (1998:2010) in %

Countries/Year	Personal income tax	Indirect taxes	Tax morale	Unemployment	Self-employment	GDP-growth	Business Freedom
Austria	15.3	31.4	10.5	11.3	19.5	2.9	9.0
Czech Republic	6.3	34.3	8.2	17.2	21.7	4.1	8.1
Germany	13.8	28.0	7.5	22.9	16.1	2.6	9.1
Poland	4.8	31.9	7.3	23.9	23.6	3.4	5.0
Slovakia	3.4	35.4	4.9	28.5	14.8	6.1	6.9

Source: Schneider und Buehn (2015), p. 29.

Informal Economy Stages



What is behind this trajectory?

- ▶ Informal employment appeared simultaneously with the political changes in the 80s, which period of time is known as the “perestroika”. During the totalitarian period of time, each informal activity (excluding home-centered activities), was considered, as a rule, to be illegal and was penalized by official authorities. Another exception to this generalization are the small segments of agricultural activities in the field of land cultivation, mutual service exchanges among house-holds, where there is relatively no direct state intervention in labor market relations of private/family nature (Poland, Hungary, Bulgaria, and others).
- ▶ Since 1989 a period of forced and chaotic informalization came, due to the neoliberal economic reforms, imposed in the 90s within the whole vast region of the Central and Eastern European Countries. The boom of unregulated employment is a result of the specific and compressed in time processes of privatization and economic restructuring of the big state-owned and state-managed companies in a large scale. These processes were coupled with mass liberalization of labor force without applying adequate measures for support of the emerging labor markets. Some of these measures, which were never applied as economic tools are requalification of individuals, labor market brokerage, labor market funneling of the labor force, stimulation of self-employment and other tools.
- ▶ The next, third wave, which occurred during the first decade of the 21st century, is a period of time, when most of the national economies of the Eastern and South-East Europe were modified into a test-field to apply the principles and policies of the Washington Consensus and its relevant tools for imposing shock therapies.

CAUSES:

Low level of tax culture



Reduced budget income – poor quality public service

EFFECTS:

Poor efficiency of inspection and customs monitoring

Increased breaches of worker rights

Inefficiency of state bodies and corruption

Unfair competition

SHADOW ECONOMY

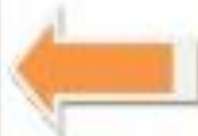
Black labor market
tax evasion
illegal business operation

High rates of unemployment and poverty

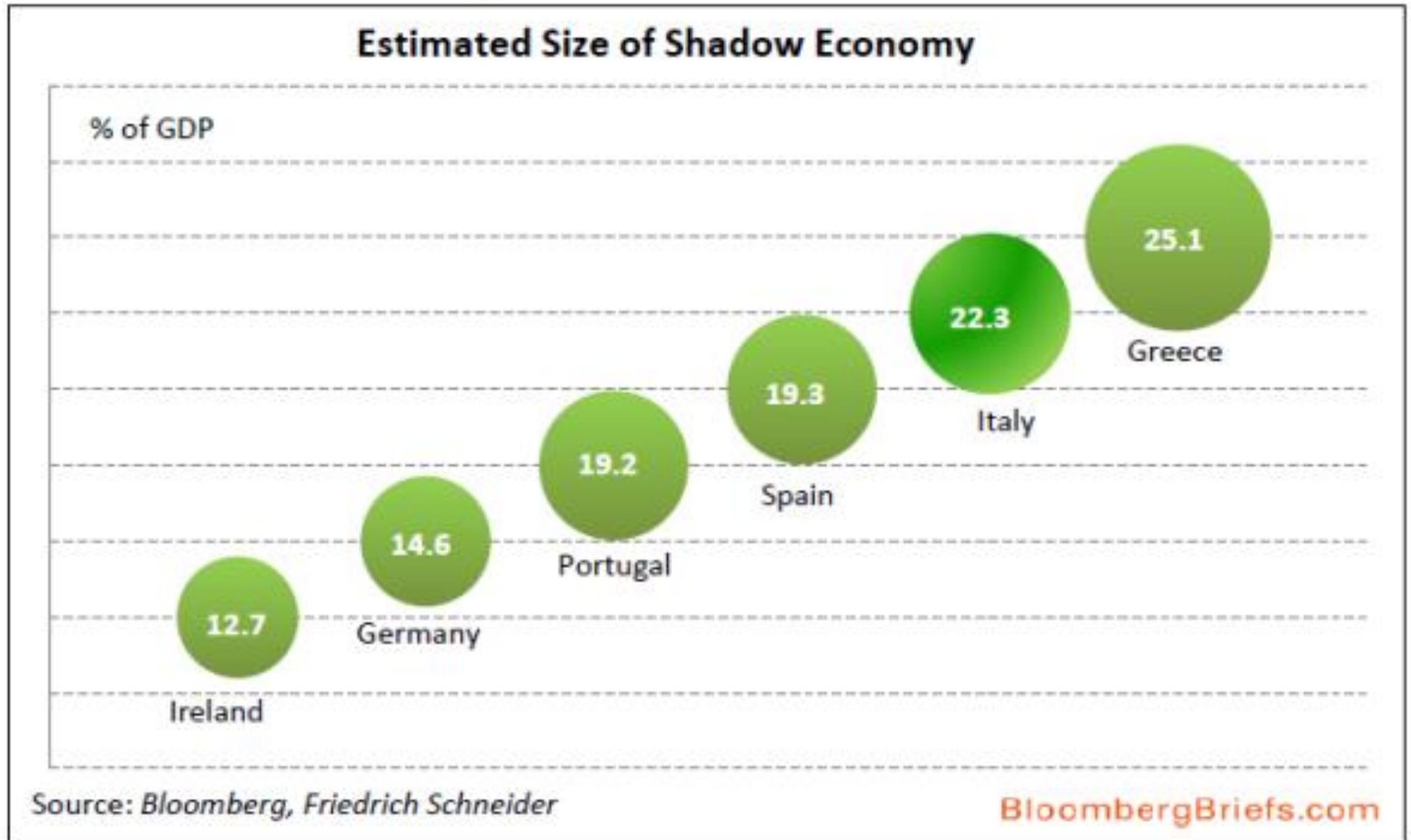
False citizens' and businesses' perception of the shadow economy

Destimulative tax policies and huge administrative burden

Compromised health and safety at the workplace



Shadow Economy



Effects of the Informal Sector to the economy

- Positive
 1. Responds to the demand of the urban services and small-scale manufacturing
 2. Provides economy with the operative and entrepreneurial spirit
 3. Absorbs those who do not have regular jobs, who lack skills and education, and those who are searching for additional income.
 4. Contributes to the national income.





Positive Effects

- finding jobs (which diminishes unemployment rates); the process of accruing additional incomes for individuals (which diminished poverty);
- evolving the way services are provided to the market (which was limited by the party-state system);
- producing demanded goods – mainly in the processing industry, information industries (internet, and mobile technologies, which allow individuals to work from their homes, or from a distance; the e-economy, in general);
- greater use of labor potential of households and so on...



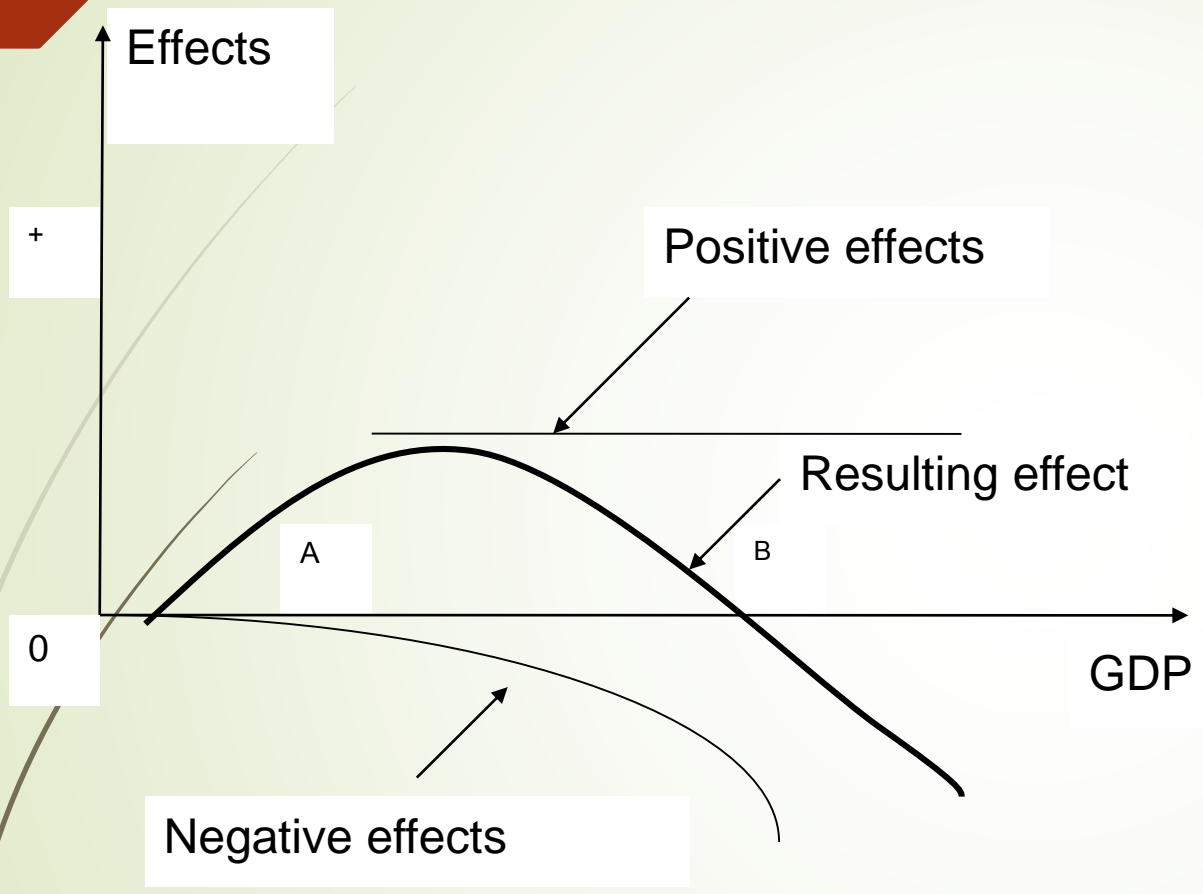
Negative effects

- ▶ **To the negative effects all national analysts relate:**
 - **at first place, direct and indirect practices to circumvent labor and social standards and acts.**
 - **diminishing tax incomes and social security proceedings into national treasury turns into financial burden for the state and social burden for the individuals.**
- ▶ **More examples of negative effects may be given here, such as non-loyal business competition /social dumping/, woman and child labor exploitation, criminalization of businesses /where shadow and black segments are organically inter-mingled/, administrative corruption, and others.**

Effects of the Informal Sector to the economy

- Negative
 1. Limit on government restrictions on the economy and society
 2. Many transition economies would perform at much lower level of production
 3. Indicates that there is a weak relationship between the country and its people





The positive effect increases in the parabola, that is, the rate of its growth slows down with the increase in the relative size of the shadow economy. But the negative effect has a pronounced tendency to accelerated growth as the shadow economy increases. In this case, the resultant effect will first have a positive sign and grow (section OA), then this growth will stop (at point A), the process of decline (section AB) will begin, and then the resulting effect will acquire a negative value, the value of which will grow rapidly (after point B).

Dependence of the effects of the shadow economy on its scale



FORMALISATION OR IDENTIFICATION?



Evolution of concepts and policies

- Transformation by economic sectors takes comparatively long time /half a century, at least/; during this period of time economic theories and political views evolve, in terms of their relation to informal activities.
- Although official data for developing countries show that even today the share of unregulated labor is comparatively low , the phenomenon “informal economy” becomes a focal point for the strategic analysts and decision-makers.
- Processes of the last decade changed significantly EU’s official position and attitude towards the process of “informalization” of the economy. The very accent of the EU policy altered the banning norms /restrictive / into curative regulations and gradual legalization of some segments of the informal employment.
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Three Competing Views of the Informal Economy and Economic Development

- By definition, informal businesses are hidden from the eyes of the state and so most of what we have relies on estimations and very micro-level studies.

An cross-country report that appeared in the [Brookings Papers](#) on August 2008 aims to improve the understanding of the relationship between economic development and the informal economy.



The romantic view

According to this view informal firms are actually or potentially extremely productive, but held back by government taxes and regulations as well as by the lack of safe property rights and access to finance.

If such barriers were lowered, informal businesses would register and take advantage of the benefits of their formal status. Thus, this view assumes that unofficial firms are fundamentally similar to official ones.



The parasite view

The parasite view states that informal firms need to stay small to avoid detection.

The decision to remain in the informal economy is a rational one, because the cost advantage of avoiding taxes and regulations allows unofficial firms to undercut official firms in prices.

Informal firms are thus hurting growth because their small scale makes them unproductive and because they take away market share from more productive, formal competitors. Government policy should aim to eradicate informal firms by reducing tax evasion and increasing government regulation enforcement.



The dual view

Informal and formal firms are operating in different markets and have different customers so they do not compete against each other.

Since informal firms provide livelihoods to millions of people, government policies should not raise the costs of doing business for them.

Instead, the role of government policies should be to promote the creation of official firms and let the informal ones die as the economy develops.



Additional arguments for the new identity

Since there is such a productivity gap between formal and informal firms and considering that there is no evidence that informal firms become formal as they grow, stimulation of formal firms is necessary for economic growth.

The evidence points out that a best move would be to support the creation of formal firms run by educated managers and utilizing modern practices to stimulate economic development.



IE-Crisis



- ▶ Figures published by the Organization for Economic Cooperation and Development (OECD) show that the world has more people working informally than formally.
- ▶ Campaigners emphasize that informal workers are not necessarily illegal workers. The OECD says that a record 1.8 billion workers are employed in underground activities, compared with 1.2 billion in the formal sector.
- ▶ During a recession, “dismissed workers frequently have to move to the first available job, even if it is of a lower quality than the one they have lost”. It says that this will have a profoundly negative effect on the United Nations’ Millennium Development Goal to halve the number of people who live on less than \$1 (69p) a day.



IE-Migration

- **Between 4 million and 8 million people reside illegally in Europe. Illegal migration is a top priority in European politics for the past few years.**
- **Illegal migrants come mainly to the Mediterranean countries from Africa, Eastern Europe, and the Middle East. Most of them also choose to stay permanently. Low fertility rates and aging populations coupled with a higher level of education have led to labor shortages in low-paying sectors.**
- **Italian sociologist Emilio Reyneri's : the IE in Southern Europe has a pull-effect on migration. The IE has deep social and historical roots and has not been caused by immigration. The opportunities for informal work, strengthened by the fact that there are labor shortages in sectors where natives no longer want to work, has made these countries attractive for migrants.**



Underground activities may be acceptable at least in the short run under three circumstances:

(1)to provide employment opportunities when times are bad,

(2)to provide individuals with freedom to choose (this is inconclusive; the debate on capitalism and socialism is still ongoing),

(3)to avoid complying with rules and regulations imposed by an ineffective government.



Thank
you

