Vadyba
Journal of Management
2012, Nr. 1 (20)
ISSN 1648-7974

SHADOW ECONOMY: UKRAINIAN CASE

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Abstract

The article is devoted to the describing of shadow economy in Ukraine and proposing methods to legalize it. In Ukraine shadow economy has some special features. It can be considered as the only possible behavior of entrepreneurs in the conditions of social and economic instability, legislative and administrative confusion. Deep-rooted corruption creates auspicious environment for existing of shadow sector. So there're special methods to fight against this phenomenon and they're examined in this article.
Shadow economy can be divided into two groups: crime and corruption and entrepreneurs who are forced to hide their incomes. First group includes drugs and weapons trade, racketeers, corrupt officials. Criminal structures act mostly in the sphere of distribution and redistribution of profits. Second group of shadow economy includes shadow entrepreneurs who are unsatisfied with tax burden and different barriers in doing business. Shadow entrepreneurs are the most interested in changing the situation as it will increase life quality in the country.
To struggle with shadow economy it's important to estimate its volume. The latter is done in the article according to the Ukrainian government and foreign experts. Thus, according to the Ministry of Economic Development and Trade of Ukraine, which is responsible for this indicator, shadow economy is equal to approximately one third of Ukraine's GDP. These data don't coordinate with the reports provided by relevant international institutions and foreign scientists. For example, the latest available result of World Bank's investigations shows that it is a half of the GDP.
Recently adopted Ukrainian laws are analyzed in the article as to their efficiency in the field of prevention of corruption, such as first Tax Code of Ukraine, the Law on Access to Public Information and the Law on Prevention and Combating Corruption.
Methods to legalize shadow economy in Ukraine are proposed, for example creation of favorable environment for business development, improvement of tax system, overcoming of illegal labor market, raising of public awareness, enforcement of capacity of power, strict punitive measures for corruption and raiders, minimizing of government regulation of various spheres of life, etc. Mechanisms proposed in this article will help to reduce the shadow economy and to increase the efficiency of legal economy.
KEYWORDS: shadow economy, corruption, tax evasion, GDP, Global Corruption Barometer, Doing Business.

Introduction

The growth of the shadow economy leads to structural distortion and imbalance of social and economic development, is an obstacle of the processes of state building in the country, doesn't favor to democratization of the society and to the European integration of Ukraine.

Activity in shadow economy is considered as criminal offence and explained by deviation from common social standards. But it's necessary to take into account that Ukraine is characterized by social and economic instability, legislative and administrative confusion etc. That is why in our opinion shadow economy has to be considered not only as deviation, but also as a forced behavior. A lot of kinds of activity are conducted legally, but final results aren't shown with the aim of tax evasion. It's widely known that economic subjects try to act rationally, so it's logic to imagine that in the conditions of shadow economy they act according to this principle.

Therefore strategy of struggle with shadow economy has to develop favorable conditions for legal activity, to take into consideration interests of entrepreneurs instead of using administrative-command methods.

Shadow economy as one of the most important problem of Ukraine

Official statistic data concerning gross domestic product (GDP) of Ukraine since 1991 doesn't seem truthful. According to it GDP of Ukraine decreased significantly comparing with rate observed in 1990. The volume of GDP of Ukraine declined almost twice during 20 years (Fig. 1).

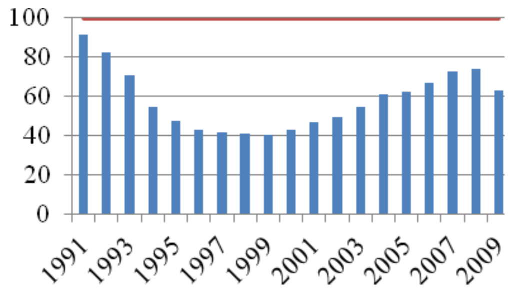

Figure 1. GDP of Ukraine comparing with 1990, %

Visible decreasing of GDP of Ukraine doesn't coordinate with other statistic data, for example, producing of electrical energy. Energy, especially electrical, is one of the most important product of industrial society. According to results of investigations a lot of indicators depend on production of electrical energy. It's widely known that production and consumption of electrical energy is a very important indicator of progress. Rates of production of electrical energy of Ukraine don't decrease as GDP (Fig. 2).

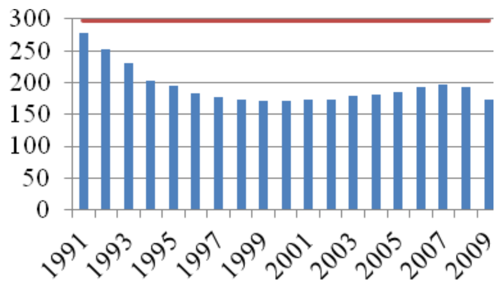

Figure 2. Production of electrical energy in Ukraine comparing with 1990, billions kilowatts per hour

This situation can be explained by unofficial economic activity. This is one of the most important problems for Ukraine.

Groups of shadow economy

Shadow economy has different displays. The corruption, as a primary source of shadow economy activities, can be detected in almost every activity of human life in Ukraine. As it can be seen from the Table 1 it permeates such spheres as political parties, parliament, police, business, media, public officials, judiciary, NGOs, religious bodies, military and education.

Depending on conditions and other significant characteristics, shadow economy can be divided into two big groups. The first group is tightly connected with the sphere of criminal offences. It is very dangerous to national economy and includes drugs, weapons trade, racketeers etc. Moreover, corrupt officials are also connected with this group.

Scales of shadow economy of this group significantly depend on high-quality legislative base and law supremacy. This group is more harmful than the second that will be presented further in the article. It is very hard to combat this type of shadow economy, since the ones who organize it are usually at the top of either power branches.

The second group of shadow economy isn't fully illegal, but by its nature it is out of legal environment. This activity is realized by shadow entrepreneurs. They have many reasons to hide their business activities. One of the main reasons "to stay in the shadow" for them is unbearable tax burden and different barriers in doing business. All these factors should be considered as causes of shadow economy if misused by the government.

Table 1. Global Corruption Barometer 2010 results for Ukraine

Question	Answer		
In the past 3 years, how the level of corruption changed?	Decreased, %	Same, %	Increased, %
	7	63	30
To what extent do you perceive the following institutions to be affected by corruption? (1 – not at all corrupt, 5 – extremely corrupt)	Political parties		4,0
	Parliament		4,1
	Police		4,3
	Business		3,7
	Media		3,2
	Public officials		4,1
	Judiciary		4,4
	NGO		3,2
	Religious bodies		2,3
	Military		3,5
	Education		4,0
How would you assess current government's actions in the fight against corruption&	Ineffective, %	Neither, %	Effective, %
	59	24	16

On the Table 2 you can see Doing Business 2011 data for Ukraine. The overall "Ease of Doing Business" rank (out of 183 economies) is 145th (in 2011) and 147th (in 2010).

Table 2. Doing Business 2011 Results for Ukraine

Topic rankings	DB 2011 Rank	DB 2010 Rank	Change in Rank
Starting a Business	118	136	↑18
Dealing with Construction Permits	169	181	↑2
Registering Property	164	160	↓4
Getting Credit	32	30	↓2
Protecting Investors	109	108	↓1
Paying Taxes	181	181	No change
Trading Across Borders	139	139	No change
Enforcing Contracts	43	43	No change
Closing a Business	150	145	↓5

These two groups of shadow economy and their subjects are related as they have the same aims and same ways of realization. But these groups also have considerable peculiarities:

- Criminal structures act mostly in the sphere of distribution and redistribution of profits. These structures misappropriate part of profits illegally (violence, blackmail, murder etc.). And shadow entrepreneurs are owners of profits as usually, but they're enforced to take them out from regulatory regime;
- First group of shadow subjects is interested in conditions favorable to decreasing of shadow economy such as disorder in the country, incapable or corrupted government. On the contrary, shadow entrepreneurs are mostly interested in changing the situation as it will increase life quality in the country.

Size of shadow economy

To struggle with shadow economy it's important to estimate its volume. This task is very difficult as shadow economy tries to escape from measuring. But without this economic development and forming of appropriate state policy are impossible.

As usually methods of estimating of shadow economy divides into two groups:

- Macromethods (indirect) based on indicators of official statistics, data of tax and financial institutions, these methods provide to high result;
- Micromethods (direct) based on questioning of population, tax revisions etc., but these methods provide too low result as information is incomplete and distorted.

According to the Ministry of Economic Development and Trade of Ukraine which is responsible for this indicator shadow economy is equal to the one third of GDP of Ukraine (Fig. 3).

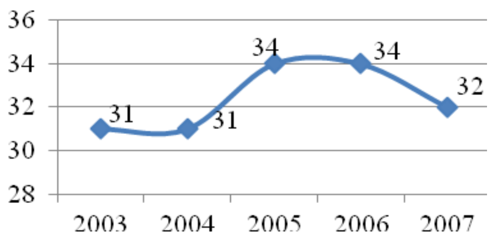

Figure 3. Size of shadow economy in Ukraine, % from GDP

Critical rate for economic security of the country is 30% of GDP. It's worth to say also that 2007 is the last year of official publication of this indicator. In 2008 and 2009 it's possible to find the number of 36%, but it's not official estimation. Data provided by Ministry of Economic Development and Trade of Ukraine doesn't coordinate with data provided by relevant international institutions and foreign scientists. For example, latest results of investigations of World Bank's scientists are shown on the Figure 4. In 2005 Ukraine has 10th biggest size (as a percent of GDP) among 104 countries after Georgia, Bolivia, Panama, Azerbaijan, Peru, Zimbabwe, Tanzania, Nigeria and Thailand.

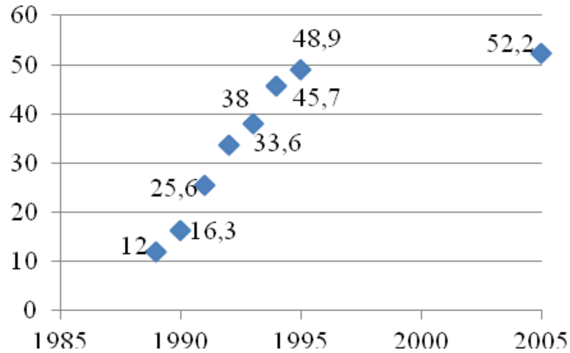

Figure 4. Size of shadow economy of Ukraine, % of GDP

Very interesting investigation was conducted by Friedrich Schneider (Austria) and Andreas Buehn (Germany). It presents estimations of the shadow economies for 120 countries, including developing, Eastern Europe and Central Asian and high income OECD countries over 1999 to 2006. The data for Ukraine is shown on Figure 5.

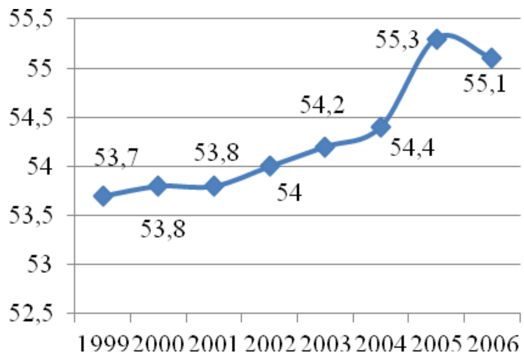

Figure 5. Size of shadow economy in Ukraine, % from GDP

During 1999 - 2006 Ukraine had the second largest size of shadow economy among post-soviet countries after Georgia (Table 3), however, after The Rose Revolution Georgia experienced significant economic and political reforms. Considering the time span, many of its achievements are impressive. Among them is a significant reduction of corruption.

Table 3. Size of the shadow economy in 19 Eastern Europe and Central Asian Countries, % of GDP

No.	Country	Country Average (1999 – 2006)	No.		
1	Albania	34,1	11	Moldavia	48,2
2	Bulgaria	35,4	12	Poland	26,3
3	Croatia	33,4	13	Romania	36,2
4	Czech Republic	18,0	14	Russian Federation	46,6
5	Estonia	37,5	15	Slovak Republic	17,2
6	Georgia	67,8	16	Slovenia	26,7
7	Hungary	23,4	17	Tajikistan	45,2
8	Kazakhstan	43,6	18	Turkey	33,9
9	Latvia	38,2	19	Ukraine	54,3
10	Lithuania	29,1			

Estimation of size of shadow economy in Ukraine by the World Bank and Friedrich Schneider and Andreas Buehn shows that Ministry of Economic Development and Trade of Ukraine underestimates its size. Actually volume of shadow economy is approximately twice bigger than it's officially announced by the government. This fact stipulates for necessity of urgent measures to legalize shadow economy.

Latest laws of Ukraine aimed to legalize shadow economy

Recent achievements of Ukrainian government in this sphere are adopting of Tax Code, the Law on Access to Public Information and the Law on Grounds of Prevention and Combating Corruption.

The first Tax Code of Ukraine was adopted in December, 2010. The majority of the Tax Code's provisions will come into force on January 1, 2011. The provisions relating to the corporate profits tax will take effect on April 1, 2011. The Tax Code consolidated many Ukrainian tax laws into one document in order to simplify and update the taxation system of Ukraine. However, the language of the Tax Code still requires further improvement. The rates of the corporate profits tax and VAT will be reduced step-by-step during the coming years. For the personal income tax, a progressive scale of tax rates was introduced. The excise rates for the majority of items were increased. The computation of taxable profits becomes closer to financial accounting. New limitations on tax deduction of some expenses were established. Some categories of companies and industries will be able to enjoy tax holidays with respect to corporate profits tax. Registration of VAT invoices in the unified statutory register was introduced. If the incoming VAT invoice is not included in the register, the taxpayer will not be entitled to credit the respective input VAT. Potentially, the provision of consulting, engineering, legal, accounting, audit and IT services should not be subject to VAT anymore. Foreign individuals will be taxed according to the rules established for residents. During the transitional period from January 1, 2011, until June 30, 2011, the penalty for breach of tax law will amount to UAH 1 (approximately USD 0.125) for each offense. According to the Tax Code, if a taxpayer violates provisions of the Tax Code regarding the corporate profits tax during the second or the third quarters of the year 2011, no penalty will be applied. Generally, some penalties were decreased.

The Law on Access to Public Information was adopted in January, 2011. This Law determines procedures for exercising and securing the right of every person to access to information of public interest possessed by government agencies and other providers of public information. According to the law, access to information about the activities and decisions of public authorities should be provided according to the following procedure: the information should be published in the media and in official publications, provided on request, posted on official Web sites on the Internet, and provided through the information services of the public authorities. The law on access to public information introduces a five-day period of response to an information request or a two-day period in the case of an emergency.

The Law on Prevention and Combating Corruption (the "Anti-Corruption Law") was adopted in April, 2011. It's scheduled to become effective on 1 July, 2011 (with minor exceptions). The Anti-Corruption Law establishes a new, comprehensive and progressive framework for the prevention and prosecution of corruption offences, including various restrictions and safeguards such as: declaring both profits and expenses by civil servants; a ban on engaging in commercial activities; pre-appointment verification of candidates' statements in job applications and the examination of draft pieces of legislation by the Ministry of Justice. In particular, the Anti-Corruption Law determines what constitutes corruption, the persons who may be held liable for committing corruption offences. The Anti-Corruption Law also enunciates the state agencies and officials who are vested with the powers to implement measures to prevent and prosecute the corruption.

All above-mentioned laws will become effective only as a part of a whole complex of anti-corruption measures. Otherwise, they will be untouched document that no one will ever follow.

Proposed methods to legalize shadow economy in Ukraine

To decrease the size of shadow economy of Ukraine we propose:

- creating of favorable environment for business development;

- monitoring of offshore areas;
- improvement of tax system;
- creation and implementation of a transparent set of tax incentives;
- optimization of tax administration;
- mechanisms of unfair payers punishment;
- economic tax amnesty;
- economic support of balance between fiscal and regulatory functions of taxes;
- overcoming of illegal labor market;
- improving of social insurance and reducing of fiscal burden on salary fund (including pension reform);
- adequate price of labor;
- legalization of salaries;
- raising of public awareness, ensuring their influence on decisions;
- state support of innovation and investment projects in real sector of economy;
- enforcement of capacity of power;
- strict punitive measures for corruption and raiders;
- minimizing of government regulation of various spheres of life;
- ensuring transparency of the real economy.

Conclusions

Shadow economy and corruption exist in all countries, but there its size is a few percent of GDP. In Ukraine unofficial sector of economy is equal to half of GDP. The size of the shadow economy is a traditional indicator of efficiency of government economic policy. If the tax policy isn't efficient and transparent business has "to hide in the shadow". This situation is observed in Ukraine nowadays. Thus, it's necessary to explore the shadow economy and look for mechanisms to reduce its size. Mechanisms proposed in this article will help to prevent shadow economy and to increase the efficiency of legal economy.

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Summary

Significant size of unofficial sector of Ukrainian economy is one of the most important and complicated problem facing the country after the collapsing of USSR. This phenomenon restrains the economic growth, welfare of the population, democratization of the society and European integration of Ukraine. Increasing the shadow economy also implies a reduction in state revenues, which creates state budget deficit problems.

The existence of shadow economy in Ukraine is confirmed by a lot of facts, for example, disparity of decreasing of GDP of Ukraine and production of electrical energy during 20 years of independence. Production of electrical energy is an indicator of the progress and it's impossible to hide it.

Shadow economy is divided into two groups. First group include crime and corruption, especially in governmental sector. The second group includes entrepreneurs who are forced to hide their incomes because of too high tax burden or bureaucracy.

So, first group is tightly connected with criminal offences. This group includes drugs and weapons trade, racketeers etc. Corrupt officials are also connected with this group. Criminal structures act mostly in the sphere of distribution and redistribution of profits. These structures misappropriate part of profits illegally (violence, blackmail, murder etc.). According to Global Corruption Barometer 2010 results for Ukraine the level of corruption has increased in the past 3 years; judiciary, police, public officials, Parliament, political parties are extremely affected by corruption; current government's actions in the fight against corruption are ineffective.

Second group of shadow economy isn't fully illegal, but by its nature it is out of legal environment. This activity is realized by shadow entrepreneurs. One of the main reason "to hide in the shadow" for them is tax burden and different barriers in doing business. According to Doing Business 2011 data for Ukraine the overall "Ease of Doing Business" rank (out of 183 economies) is 145th (in 2011) and 147th (in 2010).

There are two approaches to measure shadow economy. These two approaches are called macro (based on indicators of official statistics, data of tax and financial institutions) and micro (based on questioning of population, tax revisions, etc.) approaches.

There're several different estimates of size of shadow economy in Ukraine. According to the Ministry of Economic Development and Trade of Ukraine which is responsible for evaluation of this indicator shadow economy is equal to approximately one third of GDP of Ukraine. But according to the World Bank and famous F. Schneider it's more than a half of GDP. As it is seen, the data provided by Ministry of Economic Development and Trade of Ukraine does not coordinate with the data provided by relevant international institutions and foreign scientists.

In 2010 and 2011 Ukrainian Parliament adopted several laws to minimize unofficial sector such as first Tax Code, the Law on Access to Public Information and the Law on Prevention and Combating Corruption. The Tax Code consolidated the hundreds of currently existing laws, regulations and interpretations, which are in many cases inconsistent with one another into one document in order to simplify and update the taxation system of Ukraine. The Law on Access to Public Information determines procedures for exercising and securing the right of every person to access to information of public interest possessed by government agencies and other providers of public information. The Anti-Corruption Law establishes a new, comprehensive and progressive framework for the prevention and prosecution of corruption offences, including various restrictions and safeguards such as: declaring both profits and expenses by civil servants; a ban on engaging in commercial activities; pre-appointment verification of candidates' statements in job applications and the examination of draft pieces of legislation by the Ministry of Justice.

Finally, several economic, political and social methods of creating a favorable environment for business development are proposed. They include monitoring of offshore areas; improvement of tax system; creation and implementation of a transparent set of tax incentives; optimization of tax administration and others.

KEYWORDS: shadow economy, corruption, tax evasion, GDP, Global Corruption Barometer, Doing Business.

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