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Impact of Shadow Economy on Quality of Life: Indicators and Model Selection

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Abstract

The purpose of the study was to examine the effect of shadow economy on the level and quality of life. It was supposed that shadow economy effects positively on the level of life (as shadow income increased total revenues). But it can impact negatively on the quality of life. The relationship between growth of life level and quality of life depends from the level of the shadow economy. Some of studies demonstrate the link of shadow economy with the separate quality of life indicators. However, in that cases, the quality of life is the casual variable, witch changes leads to the changes in the latent variable (the shadow economy). Our task is to determine the reverse effect - the shadow economy on the quality of life. At the initial stage of our analysis, the original sample of 150 countries was divided into 5 groups, according to the shadow economy size. Than the average values of each indicator for each cluster was calculated. Next, the determination a regression equation for each cluster and for general sample was done. For this purpose we use averages for each indicator for the period of 1999-2007. As a result of regression analysis, we found that «life expectancy at birth» and «Children in-school rate» are significant for each cluster and for the whole sample. The level of life increases according to the shadow economy's growth. In the same time, life quality indicators which reflects a long and healthy life and access to knowledge - decreases. The regression coefficient increases with the growth of the shadow economy. Our results demonstrate the correctness of the hypothesis about interrelationship between shadow economy and life quality.

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1. Introduction

The shadow economy - is not only a Russian phenomenon. All, developed and developing countries facing this problem. There are activities that are directly related to the shadow economy, and cannot be legal (drugs and racketeering, etc.) and activities that can be legal or illegal depending from risks and benefits.

The shadow economy is sometimes considered a good thing. There are opinions that the shadow economy in the post-Soviet countries support the economic and social balance, and allows the population surviving. In our opinion, this characteristic of the shadow economy is the most dangerous. It means that the criminal economic behavior becomes the condition for business survival, and the citizens and authorities actual behavior marginally regulated by formal rules. Significant informal sector allows to increase revenues and to invest additional money. But it ignores the main purpose of the society - the preservation and development of human capital and well-being.

Shadow economy becomes a very popular object of study now. There are multitude definitions this phenomenon in literature. Handbook by OECD «Measuring the non-observed economy»¹ contains 27 terms, Williams (2004) indicates 35 terms. Also we should note the paper by Georgiou (2007) which expands this list. We took into consideration these sources, and drew up a conjoint list containing 49 definitions: alternate, autonomous, black, cash, cash-in-hand, clandestine, concealed, corrupt, counter, covert, dual, everyday, ghetto, grey, hidden, household, illegal, illegitimate, informal, invisible, irregular, marginal, moonlight, non-observed, non-official, occult, off-the-books, other, parallel, peripheral, precarious, second, secondary, secret, shadow, submerged, subterranean, twilight, underground, underwater, unexposed, unobserved, unofficial, unorganized, unrecorded, unregulated, unreported, unsanctioned, untaxed. Many studies have been also devoted to classification and typing of these activities, among which we cannot fail to mention the researches by E. L. Feige.

However, the impact of the shadow economy on the quality of life of the population is currently not sufficiently investigated. Inverse relationship between the level and quality of life was first suggested by J. Forester (founder of system dynamics). But, his model does not take into account the impact of the informal sector.

Hypothesis of the study: the shadow economy has variable effects on the level and quality of life. It effects positively on the level of life (as shadow income increased total revenues). But it can impact negatively on the quality of life (quality of working life, health, safety, etc.). Thus, the relationship between growth of life level and quality of life depends from the level of the shadow economy.

2. Review the models, reflecting shadow economy's effect on quality of life

Determination of the shadow economy is complicated by several factors: complexity assessments, multiplicity of shadow activity. Also, different methods provide overstated or understated results.

Various methods of measuring the size of the shadow economy can be divided into three approaches:

1. Direct approach

This is micro approach in whole. Direct approach includes:

- tax auditing
- surveys and other researches based on voluntary replies.

2. Indirect approach

This approach is mostly macroeconomic. Indirect approach includes:

- the method using differences between income and expenditure statistics
- the method using differences between officially measured and actual participation rates
- the transactions method
- the monetary methods

¹ Measuring the non-observed economy – a Handbook (OECD-IMF-ILO-CIS Stat, 2002)

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