



The Shadow Economy in Transition Countries: Friend or Foe? A Policy Perspective

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Summary. — By treating the shadow economy as a distinct entity, rather than just a symptom of policy failures, we are able to examine its short-term and dynamic consequences for development. First, we construct measures of the size of the shadow economy in 25 transition countries for 1990–97. We find hysteresis suggesting that, once established, the shadow economy is hard to remove: a dollar decline (rise) in official GDP is attenuated by a shadow expansion (contraction) of 31 (25) cents. We then examine whether the shadow economy prevents, merely slows down, or actually promotes economic growth and competitiveness, and through what mechanisms. We also consider implications for policymaking. © 2002 Elsevier Science Ltd. All rights reserved

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1. INTRODUCTION

A casual observer noting the levels of official unemployment in Poland in the early 1990s (over 16%) may well have wondered why the country was not experiencing street riots. A similar concern would be raised by the more-than-halving of Ukraine’s GDP over 1991–95. Why were these expectations wrong?

The conventional wisdom is that this period saw a concomitant surge in the growth of unrecorded—or “shadow”—economic activity. While in the short run this activity was probably good news for the people living in these countries—it may act as a temporary lever for promoting productive activities in the presence of paralyzing bureaucracy and government corruption—the implications of a shadow economy for longer term economic recovery and growth remain an unresolved issue. There may be negative implications on several fronts. To name a few, the existence of an economy may limit the provision of public goods that are essential for growth, impair the effectiveness of macro policy, deter foreign participation and

reduce competition in a country. It may result in serious efficiency distortions in resource use, and its persistence can contribute to the deterioration of morals in the society.

This paper illuminates the main issues related to the shadow economy, focusing mainly on transition countries. Using an improved methodology, we provide updated estimates of the size of shadow economies as they pertain to transition countries, and then discuss policy recommendations that address key questions. Primary among these are the impact of the shadow economy on economic growth and competitiveness, and the effectiveness (or countereffectiveness) of policy measures in a

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shadow economy situation. In doing so, we try to motivate the treatment of the shadow economy as an independent research topic, rather than simply a problem of tax administration.

The paper consists of three parts. The first part lays out the theoretical and empirical background for this study, drawing upon the existing literature and the experience of transition and nontransition countries. We start by presenting in Section 2 a taxonomy of the various types of shadow economies. Next, we describe the characteristics of the shadow economy in a transition country setting, underscoring the differences between the informal sector in less developed countries and that in other regions. In Section 3 we discuss the causes of the shadow economy, and its impacts are described in Section 4.

The second part of the paper estimates the size of the shadow economy in transition countries and then analyzes the resulting estimates. In Section 5 we present our method for measuring the shadow economy in transition countries. We then present our estimates that allow us to examine shadow economy activity over time and across countries. Using these estimates we return to the original questions posed in the goals of the study. In Section 6, we relate the shadow economy to various measures of economic performance, initial conditions, and institutional characteristics. We also consider the effects of the shadow economy on economic recovery and growth. In Section 7, we examine the nature of competition as well as international competitiveness in an economy with a substantial shadow economy. Section 8 considers policy implications. We first examine whether governments and donor countries were responsive to the presence of the shadow economy. We then ask how policies are affected by the presence of a substantial shadow economy, and propose recommendations for modifying policy. Finally, we discuss issues of policy implementation.

2. CHARACTERIZING THE SHADOW ECONOMY

Many experts on transition or developing countries have come under the impression that a large share of the economic activity in these countries, sometimes half or more, is done “backstage,” i.e., unrecorded in official statistics. There is now a large literature on the shadow economy as it pertains to less-devel-

oped countries (LDCs) and to advanced industrialized countries. A similar body of work is beginning to emerge for transition countries. The existence of fine surveys of this literature (e.g., Schneider & Enste, 2000) obviates the need for a comprehensive review here.¹

Perhaps because the subject of the shadow economy is so multifaceted, most papers that deal with the phenomenon remain vague as to the exact definition. Some papers simply give a list of characteristics of shadow activities. From the literature we can broadly identify several of these characteristics. These include activities that (a) evade taxes (either as part of general fiscal collections or as specific service charges) (b) avoid regulatory requirements (e.g., “licensing”) or ignore currency requirements (e.g., local currency as the only legal tender) (c) fail to appear in statistical reporting mechanisms (d) are *per se* illegal (e.g., drug dealing). These characteristics form a typology with potentially 16 situations, which would be candidates for a strict definition of shadow.² The potential confusion is intensified by the fact that firms, especially in transition countries, often fall in between the polar cases of these characteristics. Furthermore, some regulatory restrictions can proscribe some activities that would be otherwise completely legal—and even necessary—in a well-functioning market economy.³

At this point it may be fair to ask why one needs to invent the classification shadow. Isn't it enough to analyze tax evasion or the effect of avoiding regulatory compliance, for which an abundant literature exists? Our answer is that by recognizing the shadow economy as a separate sector, we are led to ask a series of questions related to the interaction between different causes of the shadow and their cumulative effect along various dimensions. These questions might have otherwise been ignored. Using the example of tax evasion, we show that firms that enter the shadow economy due to multiple causes, one of which being tax avoidance, tend to lose access to official channels of financing, reduce their capital intensity of production, and operate with shorter time horizons. They may also further reduce compliance in other areas of regulation. This can have a profound effect on long-run economic growth and lead to the deterioration of social norms. By focusing on the shadow economy *per se*, these linkages become both clear and relevant, even if they are not usually considered in the tax evasion literature. Furthermore, studying the shadow economy provides insights regard-

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