

THEORETICAL ASPECTS OF THE ROLE OF THE SHADOW ECONOMY

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Abstract. *The shadow economy is definitely a significant problem throughout the world. Research studies on the shadow economy still lack a single approach to the term shadow economy. Several definitions of the shadow economy are used to assess the role of the shadow economy.*

The present research aims to examine the theoretical role of the shadow economy and the definitions thereof given in various economic theories.

Analysing the definitions of the shadow economy, researchers identify ambiguous interpretations of the term given in various theories. The term shadow economy has a considerable number of synonyms used for researching the shadow economy. Some definitions focus on hidden outcomes, whereas others focus on hidden employment. A definition of the shadow economy is of great importance in assessing the size of the shadow economy.

The research employed the following methods: monographic, descriptive, as well as analysis, synthesis and document analysis.

Keywords: *definitions of the shadow economy; economic theories.*

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Introduction

Research studies on the shadow economy still lack a single approach to the term shadow economy. It is important to pay attention to the shadow economy because of the negative effects thereof (Sauka et al., 2016). The problem of the shadow economy exists in many countries and, depending on its size, affects the economic development of the country, the social wellbeing of companies and households and national policies. The shadow economy distorts competition, negatively affects the national tax system and its structure, and leads to unfair distribution of the tax revenues. Such economic activity distorts official statistics, which could make policies based on the statistics simply irrational

and ineffective. All this leads to significant changes in the amount of tax revenues collected by the government and slows down the economic growth of the country (Kazimieraityte & Skvarciany, 2019). The shadow economy makes a negative impact on both the lives of individuals and the development of the country. The individuals who do not pay taxes through receiving undeclared or “envelope wages” lose their right to unemployment insurance, parental leave allowances and pension or sickness allowances (Kazimieraityte & Skvarciany, 2019). This situation is particularly problematic because it is often the recipients of “envelope wages” who earn low incomes and therefore need public support (Bank of Latvia, Notiks..., 2021). The authors of the research believe that most of the employees who decide to work informally often do not consider at the first moment that they are vulnerable to sudden misfortunes and will not receive public support in the event of misfortune because they were attracted by the possibility of earning more.

Tax evasion also makes a negative impact on society as a whole, as less tax revenue is collected for public infrastructure, education and health care. It is also often observed that individuals are not at all aware of the negative externalities of tax evasion (Bank of Latvia, Ēnu..., s.a.). If a large part of a national economy represents the shadow economy and individuals default on their tax obligations but still use public services, it forces the government to raise tax rates on those who do pay taxes, thereby making their lives even more difficult (Tanzi, 2002). The authors of the research believe that the shadow economy is even more encouraged in this way. The explanation and definition of the shadow economy is of great importance in identifying the size of it. To assess the role of the shadow economy, several definitions of the shadow economy are available in the literature.

The research aims to examine the theoretical role of the shadow economy and the definitions thereof given in various economic theories.

The research employed the following methods: monographic, descriptive, as well as analysis, synthesis and document analysis.

The present research is based on the research findings made by various authors and other literature sources.

Research results

The shadow economy is definitely a significant problem throughout the world. It is also known as the “grey economy”, “informal economy”, “undeclared economy” etc. The names, although describing similar economic activities, could be interpreted differently. Some definitions focus on hidden outcomes

(Gerxhani, 2004), whereas others focus on hidden employment (Husmanns, 2004; Perry, 2007). For example, unregistered companies hide all their output, registered companies might choose to hide part of their output to reduce tax obligations (Kelmanson et al., 2019).

In economics, there is no single definition of undeclared economic activity, yet historically shadow economy activities are defined based on the following basic theories:

- the classical/Marxian approach states that the informal economy focuses on surplus labour as a product of the process whereby the capitalist economy provides its resources; an exception is the people who keep a traditional lifestyle (Sanyal & Bhattacharya, 2009); it is a process called “exclusion” by Sanyal (2007). In other words, the formal economy is dependent upon the informal economy through an unequal exchange of labour (VanderBerg, 2014);
- the dualism/modernization approach assumes that the shadow economy consists of marginal activities distinct from and unrelated to the formal sector. This approach views the shadow economy as providing income for the poor and as a safety net in times of crisis. This theory is based on the dual labour market function (Doeringer & Piore, 1971; Saint-Paul, 1996) that divides the labour market into four categories: primary, secondary, informal and illegal. The primary sector is represented by regular paid jobs that are taxed and regulated legally. The secondary sector consists of jobs that have less security than main jobs and is less regulated legally, e.g. low-wage jobs in the service sector. Informal jobs are taken by individuals who do cash-only economic activities, including those having no employment contracts and submitting no employment record books to their employers. The fourth category is illegal economic activity and includes all criminal activities that generate revenue;
- structuralism/globalization theory study the shadow economy, considering micro-enterprises and their employees, as well as labour costs. Globalization theory assumes that the mentioned factors increase the competitiveness of large companies. Unlike other theories, the theory of structuralism postulates that the shadow economy is a feature of capitalistic development of a country. This theory is based on Wallerstein’s (2004) world system model and represents the duality that exists between the formal core of the economy or the country with high wages and high productivity in business and the informal periphery with low wages and low productivity (Godfrey, 2011);
- advocates of this theory state that informal sector employees work in small businesses or are self-employed with no social guarantees. The formal sector

generates value from the informal sector in ways that block the existence of an unjust world system. This exploitative relationship between labour and capital metaphorically explains the persistence of the shadow economy (Godfrey, 2011);

- neoliberal/legalist theory (Maiti & Sen, 2010), Khadiullina et al., 2013) states that the informal sector consists of micro-enterprises that prefer to operate illegally to reduce costs. This theory postulates that a significant element is a hindrance to growth due to lower productivity, limited investments, an inadequate and ineffective tax system, a low level of introduction of technological progress and complications caused by macroeconomic policies. According to De Soto (2000), micro-enterprises will continue to operate informally as long as the tax system of the country is burdensome and expensive for the businesspersons (Alderslade et al., 2006). According to Godfrey (2011), structuralism/globalization theory differs from neoliberal economic/legalist theory in the fact that dualists view informality in the deep structure of economic roots (i.e. in the marginal value of labour supply), whereas structuralism/globalization theory views it as stemming primarily from institutional preference and agreement. Neoliberal economic/legalist theory assumes that informality is a restriction on participation imposed by the previous public policy model and therefore the shadow economy represents a free choice of individuals. A potential way out of the shadow economy would be the elimination of political and economic barriers at national level and the reduction of formalities;
- post-structuralist/illegalist/voluntarist/utilitarian theory strongly relates to neoliberalism. According to it, the shadow economy is the choice of businesspersons to avoid taxes and labour market regulation. According to the advocates of this theory, the shadow economy might seem desirable only to a part of the population that has lower skills, lower incomes and no social guarantees from formal employment (Maloney, 2004; Chen, 2012). Moreover, most of the small enterprises fall victim to low productivity and have high failure rates because of such employees, thereby contributing to the cycle of poverty. This theory postulates that the inefficiency of public administration also plays an important role, especially in the field of public services: medicine, taxes and social guarantees. This creates a situation in which employees make their own decision to join or not to join specific social protection programmes (Maloney, 2004; Chen, 2012).

Different definitions of the shadow economy are available in the literature (Table 1).

Table 1 Definitions of the shadow economy (Koufopoulou et al., 2019; Brekis, 2007; Hassan & Schneider, 2016; Perry, 2007)

| Term | Definition |
|----------------------------|---|
| Hidden economy | <p>The hidden economy generally represents three kinds of economy:</p> <ol style="list-style-type: none"> 1. The parallel economy is considered to be illegal hidden economic activities performed by formally employed individuals at their workplaces; consequently, the gross national product generated previously is secretly redistributed. It is also called the “white-collar” shadow economy, as mostly managerial or administrative personnel are involved in it. No new goods or services are produced by the parallel economy. The individuals engaged in it increase their incomes at the expense of other individuals. 2. The grey economy is considered to be unregistered legal trade in goods or services. The individuals engaged in this sector deliberately try to avoid official records, resulting in lower costs and higher profits. 3. The black economy is considered to be criminal and legally prohibited activities, which relates to the production and sale of prohibited goods or services. It involves theft and robbery as well as the production and provision of services such as prostitution, drug production and sale. |
| Informal economy | <p>It usually refers to economic activities and transactions that are sufficiently hidden to be measured or taxed, and it is assumed that the economic actors are at least passively aware that bringing the activities to the attention of authorities would lead to negative tax or other legal consequences.</p> |
| Shadow economy | <p>The shadow economy is a part of the economy that is not declared for tax purposes and usually involves the exchange of goods and services that are paid for in cash.</p> <p>It represents mostly legal economic and productive activities that are deliberately hidden from authorities and, if recorded, would affect GDP (excluding illegal or criminal activities, charitable or household activities)</p> |
| Undeclared economy | <p>The undeclared economy represents transactions that are not declared to tax, social security and/or labour law authorities for purposes where they should be declared, yet are legal in all other respects.</p> |
| Underground economy | <p>The underground economy includes the output that is not recorded and therefore “hidden” or “hidden” from taxation, mostly income taxes and VAT. Part of the output relates to legal activities, e.g. transactions between firms and retailers.</p> |

It should be concluded that the definitions of the shadow economy vary according to its linkages with the formal economy. Some of the definitions focus on economic activities parallel to the formal economy, while some of the activities are more or less independent. The definition of the shadow economy plays an important role in assessing its size (Schneider, 2014). The most

common definitions are as follows: “the shadow economy is the gross domestic product that is not recorded in official statistics because of non-declaration and/or incomplete declaration” and “the production of legal or illegal goods and services that are not included in the official GDP” (Ministry of Finance, Ēnu..., 2021). It is obviously difficult to obtain accurate information on the activities of the underground or shadow economy, as the individuals involved in the activities wish to remain anonymous (Schneider & Enste, 2000).

Encouraging electronic payments and limiting the use of cash would likely help to decrease the spread of the shadow economy, as one party to the transaction (usually the consumer) does not benefit from not reporting the transaction and might not even be aware of being engaged in the shadow economy (Kelmanson et al., 2019). Governments and businesses around the world have been debating how to reduce the use of cash for a long time. The main non-cash benefits it brings are, for example, easier and faster shopping, reducing the possibility of corruption and limiting the spread of the shadow economy. The main flow of cash occurs in retail trade, catering and service provision (“Swedbank” AS, Mūsdienīgi..., 2020).

Conclusions

The shadow economy is definitely a significant problem throughout the world. An analysis of definitions of the shadow economy revealed ambiguous interpretations of the term by various theories. It is also called the “grey economy”, “informal economy”, “undeclared economy” etc. The names, although describing similar economic activities, could be interpreted differently. Some definitions focus on hidden outcomes, whereas others focus on hidden employment. The term shadow economy has a considerable number of synonyms used for researching the shadow economy. The definition of the shadow economy plays an important role in assessing its size. The shadow economy is a part of the economy that is not declared for tax purposes and usually involves the exchange of goods and services that are paid for in cash.

The authors of the research advise every individual to avoid making cash transactions for goods and services consumed daily, especially in cases where there is doubt that taxes are not paid from the transactions, for example, for goods bought in the marketplace and services purchased from private individuals and others, thereby contributing to a decrease in the shadow economy.

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