

METHODOLOGY OF SHADOW ECONOMY STUDIES

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Abstract

This study considers the fundamentals of the shadow economy research theory developed in Russia. The variety of available approaches to shadow economy studies is analyzed. The study objective is to provide a rationale for the development of a comprehensive research approach to the shadow economy research. It is proposed to apply the institutional approach within the framework of the new institutional economic theory as the most general, interdisciplinary approach to the shadow economy studies.

Keywords: shadow economy, institutional approach to the shadow economy.

1. Introduction

The shadow economy in today's world is an important issue which is explained by the intense globalization and world economy regionalization processes. To take countermeasures against the negative impact of the shadow economy, comprehensive scientific analysis and research should be used. Nowadays, the shadow economy is the biggest threat for developing countries and emerging markets (e.g, Russia): as the World Bank reported in 2016, the informal sector accounts for about a third of their GNPs, and 70% of the employment (over a half of this number are self-employed) [1]. In most developed countries the shadow economy share is quite low and does not exceed 5 to 10% of the GNP, but in Russia, the shadow economy share is estimated at 47% of the GMP [2].

It should be noted the today fact that none of the well-known Russian economy theory textbooks ever mentions the shadow economy or includes any chapters on the subject. That is while recognizing the very existence of this phenomenon and the huge scale of its destructive consequences, the domestic textbooks lack any scientific

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ic concepts and views on it. A purely legal approach to the shadow economy prevails in the established research and, therefore, in the Russian government regulations. It sees the shadow economy as informal and illegal business transactions. This fact can be attributed to the liberal-conservative doctrine of the neoclassic theory dominating in Russian research. This doctrine is idealistic: it believes that business entities in a market economy should and will adhere to the official legislation.

Another indicator of the lack of the shadow economy theory fundamentals in Russia is a variety of definitions available in the domestic sources: “informal”, “hidden”, “non-observable”, “concurrent”, “underground”, “black”, “gray”, etc. Yu. I. Popov (2005) [3] claims that “such a fuzzy terminology may indicate that the methodology and approaches to studying the origins and essence of the shadow economy are still in the making”. Actually, the very term “shadow economy” (borrowed from English) has been used in the domestic research since the 1980s. There were clear ideological reasons (ongoing coverage and criticizing the drawbacks of the world capitalist system) for the interest to the shadow economy phenomenon in the Soviet Union. Another factor was the disadvantages of the Soviet economy (the existence of some shadow economy such as hidden revenues and anti-social profit-making was partially recognized by the authorities.) Still it should be noted that nowadays Russia still lacks a comprehensive scientific approach to the essence and manifestation of the shadow economy while such an economy covers the entire complicated web of social and economic relations, and is an objective and destructive reality. Therefore, a presumption of the shadow economy guilt exists: the Russian public sees the shadow economy as an inevitable and destructive by-product of a capitalist market system.

2. Basic Theory

By analyzing the existing range of dominating social science views on the shadow economy phenomenon one can see the need for a scientifically sound rationale for the application of the institutional approach within the framework of the new institutional economic theory as the most general, interdisciplinary approach to the shadow economy studies. The most significant papers that use on the new institutionalism concepts as a theoretical foundation for studying the modern economy are by R. Coase, D. North, G. Myrdal, Hernando de Soto, E. Sutherland, etc. The Russian institutional-based studies of shadow economy worth mentioning are A. Auzan, B. Korneychuk, Yu. Latov, D. Lomsadze, R. Nureev, A. Oleynik, Yu. Popov, V. Radayev, V. Samarukha, V. Burov, V. Tambovtsev, etc.

3. Methodology

It should be noted that the researchers and experts in various areas apply different approaches, criteria, and terminology to the shadow economy studies. The reason for this is not just a wide range of their theoretical and applied studies, but significant mismatches between the shadow economy concepts they use.

For example, *the legal approach* considers the shadow economy as legal violations by business entities and sees it as an illegal business activity. The legal approach advocates divide the shadow economy into two sectors: non-criminal (“gray”, i.e., non-criminal economic violations) and criminal (“black”, i.e., economic crime as such.) Within the legal approach, the so-called “black” economy includes illegal actions listed in the Criminal Code. That is why it is completely excluded from the formal economic life because as the advocates of this approach believe it is not formal. Still, E. Sutherland, an American criminologist and the founder of the economic-legal approach (1983) proposed a concept of a more severe “white collar” (“gray”, non-criminal) economic crime with much larger damage to the government and the society than any criminal activities. In the Russian papers, the legal approach is also mostly based on the concept of applying only formal economic regulations to shadow economic activities. The criteria of categorization as a shadow economy are official registration (government control) evasion and the very illegal natures of economic activities. Still, V. Anishchenko, A. Khabibullin, E. Anishchenko (2018) a weak aspect of the theory behind the legal approach to analyzing shadow activities is that “only the court is authorized to pronounce an action a crime.” Otherwise, in legal terms, no actions “can be considered criminal even if they are.” Besides, in real life, it is hard to prove such economic offences and crimes as fraud, corruption, etc. since they may be formally legal while bringing substantial material and moral damage to the society.”

The *economic approach* to the shadow economy focuses on its negative impacts on the government economic policy, the efficiency of resource distribution and utilization. The difference of the economic approach is in studying the shadow economy issues on global, macro, and micro levels. The most important aspect of this approach is the development and application of dedicated shadow economy size estimation methods. The economic approach pays more attention to tax violations and considers the shadow economy as a destructive economic activity which is extremely damaging for the governmental and public interests.

The economic approach essence is best expressed by F. Schneider and D. Enste (2000) with their concept of the objective nature of shadow economy governed by high transaction costs in a market environment: “A higher tax and social security burden are one of the major reasons for the shadow economy growth. The more the difference between the total labor cost and the earnings after taxation in the official economy, the more is the temptation to get rid of this difference and to operate in the shadow economy.

Sociology offers a drastically different understanding of the shadow economy. It sees the shadow economy manifestations in latent domains of social and labor relations: violations of the labor legislation (вфшдн workhours, remuneration, etc.), social justice (as with illegal migrant workers, female, and juvenile employment), and shadow payments (deposits and “backdoor” cash), etc. Under the *social approach*, an informal economy includes several social manifestations of economic activity: legal, non-legal, semi-legal (shadow), and illegal (criminal) relations. Sociologists claim the key reason for the shadow economy existence is a sharp social and income inequality. The very social stratification level governs the number of potential shadow economy entities. For instance, they believe that the probability of poor, marginal, and downgraded strata to be involved in the shadow economic activities is much higher than that for the middle-class and prosperous categories.

For the social behavior experts, the shadow economy existence is a highly anthropogenic phenomenon and a manifestation of human nature. Modern social psychology conforms the key religious and philosophic doctrines about the dualism and controversy of the human behavior, and the human’s concurrent urge for creative labor (the good) and opportunistic behavior (the sin). Even Aristotle in his *Politics* (Aristotle, 1983) noted this unique feature of the human as a special kind of social animal with intellect. “And it is a characteristic of man that he alone has any sense of good and evil, of just and unjust.” It is natural for humans to strive for more economic benefits while spending as little efforts as possible. In terms of ethology (the science that studies behavioral economy in anthropoid apes), such a rational human behavior is a result of their biological, intrinsic instincts aimed at getting benefits both for an individual organism and for a population of the species. R. Yasmilov (2015) believes that “In ethology, value means ensuring survivability both of an individual organism and the species, and enabling some kind of association between different species. Similar processes can be observed in human societies (wars are just one example.) That is why it can be noted a certain social, and also economic instinct in humans that expresses itself, for instance, as “maximization of benefit.“ Such rationalism stimulates shadow activities when the governmental or public institutions are absent or weak.

The *culturological approach* to the shadow economy also confirms the anthropogenic nature of the shadow economy phenomenon while focusing on the ethical aspects caused by a poor cultural and ethical basis of the primary business environment. The culturologists note the importance and significance of considering the national morale features and religious customs that directly affect the values and social behavior through the public conscience. In the West, according to M. Weber, the Protestantism and its business ethics and labor morale established a consistently positive social attitude towards private property and personal enrichment (Max Weber, 2002.) Conversely, in Russia, the Orthodox religious tradition and the former Soviet “builders of Communism” ideology to a larger extent resulted in a reserved attitude

towards material values focusing on spiritual and ethical self-development. A logical follow-up would be the application of the ethical approach to shadow economy studies since in this case, the moral aspects of economic activity prevail. Its essence is that any economic system has its traditions and commonly accepted moral standards that serve as core ethical institutions. Any shadow activity violates such accepted standards even if does not directly damage the society or even yields some economic benefits. It should be accepted that the urge for the highest revenue possible makes entrepreneurs take risks and very bold moves. It usually results not only in the rejection of moral and ethical standards but also a gross law violation. Thomas J. Dunning (1860) quoted by K. Marx in his *Das Kapital*, this phenomenon is explained by the significance of the profit margin in any business activity: "A certain 10 per cent will ensure its employment anywhere; 20 per cent certain will produce eagerness; 50 per cent, positive audacity; 100 per cent will make it ready to trample on all human laws; 300 per cent, and there is not a crime at which it will scruple, nor a risk it will not run, even to the chance of its owner being hanged. Smuggling and the slave-trade have amply proved all that is here stated."

There is also a statistical approach to the shadow economy studies. For statistics, the shadow economy is an economic activity concealed from official surveys and not accounted for. According to the procedure used by the Russian Federal Statistics Agency (compliant to the SNS1993 international procedure), the shadow economy is divided into "*hidden*" (a legal economic activity which is concealed or diminished by the business entities for evading taxes and social payments), "*informal*" (informal individual or household activities not properly registered), and "*illegal*" (criminal business activities.)

An example of the statistical approach in Russian in the OESR-2003 Unobservable Economy Assessment Guidelines and the hidden (informal) economy estimation guidelines from the Federal Statistics Agency. These guidelines are intended for a more accurate account of the magnitude and evolution of the national economy macro indicators compliant to the UN international statistics standards. An important benefit of the statistical approach is the very possibility to quantitatively estimate the unobservable business activity so the results are suitable for analysis, international comparisons, and for developing and implementing governmental measures and economic policy aimed at affecting the shadow economy. Still, a big disadvantage of the statistical approach is the unacceptably low accuracy of its shadow economy size estimations. Ye. Petrov (2006) notes that the very concept of the SNS system excludes the possibility of estimating and measuring the "black" (criminal) economy metrics. That is why it cannot realistically assess the actual size, structure, and evolution of the shadow economy. It is confirmed by the huge mismatches between the Russian shadow economy metrics provided by the Federal Statistics Agency and the police. The police claims the total loss through government and

corporate money embezzlement, hidden revenues, tax evasion, illegal international money transfers (mostly outgoing) can be similar in size to the country GNP.

Different views of the shadow economy attributed to various theoretical and applied tasks solved in each specific research domain resulted in the emergence of the following primary theoretical approaches: *legal, economic, sociocultural, and statistical*. Still, today the *comprehensive approach* is the most sophisticated tool for the shadow economy studies. Its substantial benefit is that the shadow economy is a multifaceted phenomenon with relatively homogenous parts and attributes of it as a whole is studied with interdisciplinary research. In this way, the shadow economy is studied in its fullest by a range of sciences and with interdisciplinary approaches.

4. Results and Analysis

The analysis of modern scientific views on the shadow economy shows that it is a complicated phenomenon that can best be estimated with such an interdisciplinary approach. It is believed that a comprehensive *institutional approach* gives the most accurate solutions to the conceptual problems of the economic theory when applied within the framework of the new institutional theory (new institutionalism.) That said, the new institutionalists consider “institutions” (traditions, customs, accepted legal and social behavior patterns) as the existing formal and informal “rules of the game”. These are such groups of socially accepted standards and enforcing sanctions that guide the individual’s behavior, and manage the relationships between the government, the society, and the business entities. Taking the very basic concept of the new institutionalism theory “institutions matter”, it can be seen that it acknowledges the domination of social institutions in today’s economy.

The core category of the institutional approach is the very concept of “institution” as a consistent behavior pattern expressed as a multitude of models applied to the economic and social life. That said, the “institutions” (traditions, customs, accepted legal and social behavior patterns) are considered as the existing “rules of the game” that restrict and guide the individual’s behavior and coordinate the relations between the state, the society, and the business entities. According to the basic new institutionalism concepts, a substantial part of the social and economic institutions is intended to mitigate the negative impacts of unfair competition, limited rationality and opportunistic behavior of economic entities involved in various shadow activities. The public institutions intrinsically and naturally create a system of priorities, positive and negative stimuli governing the human behavior and reducing the uncertainty of the social environment.

R. Coase, the American economist, a Nobel prize winner was the first to propose the use of the institutional approach to the shadow economy studies. In his opinion, the reasons for the emergence of shadow relationships are high institutional costs of the market business environment. In his work *The Nature of the Firm*

(Ronald Coase, 1937) he demonstrated that company engagement with the shadow economy should be considered as an objective and expected reaction to high transaction costs and drawbacks of the basic market institutions. R. Coase notes that the absence of profitable and consistently performing institutions that protect the property rights and contractual relationships makes the entrepreneurs reduce their transaction costs through switching to the shadow (illegal) sector. O. Williamson and G. Simon studied the essence and the nature of the shadow economy with the new institutional economic theory. G. Simon (1993) notes that it is expressed as the behavior of economic entities within the *bounded rationality* model, while O. Williamson (1993) offers an *opportunistic behavior* model. While in the new classical theory a human is a hyper-rational being, new institutionalism highlights imperfection of the human nature, its limited abilities and intellect: *our knowledge is never complete, our computational and forecasting abilities are not endless, and performing logical operations takes time and intellect*. G. Simon says that decision made by business entities can be rational only to a certain limit defined by the incompleteness of the information available and limited intellectual abilities. *Opportunistic behavior* is one of the key behavior drivers within the new institutional economic theory. Such behavior is intended to satisfy one's interests without being restricted by any morale. The shadow economy is one of the environments where, as O. Williamson proposes, the human utilizes their opportunistic behavior expressed as "...following one's own interests, even through deceiving, including but not limited to such obvious kinds of deception as lies, theft, fraud."

Hernando de Soto, a renowned researcher from Peru, emphasizes the crucial role of institutions and institutional (transaction) costs in such issues as "the price obeying the law" and "the price of illegality" of the shadow economy. In his book *The Other Path* (H. de Soto, 1989) he demonstrated incorrectness of the dominating view that the informal shadow economy in the third world countries does not inhibit their economic development. On the contrary, it establishes a more rational economic order compared to the inefficient and corrupted government by coordinating illegal private businesses in a free competitive environment. H. de Soto believes that the shadow economy is a shelter for those who have institutional costs higher than the benefits from reaching their goals. H. de Soto considers the low efficiency of the formal, legal approach, corruption, and low quality of government as the key reason for large-scale shadow economy operations. Under H. de Soto's institutional approach, the key national security threat is a "failed state" expressed as red tape, imperfect and "bad" legislation, and poor enforcement of "good" legislation.

So, the institutional approach to the shadow economy within the framework of the general new institutionalism theory is the best way to express the relation between formal and informal institutions through some basic "rules of the game" that shape the ethical foundations of behavior and the business activity. The "institutionalists" in their proofs come to a correct conclusion that stable economic

behavior patterns and models (including “shadow” ones) mostly depend on the maturity of social institutions. The public institutions are intrinsically self-regulating and self-sufficient components of market relations. They naturally create a system of priorities, positive and negative stimuli governing the human behavior and reducing uncertainty and instability of the market environment. A substantial part of the social and economic institutions is intended to mitigate the negative impacts of unfair competition, limited rationality and opportunistic behavior of economic entities involved in various forms of shadow activities.

5. Conclusions

An indisputable benefit of the institutional approach in the framework of the new institutional theory as applied to the shadow economy problem is that it is one of the most balanced interdisciplinary approaches offering most comprehensive theoretical fundamentals for such a complicated phenomenon as shadow economy. This approach (as opposed to the legal one commonly used in Russia) seems to be the most suitable to analyze the shadow economy phenomenon. It is the best tool to investigate its essence and nature through considering a set of both economic (the nature of the market economy, striving for huge profit margins, competitive environment evolution, etc.) and non-economic factors (legal and ethical foundations of entrepreneurship, traditions, ethnic mentality, etc.)

The institutional approach is the most comprehensive and general-purpose one. The reasons for its suitability for research are as follows:

- First, it enables to distinguish informal (non-criminal) economy from the anti-social and dangerous criminal economy.
- Second, it considers the shadow economy as an economic activity that co-exists with most legal business activities but for some reasons not covered by official statistics.
- Third, the institutional approach believes that the direct effects of the government agency activities on the shadow economy entities are real although limited. That is, with a certain understanding of the social institution role in the economy and with agile governmental regulation the shadow activities can be converted from a latent to a legal domain. Therefore, beneficial coercion by the government is quite possible.

At to practical applications, the institutional approach is the most comprehensive way to solve actual problems and overcome the shadow economy in Russia.

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Metodologia badań nad szarą strefą

Streszczenie

Niniejszy artykuł dotyczy podstaw teorii badań szarej strefy opracowanej w Rosji. W artykule dokonano analizy różnych podejść do badań szarej strefy. Celem przeprowadzonego badania było uzasadnienie opracowania kompleksowego podejścia badawczego do badań w szarej strefie. Efektem podjętych badań jest propozycja zastosowania podejścia instytucjonalnego w ramach nowej teorii ekonomii instytucjonalnej jako najbardziej ogólnego, interdyscyplinarnego podejścia do studiów nad szarą strefą.

Słowa kluczowe: szara strefa, instytucjonalne podejście do szarej strefy.