

CRITERIA OF CLASSIFICATION OF THE EU MEMBER STATES FOR ASSESSMENT OF THE SHADOW ECONOMY

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ABSTRACT

The shadow economy has become a serious impediment for economic development of different countries and regions. Classification of the EU member states by purposefully selected shadow economy assessment criteria would shed more light on the causes and consequences of this phenomenon in particular country groups and would allow developing policy measures appropriate to the situation in each country group.

The main purpose is to propose the criteria of classification of the EU member states for assessment of the shadow economy. The following objectives were raised: 1) to review the criteria of country classification observed in previous research in the area of the shadow economy in Europe; 2) to select and substantiate the methodology of the research; 3) to present the findings of the empirical research.

Key words: Shadow Economy; EU member states, Criteria of Shadow Economy; Classification; Tax evasion.

INTRODUCTION

The phenomenon of the shadow economy exists in any country and, in accordance with its size, more or less affects a country's social welfare and policies. The shadow economy distorts a country's GDP as due to evasion of taxes and/or circumvention of laws, a certain part of economic transactions are hidden. Despite the fact that in some cases the shadow economy is treated as a force stimulating institutional change and boosting the overall production (Enste, 2018), unregulated economic activities evidently lead to reduced tax revenue in a state's budget, lower tax morale and higher costs of control. They also negatively affect a country's tax system, pervert competition and disturb allocation of resources because resources are not used in the most efficient way. Such economy is simply irrational.

During the last decades, the shadow economy has become a serious impediment for economic development of different countries and regions. For the EU member states, it is seen as an obstacle threatening the objectives of cohesion and growth defined in the Europe 2020 strategy (Tudose, Clipa, 2016). Although economists provide valuable indicators and characteristics of the shadow economy that help better perceive, control and prevent this phenomenon, the problem still confronted is that it is difficult to explain why some countries are facing the structural conditions more favourable to the shadow economy than other countries. As it was noted

by Enste (2002), the main determinants of the shadow economy in advanced countries (e.g. Western Europe) include the burden of taxes and social security contributions, density of regulations (especially on labour markets), the early retirement, increasing unemployment rates and the long-term decline of civic virtue, while the determinants of the shadow economy in less developed countries (e.g. Eastern Europe) additionally cover lack of competence and trust in public institutions, inadequate enforcement of laws and regulations, high costs and administrative burdens for entrepreneurs and poor public infrastructures. The differences in the structural conditions within the EU determine different levels of the shadow economy in the EU member states. Hence, classification of the EU member states by purposefully selected shadow economy assessment criteria would shed more light on the causes and consequences of this phenomenon in particular country groups and would allow developing policy measures appropriate to the situation in each country group.

Thus far, scientific literature has mostly focused on the determinants (Remeikienė et al., 2014 and others), measurement (Edwards, Flaim, 2008; Schneider, Buehn, 2016 and others) and prevention (Vainionpää, 2016; Remeikienė, Gasparėnienė, 2016 and others) of the shadow economy, but the criteria of classification of the EU member states for assessment of the situation with the shadow economy in these states have hardly been considered.

The main purpose of this article is to propose the criteria of classification of the EU member states for assessment of the shadow economy. For fulfilment of the defined purpose, the following **objectives** were raised: 1) to review the criteria of country classification observed in previous research in the area of the shadow economy in Europe; 2) to select and substantiate the methodology of the research; 3) to present the findings of the empirical research.

The methods of the research include comparative and systematic literature analysis.

CLASSIFICATION OF COUNTRIES FOR THE RESEARCH IN THE SHADOW ECONOMY IN EUROPE: LITERATURE REVIEW

Although the phenomenon of the shadow economy is defined and interpreted as having multiple meanings, in the most common sense it refers to "economic activities (goods produced and services rendered) conducted

in non-compliance with applicable laws for the purpose of avoiding taxes or/and regulations" (Lithuanian Free Market Institute, 2015, p. 5). Hence, the shadow economy comprises all unregistered economic activities that have a negative economic impact in terms of damaging an economy and reducing GDP, and a negative social impact in terms of violating the principles of social equity.

As it was noted by Enste (2018), the implications of the shadow economy extend beyond the economy to the political order, and the fight against this phenomenon should be based on improvement of the legal and business environment. In order not to misunderstand or misassess the shadow economy in a certain country or region, it is necessary to develop rigorous and internationally comparable methodologies (Zaman, Goschin, 2016). The dynamics of the shadow economy can be researched retroactively only if the specific manifestations of this phenomenon (e.g. tax evasion, undeclared work, corruption, money laundering, etc.) are considered (Tudose, Clipa, 2016). The differences in the structural environment in different countries determine the variance in the level of the shadow economy in these countries. Thus, reliability of the assessment of the shadow economy in particular countries to a large extent depends on which assessment criteria are considered. Classification (grouping) of countries by purposefully selected criteria would contribute to a more accurate assessment of the situation with the shadow economy in the groups under consideration, which, in its turn, would allow developing policy measures appropriate to the situation in each country group. Previous studies in the area of the shadow economy in Europe researched different countries by considering their accession to the EU date, regional distribution, level of development and various economic features (size of the informal sector, tax burden, population's income, level of financial development and quality of life indicators). Enste (2002), Schneider (2015), Tudose and Clipa (2016) and some others employed an accession to the EU approach. Tudose and Clipa's (2016) study showed that 15 original EU countries have lower shares of the shadow economy in comparison to EU accession countries. The differences were found to be determined by lower fiscal and moral pressure, advanced economic, social and cultural systems, higher quality of public institutions and legislation, and advanced international trade in the former, rather than in the latter countries.

Other authors analysed the issues of the shadow economy in Europe by employing regional/national approach. Glovackas's (2004) research in the issues of the shadow economy in Central and Eastern Europe revealed that the shadow economy in this region existed even before the communist regime had collapsed. Thus, the present level and features of this phenomenon to a particular degree are linked to the former communist practices and a relatively recent transfer to the system of a free market economy (corruption, bureaucracy, poor protection of property rights, disadvantaged business

environment, etc.), while the main causes of the shadow economy in more advanced countries of Western Europe (Sweden, Germany, Holland and others) are high direct taxation of earned income (Schneider, 2008), business overregulation (Schneider, 2015; Williams, Horodnic, 2015b; Tudose, Clipa, 2016, etc.) and high prices of goods, services, materials (e.g., materials are normally bought in the formal market and later included as raw materials for work/service that is not declared) (Pedersen, 1998).

The level of a country's development is another criterion considered while assessing the shadow economy in Europe. Having researched the shadow economy in industrial countries (Portugal, Spain, Italy, Greece, Poland, etc.), Enste (2018) found that economic agents in these countries get involved in underground activities mainly due to strict regulation of the labour market (people work underground or employ other people illegally). Transition economies, as it was previously mentioned, suffer from underground activities due to "the numerous structural imbalances inherited from central-planning period" (Fedajev, Arsič, 2002, p. 20), while high value-added taxes on labour-intensive products are recognized to be the main cause of the shadow economy in highly-developed economies (Norway, Switzerland, Turkey) (Schneider, 2016).

The research carried out by Stankevičius and Vasiliauskaitė (2014) disclosed that there exists a strong causal relationship between a country's tax rate and the size of its shadow economy, i.e. the countries with a heavy burden of taxation and social insurance contributions have high levels of the shadow economy. According to Schneider et al.'s (2010) estimations, the weighted average size of the shadow economy (as a percentage of GDP) is more than two times lower in high-income than in low-income countries. Blackburn et al.'s (2012) empirical observations established that the countries in a lower stage of financial development have greater sizes of the shadow economy due to a higher incidence of tax evasion. Finally, Kireenko and Nevzorova's (2015) study revealed that the countries with lower qualities of life have higher rates of the shadow economy, but it positively affects the level of life in the future as shadow income increases total revenues. Nevertheless, high levels of the shadow economy lead to reduction in such life quality indicators as a long and healthy life and access to knowledge.

Summarising, although it is presumed that population's involvement in underground activities may promote institutional change and boost the overall production, the shadow economy is treated as a negative phenomenon since it reduces tax revenue and lowers economic growth rates. The differences in the structural conditions within the EU determine different sizes and characteristics of the shadow economy across the Union. The results of previous studies indicate that consideration of different assessment criteria provides different research results. Hence, classification of the

EU member states by purposefully selected criteria would provide an advantage to more accurately compare the extent and causes of the shadow economy across country groups.

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