

SHADOW ECONOMY, ECONOMIC DEVELOPMENT, AND ENTREPRENEURSHIP

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Abstract

The purpose of this article is to determine the effect of the shadow economy on the country's economy. To answer the research objectives, a literature review method was used from various research results related to the shadow economy. Shadow economy has a different impact in different countries, there is a difference in the percentage of the number of shadow economics between developed and developing countries. In developed countries, the percentage of the shadow economy is smaller than in developing countries. The formulation of policies to formalize the shadow economy is carefully prepared because the shadow economy on the other hand also increases the absorption of production from the formal sector.

Keywords: *Economy, Development, Entrepreneurship*

I. INTRODUCTION

The magnitude of economic activity in a country is described in Gross Domestic Product (GDP). However, in practice, not all economic activities can be monitored and recorded in GDP statistics. Unrecorded transactions, whether intentional or unintentional, are outside the official government accounts. This condition causes a country's economic performance as seen in GDP to be biased.

There are five important facts about the informal economy. (Ghose, 2017). First, the numbers are huge, especially in developing countries. Second, productivity is very low compared to the formal economy.

Third, the productivity of informal enterprises is too low for them to thrive in the formal sector. Fourth, the informal economy is largely disconnected from the formal economy. Informal enterprises rarely turn to formality and continue to exist. Fifth, as the country grows and develops, the informal economy eventually shrinks, and the formal economy dominates the economy.

Economic activities that take place in an economy but are not included in the calculation of GDP are often considered underground economic activities. This economic activity has been going on for a long time and is a trend that occurs in almost all countries, both poor countries and rich countries. The results of a study by Schneider in 2010 for all the countries investigated, (162 countries from 1999 – 2007) show that the shadow economy has reached a very large size.

Business activities included in the shadow economy exist in every country (Almenar et al., 2020). Defining business activities that are not officially registered is still largely controversial in the academic literature. Despite this controversy, unannounced activities are considered to include all production and supply of legal goods and services that are intentionally hidden from public authorities to avoid taxes or social security contributions or to avoid meeting certain legal standards or meeting certain standards. Regardless of the definition used, it is common practice to report unannounced measures of the economy as a percentage of gross domestic product (GDP).

Shadow economy underground, non-observed, hidden, informal economy, or parallel, includes not only illegal activities but also unreported income from the production of legal goods and services, whether from monetary or barter transactions, the attention of stakeholders, especially the government. The government's attention to the informal economic sector because it has a very important role in the national development process. (Sartono & Rahmawati, 2018). Harriss-White and Sinha (2007) in (Sinha et al., 2014) define the informal sector in general as consisting of business units involved in the production of goods or services that usually operate on a small

organizational scale, with little or no division between labor and capital as factors of production, (labor, management or ownership is blurred), and on a small scale.

In developing countries, informal enterprises account for up to half of economic activity. They provide livelihoods for billions of people. However, their role in economic development is still controversial. One of the important roles of the informal sector is in terms of employment, contributing to the modernization process of society. Before they work in the formal sector, workers from rural areas will work in the informal sector to gain expertise, knowledge, and skills.

The informal sector in recent years, in various literature developments, has become a topic of discussion that the informal economy is an incubator for the creation of companies. (Williams & Martinez, 2014) Entrepreneurs try to sell (trade) their business results without registering their company to find out opportunities for business continuity before deciding to register and legalize their business. The research results also show that the shadow economy for business people is a natural business incubator.

To allocate resources more effectively and efficiently, a country needs to collect information about the level of the shadow economy, its number, and who is involved in these economic activities.

This study aims to determine the policies to be able to formalize economic activities in the shadow economy taken by local governments, especially agencies related to MSMEs in Tulungagung Regency.

II. RESEARCH METHOD

1. Definitions Shadow economy, underground, non-observed, hidden, informal economy Also called the underground, informal, or parallel economy, the shadow economy includes not only illegal activities but also unreported income from the production of legal goods and services, whether monetary transactions or barter (Schneider & Enste, 2002). *Shadow economy*: All economic activities that are not currently officially registered and

calculated contribute to the calculated (or observed) Gross National Product. (Schneider & Hametner, 2014)

Smith (1994, p. 18) defines “market-based production of goods and services, both legal and illegal, that goes undetected in official estimates of GDP.

The shadow economy includes unreported income from the production of legal goods and services, whether from monetary or barter transactions – and also includes all productive economic activities that would normally be taxed if reported to state authorities (taxes).

Shadow Economy is all market-based legal production of goods and services that is intentionally hidden from public authorities for the following reasons:(Schneider & Hametner, 2014)(1) avoidance of taxes, (2) avoiding payment of social security contributions, (3) avoid having to meet certain legal labor market standards, such as minimum wages, maximum hours, safety standards, etc., and/or (4) to avoiding compliance with certain administrative procedures, such as filling out statistical questionnaires or other administrative forms.

I. Types of the shadow economy(Schneider & Williams, 2013)

a. Illegal economic activity

1) Financial transactions; trade in stolen goods, manufacture and distribution of drugs, prostitution, smuggling, gambling, fraud, human trafficking, drug trafficking, and arms trafficking.

2) Non-financial transactions; Bartering drugs, stolen goods, smuggling, etc.; producing or growing medicine for own use; theft.

b. Legal economic activities

1) Tax evasion; unreported income from self-employment; benefits of wages, salaries, and assets from unreported work related to official services and goods. Barter services and legal goods (official)

2) Tax avoidance; employee discounts; allowances; work done alone or with the help of neighbors

The informal sector as an economic reality has received mixed views among development economic observers. Many observers regard the informal

sector as marginal or peripheral and unrelated to the formal sector or modern capitalist development. Some observers believe that the informal sector in developing countries will disappear once these countries reach adequate levels of economic growth or modern industrial development. (Alter, 2012) while others argue that industrial development may take a different pattern in developing countries, including the expansion of informal economy activities, than in developed countries.

Attention to the dynamics of the informal sector is important for many reasons. The first dynamic results in a bidirectional causality between informal employment and GDP per worker i.e., a decrease in informal employment causes an increase in GDP per worker, while an increase in GDP per worker causes a further decline in informal employment. (J & Wedge, 2000). The government's attention to the informal sector is more on policy formulation by considering how to legalize the sector where informal workers can obtain the minimum rights of workers such as minimum wage eligibility, and health and safety insurance, but on the other hand, the government also needs to consider the interests of business owners.

III. FINDINGS AND DISCUSSION

1) Shadow Economy Impact

The relationship between the shadow economy and economic growth is controversial. Several studies reported that the former had a significant negative impact (Loayza, 1996; Borlea, Achim & Miron, 2017; Baklouti & Boujelbene, 2019). According to Baklouti and Boujelbene (2019), an increase in the informal economy can lead to a reduction in the tax base, which has a negative impact on investment in public infrastructure and the efficiency of public services. These factors can harm the economic growth of a country.

Schneider (2011) argues that the effect of the shadow economy differs between countries. Increasing the size of the shadow economy may benefit growth in developed and transition economies. However, in developing countries, the larger size of the shadow economy can hamper economic growth. Meanwhile, Goel, Saunoris, and Schneider (2017) investigated the

impact of the shadow economy on economic growth in the United States for more than a century. The authors conclude that before World War II, the shadow economy was negatively related to economic growth; meanwhile, the shadow economy in post-World War II boosted economic growth.

The results show that the shadow economy has a negative impact on economic development and a diminishing effect on aid effectiveness. (Hassan, 2017). This is because the effect of changes in aid on income depends on the size of the shadow economy in Egypt, it is important to calculate the marginal effect of aid on income for different values of the shadow economy. Based on the calculation of the marginal effect, it can be concluded that the effect of assistance on income will have a negative effect. The continued existence of the shadow economy poses a major challenge to policymakers because of its negative effect on economic development and aid effectiveness.

The results of research by Schneider Shadow economy has a negative effect on Colombia and most other South American countries (except Chile) The size of the shadow economy in Colombia fluctuated during the 1980s between 40 and 50% of GDP, followed by higher volatility in the period 1990s. (Schneider, 2007) The main cause of underground activity shows that on the one hand taxation does not directly have a major influence on the growth of the shadow economy in the 21 countries, on the other hand, a considerable influence is caused by unemployment and its intensity. Shadow economy regulation and corruption have a negative impact on the economy and development in high-income countries (Hoinaru et al., 2020). Low-income countries, where the government is weaker than in high-income countries, corruption and shadow economy help companies to avoid government regulation, In this way, the negative effects of corruption and shadow economy will be reduced for low-income countries.

Scheiner in his research on the shadow economy for 162 countries, including developing countries, Eastern Europe, Central Asia, and high-income countries during the period 1999 to 2006/2007. According to estimates, the weighted average measure of the shadow economy (as a

percentage of “official” gross domestic product) in Sub-Saharan Africa is 38.4 percent; in Europe and Central Asia (mostly transitional countries), it was 36.5 percent, and in high-income OECD countries, it was 13.5 percent. (Schneider et al., 2010) A clear negative trend in the size of the shadow economy: The unweighted average of 162 countries in 1999 was 34.0 percent and in 2007 31.0 percent; there was a reduction of 3 percentage points. The driving force of the shadow economy is an increase in the burden of taxation (both direct and indirect), combined with labor market regulations and the quality of public goods and services, as well as the formal state of the economy.

Shadow economy on the country's economy has different effects. In general, the scale of the economy, corruption, and the taxation system will have a different impact on the size of the shadow economy.

The Shadow economy is related to labor (Sookram et al., 2009; Williams, & Nadin, 2012). The results of a study by Wiseman in Poland on the labor market in Poland (2013) argue that high unemployment is the reason for the increase in informal employment., Cichocki and Tyrowicz (2010) argue that on the one hand, the shadow economy causes taxation disturbances in the official labor market, and on the other hand due to the absence of demand for some professions in the official market. Another factor is the level of trust in the government and good governance.

Teobaldelli and Schneider (2013), and Ipatov et al. (2018) confirm that countries where economic fiscal regulation is carried out based on democracy, have lower shadow economies. The results of research from Din et al in Malaysia show different results, the determination of the individual income tax burden has an impact on the shadow economy in Malaysia. Lower personal tax rates discourage people from participating in the shadow economy. On the other hand, the increase in national income and government consumption also reduces the shadow economy; while increasing misery boosts Malaysia's shadow economy. (Din et al., 2019).

In general, for most industrialized countries, the following factors affect the level of the shadow economy (Enste, 2015): excessive tax burden

and social insurance contributions; the frequency and intensity of officially recorded economic regulation, very strict labor market regulations with early retirement, rising unemployment rates and restrictions on possible hours of work per week, define illegal job searches. Typically, countries with high levels of the shadow economy exhibit low levels of tax preparedness, determined by corruption, tolerance for the state, and low respect and loyalty to public organizations. Analyzing countries in Central and Eastern Europe, including the Baltic states, scientists (Schneider, 2007) point out other reasons that define the shadow economy: the inability of official institutions (legal action, bureaucracy, judicial practice); corruption that undermines trust in government; weak implementation of legislation, impossibility or unwillingness to protect property rights; high costs for business development and business administration expenses; low probability of the fact that it is possible to avoid it if a person avoids paying taxes or doing illegal work; very high bureaucracy.

The impact of the shadow economy on a country is as follows:

- The high percentage of the Shadow economy makes official statistics (on unemployment, official labor force, income, consumption) biased. Development policies and programs based on these statistics will lead to inappropriate policies and programs.
- The percentage growth of the shadow economy can trigger a destructive cycle. Transactions in the shadow economy escape taxation, so tax revenues are lower than they should be. If the government raises tax rates, it will encourage an increase in the percentage of the shadow economy which will cause budget constraints in the public sector to worsen. The increasing percentage of the shadow economy on the other hand, at least of the income earned in the shadow economy is used for the consumption of goods or services of the official economy and produces a sizeable positive stimulus effect on the official economy.

2) Determinants of Shadow Economy

Empirical research on the determinants of the shadow economy mostly considers variables such as income per capita, unemployment, tax burden,

government spending, regulatory costs, openness to international trade as well as several institutional and cultural characteristics as mentioned in the study (Johnson, et al. 1997, 1998; Friedman et al. 2000; Torgler and Schneider, 2007; Elgin, 2010 in(Saputra & Nugroho, nd). The quality factor of policymaking in the financial sector (Cicek and Elgin, 2011); the effect of the shadow economy on the policy of establishing social safety nets and the behavior of labor force participation(Schneider & Enste, 2000); the effect of shadow economy on income distribution (Hatipoglu and Ozbek, 2011); the effect of shadow economy on the effect on the magnitude of the business cycle (Elgin, 2012); the effect of shadow economy on the monetary base (Tanzi, 1983); D'Erasmus and Moscoso Boedo (2012) who examined the effect of the shadow economy on the amount of total factor productivity (TFP). The direct and indirect tax burdens, the high number of regulations, and the level of corruption are considered the main factors that cause the high shadow economy indicators in the transitional economy to affect Russian and Ukrainian entrepreneurship(Markina et al., 2018)The discount factor increases as the level of the underground economy increases. This happens because an increase in the discount factor means a decrease in the interest rate, which will increase consumption. Consumption growth has also boosted the underground economy. This means that the growth rate of the underground economy is proportional to its size. As a result, an increase in the discount factor will determine an increase in the growth rate of the underground economy(Badulescu & Caus, 2011)

Measurement of the shadow economy is notoriously difficult because it requires an estimate of economic activity that is intentionally hidden from official transactions, but econometric techniques can now be used to gain a much better understanding of its size. (Futselaar & Ying-Hui, 2021)

Shadow economy drivers by group: (Bilan et al., 2019)

- a. tax system; the amount of tax payment, the total tax burden on business
- b. Labor system; income volume of citizens, official unemployment rate, real average salary, labor migration rate.

- c. trade openness; levels of imports and exports, lost income for exports of goods and services and payments for imports, which did not arrive, the volume of public debt, outflows of unregistered funds (elimination of financial resources)
- d. Banking System; weighted average interest rate, the interest rate for deposits, the interest rate for credit, deposit outflow rate, number of banks, official exchange rate
- e. Quality of state regulations; the level of efficiency of the legal system in arbitration arrangements, corruption index, state inflation rate, and yield of state securities in the primary market.
- f. industrial development; quantity of industrial production sold, the share of profitable enterprises

The following four reasons. (Erdinç, 2016)

- To avoid paying income, value-added, or other taxes
- to avoid paying social security contributions
- To avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc.
- To avoid fulfilling certain administrative obligations, such as filling out statistical questionnaires or other administrative forms.

IV. CONCLUSIONS AND SUGGESTIONS

From the study of various works of literature, the impact of the shadow economy on the country's economy will vary. The scale and condition of the economy, the taxation system, politics, society, and culture of each country are different. In developing countries, the existence of a shadow economy where the industry is not yet developed, corruption and loose regulations tend to be high. On the other hand, the existence of a shadow economy will help provide jobs in the informal sector. Education levels and skills that are still low are a source of labor for the shadow economy.

The main drivers of the growth of the shadow economy are; tax burden and social security, tax morale, quality of state institutions, and labor market regulation. Tax policies and business legalization policies must be formulated

carefully and carefully. Policies that focus on prevention are unlikely to be particularly successful when it comes to tackling the shadow economy. This is because the shadow economy is pervasive and consists of a large number of small and scattered transactions.

The reduction in the number of informal sector actors was driven by the formation and expansion of formal enterprises managed by educated entrepreneurs. Uneducated entrepreneurs in both the informal and formal sectors, generally run small and inefficient companies. Educated entrepreneurs and managers run bigger and more efficient companies. Dualism: the informal economy is so large in poor countries because their employers are so unproductive. (Ghose, 2017)

An important constraint to economic growth is not the supply of better-educated workers, although at least on many observable characteristics, workers are somewhat similar in informal and formal enterprises. Instead, the bottleneck is the supply of educated entrepreneurs—people who can run productive businesses. These entrepreneurs create and expand modern businesses with which informal enterprises, despite all the benefits of avoiding taxes and regulations, cannot compete. This is how the informal economy dies in the process of developing its business.

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