**Shadow Economies. Results of the 2019 Survey in Ukraine**

***Research on the size of shadow economy in Ukraine has been conducted in 2019 by Kyiv International Institute of Sociology under H2020 Project SHADOW, which financed by the European Commission (GA no. 778188).***

***The task of the project is an exploration of the nature of informal economies and shadow practices in the former USSR region.***

SHADOW project has two main aims:

1) estimate the level of shadow economy in 5 counties of the post-USSR region by applying the consolidated methodology used for the three Baltic countries from 2009;

2) enhance capacity of participating researchers and thus their ability to consult national governments and international organizations on how to tackle shadow economies in the region.

**Shadow economies conception**

Shadow economies sometimes can be regarded as related to corruption and illicit flows (i.e. a large payment to influence policymaking or to cover criminal activities). However, in contrast to illicit transactions and corruption that are mainly feeding criminal activities, their main nature is economic. Accordingly, the main damage they cause is fiscal. They reduce taxable income thus affecting state economic capacity. In other words, a state has less to spend on infrastructure and services for its citizens.

**Measuring shadow economies is important, while:**

1) Estimating the size of shadow activities in a countries is useful to decide how strong, and targeted, should be measures to tackle it. How much is the state expected to gain from tackling the shadow economy? How much they are ready to spend? (the “tickets inspector principle”, Polese 2009)

2) Shadow economies are not evenly distributed across sectors. Measuring them enables to make decisions about what sectors it is more urgent to target with corrective measures.

**Besides, shadow economies can be used to survey citizens’ attitude towards policies**

An important component of the project is to consider shadow economies as a proxy of the attitude of citizens towards the law and how much a law is effective (or enforced). In other words, if one company under-reports its income, the company is acting illegally. But if too many companies engage in fiscal fraud, it is worth to consider this tendency as “feedback” from the business sector that some rules and laws are not working properly or that economic actors “disagree” with them.

Accordingly measuring and understanding shadow economies can help government not only to think of punitive measures but also, and more important, to identify possible ways to invite business out of the shadow.

Eventually, It is cheaper and faster to regularize (or formalize) business activities than to “punish, destroy and reconstruct” a large number of companies, a thing that might slow down the country’s economy.

**Our study based on the Putnins and Sauka methodology (2015 р.),** where the size of shadow economy estimated by the data of the business sample survey with using macro-micro modeling approach. It separate observed and non-observed components of GDP:

1. Income from all economic production (theoretical GDP)

2. Income from production of LEGAL goods/services

6. Income that is REPORTED and fully OBSERVED income

3. Income from production of ILLEGAL goods/services

5. Income of UNREGISTERED producers

4. Income of REGISTERED producers

OBSERVED ECONOMY

NON-OBSERVED ECONOMY

7. Income that is NOT REPORTED

SHADOW ECONOMY

UNREGISTERED ENTERPRISE

**Ukrainian business survey** was held in March– May 2019. By CATO method were surveyed 800 owners and top-managers of companies over all Ukraine except AR Crimea and temporary occupied NGCA of Donetsk and Luhansk oblasts.

Survey sample design was random, stratified and covered all regions of Ukraine as well as all economy sectors. All size types of companies were sampled: big, medium, small and micro.

**Survey results**

Size of shadow economy in 2018 was 38.3% of the total GDP and 38.5% in 2017. By the regions the size of shadow economy distributes as:

South : 41.2% in 2018 and 40.3% in 2017;
West: 32.5% in 2018 and 34.9% in 2017;
East: 50.2% in 2018 and 52.0% in 2017;
North/Center: 30.3% in 2018 and 30.3% in 2017;
Kyiv city: 43.8% in 2018 and 40.9% in 2017.

In average, the size of the shadow economy felt down on 0.3%, for two regions South and Kyiv city it grew 0.9% and 2.9%, respectively, for North/Center, it stayed without changes.

The most shadowed economy sectors are Retail, Manufacturing and Construction, for they shadow economy outreaches 50%, at the same time in Retail and Construction the size of the shadow economy increased from 2017 to 2018

There are three Components of the shadow economy: (1) Underreporting of business income, (2) Underreporting of real number of employees, (3) Underreporting of real value of paid wages, or «Envelope wages ».

1. The largest part in the shadow economy in 2017 and 2018 takes Unreported business income, though its share has diminished from 60% to 58%.
2. The followed one is Unreported employees, its share reduced from 22 % in 2017 up to 19% in 2018
3. The third component is Envelope wages and it is the smallest among others but in contrane of them its share significant grew from 18 % in 2017 up to 23% in 2018.

**Level of underreporting and expected penalties for deliberate misreporting**

Levels of underreporting and misreporting are quiet high and by the survey results, in average:

* 30% of business incomes companies left underreported in 2017 and 2018;
* 20% of employees occupied illegal in 2018 and in 2017 28% of employees were not able to get legal job ;
* 31% of employees earning was paid in “envelopes” in 2018 and 46% in 2017.

At the same time, entrepreneurs afraid to be caught for deliberate misreporting.

The majority of them believe, if they had been caught for misreporting, then it threatens them with serious penalties that will affect the further activity of the:

* 35% of respondents believe that penalties would affect the competitiveness of the company;
* 26% afraid that penalties would put the company at risk of insolvency;
* 12% said the company would be forced to cease operations.

Only 28% of respondents don’t expect any significant consequences from penalties for misreporting, among them 22% suggested it could be a small fine, while 6% believe that nothing serious could happened at all.

**Conclusions and significance of the study**

1. shadow economy occupies a significant part in business life in a number of sectors;
2. shadow economy index is only partly able to identify non-monetary transactions (blat’, exchange of favours), should not be confused with corruption and overlaps only partly with with the illegal economy;
3. a significant amount of people is afraid of getting caught and this means that they are potentially open to viable alternatives;
4. understanding the motifs for engaging with shadow transactions can help policymaking

**Annex**

**Components of the shadow economy**