

# Shadow economy in Ukraine: causes and solutions

The shadow economy in Ukraine is one of the major barriers to competitiveness, improving living standards, and European integration. The shadow economy reflects active illegal economic activities, a high level of public sector corruption and low legal and tax morale of legal entities and individuals. After political changes of 2013–2014, the resolution of these problems is a major challenge for Ukraine.

## Current situation

The shadow economy exists in almost every country in the world. While in some countries the size of the shadow economy has no significant impact on national economy, in other countries it grows into a self-sufficient parallel system of economic activities. Unfortunately, Ukraine belongs to the second category, with the size of its shadow economy reaching 20–50 % of GDP, as various sources suggest.

**The shadow economy reaches 20-50 % of GDP in Ukraine**

Ukraine’s shadow economy in relation to GDP (%):

Year	Evaluation by the method of the State Statistics Service of Ukraine	“Household expenditure — retail turnover” method	Electricity method	Monetary method	Unprofitable enterprises method	Aggregate demand – aggregate supply method	The Prof. Friedrich Schneider’s method
2004	18,9%	33,5%	28,0%	29,5%	25,0%	39,0%	49,0%
2005	18,1%	46,5%	28,0%	25,0%	24,0%	37,0%	48,0%
2006	17,3%	40,5%	27,5%	24,5%	23,5%	33,5%	47,0%
2007	15,5%	38,0%	27,0%	26,0%	24,0%	34,5%	47,0%
2008	15,1%	40,0%	26,0%	38,0%	30,0%	35,5%	46,0%
2009	16,1%	45,0%	35,0%	40,5%	31,0%	30,0%	46,0%
2010	16,5%	44,0%	37,0%	30,0%	31,0%	33,0%	45,0%
2011	16,0%	44,0%	37,5%	27,0%	31,5%	34,0%	44,1%
2012		The integral indicator of the shadow economy — 32%					
2013		The integral indicator of the shadow economy — 35%					
2014, Ikv		The integral indicator of the shadow economy — 40%					

Source: figures presented by the State Statistics Service of Ukraine, Ministry of Economy, as well as Prof. F. Schneider’s data

Over the last years, the State Statistics Service of Ukraine has estimated the size of the shadow economy at an average of 15%-18% of GDP. It should be noted that these figures considerably differ from those presented by other state agencies and researchers.

**The size of the shadow economy at an average of 15%-18% of GDP is underestimated**

According to Ukrainian Ministry for economic development and trade, over the last 5 years the share of shadow economy in Ukraine has varied between 28% and 39% of GDP. This figure is calculated by various estimation methods, which consider the discrepancy between revenues and expenses of Ukrainian residents, dynamics of cash in circulation and production output, energy consumption and production output, as well as dynamics of the cost of resources, finished goods and profitability of production.

The “household expenditure — retail turnover” method is based on the finding to which extent consumer expenditure on commodities surpasses a gross sales volume.

Electricity method is based on the comparison between the growth of total domestic electricity consumption and GDP growth. It is assumed that the growth of household consumption of electricity should correlate with the real GDP growth. In case the growth of household electricity consumption is bigger than the GDP growth, it is believed that electricity is consumed “in the shadow”.

Monetary method lies in tracking changes in correlation between cash and deposits over a specific period.

Financial method is based on the measurement of changes in the ratio of the cost of goods, labour and services used in production to the gross profit of enterprises in country in general or in the form of specific economic activity.

According to Y. Kharazishvili, who used aggregate demand and supply model in his research, the size of the shadow economy in Ukraine fluctuates between 30% and 40% of GDP.

Austrian economist Prof. F. Schneider estimated that the size of the shadow economy in Ukraine reaches 52.8% of the official GDP. This figure is widely used in international comparisons.

The size of the shadow economy in Ukraine reaches 52.8% GDP according to international comparisons

The extension of the shadow economy negatively affects the efficiency of global management mechanisms and instruments, as well as management of national economies. The main present-day problems with the growing shadow sector of economy at global level are undeclared work and financial flows in the shadow sector.

The main instruments of shadow financial flows are tax minimization, tax evasion, capital outflow from Ukraine, money laundering and improper use of budget revenues.

According to fiscal bodies estimates, the total size of the shadow economy in Ukraine in 2012 totalled at least UAH 350 billion per year. Out of this amount, the conversion of non-cash money into cash or FX deposit accounts in foreign banks was worth UAH 100 billion, unofficial payments — UAH 35 billion, shadow fixed assets, tangible assets and services — UAH 45 billion.

In 2013, approximately UAH 250 billion of Ukrainian tax payers' money was circulating in the shadow economy. 41% of public procurement was done by state and municipal enterprises without tenders. According to the Security Service of Ukraine, 50-75% of public funds during public procurement are allocated with multiple violations. Due to corruption schemes in public procurement, financial losses account for 10-15% (UAH 35-53 bln) of budget expenditure annually.

Approximately UAH 250 billion of budgetary resources was circulating in the shadow economy in 2013

According to various international experts, the outflow of money received as a result of corruption and economic crimes exceeds USD 10 bln per year. Over the last years, money laundering though underestimated export prices has amounted to 73-79 %.

According to the International Labour Organization, the size of the shadow economy in Ukraine is about 9%. According to the Institute for Economics and Forecasting, in 2012 the share of Ukrainian citizens working in the shadow economy was 16.61% of employed population. According to the Confederation of employers, 5-7 million Ukrainians work “in the shadow”. In January–October 2013 the Ministry of tax and revenues of Ukraine identified more than 80,000 unofficial workers.

A special feature of the shadow market in Ukraine is a variety of combined forms of wage payment, with some part of the wage being received “in envelopes”. According to trade unions, the size of the shadow wage in Ukraine reaches UAH 200 billion annually, while, according to tax authorities, this figure is UAH 170 billion annually.

The size of the shadow wage in Ukraine reaches UAH 170-200 billion annually

When evaluating the size of the shadow wage based on the comparison between statistics data on income and retail turnover, the size of households shadow profits may reach 40–45%. Tentative budget losses are estimated at over UAH 46 billion, and social security contributions losses amount to over UAH 97 billion per year.

Besides, main deductions of the minimum salary in Ukraine are as follows:

1) For employees:

- Personal income tax — 15%;
- Single Social Tax — 3.6%;
- Military fee — 1,5%.

The taxpayer is entitled to reduction of a total monthly taxable income derived from one employer in the form of salary for the amount of the tax social benefit:

- in an amount equal to 100 percent of the minimum subsistence level for able-bodied persons (per month) in accordance with the law as of January 1 of the reporting tax year — for any taxpayer;
- in an amount equal to 100 percent of the benefit — for a taxpayer who maintains two or more children under 18 years — per each child;
- in an amount equal to 150 percent of the benefit — for a taxpayer who:
  - a) is a single mother (father), widow (widower) or tutor, custodian — per each child under the age of 18 years;
  - b) maintains a disabled child — per each child under 18 years;
  - c) is a person ascribed to the first or second categories of persons affected by the Chernobyl disaster, including those awarded with diplomas of the Presidium of the Verkhovna Rada of Ukrainian SSR due to their participation in the liquidation of consequences of the Chernobyl disaster;
  - d) is a pupil, student, graduate student, intern, junior scientific assistant;
  - e) is a disabled person of disability group I or II, including those from childhood;
  - f) is a person who receives life stipends as a citizen being prosecuted for human rights protection activities, including journalists;
  - g) was involved in hostilities in other countries during the period after World War II and is subject to the Law of Ukraine “On the Status of War Veterans and Guarantees of their Social Security”;
- in an amount equal to 200 percent of the benefit — for a taxpayer who:
  - a) is a Hero of Ukraine, Hero of the Soviet Union, Hero of Socialist Labor, bearer of the Order of Glory or Order of Labor Glory, those awarded with four or more medals “For Courage”;
  - b) was involved in hostilities during the World War II or a person who at that time worked in the rear, and is a disabled person of I and II group among participants of battle actions in other countries after the World War II subject to the Law of Ukraine “On the status of War Veterans and Guarantees of their Social Security”;
  - c) is a former prisoner of concentration camps, ghettos and other places of detention during the World War II or a person recognized repressed or rehabilitated;
  - d) is a person who was forcibly taken out the territory of the former Soviet Union during the World War II to countries that were at war with the former Soviet Union or were occupied by Nazi Germany and its allies;
  - e) is a person who was in the blockade territory of former Leningrad (St. Petersburg, Russia during the period from 8 September 1941 to 27 January 1944.

2) For employers: single social tax — from 36.76% — for 1st class up to 49.7% — for the 67th class of occupational hazard.

A negative tendency as to the shadow economy is characterized by various international ratings, in which Ukraine has one of the lowest places:

**Ukraine has one of the lowest places in various international ratings**

	Economic Freedom Index, 2014	Corruption Perception Index, 2013	Doing Business, 2014	World Competitiveness Report, 2014-15	Shadow Economy Index, 1999-07
Ukraine	155 (out of 186)	144 (out of 177)	112 (out of 189)	76 (out of 144)	145 (out of 162)
Source:	Heritage Foundation	Transparency International	World Bank	World Economic Forum	Schneider, Buehn, Montenegro

The analysis of the Economic Freedom Index 2014 showed that Ukraine has some of the worst conditions for economic development among European and post-Soviet countries. The dynamics of indicators shows unsatisfactory investment climate and corruption level, which put Ukraine low in international rankings, with 168 and 152 places respectively. Similar figures can be observed in African countries: in Cameroun as regards corruption level and in Congo as regards investment climate.

The results of Corruption Perceptions Index 2013 by Transparency International indicate that conditions for long-term business have deteriorated significantly. The main reasons for this are corrupt protectionism and convergence of political and business interests. According to this year's Corruption Perceptions Index, Ukraine's rating as regards corruption level remained almost unchanged — 25 points out of 100. Thus, with 177 countries in the ranking, Ukraine comes 144th. The main reasons for such situation are business monopolization, impossibility of long-term business planning and corrupt public officials taking control over business.

In the Doing Business-2014 rankings, Ukraine went 28 positions up to reach 112 place in comparison with Doing Business-2013. In general, Ukraine improved its figures in such areas: registration of enterprises (by 3 points); construction licenses (+145 points); property registration (+61 points); loans (+11 points); taxation (+4 points). According to the World Bank, deterioration was reported in a number of spheres, such as electricity system connection (-2 point), investors protection (-1 point) and insolvency permit (-5). According to "international trade" and "contracts execution" criteria, Ukraine took 145 and 48 places respectively.

Ukraine improves its position in the Index of World Competitiveness of the International Economic Forum, rising from 84th place last year to 76th place this year. Ukraine had the best positions in such sectoral indexes — market size (38 place), higher education (40), health care and primary education (43), infrastructure (68). The worst positions were — institutional structure quality (130 place), financial market development (107), macroeconomic environment (105), and business conditions (99). According to the ranking, the most unfavourable factors for business are (in a descending order): corruption, political instability, access to financing, frequent change of governments, red tape, inflation, tax rates, tax administration etc. The rankings were made on the basis of statistic data for 2013 and opinion polls among entrepreneurs at the beginning of 2014, prior to the annexation of Crimea by Russia, Russian aggression in Ukraine, military actions in Eastern Ukraine. Accordingly, these factors were not taken into account and did not influence deterioration of Ukraine's standing in rankings.

## Shadow economy factors

The most significant factors of shadow economy include:

1. Ineffective state economic regulation — lack of trust between business and government, red tape, inadequate institutional and legal framework. It results in formation of corporate-bureaucratic structures, which actually replace public governance system. Another problem is a frequent change of legal framework for entrepreneurship, which renders it impossible to effectively plan business and promotes shadow economic activities.

Ineffective state economic regulation is one of the most significant factors of the shadow economy

2. Ineffective tax administration, which is confirmed by various rankings regarding effective taxation. Heavy and unfair tax burden, increasing number of unprofitable enterprises, low payment discipline, instability and tax legislation flaws, poor knowledge of tax legislation, lack of legal protection for taxpayers are all contributing factors to shadow economic activities. Another important reason is the absence of effective penalty mechanisms for violation of tax legislation that creates additional stimuli for the tax minimization and tax evasion.

Ineffective tax administration is confirmed by various rankings

3. Labour market problems associated with low economic incentives for official employment and growing unemployment rate.

The main problem is the absence of effective system to ensure punishment for undeclared work and non-taxed wages

However, the main problem is the absence of effective system to ensure control and punishment for undeclared work and non-taxed wages.

4. Inadequate monetary regulation, that is non-transparent refinancing of commercial banks and establishment of floating FX rate, excessive activities of state on loan market — the issuance of state bonds to replenish state budget facilitates concentration of the capital in speculative operations and increases interests rates; excessive money supply does not match real economic needs and results in deflation or inflation.

5. Imperfection of budget system, low control over use of budget funds. It is confirmed by the Accounting Chamber of Ukraine, which reports numerous violations in public funds use.

6. Imperfection of judicial and law enforcement system, the absence of specific state program on fight against organized crime, including economic crimes, low public trust to judicial and law enforcement agencies.

7. Crime rate — since 2012, the Ministry of Internal Affairs suspended publishing of crime rate data in Ukraine. According to the latest data available (as of November, 2012), 443,7 thousand crimes were registered. Criminal environment is one of the major grounds for economic crimes and is closely connected to shadow economy.

## Reforms needed to fight against shadow economy in Ukraine

Priorities for fight against shadow economy in the context of economic reforms implementation include measures against shadow financial flows and legalization of labour market.

### 1. The enhancement of market economy regulation and implementation of anti-corruption reform.

- Instead of the existing Soviet-style economic regulation, it is necessary to introduce economic regulation with new structure and principles. State bodies and regulatory acts that contribute to wieldy bureaucracy and overregulation should be reformed. Better effectiveness of state bodies and improvement of legal framework for entrepreneurship will significantly decrease stimuli for shadow activities and enhance control over shadow operations by state bodies.
- The implementation of anti-corruption reform needs numerous measures. The biggest efforts should be aimed at institutional reform and legal enforcement of special measures aimed at corruption prevention and punishment. The first step should be establishment of the Anti-corruption bureau, which would be responsible for effective coordination of comprehensive anti-corruption program.
- The enhancement of IT-infrastructure of public administration — the introduction of new information systems in state apparatus eradicates corruption and reduces the apparatus.
- Increase in business confidence in state, and vice versa, is possible only provided specific incentives are applied, for example, reduction of audit inspections, faster registration and issuance of licences, certificates and other documents, equal opportunities for entrepreneurship for all economic agents.

It is necessary to introduce economic regulation with new structure and principles

The introduction of new information systems in state apparatus eradicates corruption

2. **Tax reform** should be directed towards the implementation of the following priorities: 1) equal tax conditions for all economic agents; 2) lower tax burden; 3) effective tax administration and public finances stability. In order to implement these priorities, we determine the following measures:

- To conduct tax amnesty based on transparent and clear procedure that will increase business confidence in state bodies, and vice versa, and increase budget revenues;
- To enhance the role of electronic systems in tax administration which will allow for less physical contact between tax officers and tax payers, and enhance the transparency of tax control;
- To lower tax burden, decrease the number of obligatory payments and tax privileges which will ensure equal opportunities for all taxpayers and stimuli for tax obligations minimization;
- To reform the simplified system to include only small enterprises and prevent it from being an instru-

Tax reform should be directed towards the implementation of effective tax administration

- ment for shadow financial flows;
- To solve problems with VAT reimbursement to support export and enhance business confidence in state;
- To enhance responsibility for the use of shadow tax schemes and deliberate minimization of tax obligations.

### 3. Banking system reform

- Promotion of clearing operations will allow for better control over the source of revenues, quicker identification of cases when expenses surpass revenues. In his research Schneider confirms that there is a strong negative correlation between the frequency of electronic payments and shadow economy — the size of shadow economy is bigger in countries where there are fewer electronic payments;
- The introduction of amendments to the legislation as to ensuring the disclosure of information about the final bank owners and non-bank financial institutions;
- The enhancement of transparency of the National Bank of Ukraine as to the bank refinancing, floating FX rate, and nationalization of banks, which are commercially frail and may be sold at a fair price;
- The counteraction to the outflow of national capital to low-tax countries, the development of effective system to return money and assets from abroad which were received through illegal practices, such as money laundering and terrorism financing.

Electronic payments should be expanded

### 4. Labour market reform

A pre-condition for fight against shadow labour market is pension system reform — the existing pension system does not favour the market coming out of shadow, payments into pension fund are pitched too high, given inadequate pension system. The main reason is that pension system of Ukraine is based on Soviet principles and is thus not effective. It results in considerable public expenses to cover Pension fund budget deficit as well as in high tax privileges for some categories of pensioners, while most pensioners receive small retirement benefits.

**For business**, it is necessary to increase the use of administrative measures, in particular, strengthened accountability for evasion of registration of labour relations between the employee and the employer as well as tax evasion and social security contributions evasion.

**For employees**, it is necessary to redistribute tax burden between the employee and the employer, to lower tax burden. It can be achieved only if the state changes the Single Social Payment and income tax level, with the enterprise increasing their official average salary. Only in case there is joint responsibility, this goal may be reached.

**For state bodies**, it is necessary to adhere to the Tax Code provisions. One of the main problems is the excessive frequency and unpredictability of amendments to the Tax Code. For this reason, the adherence to the Tax Code as well as high-quality analysis of draft amendments to the Tax Code will mitigate risks for economic activity and improve the budget planning of the organization.

5. **Justice reform** should be directed at ensuring the fair justice and implementation of decisions of courts of law, protection of property right, fight against raids. The implementation of justice reform should result in lower corruption level, increasing professionalism of judges and law enforcement bodies, enhancement of judicial independence from political processes, enhancement of constitutional justice and ensuring of transparency and impartiality of court proceedings.

It is necessary to strengthen accountability for evasion of registration of labour relations

The implementation of justice reform should result in lower corruption level

## Conclusions

The main goal for fight against shadow economy in Ukraine is to create conditions necessary for the enhancement of investment climate, lowering of tax and regulation pressure on entrepreneurship, protection of property rights and labour relations. These reforms will also give impetus to economic development, which, given high shadow economy indicators, is currently impossible.

*This publication has been prepared within the project “Hidden triggers of economic growth in V4 plus Ukraine”, that has been launched by the International Centre for Policy Studies in cooperation and with support of the International Visegrad Fund.*

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