

CORRUPTION AND THE SHADOW ECONOMY - EFFECTS ON A COUNTRY'S ECONOMICAL DEVELOPMENT

Costin-Dan DAVID¹, Dănuț-Dumitru DUMITRAȘCU²

^{1,2}Lucian Blaga University of Sibiu

Abstract

Corruption and the shadow economy represent an interesting and current topic in the field of business, because they are responsible for important economic and financial losses, for the governments and the economic and social future of one's country. Therefore, the current paper aims to underline the concepts of corruption and shadow economy, the main types of corruption and how the shadow economy manifests itself in different economical systems as well as some methods of analysing the shadow economy size. We are presenting some interesting results of a secondary data research developed in order to understand the impact of the corruption phenomena on the economical results of certain European countries, as well as assessing the evolution of the Corruption Perception Index in the EU and its impact in the population perception of corruption, combined with pointing out how the shadow economy reduces the value of the GDP, by providing a comparative analysis of different countries.

Keywords: *corruption, shadow economy, economic development, management systems*

JEL classification: *E00, M0*

¹ PhD Student, "Lucian Blaga" University of Sibiu, Faculty of Economic Sciences, Sibiu, costin.david@ulbsibiu.ro

² Professor, PhD, "Lucian Blaga" University of Sibiu, Faculty of Engineering, Sibiu, dan.dumitrascu@ulbsibiu.ro

1. Introduction

Corruption represents one of the most unwelcomed aspects of the socio-economic and cultural lives within a country of a society. No matter its dimension, corruption represents a real scourge that must be fought, but at the same time it must be understood from the perspective of the implication and how it effects, one side the economic development of a country, and on the other side, how it leads to the development of criminal entities and activities within said country.

Right now, we can consider that corruption represents a dangerous phenomenon that has a destructive effect on the quality of the institutional processes and especially on the trust of the population on the ways and means of institutionalised and public processes (Volintiru, 2014). The study of corruption and especially of corruption and economy has become of interest for todays' academics but also for multiple international entities that are trying to understand and also combat corruption (Jain, 2008).

The link between corruption, public policies makers, the existence of unsuitable public policies, effects of the economic environment are interesting areas that must be studies and understood to their full extent, due to the social and financial implication, but also for the need of developing sound policies, aid efforts that can stimulates self-sustaining growth and development within a country (Kaufman et.al., 1999 in Jain, 2008).

At this time, for a society and for a working economy, probably, the most devastating forms of corruption include the diversion and outright theft of funds for public programs and the damage caused by firms and individuals that pay bribes to avoid health and safety regulations intended to benefit the public, (Svensson, 2005), but that can and should be developed and delved into in future research. The purpose of this paper is to underline the concepts of corruption and shadow economy, the main types of corruption and how the shadow economy manifests itself in different economic systems as well as some methods of analysing the shadow economy size, linked to a secondary data research developed in order to understand the impact of the corruption phenomena on the economical results of certain European countries, as well as assessing the evolution of the Corruption Perception Index in the EU and its impact in the population perception of corruption, combined with pointing out how the shadow economy reduces the value of the GDP, by providing a comparative analysis of different countries.

2. Corruption – concept and typology

One of the most difficult questions to answer is “what is corruption?”. If we look at the word corruption from an etymological point of view, the word corruption comes from the Latin word “*coroptio-onis*”, meaning going away from morality, honesty, and honour (dexonline.ro, 2021). The conceptual evolution of corruption has been generated by the transformation of the political power from the idea of a private right of the nobility of the feudal period, to the current, public requirement in the modern society of today.

Even if it is difficult to agree on a clear definition of corruption, it seems that there is a general consensus that corruption represents a “acts in which the power of public office is used for personal gain in a manner that contravenes the rules of the game. Certain illegal acts such as fraud, money laundering, drug trades, and black-market operations, do not constitute corruption in and of themselves because they do not involve the use of public power (Vogl, 1998, Jain, 2008).

Another approach to the concept of corruption is that of Maoro (2002), by which he defines corruption as “an expression of the relationship between authorities and citizens, which means the discretionary usage of a public position or function, by using illicit and illegal means, with the purpose of obtaining personal or group interests / results or rewards”. At the same time, we are aware of the fact that corruption leads to an inequality of financial incomes and poverty (Gupta et.al., 1998) in those countries where this scourge exists, and also it generates a decrease in the economic development of said countries (Maoro, 2002).

Corruption has a long standing tradition in Romania, ever since the the Phanariot era, when the model of bags of money were sent to the Otoman empire, which was continued by big businesses of the time of the Kingdom of Romania, and it has become a highly accepted phenomenon, by the citizens, while certain “attentions” are still being offered today within the health system or to public officials, actions that are being considered normal (Rădulescu, 2007). As stated, before there is little consensus in the conceptual definition of corruption, usually the countries have defined the corruption in their national legislation, in combination with international norms in order to offer the largest cover of the corruption phenomena and consequently in the sanctioning of said activities.

Within the international legislation (EU Council, 1994, Romanian Law 127 / 2002), we encounter a definition that summarises the corruption as "the act of soliciting, offering, giving or accepting, directly or indirectly, an illicit commission or other unlawful advantage, or the promise of said advantage, that affects the normal activity of a function or behaviour of a beneficiary". At the same time the UN Manual on anticorruption policies (UN, 2021), defines corruption as "the abuse of public power for a private benefice, to the detriment of the public interest". Transparency International (2021) defined corruption as "the abusive use of the power intrusted with the purpose of satisfying some personal interests". The same definition was used by the UN in 2003 and adopted by Romania in 2004. Another definition, that of Rose-Ackerman (1999), defines the corruption as "the exploitation of the public function for personal gain", goes along the same direction as those of the previous ones. So, we can see similar approaches to defining corruption, by public, national or international bodies, that seem to agree on several important common characteristics of corruption:

- it always involves a public official.
- it leads to personal gain for the official and for the beneficiary of the corruption activity.
- it usually linked to abuse of power.
- corruption has important economic repercussions.

Therefore, from a conceptual perspective the concept of corruption underlines *an abuse of power that is being done while discharging public function specific activities, with the purpose of obtaining a personal gain, directly or indirectly, for oneself or for another individual.*

At the same time, while defining corruption, one must not forget the typology of corruption and how it manifests in and social-economic and cultural environment of a country. According to the European Union Council (1997), we can identify two main forms of corruption:

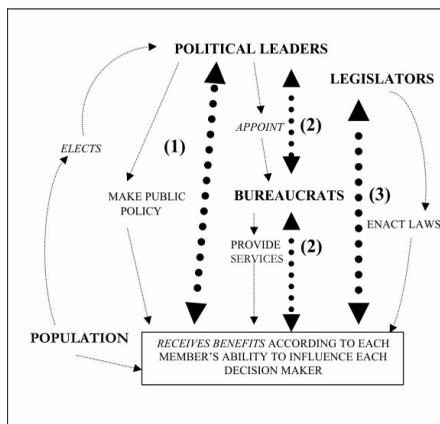
- a) *Active corruption* - the deliberate action of whosoever promises or gives, directly or through an intermediary, an advantage of any kind whatsoever to an official for himself or for a third party to act or refrain from acting in accordance with his duty or in the exercise of his functions in breach of his official duties in a way which damages or is likely to damage the EU's financial interests (Lawinsider.com, 2021).

b) *Passive corruption* - the deliberate action of an official, who, directly or through an intermediary, requests or receives advantages of any kind whatsoever, for himself or for a third party, or accepts a promise of such an advantage, to act or refrain from acting in accordance with his duty or in the exercise of his functions in breach of his official duties in a way which damages or is likely to damage the EU's financial interests (Lawinsider.com, 2021).

From another perspective, Jain (2008), underlines three types of corruption, that can be found in a democratic society. These three types of corruption differ from each other in terms of the types of decisions that are influenced by corruption, by the source of (misused) power of the decision maker, and hence the types of models that can be used to explain corruption, as it can be seen in figure 1 and explained below (Jain, 2008):

Grand corruption - generally refers to the acts of the political elite by which they exploit their power to make economic policies. This type of corruption generates major financial losses, from the perspective of the amounts of money lost by the state, as well as from the indirect costs' perspective, that are needed to fix what was done illegally.

Figure 1: Types of corruption and the links within a democratic society



Source: Jain, A.D, (2008), *Corruption – a review*, Journal of Economic Surveys vol. 15 (1), pp. 71- 121

Bureaucratic corruption - refers to corrupt acts of the appointed bureaucrats in their dealings with either their superiors (the political elite) or with the public. In its most common form, usually known as petty corruption, the public may be required to bribe bureaucrats either to receive a service to which they are entitled or to speed up a bureaucratic procedure (Kaufman, 1997; Ionescu et. al, 2012)

Legislative corruption - refers to the manner and the extent to which the voting behaviour of legislators can be influenced. Legislators can be bribed by interest groups to enact legislation that can change the economic rents associated with assets (Rose-Ackerman 1999).

From a different perspective, there is another typology of corruption, the one based on the perception of the public regarding this type of illegal activity. According to Ionescu et.al. (2012), we have: Black corruption – that is condemned by the entire population; Gray corruption – that is condemned just by a part of the public opinion; White corruption – tolerated by the public opinion and by the elite / governmental entities), but we also have, according to Prodan (2006), Need corruption – which is governed by idea that to get some bureaucratic document sooner, one bribes the public official; Greed corruption – getting a document without going through the legal system.

3. Shadow economy

The corruption phenomenon is affecting along side the social and political aspects of ones' life, also the economical side. By hijacking the public resources for their personal gain, the corruption disturbs the institutional processes by developing vicious circles of waste and by making all participants miss important resources (Volintiru, 2014).

The impact of corruption in the economic field can be approached from a direct or indirect point of view, where the direct way is to reduce public resources by embezzlement and wrinkling, which can fully benefit the participants in the act of corruption (e.g. preferential concession of public space for private use) or indirectly by creating a negative and unfair business environment, sabotaging the free market by favouring some economic agents participating in the act of corruption, to the detriment of others. All this generates additional, unjustified costs of state institutions, fuelling the decline towards widespread, systemic corruption.

From this to the development of a shadow economy is just a step away. But what does the shadow economy entitle, and does it represent? According to Schneider and Enste (2002), the shadow economy represents “not only illegal activities, but also unreported income from the production of legal goods and services, either from monetary or barter transactions”. From the perspective of the types of shadow or underground economy, we can observe in table 1, the main types of activities that relate to it, based on the illegal or legal activities.

Table 1: Types of shadow economy activities

Type of activity	Monetary Transactions		Nonmonetary transactions	
Illegal activities	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud.		Barter of drugs, stolen, or smuggled goods. Producing or growing drugs for own use. Theft for own use.	
	Tax Avoidance	Tax Avoidance	Tax Avoidance	Tax Avoidance
Legal activities	Unreported income from self-employment. Wages, salaries, and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits.	Barter of legal services and goods.	All do-it-yourself work and neighbour help.

Source: Schneider, F., Enste, D., (2002), *Hiding in the shadows – the growth of the underground economy*, International Monetary Fund, *Economic Issues no. 30.*, based on Lippert and Walker, 1997

While estimating the size of the shadow economy can be difficult because it varies from country to country, according to Medina and Schneider (2018), there are several methods of determining the size of the shadow economy. Among the most important and most common used ones are: (a) Measurement by the System of National Accounts Statistics - Discrepancy method; (b) Survey technique approach; (c) The use of surveys of company managers; and (d) The estimation of the consumption-income-gap of households.

Other methods proposed some years earlier by Ene (2010, in Tudose and Clipa, 2016), propose the following: (a) Methods based on direct approach, specific to the microeconomic field, based on surveys / voluntary interviews, fiscal statistics, tax audits and other similar methods; (b) Methods based on

indirect approach, specific to the macroeconomic field, used to estimate the size of certain components of the economy; (c) Causal methods, which were developed as a response to the need to integrate multiple causes of manifestation and development of the underground economy with generated effects over time, like: MIMIC (Multiple Indicators and Multiple Causes), DYMIMIC (Dynamic Indicators Multiple Causes Multiple).

4. Corruption and the shadow economy – statistics and effects

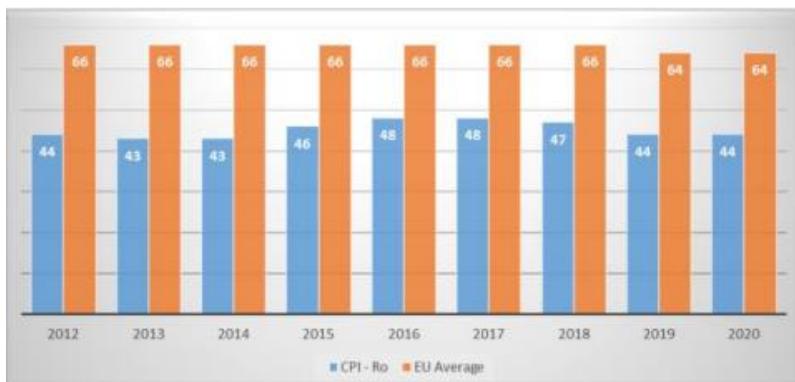
Both corruption and the activities within the realm of the shadow economy have greatly affected the development of the countries where these two phenomena are present at higher rates. In the countries where the corruption is systemic, usually the administrative and economical reforms can become counterproductive, mostly due to the lack or reduction of governmental controls that sometimes can facilitate the development of shadow economy (Manole and Edrinc, 2014)

Following some extensive research in the scientific literature, we can state that there is a clear negative association between the corruption in a country and that country's economic development, were usually, the less developed countries have higher corruption levels (Tanzi and Davoodi, 2000). One of the best ways to evaluate the corruption level in ones' country is by following certain global indicators that cover the degree of corruption. Said indicators usually measure the depth to which the public authority is being used for the benefit of the private gain, including small and large corruption.

One of these important indicators is the Corruption Perception Index (CPI) developed by Transparency International on a yearly basis. It measures the perception of corruption within the public sector of each country. This indicator was launched in 1995 and Romania is being evaluated since 1997 (Manole and Edrinc, 2014).

According to Transparency International Romania, in the last report of the Corruption Perception Index (CPI) published for the year 2020, Romania was evaluated at a level of 44, from a maximum of 100 point, where 100 points meaning the least corrupt country.

Figure 2: Corruption Perception Index – Romania vs. EU Average (2020)



Source: <https://www.transparency.org.ro/ro/tiropage/indicele-de-perceptie-coruptiei-2020>

As we can see from figure 2, the corruption index for Romania had a sinuous evolution over the last 9 years, starting from a 43 average in the years 2012 & 2013, rising to a maximum of 48 points in the years 2016 and 2017, then going down to 44 points in the years 2019 and 2020.

Starting from the idea that higher is better, the least corrupt years were 2016 and 2017, and the most corrupt ones were 2012 and 2013. Comparing these figures to the European average, we can observe that the CPI maintained its level of 66 for 7 years, dropping to an average of 64 points in 2019 and 2020. When we look at the hole of the European Union states (figure 3) we can see that, in 2020 the least corrupt states are Sweden (85), Finland (85) and Denmark (88) and the most corrupt ones are: Bulgaria (44), Hungary (44) and Romania (44).

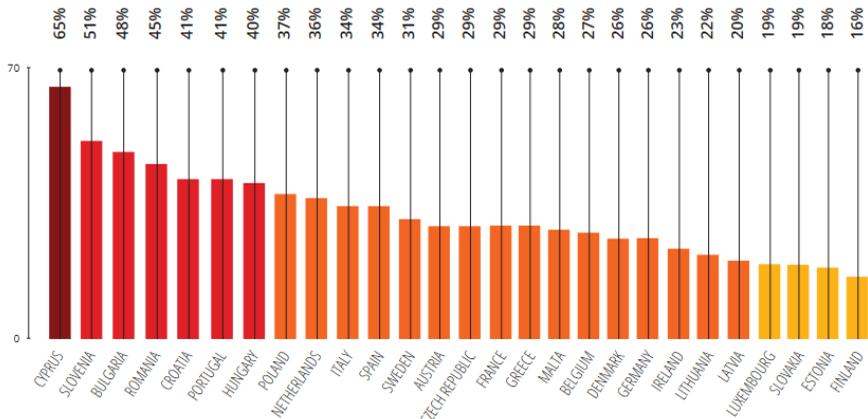
Figure 3: Corruption Perception Index – the European Union (2020)



Source: <https://www.transparency.org/ro/tiropage/indicele-de-perceptie-coruptiei-2020>

Also, Transparency International released its findings for the 2021 Global Corruption Barometer for the European Union, and according to more than 40 thousand respondents, aged over 18 y.o, from 27 EU countries, that answered a phone interview, for the question of increase in corruption in one’s country in the last 12 months, responded as seen in figure 4.

Figure 4: Increase in corruption over the last 12 months in EU countries.

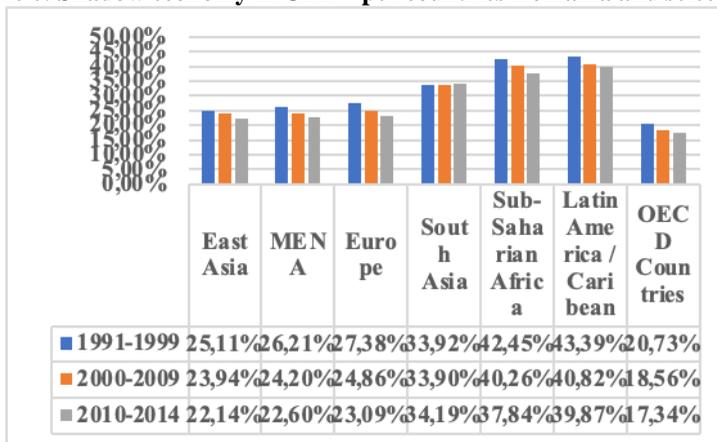


Source: https://www.transparency.org/ro/sites/default/files/gcb_eu_2021_web.pdf

We can observe from a brief analysis of the above figure that the citizens of Cyprus, Slovenia and Bulgaria consider that corruption has increased in their countries, with percentages that range between 40 % – 51%. The least perception of increase in corruption is that of the Finland with 16%. As an overall average for the EU, the Barometer for 2021, shows that 32% of the respondents consider that corruption increased, 44% say that corruption is at the same level and 16% state that corruption levels decreased (Transparency International, 2021)

As we can see the situation for Romania and the European Union is an interesting one, but what about the shadow economy impact on the economic development. According to research done by prof. Friedrich Schneider (2019) and published by the Romanian National Bank (BNR), the impact of the shadow economy as percentage of the GDP for the 1991 – 2014 period varies from global region to region. With the highest levels in Latin America / Caribbean Over 39% of the GDP, and with the least impact on the GDP for the East Asia region with less than 25,11% of the GDP. Lower than East Asia region is the OECD countries, as seen in figure 5.

Figure 6: Shadow economy in GDP – per countries Romania and selection

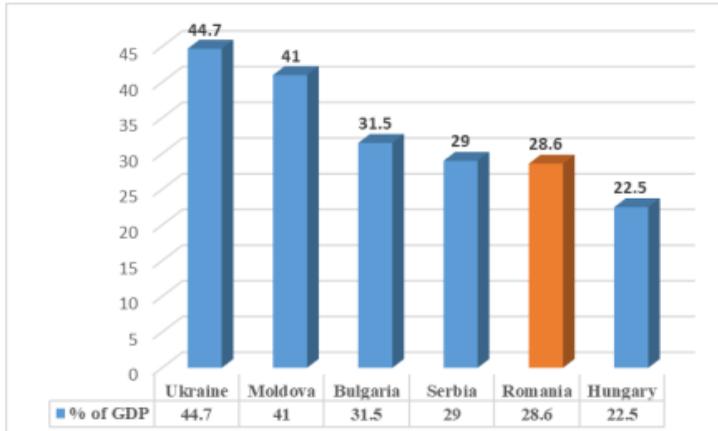


Source: Schneider (2019)

In figure 7 we can see the percentage of the Shadow economy of the GDP for Romania and its Neighbouring countries. As we can observe, Ukraine has the highest level with 44,7% and the lowest with 22,5% in

Hungary. Romania is registering an average of 28,6% of the GDP as an average for the 2008 – 2018 period of time.

Figure 7: Shadow economy in GDP – Romania and Neighbouring countries



Source: Schneider (2019)

According to studies developed in 2019, on a sample size of 185 countries, that were analysed for the 2005-2015 period of time, Hoinaru et. al (2019), have identified that there are, on one side, a clear negative link between corruption and the shadow economy, and on the other hand a sustainable economic development. The said study point out the fact that “the durable economic development of countries with higher income is strongly and negatively impacted by corruption and shadow economy, compared with lower income countries. Therefore, for countries with lower income, where the government is weaker than in the other countries, the corruption and shadow economy can help companies to avoid governmental rules and to solve various economic issues.”

5. Conclusions

Corruption and the shadow economy are important and at the same time dangerous influence factors for the economic development of a country.

Understanding the impact and effects of the two elements is essential for finding the best methods to fight corruption and to reduce the level of shadow economy as well as their effects.

In this paper we have shown the concept of corruption from the perspective of various authors or institutions and we have identified several key characteristics of this illegal factor, such as: it always involves a public official; it leads to personal gain for the official and for the beneficiary of the corruption activity; it is usually linked to abuse of power; corruption has important economic repercussions. In order to have a better understanding of corruption we must understand the types of corruption and the main relationships with different local or national authorities / public officials.

At the same time, one must understand that the shadow economy has also been an economic downfall factor, through its illegal and legal activities, illegal activities that can and are strongly linked with corruption. We have observed, on one side, the evolution of the CPI index over the years for Romania as well as the status for EU countries, and on the other side the evolution of the shadow economy evolution as percentage of the GDP for various countries over longer periods of time.

From our analysis we can clearly conclude that corruption and the shadow economy strongly influence the socio-economic and cultural development of poorer or less developed countries with weaker governments, as compared to the countries that have a stronger economy, a better justice system and a more established rule of law. At the same time, we also must acknowledge the fact that at this time we have not been able to identify clear and current theoretical and statistical data, that can demonstrate the real effects of corruption on an economy.

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