

The Informal Economy and Economic Growth of Russia



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The informal economy refers to all kinds of economic activities conducted unofficially in the market, and thereby unseen from official authorities. There are many synonyms for the “informal economy,” such as the shadow economy, black economy, hidden economy, or grey economy, each definition being marginally different from the others depending on what it precisely deals with among the total spectrum of informal economic activities. The informal economy includes a host of illegal and criminal wrongdoings (such as drug dealing, prostitution, and gambling). However, it is surprisingly easy to find some legal and productive activities unofficially taking place for many reasons.

First, when there is no market formed in the economy, economic agents cannot help but resort to unofficial trades or economic autarky outside the market institutions. It is well known that the official GDP and growth rates of sub-Saharan economies vastly underestimate actual GDP and growth

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rates since those economies still have not established markets even for basic household necessities such as foods and garments. Hence, the size of the informal economy for an undeveloped country tends to get proportionally more massive than those of developing and developed economies. Even when the official market is full-fledged, economic agents may find it optimal to participate in the informal market. This is simply because transaction costs in the official market can be unacceptable when the official market is highly susceptible to opaque and corruptible laws or public administration, including predatory taxation or unfair and inefficient enforcement of statutes. If transaction costs surge up in the official market, economic agents will voluntarily hide into the informal market relatively free from such institutional frictions, or even worse, they will eventually abandon both socially and privately profitable economic exercises. That is, not only the existence of the market but also the market efficiency matters for the size of the informal sector. This is why many developing economies suffer from a sizable informal sector, even when there are enough markets mushroomed already.

It is highly tricky to measure the exact size of economic activities unofficially taking place since, by nature, they are not registered and monitored by authorities. Therefore, the estimated size of the informal sector differs substantially by estimation method and data used. For instance, in a research paper published in 2017, the Korean Institute of Public Finance (KIPF, henceforth) estimated the size of the informal sector of the Korean economy in 2015 to be 8% of the Korean GDP, while the IMF calculated it to be nearly 20% of the GDP in its report released in 2018. That is, the IMF report yielded an estimate more than two-fold of the KIPF estimate because of the different methods and data employed. Similarly, the size of the Russian informal economy estimated by the IMF in the same report amounts to 33.72% of the Russian GDP. In comparison, the Federal State Statistic Service of Russia (Rosstat, hereafter) estimated the size of the Russian informal sector at only 13.8% of its GDP.

Hence, one needs to be particularly careful when comparing the sizes of informal economies across different countries, especially when the comparison exploits figures calculated by different methods and datasets. The similar logic applies to when it comes to talking about the size of the informal economy within a country over time. Since the estimate for the size of the informal sector at any specific time is prone to vary a great deal by statistical methodologies and data used, it is more proper and meaningful to look at the trend of the estimated size rather than focusing on the estimate for a specific time. That is, the trend estimation is more robust to processes and data employed than the point estimation.

According to the latest report by the Rosstat released last August, the size of the Russian informal economy has attenuated since 2014. The size of the Russian informal sector in 2014 is estimated at 10.9 trillion rubles, or 13.8% of the GDP, and the volume gradually slims down to 12.7% of GDP in 2017. Also, 19.3% of the economically active population, which is about 1.4 million workers, engaged in economic activities in the informal sector in 2018. In other words, one out of every five economically viable workers were involved in economic exercises through informal funnels instead of official instruments.

These informal economic activities appear to occur most intensively in real estate transactions. The value-added generated from unauthorized real estate transactions account for a whopping 70.6% of the total value-added generated in the real estate industry. The agriculture, fishery, and forestry industry is the second most vulnerable to informal economic activities, the value-added of which takes up 38.1% of the total value-added in the industry. The construction industry snatches the next position, where unofficial activities produce 15.8% of the industry's total value-added. Assuming that market formation in the Russian economy has not been severely tumbling, this means that the top three industries in terms of the intensity of informal activities are exposed to more evident institutional frictions than all else. Ilya Zharsky, at the Veta Group, analyzes these results as indicating a lack of consistency in transaction-related laws, high administrative costs, and confiscatory tax rates due to vague and heavy-handed administrative systems.

The IMF report aforementioned above indeed demonstrates that the more transparent and efficient regulations and enforcement of laws, the smaller the size of the informal sector. On the contrary, the bigger the government is, the heavier the informal economy is. One can explain this by noting the fact that a bigger government is more likely to devise intricate regulations, and hence, create more room for rent-seeking, ultimately causing transaction costs to swell. Of course, in cases where official market transactions are fundamentally blocked for some reason, as in a socialist economy, so that leaning on the informal sector, including moonlighting, is the only option left, the informal economy could help economic growth at least in the short term. However, in a capitalist economy like the contemporary Russian economy, where free and voluntary market participation is allowed, having a larger informal economy tends to ossify economic vim, and therefore to erode growth potential.

One reason behind this negative impact of the informal economy on growth is that the government's revenue gets lighter, putting a strain on its budget. The more fundamental reason is that the free market's intrinsic virtue of specialization through a highly sophisticated division of

labor cannot be served in the informal economy as smoothly as the official economy. This is partly because information flows and exchanges are relatively limited and inefficient in the informal economy due to the lack of participants and suppressive atmosphere. Also, it is more challenging to receive bulk investments in the informal sector due to the lack of institutional back-up and higher risks being appropriated illegally. Lastly, one needs to note that the informal economy does not guarantee adequate workers' benefits in general, and hence, it may deter so-called inclusive growth.

The road to economic prosperity from indigence is bumpy. It requires a massive transformation that entails fundamental changes, one of which is the "openness" of the free market that dwindles the informality. It is not accomplished swiftly and spontaneously. Rather, it calls for a considerable amount of conscious efforts for better economic systems underpinning individuals' free and voluntary exchanges of talents, skills, and ideas for everyone. This feature is the most desirable essence underlying the openness of the free market. **KIEP**