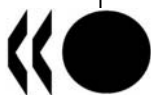


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Global Forum on Competition

COMPETITION POLICY AND THE INFORMAL ECONOMY

Contribution from Ukraine

-- Session II --

This contribution is submitted by Ukraine under session II of the Global Forum on Competition to be held on 19 and 20 February 2009.

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COMPETITIVE POLICY AND INFORMAL ECONOMY

--Ukraine--

1. Definition of the informal economy

1. In Ukraine, the informal economy or, as it is usually called, “shadow economy,” has been quite a severe problem since the second half of the 1990s to the beginning of 2000s.

2. At the same time, the informal economy in Ukrainian research works and governmental documents is understood as the economic activity, i.e. production and sale of goods performed outside the mechanisms of legal regulation and official monitoring. First of all, it consists in evasion of taxes and of going through the established licensing procedures for business start-up, as well as evasion of quality and product safety control, non-compliance with environmental requirements and the requirements concerning working conditions etc.

3. For the most part, informal economy exists in two major forms: functioning of non-legalised agents and part of the activity of legalised economic agents, which is performed outside the formal monitoring mechanisms and legal regulation.

2. Causes, characteristics, and extent

4. The emergence of fairly significant sector of informal (shadow) economy in Ukraine in the mid-1990s was caused, in our view, by two main groups of reasons.

5. Firstly, in the conditions of market transformation, a significant number of independent economic agents emerged, which for some time existed without completing the relevant legalisation procedures, because as a result of poor development of government regulation of market and lack of business experience, the market did not feel any benefits from such legalisation or any loss from its absence. Effects of the above-mentioned reasons were temporary and almost stopped in the second half of the 1990s.

6. Secondly, emergence and development of the informal (underground) economy is a reaction to excessive tax and regulatory pressure on the part of the state. For example, according to experts, in early 2000s, the share of net taxes in the legal sector amounted to 20.1 per cent of GDP, the level of budget and extra-budgetary funds revenue amounted to 44 per cent of the official GDP. However, with account of the informal sector, net taxes declined to 14.4 per cent, that is, became closer to that figure in the OECD countries, and the level of the budget and extra-budgetary funds revenue decreased to 31.4 percent of the aggregate GDP. [Крючкова І.В. Структурні чинники розвитку економіки України., Київ, 2004. стор 265].

7. Of the respondents surveyed in 2003 by the International Financial Corporation, 70 per cent characterised the administrative procedures necessary for obtaining permission for business start-up as difficult and very difficult, mentioning that to obtain such permissions, one must spend an average of 33 days and the equivalent of 115 euro (moreover, the third of those surveyed had to spend three years or more to get such permissions), 72 percent of those surveyed described the certification procedures as difficult and very difficult, 54 per cent described the registration procedures as such. [Бізнес-середовище в Україні 2005. Міжнародна фінансова корпорація. 2005 Стор.6].

8. According to the official data, the informal (shadow) economy reached its maximum size in 1997, when it amounted to 43.5 per cent of the legal economy, and decreased to 35 per cent in 2003 [Послання Президента України до Верховної Ради України. Про внутрішнє і зовнішнє становище

України у 2003 році. Київ, 2004 Стр 7, 143]. According to expert estimations, in 2001, the ratio of total shadow output of products and services to the official output was no less than 30 per cent, the gross value added was no less than 57 per cent of the legal value added [Крючкова І.В. Структурні чинники розвитку економіки України, Київ, 2004, стор 265]. Official or expert data on estimates of the size of the informal sector of the Ukrainian economy within the period of 2004–2008 is unknown, but certain figures allow the assumption that there is a tendency to its reduction. For example, the number of industrial enterprises in Ukraine in 2003-2007 declined by 6 percent, while the financial result of industry increased (with account of inflation) by 2.89 times. Since substantial technology changes during that time did not take place, the above-mentioned increase occurred largely as a result of the legalisation of activities that previously had been carried out in the informal sector.

9. Functioning of informal (shadow) economic agents is primarily inherent to products and services markets where there are individual entrepreneurs or small number of partnerships, the activity of which is difficult to control for the government. Such markets are, in particular, retail trade, consumer services, certain kinds of agricultural production that do not require any special cultivation and processing technologies, certain categories of transport, some types of construction work, particularly civil construction, and the like. The informal (shadow) activity of legalised economic agents covers much broader range of economic activities.

10. According to the International Financial Corporation, in 2004, less than 20 per cent of the 3 thousand surveyed chief executives of companies in different economy branches confirmed that they did not hide their profit from tax authorities [Бізнес-середовище в Україні. 2005. Стр 29].

3. Level of markets and productivity

11. In the areas with a large number of informal economic agents, they were significant competitors of the legalised economic agents. However, conditions of competition in such areas have certain characteristics compared to the fully legalised sector. On the one hand, informal economic agents and economic agents who sell their products in the informal conditions do not incur certain expenses that their competitors incur in the legal sector. Although they also have specific costs associated with maintaining their informal status. However, these costs are lower compared to the cost of legalisation and taxation; otherwise the relevant economic agents would leave the informal sector. Consequently, in terms of the transaction costs, the economic agents of the informal sector have an advantage over competitors from the legal sector. At the same time, the condition of the informal sector functioning is information opacity (informal economic agents, informal economic activities seeking to "hide" from government control). As a result, competitors from formal and informal sectors are asymmetric in terms of information for the consumer, and this asymmetry creates advantages for the legal sector.

12. In addition, the specific conditions of the informal sector functioning, usually do not allow economic agents to use technological advantages and economies of scale.

13. Ultimately, as the government reduces tax and regulatory pressure, the advantages of legal sector become more substantial, thus reducing the informal sector.

14. In the practice of the Antimonopoly Committee of Ukraine, there is no data that would clearly indicate that the informal sectors generated any significant barriers for legal companies, including foreign ones, to enter commodity markets.

15. However, in conditions of the transformational crisis of 1994-1999, the existence of the informal sector contributed to satisfaction of consumer demand, especially of the disadvantaged groups, which had little opportunity to purchase goods from economic agents of the legal sector.

4. Application of the competition law

16. Direct application of the laws on protection of economic competition on the relations that arise in the informal economy is not possible. Business processes that occur in the informal economy could become the subject of regulation of competition law only if legalised. For example, if during an investigation of unfair competition, facts of misuse of someone else's business reputation by an informal economic agent are revealed, this agent may be held liable only if legalised.

17. Similarly, for example, a statement of certain business entities that they are experiencing significant competition from the informal economic agents could have legal consequences only if the existence of these economic agents is proven using the formal legal mechanisms of monitoring and government control. But in this case, the relevant economic agents no longer belong to the informal sector. If there is no evidence, no allegations of existence of competitors in the informal sector can be taken into consideration. At the same time, since the existence of informal competition can only increase the market size and reduce the actual market shares of separate legal entities, non-consideration of such competitors may not lead to a lack of competition or insufficient resistance to the abuse of market power.

5. Facilitation of legalisation of the informal sector

18. The legalisation of the informal sector can be done in two ways: restrictive and encouraging. Restrictive method consists in creating so much risk for the informal economic agents (in case of their identification) that these risks would prevail over the benefits they have operating outside the formal monitoring mechanism and government regulation. Restrictive activities include the removal of legal business methods (such as barter payments) that reduce the transparency of economic processes and create conditions to avoid formal monitoring and regulation. The promotional method lies in reducing regulatory and tax pressure on the economic agents that eliminates the inducement to leave the sphere of official monitoring and government regulation.

19. The most effective method is a combination of both ways, with an emphasis on the latter. For example, in Ukraine in 2004-2005, a number of measures were taken to mitigate regulatory pressure on business entities. Their consequence was, in particular, the increase during 2004-2007 of the number of registered small businesses up to 40.6 thousand or 14 per cent. A large part of them are the economic agents that previously operated in the informal sector and legalised themselves.

20. Participation in the activities of the restrictive nature, aimed at legalizing informal agents, is generally not inherent to the competition departments.

21. With regard to promotional activities that are aimed at legalizing the informal sector, competition authorities may take part in them, if they are, in particular, authorised in relation to the actions of state bodies that lead to increase of costs of economic agents related to the legalisation and official procedures for monitoring and regulation and hence stimulate activities in the informal sector. In Ukraine such problem exists, in particular, in the field of paid services of public authorities relating to the implementation of state quality control standards, the examination required for business start-up, etc. The relevant services are provided by public authorities for payment to those who need them, that is, sold as a commodity. But because such services are provided at the sole basis, the markets which they form are for the most part monopolistic. In 2007, the Antimonopoly Committee of Ukraine identified more than 960 monopolised markets of paid services of public authorities.

22. Planned total volume of paid services of public authorities in 2008 exceeded the amount of revenue from excise duty of goods produced in Ukraine. It should be noted that in the above-mentioned markets there is an acute problem of monopoly abuse, in particular, the high prices, discriminatory prices,

imposition of terms and conditions of contracts that are not related to the subjects of these contracts. Only during 2006-2007, the Antimonopoly Committee of Ukraine discovered more than 1500 such violations in the markets of paid services of public authorities. Their termination in some way helped to mitigate regulatory and administrative pressure on economic agents.

23. Another area of activity of a competition agency that promotes legalisation of the informal sector is termination of actions of state authorities that have anticompetitive effects and, at the same time, lead to increased regulatory pressures on businesses. It is a particular question of establishment of unlawful prohibitions or obstacles to the entrepreneurship, or prohibitions not provided by law, and restrictions on independence of companies (such actions may be, for example, in the introduction of additional permitting procedures not provided by law, or in an unauthorised shortening of validity of the relevant permits). Only during 2006-2007, the Antimonopoly Committee of Ukraine terminated more than 260 such acts of state bodies, which also, in a certain way, helped to mitigate the regulatory burden on entrepreneurship.