

## The Impact of the Shadow Economy on Small and Medium Sized Companies in Poland. A Barrier or an Opportunity for Growth?

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### Key words

Transition economy, small and medium-sized enterprises, SMEs, shadow economy, barrier, opportunity

### Abstract

*In this article, I argue that it is difficult to arrange the development of small and medium sized companies in Poland ignoring the role of the shadow economy. The shadow economy exists in every country. The differences are related to its scale and its category. It can be regarded as a phenomenon found in a transition economy especially. All efforts to abolish the shadow economy have proven to be ineffective. During the era of the planned economy in Poland, the shadow economy was operating at a high level, mainly due to the fact that such a planned economic model proved to be very unsuccessful. The communist era was known as the economy of shortage, and this made a considerable impact on the development of the shadow economy. The shadow economy affects many aspects of the economy, including small and medium sized-enterprises (SMEs). These companies play a fundamental role in market oriented countries. The aim of this study is to examine the relationship among the factors fostering the activity of small and medium-sized enterprises. The study is concerned with companies operating in the legal economy in Poland. The study shows that the shadow economy is regarded as a chance for further development for many SMEs.*

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### Introduction

Based upon the literature review, there are many definitions related to the shadow economy. It can be coined as the grey zone, informal activity, not registered, unreported, undeclared activity, hidden, parallel, irregular, and black and even the criminal economy (Henry, Sills, 2006). Schneider (2005) describes the 'shadow economy' as currently unregistered economic activities that contribute to the officially calculated (or observed) Gross National Product. According to Williams (2005), the informal economy consists of goods and services which are perfectly legal in and of themselves, but whose production is hidden from the state and can involve systematic and serial law violation. This definition distinguishes the informal economy not only from mainstream conventional activities on the one hand, but also from criminal activities on the other hand (Jones, et al. 2017). Ditton defined the hidden economy as the sub-commercial movement of materials and finance, together with the systematic concealment of that process for illegal gain (Ditton, 1977). Different definitions create various economic categories, and this creates various methods of attempting to measure the shadow economy and its level.

For this reason, the level of the same shadow economy in the research literature quite often varies when presented by different investigators (Schneider, Williams, 2013, Teobaldelli, 2011, Lacko', 2000, Gerxhani, 2004). In this article, the shadow economy is defined as such activity that avoids budget revenues and affects the GDP calculation. The benefits and threats of the shadow economy are not unambiguous. Generally, it is stated that the shadow economy has a negative impact on the general economy. One of the most important causes of the increase of the shadow economy is the rise of tax and social security burdens (Isachsen, Steinar, 1980). Houston concludes that the shadow economy could lead to overstatement of the inflationary effects of fiscal or monetary stimuli (Houston, 1987).

Together with the shadow economy, corruption exists. Mauro (1995) finds a significant negative correlation between a corruption index and the investment rate or the rate of GDP growth (Mauro, 1995). Corruption can hamper innovativeness and competitiveness (Baumol, 2002). Also, it often mallets entrepreneurs (Avnimelech, Zelekha, Sarabi 2011). Corruption stifles economic growth, undermines the rule of law, and squanders talent and precious resources (World Economic Forum, 2008). Interesting view on shadow economy was presented by Mukherjee. He states that informal economy especially in emerging economies is not a substitute but a complement. It cannot be excluded from general business activity (Mukherjee D., 2016). But coming to the definition case Mukherjee identify shadow economy with informal one. This is interesting point of view but arguable approach, since informal economy is just a part of the shadow economy.

Referring to the proposed definition of the shadow economy, activities related to criminal behavior (such as robbery, drug dealing, smuggling, trading in stolen goods, tax evasion, tax avoidance, fraud, prostitution, slave labor, and so forth) have a negative impact on the economy as well. However, on the other hand there are opinions that the shadow economy could provide some benefits. As early as in 1958 during the annual meeting of the American Sociological Association, Ferman mentioned that some activity within the framework of the shadow economy was deviant, but some was not since it provided work opportunities. The advantages are related to the possibility of work which may be prohibited in the legal structure. Secondly, this may provide the worker a sense of accomplishment and competence, thirdly such work is not strictly accountable to legal authority for earnings since no record is kept of this work for public scrutiny (Henry, 1993). The third argument is discussable, since all business activity should be transparent. The shadow economy provides an opportunity for the unemployed. Not all of the shadow economy workforce chose the criminal way, quite often they chose the legal option but did not register such projects like home repair (plumbing, painting, etc.), gardening, or the distribution of low-priced goods and services (Bakke, 1940). From an economic perspective, the shadow economy can be diagnosed as a mechanism which helps people to survive in industrialism, especially during tough capitalistic competitiveness and times of transformation. People begin to produce, trade, and barter goods and services. From this domestic and neighborly help, the shadow economy was born. Such activities are widely spread among local communities, neighborhoods, and families and are based upon specific rules and conditions (Hart, 1973, Ferman, Berndt, 1981). The shadow economy gives the chance to move away from poverty. This is especially important in less developed countries. The regular market does not offer enough opportunities for work, so the only chances for many appear in the shadow economy.

In a way, the shadow economy absorbs the labor force and provides a higher possibility to work in the official economy. Even in well developed countries, the shadow economy is regarded as being an opportunity to earn more money working part time during the holidays or days off for legally employed workers. Such activity is not registered, since the worker is officially not on duty and should be resting. In this way, he/she earns extra money, which can be transferred into legal transactions. This is supported by Alden, who found that irregular, and unregistered jobs are typically done by those who are already highly active in the legal economy (Alden, 1981). Roberts described the transition from the shadow economy to legal activity of young men in Mexico.

In the low-income regions of this country, young men started their unregistered jobs first, and after some time they created micro and small (but official) companies (Roberts, 1989). The shadow economy backs the growth of the official economy by providing low cost consumer goods, native capital goods and a more labor-intensive form of manufacturing (Bremen, 1976). Gutmann explained the rise of the shadow economy by the growing state bureaucracy and government expenditures (Gutmann, 1977). Due to the bureaucracy, the government inspired the shadow economy, especially with a high rate of taxation. The shadow economy can be seen as the discipline factor having an influence on the official economy. If the official economy performs unfairly or immorally, the shadow economy expands. A growing shadow economy may attract (domestic and foreign) workers away from the official labor market and create competition for official firms. On the other hand, at least

two-thirds of the income earned in the shadow economy is spent in the official economy, thereby having a positive and stimulating effect on the official economy (Schneider, Enste 2000). This article is organized in the following manner: After the introduction, two theoretical chapters emerge. The first chapter is related to the roots of small and medium-sized enterprises (SMEs) in Poland, the second chapter is devoted to the shadow economy. The fourth section focuses on the methodological approach. The fifth section is dedicated to the results. The study is then completed by the conclusions.

### **1. The Genesis of Small and Medium-Sized Enterprises (SMEs) in the Polish economy**

In Poland, as in the European Union, the category of small and medium-sized enterprises (SMEs) is applied to enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro. The small and medium-sized companies have had a relatively long tradition in the Polish economy. They did not disappear, even during the communist regime, even though the state and cooperative companies were given priority.

This is because the model of the planned economy was artificial. This model proved to be very ineffective. The private sector did not have any chance to grow, but was more market oriented, manufacturing products and services which met market demand. On 3<sup>rd</sup> January 1945, the nationalization act was issued. Based upon this legislation, all agricultural farms exceeding 50 hectares were transferred to state ownership, together with factories employing more than 50 workers. Some branches such as mining, the food processing industry, steel, and the textile industry were totally nationalized. This is the only way that small and medium-sized private companies could operate under the communist regime. Furthermore, they were under strict control. They had problems with attaining raw materials, taxation, employment, and access to bank credit. With these methods, the government attempted to limit the number of private companies and their development.

Additionally, the children of private entrepreneurs could not enter University and gain higher education, and sons were sent to the army. Other citizens had the green light to study and were given permission to postpone their military service. The duration of military service was reduced to one year for those who graduated University studies. The conditions of service were far better than the normal two or three years of military duty. A special supervision body was set up, known as "The Central Price Office". This office was responsible for setting the price level of private companies and trying to avoid the earning of higher profits. Two crucial acts of law were established. One was related to overpricing policy and the second one a so-called citizen's control of business activity. Based upon the second law, a delegation consisting of workers could come to private companies and judge their activity. If their opinion was not favorable of the private company, they firm could be closed down and the owner even sent to prison. Such harsh business circumstances did not stop the activity of small and medium-sized companies; however, their numbers decreased. In 1947 there were 147 thousand private shops in Poland, 87 thousand construction companies, 92 thousand manufactories, and 78 thousand service companies. In 1951 there were 73 thousand private shops, 33 thousand construction companies, 44 thousand manufactories and 27 thousand service companies (Statistical Yearbook, 1954).

On the other hand, the small and medium-sized companies created a specific strategy, quite well adjusted to the planned economy. First, it must be remembered that the planned economy is quite often called an economy of shortage. There was a permanent lack of basic consumer products, and the quality of them was very poor. Therefore, even the smallest product or service could generate extremely good profits. Secondly, government officers were not paid enough money. In the 50ties, the average salary was on the level of 1000 PLN (Polish zloty - PLN), but the owner of a private shop could earn monthly ca. 20 000 PLN (Archiwum Akt Norwich, 1962). Similar earnings could be made at other private companies.

However, this only related to the owners. Managers and employees were paid not nearly as much, but at least twice more than in state owned companies. This was a temptation and risk-taking activity. Such a business environment created a base for corruption and the shadow economy. A popular strategy for private small and medium-sized companies was to hide revenues and profits. On the other hand, corruption was a way to protect the business and get access to the market as well as a supply of raw materials. During the planned economy, corruption and shadow economic activity were common. Corruption was widely spread even among workers, managers, and presidents of state owned companies as well. This was mainly due to the shortage of goods. Having access to goods was even more important than the possession of money.

The barter trade of goods (which was officially prohibited) was very popular in Poland. Protection and access to the possibility of buying products (based upon corruption) was a popular way of improving living standards (Prywaciarze, 2006). However, such practices were supposed to be regarded as shadow economy activities. During the 60ties and 70ties, the number of small and medium-sized companies slowly but steadily grew. Their total number has been calculated at 250 thousand (Statistical Yearbook, 1982). In March 1972, a new legal act regulating private companies was set up (Ustawa 8 March 1972).

Based upon this regulation, the procedure for setting up a company was made more transparent. Anybody who met the requirements could theoretically create a company. From a practical point of view, the procedure was long (nearly 6 months in duration) and the Municipality could reject the registration based upon any "important government reason" – which was simply an ambiguous excuse. Such a possible negative outcome could be easily avoided by paying bribes. Small and Medium-sized private companies in Poland conducted sales through their own Distribution Channels. It was a special economic model where state owned companies were engaged in fundamental industries and private small and medium-sized companies were focused on service and support industries. Whenever riots erupted (1970, 1976), it was mainly because of a shortage of food and other basic products.

In response, the government would loosen the regulations concerning private companies. Even though the economic situation was very difficult in 1988, the government introduced a new legal act regulating the activity of private companies. It was interesting that the main architect of the act was Wliczek, who acted as the minister and was a successful private entrepreneur (Ustawa 1988). This act gave a real green light for private business, but it was too late for the communist regime to keep power and supervise the reforms. Since the beginning of the transition in 1990 from a centrally planned economy to a market oriented economy, the performance of Poland's economy has been outstanding if we take GDP growth as our measure. It is not specific reforms that can explain this performance but the radical ("big bang") reforms at the beginning of the transition in conjunction with persistent efforts during the subsequent two decades by all governments to keep on a reform path, no matter what their political orientation. Reforming a centrally planned economy that has very serious macroeconomic disequilibria requires reforms that can be done immediately, but also structural or systemic reforms that require years to implement (Lehman, 2012). This had a great impact on the development of small and medium-sized companies. In 2015, nearly 1.9 million businesses were operating in Poland.

The vast majority of them - as many as 99.8% - are small and medium-sized enterprises (SMEs). Polish SMEs operate primarily in the sector of services and trade (76%), less often in construction (13.4%) and industry (10.6%) (Statistical Yearbook, 2016). When compared to the EU average, the SME sector in Poland is increasingly dominated by microenterprises and the share of small firms represent about half of the share of small enterprises in the EU. In terms of the structure of the sector's contribution to GDP, SMEs generate every other zloty (47.3%); whereas the smallest companies account for nearly every third zloty (29.4%) generated. The share of medium-sized enterprises is three times smaller (10.1%) as compared to microenterprises and the contribution of small enterprises is nearly four times lower (7.8%). Over the years, a significant upward trend has been observed

among Polish companies, confirmed primarily by the increasing share of large enterprises in GDP generation. In the case of small and medium-sized enterprises, their share of GDP varies and the identification of clear trends is difficult (PARP, 2013). Criticism of the transformation period in countries with a planned economic model should refer to the term originally coined by Burawoy called "involution". Involution in this context means the opposite of the term "evolution" (Burawoy, 1977).

This definition applies well to the Russian case. However, in Poland the period of time that lead to the reform from a central planned economy to a market oriented economy should be termed "transmission". In fact, the reform to a market oriented model kept nearly all shadow economic activity from the previous system. The reforms gave a chance for informal business activity as well, which finally became the shadow economy. The initial period of reforms transmitted the shadow economy into the market oriented environment. This situation affects the performance of small and medium-sized companies.

## 2. The performance of the shadow economy in Poland

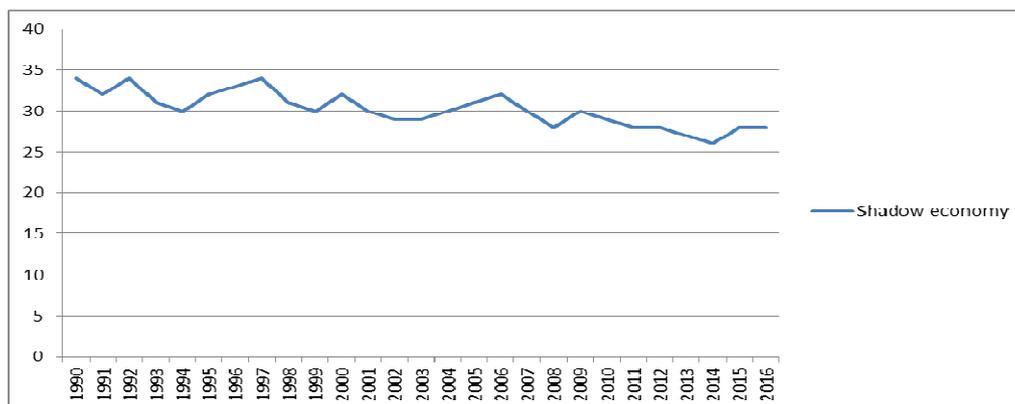
The roots of the shadow economy in market oriented economies are more or less the same. The difference is related to the impact and the category of the roots only. But generally, they are related to the level of taxation and social security contributions (Buehn, Dell'Anno, Schneider, 2012), inefficient labor markets, a high unemployment rate (Maloney, Mendez, 2004), a high level of organized crime (Fletcher, 2015), a complicated legal system and the level of development. Estimates for the shadow economy in OECD countries range from 5% of official GDP to 27%; while developing economies have a much higher estimate, ranging from 25% of official GDP to around 70% (Gomis-Porqueras, et.al.,2014). Especially in the context of Poland, one must take into consideration three additional important factors fostering the shadow economy.

First, it is related to history and especially to the times of the communist regime. During 1945-1989, the planned economic model was created. This model was quite often named "the shortage economy". This is because of a permanent lack of basic goods in the markets. State owned and cooperative companies proved to be very inefficient. The market demand was supplied by shadow economic activity. The second factor is based on cultural dimensions. Culture is commonly understood in Weberian sociology as the shared set of beliefs that influence what we consider to be meaningful and valuable (Harvey, 1997).

Based upon cultural dimensions originally coined by Hofstede (1980), they support the creation of the shadow economy in Poland. G. Hofstede's work is the most popular, and originally includes four dimensions of national culture: power distance, uncertainty avoidance, individualism vs collectivism, and masculinity vs femininity. Poles do not trust the government and its institutional organizations, so the power distance is relatively high. They are more self-focused and not willing to cooperate, so social and relational capital is relatively low.

Additionally, Poles are regarded to have a masculinity orientation and a high level of uncertainty avoidance (Hofstede, 1991). The third factor is connected with the time orientation (This factor was added to cultural dimensions later). After the communist era, Poles became short time oriented and tried to gain high material status rather quickly, by any means necessary. Due to this cultural tendency, the gate to the shadow economy was thrown wide open.

Figure 1  
The level of the shadow economy in Poland between 1990-2016 (% GDP)



Source: own calculation based on DYMIMIC and the Currency Demand Method approach

Since 1990, the shadow economy has been decreasing slightly. In 1990 its level was estimated at 34% of GDP; in 2016 its level was estimated at 28% of GDP. The structure of the shadow economy changed. The decrease was noted in simple activities such as smuggling, trading in fake goods, even organized crime was lowered. The most important criminal groups which emerged during the first years of the transformation were liquidated or at least had decreased levels of performance. These included groups such as Pruszków Organized Crime Group (OCG), Wołomin OCG, Mokotów OCG, Łódź OCG called Octopus. They were mostly involved in extortion, criminal terror, drug, spirits, tobacco production and tariffing (Jasiński, Mądrzejowski, Wiciak ed., 2013). On the other hand, the current entities in the shadow economy in Poland are very active in:

- swindles and fraud linked to VAT,
- unpaid income tax,
- losses due to unpaid corporate taxes,
- losses due to unpaid excise.

According to Murphy (2012), the size of the Polish shadow economy is at the level of 27,2% of GDP, with a tax burden of 31,8% which can be estimated at 31 billion Euros in total. In this way, the taxation gap has been growing due to tax evasion and tax avoidance. The problem with the shadow economy in Poland is undeclared and unregistered work. The dominant part of undeclared and unregistered labor is performed by self-employed own-account workers. Such activities constitute ca. 12% GDP on a yearly basis (Statistical Yearbook, 2016). The problem in this respect is related to young people (aged 18-26). In 2013, less than 25% of them were employed legally (Rorat, 2014).

The complexity of tax regulations in Poland are the single biggest obstacle reported by businesses, so avoiding tax regulations can be an important benefit of staying in the shadow economy. The complex and unstable tax legislation mutually reinforce their negative impact on business and investment (Łaszek, Trzeciakowski, 2015). Poland faces a lack of innovation. This fact has slowed its productivity and eroded its international competitiveness. The distance between Poland and well-developed countries has been kept at the same level. Despite recent Polish reforms (which lead the country to a market oriented economy), it is still very difficult for small and medium-sized businesses to obtain the resources and required support they need to grow; even though Poland was placed 39th among 128 countries in the 2016 Global Innovation Index ranking published by Cornell University in cooperation, among others, with the World Intellectual Property Organization. Poland, having gained 44.2 points out of 100 points possible, has advanced in the ranking by seven places since 2015. Poland achieved a good position in the most innovative economies ranking thanks to the ease of starting a business, level of education, domestic gross outlays on R&D, number of scientific publications, and the creativity of the ICT sector (<http://www.pap.pl/en/news-/news,638509,poland-39th->

in-global-innovation-index-ranking.html,access 2017/02/19). Such a ranking is discussable; this is because the place in the ranking partly depends on Polish efforts and partly depends on the performance of other countries.

It can be that Poland did not increase innovation very much, but that other countries did less, and finally the Polish position improved. Polish small and medium-sized companies are recognized by IT software products (computer games), slow food production, furniture, and construction products. In spite of that, Poland is still regarded as an inefficient innovator. The chances for further development are dependent upon an increase in innovation.

### 3. Empirical Approach

The survey was conducted on a group of 249 managers. They represented 119 companies operating legally. The small and medium-sized companies were from the following sectors: 34 construction industry, 32 services, 27 trades, 26 manufacturing. The rate of correctly filled in questionnaires was 75% (n =187). 73 % of the survey participants were male and 27 % were female. The participants had a mean age of 33.5 years, a median of 32.24 % of participants had a bachelor's degree, and 76 % had a master's degree. Each answer was measured by a 9-point rating scale (1: Strongly Disagree - 9: Strongly Agree). The items in the questionnaires were related to the barriers of activity for small and medium-sized companies operating legally and opportunities for development, if it is assumed that the interviewed company operates in the shadow economy. A sample K-S test was used for testing normality in distribution. The Cronbach's alpha test was used to test the reliability of the survey. The Cronbach's alpha scores obtained were;  $\alpha = 0,878$  for the barrier's scale, and  $\alpha = 0,816$  - for the opportunity scale for development of small and medium sized companies. This indicates that the scales were reliable (since the scores were higher than 0,7; Nunnally, 1978).

Based upon the literature review related to the shadow economy and small and medium-sized companies, the following hypotheses were developed:

1. Hypothesis: The tax burden is negatively correlated with investment
2. Hypothesis: The tax burden is negatively correlated with innovation
3. Hypothesis: The social burden is positively correlated with unregistered work
4. Hypothesis: The complicated and contradictory legal system is positively correlated with tax avoidance.

The survey was performed in September 2016. The first factors are related to the barriers and the second factors are related to the opportunities for development. The questions mainly referred to taxation, the legal system, opportunities for investment and innovation. Based upon the investment factors analysis results and rendering the factor loadings of barriers for development, 10 items were deleted and 5 factors were found, but 6 opportunities for development were deleted and 6 factors were found. The found factors related to investment and Cronbach  $\alpha$  result are presented in the table 1. Referring to the factors of innovation, the factor loading of 7 barrier items were deleted and 3 factors were found. With regards to opportunities for development (operating in the shadow economy), 5 were deleted and 4 were found. The results are shown in the table 2.

### 4. Results

Table 1  
Results of Exploratory and Reliability Factor Analysis of the Investment Scale

Item	Factor 1	Factor 2	Cronbach alpha
Company pays high taxes	,811		
Company faces high costs of activity	,822		
There are often changes in the taxation system	,856		,866
The legal system is complicated and hard to understand	,889		
There are problems getting sources for investment	,890		

High rate of profitability		,834	
Adaptable activity		,802	
Meeting customer needs		,715	,801
Creating good relations with business partners		,726	
Sound financial standing		,784	
No problems hiring skilled workers		,790	

Table 2  
Results of Exploratory and Reliability Factor Analysis of the Innovation Scale

Item	Factor 1	Factor 2	Cronbach alpha
Company cuts R&D spending	,799		
Company cannot afford to cooperate with Scientific Centers	,801		,811
Company has not started a new project for at least 3 years	,822		
High possibilities for new business venturing		,766	
High possibility to create an R&D department		,819	,843
Possible cooperation with Researchers		,812	
High possibility of introducing new patents, know-how		,827	

The correlation between variables has been displayed in table 3. There is a negative correlation between the tax burden and investment (-0,31). In this way, hypothesis 1 has been supported.

Table 3  
Correlation between variables

Variable	1	2	3	4	5	6	7
Tax burden	1						
Social burden	0,33	1					
Unregistered work	0,45	0,56	1				
Tax avoidance	0,55	0,61	0,48	1			
Complicated and contradicted legal system	0,41	0,52	0,31	0,71	1		
Innovation	-0,23	-0,21	0,18	0,46	0,52	1	
Investment	-0,31	-0,43	0,22	0,07	0,16	0,33	1

Correlation is significant at the 0,05 level ( $p < 0,05$ )

In addition to this, there is a negative correlation between the tax burden and innovation (-0,23). The second hypothesis has been supported. The social burden is positively correlated with unregistered work. The score is relatively high at 0,56. The complicated and contradicted legal system is positively correlated with tax avoidance. The score is the highest among all variable correlations 0,71.

These results are not very optimistic for the further development of small and medium-sized companies in Poland. The shadow economy has been detected as a possible chance for development. The taxation and legal system is regarded to be one of the barriers. The legal system is complicated and contradicted. Taxation is at a high level.

Due to this, small and medium-sized companies face problems with investment. Whenever the idea of investment appears, the source of money must be considered. If the company relies on outside sources of financing (not only one's own sales), the future business should be profitable enough to cover debt spending. The business of SME companies in Poland is not profitable enough to search for sources of investment. The good news is that investment is connected with innovation. The way to improve is related to effective R&D spending, cooperation with research centers, and

employing skilled workers. At this moment, such activities are a barrier to SMEs. The legal system and a high taxation rate support tax avoidance and a high rate of unregistered work. SMEs state that they do not have sound financial standings.

## 5. Conclusion

All of the developed hypotheses were supported. The business environment is not very favorable for small and medium-sized companies in Poland. The companies see the option of operating in the shadow economy as a chance for further development. Based upon this research, shadow economic activity is familiar to legally operating SMEs. They should have close contacts with companies from the shadow economy. Further research is required, especially with regards to the tools to reduce the shadow economy and make the legal business environment friendlier. The first steps should be to improve innovation, simplify the legal regulations and increase financial profitability. The success of SMEs in Poland means the success of the entire economy. The shadow economy should be reduced naturally. For example, the option of operating in it should be treated as being unprofitable with little chance for development. Legal regulations and punishments for such activities should not be regarded as the only correct solution. An economic approach must be taken into an account as well.

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