



## **Is the Hungarian Non-Observed Economy Rooted in Socialism?**

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# Is the Hungarian Non-Observed Economy Rooted in Socialism?

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## 1.1 Introduction

This paper examines the relationship between the development of the unobserved economy due to tax evasion and the second economy in socialism. The non-observed economy due to tax evasion in Hungary was the most significant non-observed activity in 2005, accounting for 57.7% of the total non-observed economy and 8.6% of the GDP in 2005. (Murai & Ritzlné Kazimir, 2011) The Hungarian shadow economy occupied the 12th place in 2005 compared to the 28 member states of the EU.

During the regime change, in parallel with the development of the market economy, the non-observed economy due to the tax evasion also started to grow dynamically in Hungary, reaching 30% of the GDP by 1992. (Árvey & Vértes, 1997/7) Later on, in the second half of the 1990s, its level decreased, but Hungary still was listed among the European countries with relatively high non-observed economies in the 2000s. Surprisingly its relative position within the European countries remained almost unchanged in 2015.

To understand this, it is worthwhile to place this phenomenon into a broader context, in economic, historical and theoretical framework. The article emphasizes that the significant tax evasion that emerged after the transition and has not decreased to the average level of Western European countries is not the direct result of the second economy in socialism. The aim of second economy was not the tax evasion, but it supplemented the socialist economy, and its operation was not illegal. After the regime change, much of its activities has disappeared, its significance has diminished somewhat, or it was integrated into the market economy. The emergence of the second economy was a natural response to the functioning of a socialist institutional system, and their operation after regime change has become obsolete.

At the same time, however, the socialism could cause indirectly the emergence of the significant tax evasion during transition. There are three major reasons for this:

1. Market coordination in Hungary developed much later than in Western Europe and it was significantly restrained during socialism. During the regime change the market coordination did not replace the system overnight, and the rules of redistribution also changed significantly. The natural consequence of this was the significant increase of reciprocity-based transactions.
2. During the regime change, the operation of the former economy simply collapsed, causing unemployment and a huge loss of income. Tax evasion and undeclared employment have mitigated the effects of crisis.
3. The functioning of the market economy required the capitalist layer. Privatization could not be carried out in the absence of this. The formation of the new entrepreneurial layer and the accumulation of capital were promoted by several not entirely legal activities.

The significant rate of non-observed economy due to tax evasion associated with the transition did not diminish after the regime change with the emergence of a market economy and the normalization of the situation. There are psychological reasons for this.

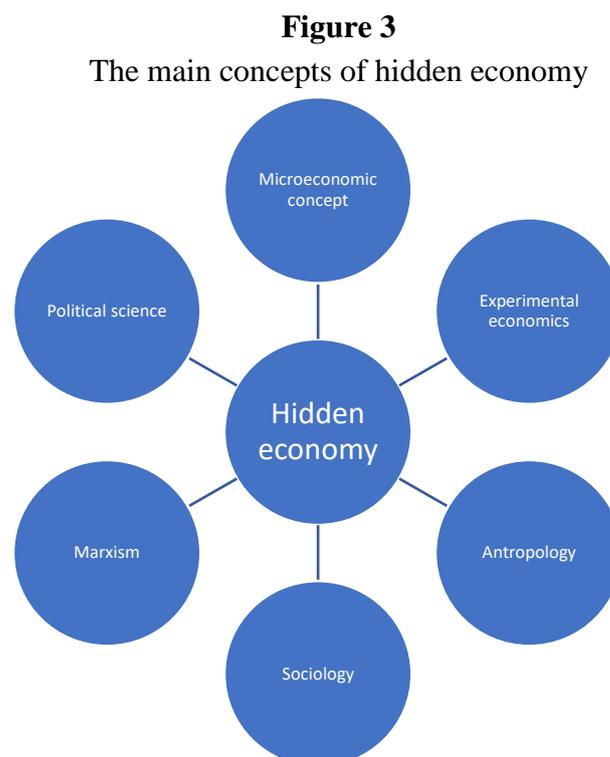
In the nineties, fraud, exploitation of loopholes and economic crime took place in public. More or less everyone has become a participant in the non-observed economy, it has become fully accepted economic behaviour and integrated into the market norms. This also explains

why the reducing of tax rates in 2006 did not reduce tax evasion in contrast to expectations, and the government was forced to raise the tax rate again. (Ritzlné Kazimir, 2013)

The article describes the relevant economic theories that may explain tax evasion, and then focuses on the development of the second economy and the development of the unnoticed economy following the regime change.

### 1.2 The theory of hidden economic activities

The motivation for hidden economic activities is influenced by several different factors therefore the theoretical framework of hidden activities involves several disciplines, which are shown in the next figure.



The economic analysis of tax evasion is possible in several ways. On one hand, the rational and optimal behaviour of the actors, on the other hand the phenomenon in the market context deserves attention.

The theory of expected utility (Von Neumann & Morgenstern, 1944) is basis of Becker's (1974) pioneering model of the social optimization of crime. In his analysis he counts with the direct cost of illegal activity - this is the damage caused to the victim – and the direct and indirect social costs. The state determines the amount of money spent on the detection and the penalties. The perfect detection of crimes can in principle be realized, but this is not the optimal choice. The social optimum should be defined in the context of direct and social costs where the marginal social revenue and marginal costs are equal, and it can be interpreted only for the offenders, who have preference for risk. (Becker, 1974) Based on Becker's framework, the theory of income tax evasion was developed by Allingham and Sandmo. (Allingham & Sandmo, 1972)

Another aspect of tax evasion analysis is the relationship between tax and public goods. From the point of view of the taxpayer, the tax can be regarded as the price of public goods, which may include public services in the widest sense. The taxpayer does not know the quality of public services, he can only evaluate their expected value based on subjective probability.

Information asymmetry arises, and the taxpayer determines its tax accordingly for subjective value of the poor quality public service. (Akerlof, 1970)

Tax evasion can also be described in a game theory context, whereby the potential tax evader should analyse the behaviour of the tax authority and the strategy of other potential tax evaders. Thus, the benefit of the tax evasion depends on how many people decide on the tax evasion overall, and on the probability of the detection (Szántó & Tóth, 2001)

This result is supported by Fazekas. If a tax evader can reduce the marginal cost of production by tax fraud, it can achieve a competitive advantage, which can also cause competitors to behave in the same way. If tax evasion is typical of a market close to perfect competition, the one who does not evade taxes will be forced out of the market. (Fazekas, 2009) On the other hand, if a larger company enters the market, the competitors, suppliers, or customers of the company do not reduce their tax evasion evidently. (Szabó, et al., 2009)

The experimental economics reflects on the results of microeconomics when it analyses the operation of models under experimental controlled conditions. According to this, the tax evasive behaviour is closely related to the self-image and rule-following behaviour of the individuals. The individuals are not necessarily rational, and their risk preference is not standing because they follow the shorter path in their decisions and their decision depends on the formulation of the problem, as well. (Kahneman & Tversky, 1979) (Hámori, 2003)

Experiments by Mazar-Amir-Ariely have demonstrated that the probability of detection and the expected payment do not affect the average level of fraud. In addition, the level of fraud does not depend on fear of spurge, but behaviour becomes in a fraudulent situation typically. The surprising results are underlined by the fact that most people want to keep their positive self-image, but they do not want to give up their payouts either. Therefore, they will find an optimal compromise balance. (Mazar, et al., 2008)

According to the experimental economics, the financial penalty does not bring much results. To reduce tax evasion, taxpayers should be given amnesty, reinforce a positive self-image of rule-following behaviour. In addition, it should avoid, that the tax evasion behaviour becoming widely recognised and commonly accepted. Furthermore, the ongoing reminders of ethical rules reduce the hidden activities. The reminder can be made even by signing a simple statement, but the various religious rituals serve this purpose as well. (Ariely, 2015) (Mazar, et al., 2008)

According to Marx, the presence of illegal activities is also needed, in such situation as the original capital accumulation and unemployment in the market economy. However, the two situations are not like because the original capital accumulation is the development of capitalism, it is a one-off process and it ended in the 19th century in England. At the same time, the temporary growth of illegal activities, coupled with unemployment and crises, is a counter-cyclical and inevitable consequence of capitalist production.

To sum up, capital accumulation was done by force, which made many people's livelihood impossible, forcing them into illegal activities. With the development of industrial production, labour demand grew, and more and more people moved to the legal labour market to become workers. The two populations change over time, the direction of change is determined by labour demand and the underlying commodity processes.

Illegal activities in the capitalist mode of production are the natural features of the system as a market economy cannot provide full employment. The tolerance of illegal activities is sometimes the interest of the whole society, as it is a kind of implied, implicit solution for the maintenance of people without legal work. However, with the increase in labour demand, legal legitimacy of illegal activities can be facilitated by making possible the legal employment of people. (Marx, 1978)

Economic integration examines the forms of economic transactions from an anthropological point of view, revealing that the market and the price mechanism are not the only form of integration.

According to Károly Polányi, the difference between the substantive (empirical) and formal formulation of the economy is not negligible and if the formal definition is used in general, substituting the substantive approach, it can be misleading. Explanations based on classical economics, therefore, do not consider a number of factors and they detect also markets where the price mechanism is not the basis of distribution. (Polányi, 1976) (Polányi, 2004)

The empirical economy is the institutionalized process of interaction between man and the environment, which ensures the continuous supply of the goods and services (Polányi, 1976, p. 236) Institutions provide stability and create structures. The mode of institutionalization is determined by the way that the parts of the economy interact with each other and are reproduced. According to Polányi, integration is the way of institutionalization, it has basically three types, such as reciprocity, redistribution and market coordination. In different ages and societies, forms of integration have different weights.

The presence of institutions is necessary for integration, for example there is no reciprocity without symmetric groups, market coordination without the commodity, money and labour markets. Moreover, market coordination is associated with a significant weakening or cessation of reciprocity, as participation in the labour market limits the possibility of mutuality, and the commodity market supply the goods which can provide the mutual relationships as well.

However, from the point of view of illegal activities, the explanation is based on completely different basis. Considering what Polanyi wrote about the substantive and formal interpretation of the economy, illegal activities do not fit into the institutional system for market coordination and redistribution. It is possible that reciprocity motivates these activities.

From the point of view of illegal activities, the role of relationships is also very important, and many illegal activities are determined by the existence, absence or nature of relationships. For example, Feinstein based his income tax evasion estimation on the socio-economic factors. (Feinstein, 1990)

Finally, it should be noted that certain illegal activities may appear as a resistance to totalitarian authority. Political conflicts are usually analysed in their open form, including demonstration, strike, vote and uprising. According to James Scott's analysis, however, there are forms of collective resistance that give groups without political power to express their resistance to authority. They use these tools when open resistance is too risky. These - usually small-scale - actions do not want to attract attention, and even more specifically, their purpose is anonymity, but they act to change the institutions like the open resistance.

In summary, everyday resistance includes collective and deliberate actions, the purpose of these activity is the material self-interest, that is intended to be achieved directly (e.g.: by taxing or tithing) or by symbolic means (e.g.: gossip, slander).

Forms of everyday resistance can be varied, each of which is designed to help theft. Nevertheless, Scott describes a few typical examples of different ages and geographic areas. (Scott, 1996) (Scott, 1996)

## 1.3 The history of non-observed economy in Hungary

### 1.3.1 The hidden activities in socialism

Like in the case of resistance to state socialism, it happened in Hungary. The system of compulsory deliveries forced the agricultural workers to produce the same and wide variety of agricultural products, while the farms were around five acres. This system increased the villagers' independence because it forced them to build self-sustaining farms. At the same time, the socialist system was anti-individualist because it wanted to resolve the contradiction between production and property. But to do so, however, the perfect planning of individual activities was necessary. The implementation of the plan was problematic for several reasons, and because of the different methodology of division and aggregation it was simply impossible to accomplish.

Therefore, each participant was interested in the distortion and falsification of the data, and so while the data were transferred back to the planning centre, it went through multiple shifts. The next plan obviously exceeded the main figures of the previous plan.

The plan could not be accomplished, and year by year there was a significant shortage of products. In the following year, they focused on the production of these products, which generated a new shortage. It was impossible to bring the system into equilibrium, because those who performed well in a campaign-like production competition were responsible for the next year's shortage. Those who realised its unsustainability and attempted to mitigate the negative consequences were stigmatized as saboteurs.

Individualization in the economy have been involved in atomization in politics. In a totalitarian system any kind of political dialogue becomes impossible. However, instead of the death of politics, in fact, every act is made political. This is causing the rise of terror and repression, which in 1953 led to the fall of the Stalinist political system and to the 1956 Revolution. (Rév, 1996)

The second economy means the economic activities besides the socialist system. The second economy developed in the first half of the 1960s in Hungary, where, due to the significant oversupply in the labour market and the relatively high numbers of inactive people and the constant shortage of goods, certain traditional activities were strengthened outside the public sector. The attitude of the economic policy to the second economy was ambivalent. Formally, they could not support this activity along with the socialist framework, but it was needed, so it was tolerated.

In the 1970s, due to the growing demand, economic rationality became the main motivation of second economy instead of livelihood constraint. Due to rising wages, a significant proportion of economically active people were involved in the second economy and the role of the missing socialist small enterprises were taken by private companies.

The second economy employed 20% of all labour, and 75% of household's benefits in their income. Its typical activities were small agricultural production, private industry, private retail, private housing construction, real estate renting and the corruption (tip, kickback, gratitude).

Small-scale agricultural production was practically home farming, producing more than one third of total agricultural output, while the private handcraft sector was half of the services, while retail sales accounted for one-sixth of all retail sales. Private dwelling construction consisted in voluntary work cooperation, i.e. construction work in the form of a work exchange, half of all apartments were built in this way. Due to the insufficient money supply construction works could only be carried out in this form. It is understandable that private

dwelling construction were carried out mainly by people with the right knowledge and profession.

The aim of the socialist economy is to have expanded reproduction with centralized control, it is typically a commodity production aimed economy, and the commodity nature of the labour also prevails. Because of the central control, prices are stable, the price mechanism does not work, so workers react to the changing situation by determining (reducing) their performance. The subjective assessment of the average standard of living perceives the relatively higher income of the others, the second employed economy. Because of the subjective assessment of the average standard of living, the relatively higher income of the second economy is perceived. As a result, the production is reduced in the public sector, therefore the productivity is lower than in the second economy.

However, in the second economy the price mechanism operates, the labour productivity is higher and therefore the income is higher. The two economies complement each other. The enterprises are rational in the capitalist economy, but the whole economy does not produce in social optimum. The socialist economy strives for social optimum, but within the companies there is no rationality. The second economy functioned as a balance and promoted the political stability of the system, as well the production could be brought to the required level, income could be reallocated.

The commodity production part of the second economy - agriculture and industrial activities - formed an essential part of the socialist economy. In fact, activities outsourced from the large state-owned companies appeared in the second economy. Industrial, outworker activities were completely unviable without state-owned companies or production co-operatives, and did not fulfil the institutional conditions of self-employment (autonomous decision-making, separate operations and incomes). Therefore, these activities disappeared completely when the regime changed. The situation is different with the backyard production. With the cessation of co-operatives, they also lost orders. However, remained the production for own consumption and market took over the role of co-operatives` orders in some extent. Therefore, the importance of small-scale agricultural production decreased more slowly. In summary, the change of regime meant a significant loss for the population living in the countryside, and losing the main sources of income, masses were impoverished.

The second economy in housing construction also lost its significance. The most important motivation for home construction was the inadequate housing market, the over-demand, the decision anomalies of dwelling's distribution and the insufficient money supply.

Small businesses in services were independent, and supplied in framework of market , they produce for households. These businesses could continue the production after the change of the regime but did not report a significant proportion of the domestic economic performance. (Gábor & Galasi, 1981)

Gratitude is an example when the government forced the individuals to illegal activity because it could not finance the service. Gratitude is also a hidden activity and a Hungarian specialty. Its development is related to the post-war socialist regime, and it is controversial in the society. It has become so characteristic in the health care that today it still exists.

Before Second World War social insurance was not widespread in Hungary, health care was privately financed, doctors requested a fee for their services, and the free provision of the poor was obligatory. There was no gratuity in any area of health care, but it was built after the Second World War while the formation of socialist system and there were basically three reasons for its appearance.

1. Infrastructure suffered major damage during the war, but the socialist system focused on rebuilding the railway.

2. With the introduction of compulsory social security, healthcare has become free almost for everyone.
3. The wage policy of the Rakosi system, however, declared that nobody could earn more than a skilled worker.

Due to these factors, there was a significant over-demand for healthcare services, with significant wage tension for doctors. Because of the queues, the corruption namely the "gratitude money" was a natural reaction of patients.

In 1950, wages in health care were raised by taking into account the possibility of gratuity. In practice, this meant that the salary of doctors who could receive gratuity (for example, obstetricians) earn much lower than those who had less chance of doing so (such as paediatricians or pathologists).

The fact that the amount paid to doctors would be the expression of gratitude first appeared in the second half of the fifties. Gratuity was treated as an ethical problem and not as a legal issue, although the doctor were not allowed to accept any benefits from the patients according to the Criminal Code.

From the beginning of the story to the late sixties, the government was concessive for gratitude money, but it was constantly emphasized that the gratuity was a temporary phenomenon, it would eventually disappear. However, by the end of the 1960s the attitude of the government had changed, and it stressed, that the gratitude was the natural characteristics of individuals, the expression of gratitude cannot be, but should not be prevented. This romantic approach was somewhat undermined by the sociological researches of the sixties, which showed the spread of gratitude, and in addition highlighted its motivations. The practice and fear from worse care was the most important reason for the respondents, gratitude explained the parasolvency only for infinitesimal part of the respondents.

In the seventies, the problem of gratuity was in the centre of attention due to the sociological researches and scandalous incidents. The government began a medical ethics action program in which gratuity was treated as an ethical issue exclusively, instead of clarifying its legal aspects. The program was completely ineffective; the gratuity became fully accepted strengthening the delusion in society that the gratuities were acceptable

The history of gratuity is a classic example how the economic and political situation "forces" decision-makers to bring a significant part of society into hidden activities. The process was supported by economic policy (wage setting), communication (as someone in government stated that the situation was inadmissible, the government hastened to correct the mistake, the situation is unacceptable, but the current situation is not yet appropriate for the change) and legislation. (Ádám, 1986)

### 1.3.2 After the regime change

After the change of regime, extensive tax evasion and rule avoidance were characteristic of legally operating businesses, from which relatively few operated in the previous system. It would be bold to claim that the legally operating companies in socialism would have introduced a general tax evasion culture throughout the Hungarian economy, mainly because many of these enterprises did not survive the regime change.

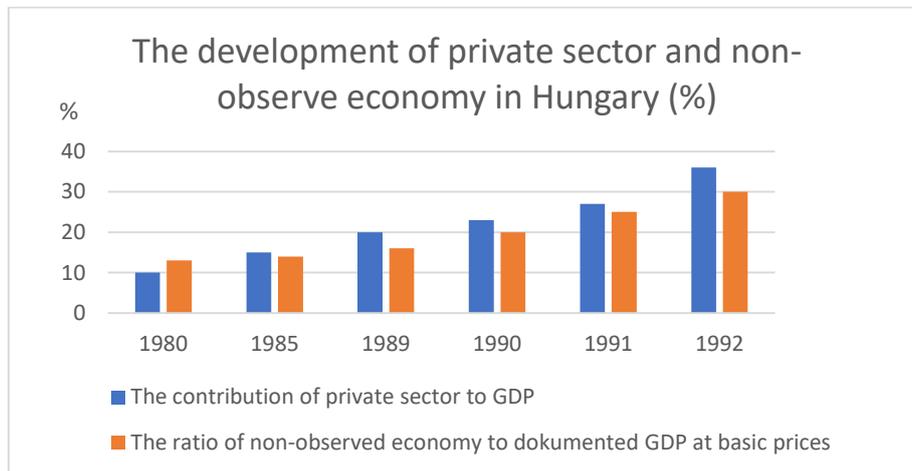
At the same time, if we look at the value added of the typical illegal activities after the change of regime, they are more of crime, and again there is no connection with the second economy.

In summary, the second economy is typically a Hungarian phenomenon, it is typical for socialist systems, it was originally created by economic inefficiencies of socialism. They are not similar to today's unobserved economic activities. During the change of regime, a

significant part of the second economy was abolished, and the rest worked in the legal economy within the framework of the new economic system.

The extent of non-observed economy was analysed by a widespread research on the initiative of “Kék Szalag Bizottság” in 1991. It examined the development of private sector’s share in total GDP, and the ratio of non-observed economy to GDP was also estimated by them.

Figure 1

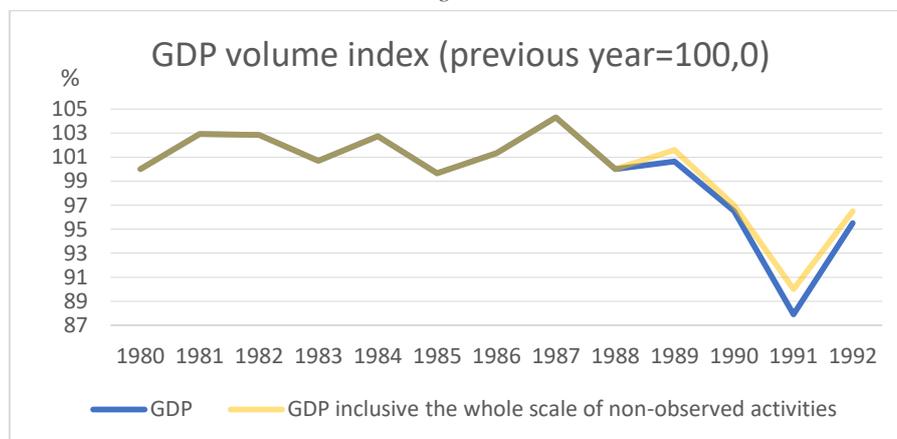


Source: (Árvay & Vértes, 1997/7)

The above figure shows, that the ratio of non-observed activities increased together with the contribution to GDP of private sector.

The part of non-observed activities was included in the official GDP, but a significant part of international organization’s recommended items was not estimated in the Hungarian GDP. Therefore – utilized the results of estimation – the GDP volume index was completed by the development of non-observed economy. The main results are included in the next figure, which shows, that the increasing share of non-observed economy mitigated the crisis due to the change of regime. (Árvay & Vértes, 1997/7)

Figure 2



Source: (Árvay & Vértes, 1997/7) and HCSO

The transformation between the second economy and the unobserved economy after the change of regime is well illustrated by the operation and alteration of the KGST markets.

The markets are located on a scale between informal and formal trade scale, and the formality of trade differs also in the territory of markets. The name of the KGST market is the commonly known ironic name in the everyday language of the ad hoc emerged, informal markets that in the early 1970s developed with economic easing. The buyers and sellers came from KGST (Council for Mutual Economic Assistance) member states, and they have taken advantage of the comparative advantages in specialization and price control, and thus the sellers and buyers have also benefited from trade. It was possible to purchase the goods from which there was a shortage or a worse quality in the country. With regard to the products, the KGST markets specialize mainly in cheap manufactured goods, technical articles and foodstuffs.

The KGST markets flourished around and after the change of regime, when the inadequate trade within KGST collapsed. This was accompanied by a significant decline in income and increase in unemployment. These circumstances have determined the high demand for products sold on the KGST markets. (Sik, 1997)

After the change of regime, with the emergence of the new economic order, expensive import products appeared in the retail trade, but due to the general crisis, demand for them was low. Informal trade is cheaper due to low costs, tax evasion and lack of guarantee. Therefore, the markets were popular even after the change of regime, although the former KGST specificity has changed.

The trade that has developed along the borders with the use of local border traffic still works, but trade within KGST countries has been taken over by another structures. Markets have changed profile. Some of them acted as a farmers' market or became a market for second-hand goods. The emergence of Far East Traders in markets is all typical. Their product range consisted mainly of clothings. Another typical commodity is food imported from Western countries. (Czakó, 1997)

The local government's attitude is also remarkable for the KGST markets. Initially, ad-hoc markets were tried to sell off by the local government. However, the municipality appointed an area for the KGST markets subsequently. It has become obvious that this type of trade is necessary and cannot be eliminated. Processes are more controllable and safer on the whole market if trading is in a designated place.

Markets were part of the second economy and most of their activities fall actually into the non-observed economy (tax evasion, non-observed imports, and trade in smuggled goods). Low income social strata have a constant demand for their products. At the same time, the product range, the structure of sellers and buyers has also changed continuously with the changing economic environment.

The other problem, which arise during the regime change was the lack of capital and entrepreneurs. The aim of regime change was the formation of market economy by the privatization, but in Hungary there were not solvency demand for the public corporations.

The government get vouchers the descendants of the previous owners of public goods, whose properties were nationalized after the second world war. This voucher could be utilized above their nominal value in the auctions of public corporations. But unfortunately, the distribution of the vouchers was overly atomized, that the compensated persons cannot utilize their vouchers. Therefore, the secondary market of vouchers emerged, the prices developed at the 40-50% of the nominal value.

The government provided also interest rate subsidy, the subsidized loans could be claimed for the privatization. State-owned companies have been able to obtain up to one percent own resources by using the secondary market of compensation vouchers and subsidized loans.

However, the development of a legal and normative system corresponding to the market economy took longer time, so there were many opportunities to take advantage of loopholes. (Kolosi & Szelényi, 2012)

This situation has dramatically increased the value of the social capital. The most important types of social capital were the political, economic and cultural capital in Hungary during the regime change. The accumulation process of economic capital associated with completely or partly illegal activities, the private sector partly intertwined with the organized crime. (Bezsenyi, 2015)

The capital accumulation process was completed by the end of nineties, but the legal and social closure of these processes is still missing. That is why it is possible that a reputable and extremely wealthy Hungarian entrepreneur is now in the spotlight due to a crime committed in the nineties. (Index, 2018) The social and final closure of the regime change would be necessary in Hungary. (Sárközy, 1996)

### 1.3.3 The non-observed economy nowadays in Hungary

After the change of regime, by the development of the new economic order, the non-observed economy contributed to the wider strata of society in the process of overcoming the loss of income caused by the change of regime. At the same time, certain forms of non-observed activities, some of which were realized within the framework of organized crime, were similar to process of the original capital accumulation.

Towards the end of the 1990s, the new economic order emerged, but not all non-observed activities were channelled into the observed economy. The persistently high level of non-observed economy seemed to be steady.

From the beginning of the 2000s, the government took a series of measures to reduce the level of non-observed economy due to tax evasion.

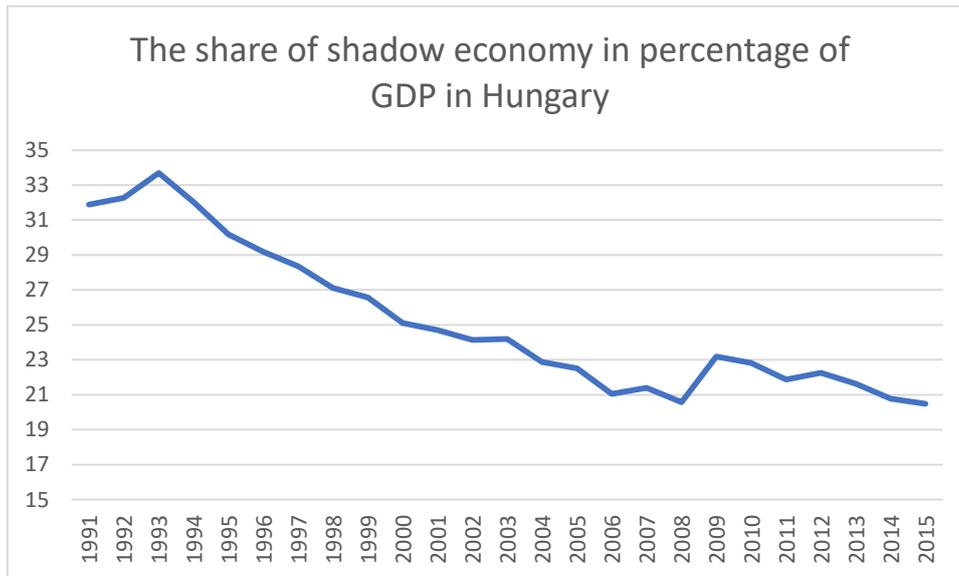
Among the most important of these measures were the following:

- Introduction of simplified employment
- Reducing VAT rates in particular industries
- Introduction of EKÁER and the online cash register
- Tax amnesty
- Establishment of tax audit systems, wealth accumulation audits
- Tax-friendly tax office

Among the above measures, the introduction of the online cash register seemed to be the most effective. However, many areas of tax evasion are not affected by the online cash register, including personal services.

The development of the non-observed economy from 1999 is shown by the following figure, which is based on Schneider's calculations.

Figure 3



Source: (Medina & Schneider, 2017)

However, the decreasing is not significant in European comparison, the Hungarian shadow economy occupied the 12<sup>th</sup> place among the member states of European union. (Schneider, 2015)

#### 1.4 Summary

In the socialism, the second economy included activities which did not fit into the current economic integration system. Some of these were part of the activities that complemented the socialist economy, and their production was utilized by the socialist large corporations.

The other part satisfied the consumer needs that the socialist sector was unable to deliver. Some of these were based on reciprocity, while others were organized on the basis of market coordination.

These activities were not illegal, their purpose was not tax evasion or fraud. After the change of regime, their proportion decreased significantly, while the activities organized on a market basis became part of the new economic order.

Tax evasion, which forms part of the non-observed economy, emerged in the years of transition. Among the reasons for its development, it should be mentioned the lack of a market integration form, the serious crisis that made the population's livelihood difficult and the formation of the entrepreneurial layer and capital accumulation.

By the end of the nineties, the process was completed, but the social closure of the transition was not completed. For this reason, tax evasion has become a socially and widely accepted activity even today in Hungary. The measures taken by the government to reduce tax evasion in two decades have unfortunately only led to a moderate result.

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