

**Volume 21, Special Issue****Print ISSN: 1098-8394;****Online ISSN: 1528-2651**

# **ENTREPRENEURIAL ENTRY AND SHADOW ECONOMY: THE CASE OF TRANSITION COUNTRIES**

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## **ABSTRACT**

*Entrepreneurship is at the core of the modern view on the economic relations development. Hiding of economic relations is one of the most significant obstacles to ensuring sustainable economic development, improving the welfare and standard of living of the population and strengthening national security. The purpose of the research is to conduct a comparative analysis of external factors of innovative development of entrepreneurial activity and entrepreneurship education, which is the main factor in the transition to a new level of economic relations and reducing shadow economy. The results of the diagnostic analysis show that information, communication factors (19%), and social indicators (labor market, entrepreneurship education and culture, 16%) of the development of innovative entrepreneurship have the greatest influence. A comparative analysis of the size and dynamics of the shadow sector shows a high level of shadow economy, which is a significant damper to the development of entrepreneurship.*

**Keywords:** Shadow Economy, Entrepreneurship Education, Entrepreneurial Development, Transition Countries, Hidden Business, Educational Restructuring.

## **INTRODUCTION**

One of the main transformation goals of the modern economy is the creation of an innovative economy, which is based on entrepreneurship (Khairutdinov et al., 2018; Rogo et al., 2017; Shpilina et al., 2017). The development of economic relations in countries that are overhauling or developing their economic system is complex and contradictory. The transition to new management forms creates conditions for various abuses and the formation of a modern shadow economy (McMillan & Woodruff, 2002). Corruption, bureaucracy and the consequences of the economic crisis have a certain influence on the development of entrepreneurship (Stankevičius & Vasiliauskaitė, 2014; Zaman & Goschin, 2015; Gaspareniene & Remeikiene 2016).

Shadow economy is the activity of economic entities, which develops outside state system of accounting for and control (Nechaev & Mikhailushkin, 2011; Medina & Schneider, 2018; Berdykulova et al., 2014). This is a complex socio-economic phenomenon that affects all socio-economic relations and, above all, the reproduction sector, where entrepreneurship is

hidden from government (Williams & Nadin, 2012; Sarsenbayeva, 2017; World Bank, 2017). The shadow economy refers to illegal economic activity. Operations in the shadow economy are illegal, either because the product or service is illegal or because a legitimate transaction does not meet the government reporting requirements. An example of the first category is drugs and prostitution. An example of the second category is non-taxable labor and free of duty sales. When we talk about the shadow economy, we mean the so-called second (or white-collar) economy, the black market or the informal economy (grey market) (Schneider & Buehn, 2018). The prevalence of shadow economy directly depends on the economic, political and social level of the country's development (Medina & Schneider, 2018; Mandroshchenko et al., 2018). In countries with developed market economies, the proportion of enterprises that conduct legitimate activities is significantly higher than in the countries with emerging economies.

The main negative consequence of the shadow economy is the deformation of the economy structure, manifested in increasing investment risks and loss of investment. First, there is a reduction in investment in the real sector of the economy, which negatively affects the development of the production sector. In addition, prevalence of shadow economy leads to income differentiation by enriching the subjects of illegal and hidden business. The most significant statistical studies covering different economies and countries are the results presented by such organizations as the International Monetary Fund (Medina & Schneider, 2018), the Association of Chartered Certified Accountants (Emerging from the Shadows, 2017). They give an overall assessment of the shadow economy level, make a comparative analysis of countries and a forecast. As the studies show, the level of shadow economy in the world fluctuates on average about 23.1% of GDP. For the most developed countries, this figure is 10-12%, while for developing countries and countries with transition economies this figure can reach 60% (Medina & Schneider, 2018).

Despite the abundance of publications, most often the level of shadow economy is estimated as a percentage of GDP. Sometimes this figure is expressed in absolute units. Most often, the reasons for the emergence of shadow economy include bureaucracy, corruption, high taxes, the living standard and business environment (Emerging from the Shadows, 2017; Stankevičius & Vasiliauskaitė, 2014; Blackburn et al., 2012; Filippova, 2015). The current trend in the development of economies of the world's leading countries is the transition from the industrial to innovative economy, the essence of which is to change priorities from the use of natural resources, equipment and labor to application and generalization of new knowledge to ensure development (Aripov, 2012; Yusupov, 2016; Ablav, 2013; OECD, 2017:2018). The central element of the modern economy development in the world is knowledge, which must be turned into innovations under the influence of the environment.

Hiding of economic relations is one of the most significant obstacles to ensuring sustainable economic development, improving the welfare and standard of living of the population and strengthening national security (Ablav, 2013; Akindinova et al., 2016; Makarova & Pavlov, 2017). The problem of shadow economy exists in all countries of the world without exception. In addition, globally, this problem as a negative socio-economic phenomenon tends to exacerbate.

The influence of the post-industrial era on the economy showed up in a number of problems related not only to the need to maintain market positions and to keep high economic indicators, but also to the possibility to stay on the market. The lack of financing, the reduction of external investment, the inadequacy of scientific and technical support of products, the deterioration of fixed assets, obsolete technologies all require drastic changes (The key word of 2015 will be "*Innovation*"; Halvarsson et al., 2018).

Entrepreneurial process occurs in a certain business environment (external and internal factors), which should create favorable opportunities for the development of entrepreneurship. Therefore, an urgent task is to study and identify the most important factors of the business environment that affect the innovative development of enterprises.

It should be noted that the conditions in which the entrepreneurship is developing in the country are to a greater or lesser extent related to the existence of shadow economy (Medina & Schneider, 2018; Emerging from the Shadows, 2017). Even countries with a developed economic relations system are exposed to shadow economy. This is due to the dual nature of the shadow economy and its close relationship with entrepreneurship. On the one hand, inadequate legal, economic, public policies are the main reasons of the shadow economy growth. On the other hand, entrepreneurship is realized by people who aspire to self-preservation, protection of their social benefits and inadequate enrichment. As the analysis shows, the bureaucratic and corruption environment is a fertile ground for the shadow economy.

The most widespread forms of shadow economic relations are the concealment of business activity and incomes, and the non-payment of taxes. The legislation provided ways to legalize many types of shadow businesses, but the majority of people did not choose those ways because they close doors to super-profits. This situation will remain as long as there is a hard tax press (Adrian & Ashcraft, 2016; Colombo et al., 2016).

Entrepreneurs with a propensity towards criminal ways of doing things and with a criminal record are unlikely to legalize their shadow businesses. The rules of criminal economic behavior that business entities follow also apply to law-abiding entrepreneurs, who are forced to conduct their activities in accordance those rules. This calls for other forms of influence, specifically economic and legal ones (Ferrante, 2018; Pozdnyakova et al., 2019).

Thus, shadow business holds up modern criminal network and supports corrupt government officials. Shadow capital with a powerful resource base act as an umbrella for criminal characters and drew the significant forces of bureaucracy to one's side, creating tight and organized criminal groups. Once these forces united, a system of specific economic relations formed in society, not formal ones that define and regulate a significant part of social processes in the country (Putniņš & Sauka, 2015:2017).

Thus, the development of entrepreneurship is possible if there are conditions for the transition to an innovative economy. This raises the question of what external factors have the most significant impact on the innovative development of entrepreneurial activity. The purpose of the research is to conduct a comparative analysis of external factors of innovative development of entrepreneurial activity, which is the main factor in the transition to a new level of economic relations and reducing shadow economy.

## METHODOLOGY

This article is a comparative analysis of external factors affecting innovation-driven entrepreneurship development. Those were International, Political, Economic, Social (labor market, education and culture), Institutional, and Technological factors, as well as Information and communication. These factors were selected for their significant effect. The factors have been identified through an expert survey. The group of 9 experts, formed in accordance with the level of awareness of the research subject, assessed the impact of factors. Experts were asked to assess the impact of each factor by assigning scores from 0 to 10. That is, if the factor has no significant influence, then the score is 0; if it is significant, then 10. If the expert believes several factors have the same effect on the research subject, equivalent assessments are given.

## RESULTS

Different types of economic relations can be put into correspondence with different forms of shadow economy. At the same time, the common prerequisite for the emergence of the shadow economy is the desire of various population groups to raise funds for their existence or enrichment, without paying the state compulsory taxes and payments. In its economic essence, entrepreneurial activity in the shadow economy is similar to the one in the formal legal sector. One of the central entrepreneurship functions is the development and implementation of innovative technologies in production. This function in shadow activity has two aspects—on the one hand, some business entities of the informal sector use old technologies, an extensive method, and on the other hand, others use the most progressive technologies and an intensive development path. Since entrepreneurial activity forms the basis of market relations, it is advisable to study external factors affecting the development of enterprises.

In the modern scientific literature, we can find many approaches and analysis methods to forecast the external environment of enterprises. Each of these methods can be used to analyze the external environment of the enterprise. But it should be noted that each method does not provide an unambiguous assessment of the environment, since the determination of each factor's significance and the assessment of its influence may be subjective.

The conducted analysis of external factors confirms the need to choose the most important factor. To take into account groups of external factors, we have divided them into factors contributing to or hindering innovative development (Table 1). It is appropriate to carry out such an analysis on the basis of expert assessment method.

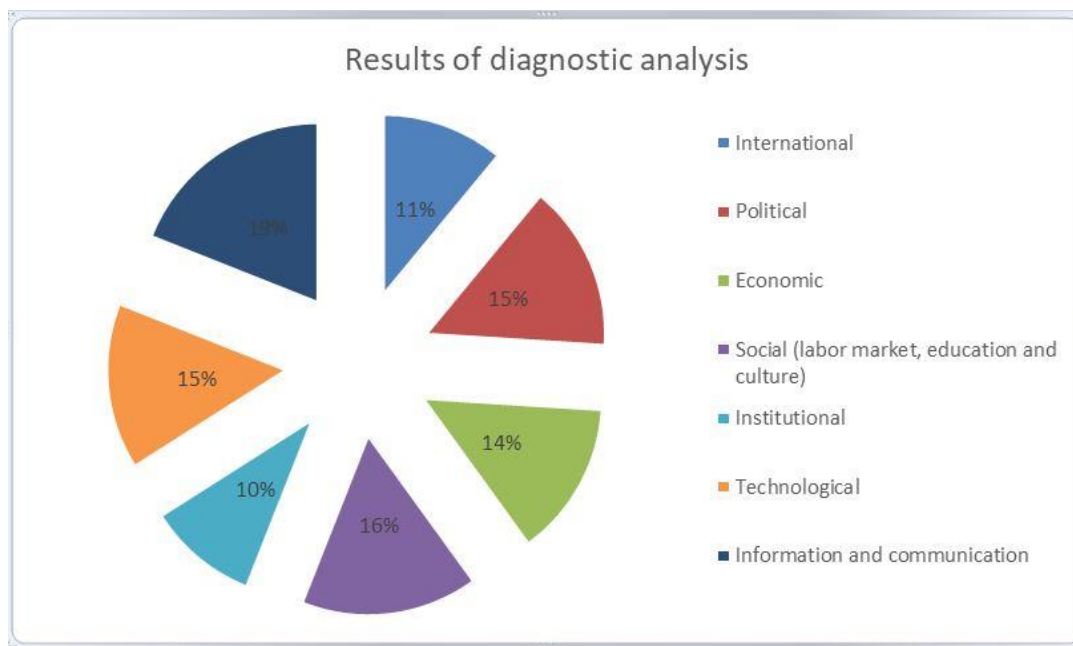
<b>Factors</b>	<b>Promoting development factors</b>	<b>Hampering development factors</b>
<b>International</b>	International economic cooperation; support and development of international relations in scientific, technical and educational cooperation and restructuring; education and exchange of scientific personnel; implementation of national programs of the participating countries and the associated states; development of cross-border research networks.	Lack of an innovation-oriented public system; lack of support and use of special tools, such as the coordination and pooling of the research program capabilities.
<b>Political</b>	Availability of an up-to-date regulatory framework for the development of innovative activities; promotion of patent and licensing activities, improvement of the intellectual property management; formation and development of effective public-private partnership mechanisms and removal of administrative barriers; implementation of the programs aimed at creating favorable conditions for attracting investments.	Instability of the political situation in the country; imperfection of legislative base on innovation activities, protection of intellectual property.
<b>Economic</b>	The use of external resources to support the innovation processes; the development of innovations to reduce production costs to a lower level than that of competitors; financial support for innovative development provided by support funds of scientific activities, small enterprise assistance funds; stable financial condition of enterprises; the state of the investment climate; development level of public-private partnership.	Instability of the economic and political situation in the country; lack of funds to finance innovative projects.

<b>Social (labor market, education and culture)</b>	Quantitative and qualitative composition of labor resources; maintaining the integrity of employees; ensuring a high level of labor productivity; ensuring effective relations with employees; employees in innovative spheres; advanced system of entrepreneurship education.	Lack of economic and managerial knowledge of employees; resistance to change; lack of material incentives and conditions for creative work; outflow of scientific personnel; low professional status of the innovator.
<b>Institutional</b>	Functioning of development institutions; developed educational, scientific, technical and innovative infrastructure; developed residential, social, engineering, transport, energy infrastructure of enterprises, innovative infrastructure facilities.	Absence of mechanisms facilitating the reproduction of innovations; conditions for innovation; lack of a developed strategy that provides for the implementation of large-scale integrated innovative projects - the creation of technology parks, industrial clusters, etc.
<b>Technological</b>	Design and purchase of new equipment; development of new products and new technological processes; improvement of existing technological processes and product range modification; scientific and technological preparations for future periods; ensuring the improvement of existing technological processes in order to reduce costs, improve the product and prepare new products to enter the market.	Unpreparedness of the material and technical base for the introduction of new technologies; outdated technology.
<b>Information and communication</b>	The level of intellectual capital in the development of Computer Technology (CT), the use of modern information technology in the enterprise activities; ensuring the availability of information on the activities of innovative infrastructure facilities; Internet access, the development of information technology and telecommunications, the high quality of hosting services, the size and growth rate of the Internet audience.	Insufficient information on innovations; insufficient information exchange for innovation management.

The results of the diagnostic analysis of external factors are presented in Table 2.

<b>Factors</b>	<b>Experts</b>								
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>
<b>International</b>	5	6	4	5	6	4	5	5	6
<b>Political</b>	6	7	7	8	6	6	6	8	4
<b>Economic</b>	6	6	7	7	5	6	6	7	6
<b>Social (labor market, education and culture)</b>	6	7	6	8	7	7	6	6	8
<b>Institutional</b>	4	5	5	4	4	6	3	4	5
<b>Technological</b>	6	5	7	6	5	6	8	7	5
<b>Information and communication</b>	7	10	8	9	9	8	6	10	9

The pie chart shows the results of the analysis (Figure 1)



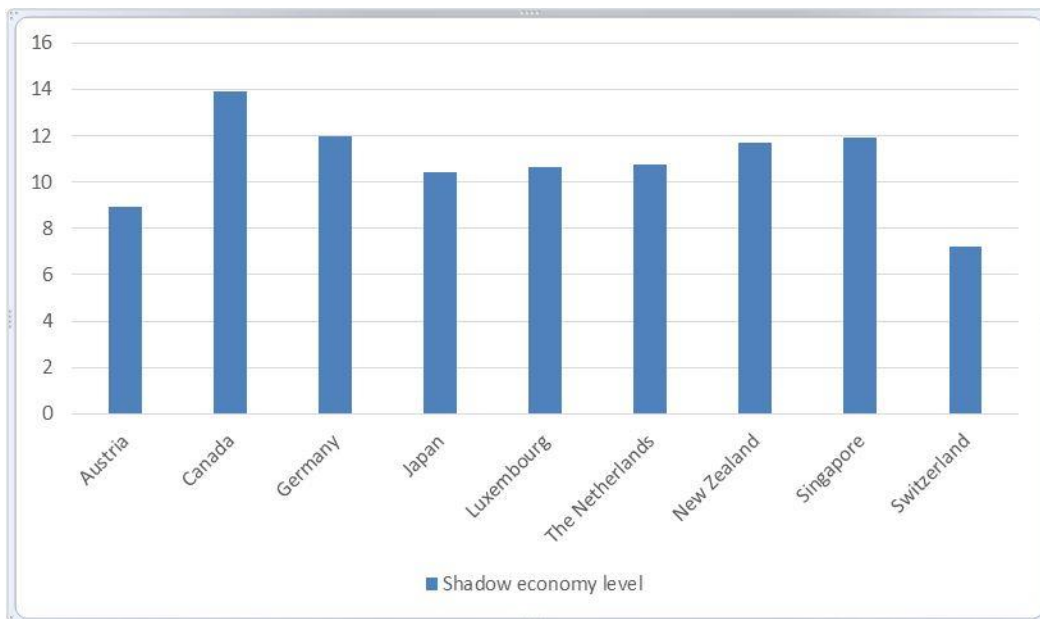
**FIGURE 1**  
**THE RESULTS OF THE DIAGNOSTIC ANALYSIS OF THE IMPACT OF EXTERNAL FACTORS ON THE INNOVATIVE DEVELOPMENT OF ENTERPRISES**

The results of the diagnostic analysis indicate that information and communication and network factors (19%) have the greatest impact. Social factors are on the second place (16%). This confirms the assumption that in the modern information world, domestic factors have a less important influence on the development of entrepreneurship, and the access to the world's information resources is crucial. Social factors also play an important role. This is due to the nature of entrepreneurial activities related to the organization of life support for individuals. The analysis of the external environment of the enterprise is an important component of innovative development and serves to justify the adoption of strategic decisions on the development of the enterprise. Such an analysis should be carried out regularly in order to level out threats in a timely manner, to use all opportunities and to meet the current and forecasted requirements of the external environment. Thus, the development of information and social factors that contribute to innovative development becomes the basis for effective entrepreneurship.

As many researchers note, the main motive that determines shadow entrepreneurial activity is the natural struggle for survival and raising the living standard, as well as the desire for inadequate enrichment. The first is the main driving force of entrepreneurship and it ensures its innovative development. The second is the result of excessive bureaucratization and corruption of the economy. We will carry out a comparative analysis of the shadow economy in Russia, Kazakhstan and Azerbaijan.

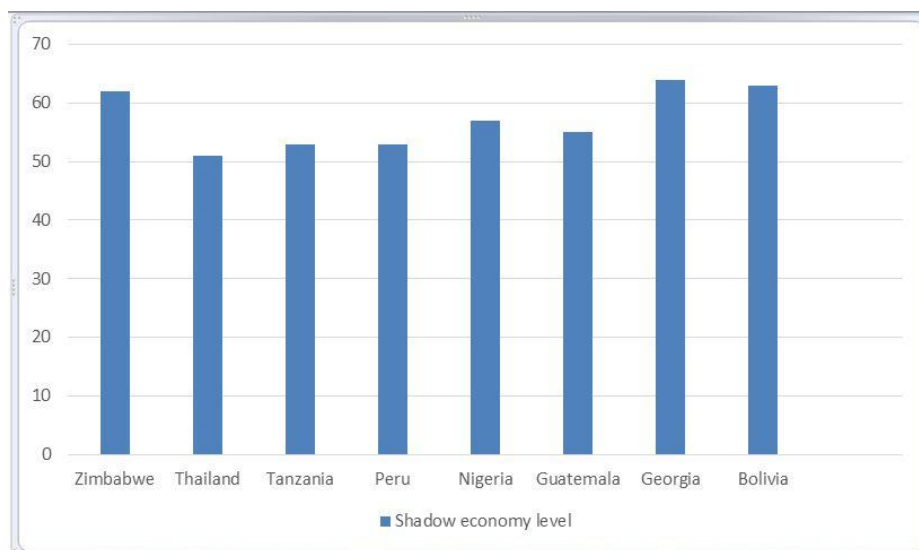
According to the research data (Medina & Schneider, 2018), the share of the shadow sector in GDP does not exceed 12-15%, while in outsiders this figure reaches 64%. This suggests that if there is a high level of shadow economy, there are conditions for inadequate enrichment in

the country, corruption and a developed bureaucratic system. It is obvious that the development of entrepreneurship will be difficult in such conditions. Figures 2 and 3 shows average estimates of the shadow economy as a percentage of GDP for developed countries and for countries with a high level of shadow economy.



**FIGURE 2**  
**SHADOW ECONOMY LEVEL IN DEVELOPED COUNTRIES**

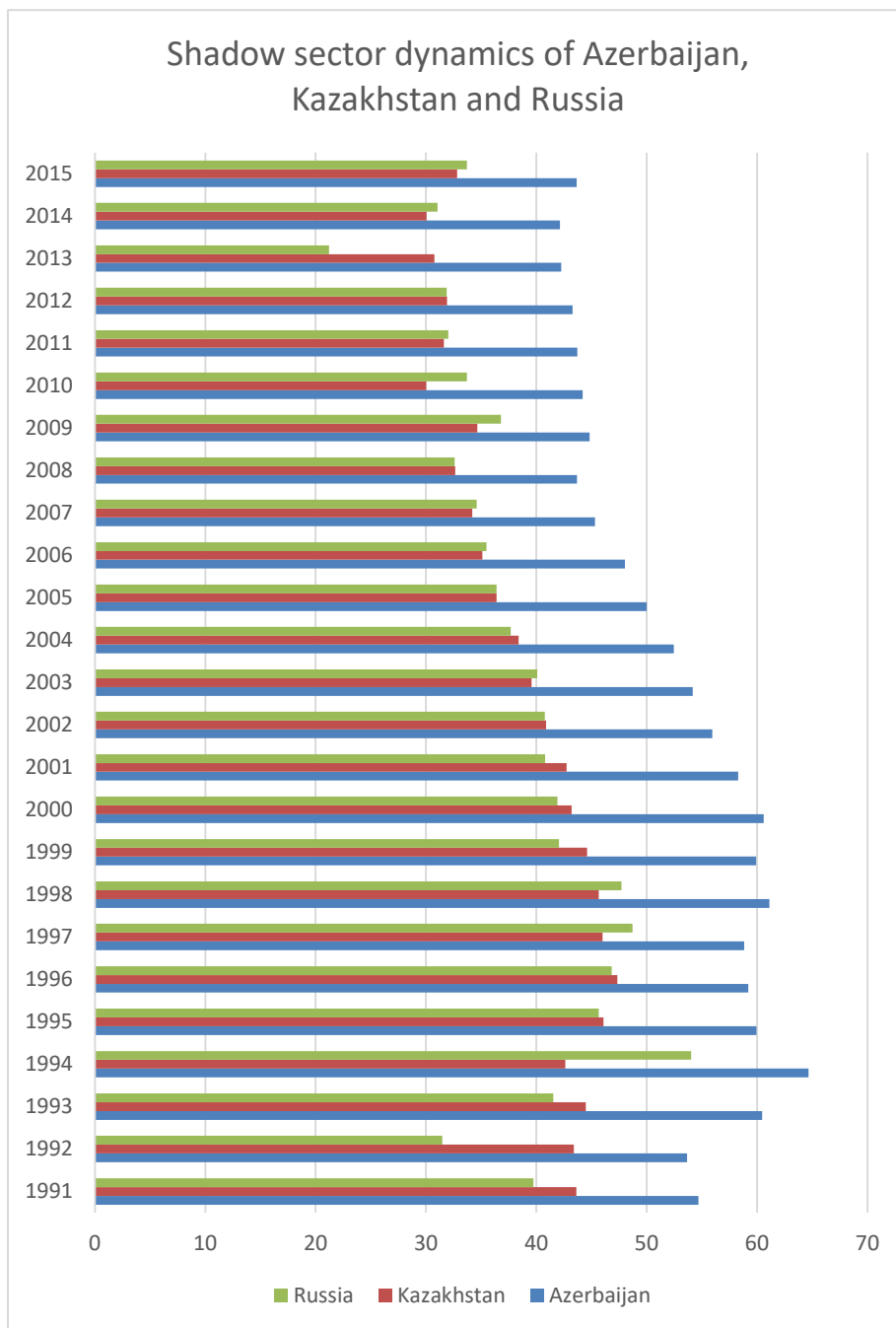
Source: Medina & Schneider, 2018.



**FIGURE 3**  
**AVERAGE SHADOW ECONOMY LEVEL IN COUNTRIES WITH WEAK ECONOMIES**

Source: Medina & Schneider, 2018.

Let us have a look at the shadow sector dynamics of Azerbaijan, Kazakhstan and Russia, whose economies are being transformed (Figure 4). As the analysis shows, the countries have a high shadow economy level, which certainly hampers the active development of entrepreneurship and the transition of the economy to the new innovative level.



**FIGURE 4**  
**SHADOW SECTOR DYNAMICS OF AZERBAIJAN, KAZAKHSTAN AND RUSSIA**  
 Source: Medina & Schneider, 2018.



The analysis of the shadow economy for the period from 1991 to 2015 shows that at the beginning of the transition period all countries had a very high share of the shadow sector, which is due to objective political and economic reasons of the collapse of the USSR. Despite the high share of the shadow economy, we can see a tendency towards shadow economy reduction. This is connected with the transition to market principles of management, which contributes to the development of entrepreneurship and free competition. On the other hand, the level of the shadow sector is still very high. The average for Russia is 38.42, Kazakhstan-38.88, and Azerbaijan-52.19. This suggests that to achieve favorable conditions for the development of entrepreneurship and the transition to an innovative economy, government intervention is necessary to reduce the shadow sector share.

## DISCUSSION

The shadow economy is a common characteristic of countries all over the world. In one form or another and to a lesser or greater extent, it exists in all societies. The influence of the shadow sector on economic and social development can be significant. The existence of a shadow economy can have serious consequences for economic activity and state policy.

The activities carried out in this sector are not protected and regulated in the same way as in the formal sector (Khairutdinov et al., 2018; Williams & Nadin, 2012; Blackburn et al., 2012). Prospects for growth can be compromised because of the lack of information and social infrastructure. For example, the authors (Olotuase et al., 2018) study the impact of the shadow economy determinants. Empirical studies have shown that the main factors of the shadow economy are the tax rate, the general level of employment, the import of goods and services, GDP and the participation of people of working age in the labor market.

On the other hand, the shadow economy gives a certain opportunity to develop entrepreneurship in the context of economic relations transformation, since promotes the growth of well-being. The positive side of the shadow sector is confirmed by the fact that even countries with developed economies are characterized by a certain extent of the shadow sector (Medina & Schneider, 2018; *Emerging from the Shadows*, 2017; Stankevičius & Vasiliauskaitė, 2014). It should be noted that in this case, the level of the shadow economy is characterized by 12-15% of GDP, while Russia and Kazakhstan have 38%, and Azerbaijan - "leads" with an estimate of 52%. The diagnostic analysis of external factors affecting innovative development shows the importance of the information and communication sector, which is also confirmed by the results presented in (Khairutdinov et al., 2018; Yusupov, 2016; Berdykulova et al., 2014). In particular, the authors of (Khairutdinov et al., 2018) conduct the research on the phenomenon of digital shadow economy.

Thus, it can be concluded that the business environment in Russia, Kazakhstan and Azerbaijan is in the shadow economy sector, which, of course, is a national problem. Comparison with the world's leading economies shows a large gap in the level of the shadow sector and only its decline can lead these countries to the right vector of economic development. The main direction of economic development in modern conditions is the transition to an innovative economy, but the large share of the shadow sector reduces the level of investment and investment attractiveness of the country, which does not allow the development of entrepreneurship. At the same time, the identified factors of innovative development correspond to the modern views of researchers, which emphasize the prospects for the development of information and communication technologies.

## CONCLUSIONS

The analysis shows a significant lag in the post-Soviet economies in terms of the market relations development. Entrepreneurial activity, which is the basis of the market economy, is actually in the shadow. This is confirmed by the large share of the shadow sector. The average for Russia is 38.42, Kazakhstan-38.88, and Azerbaijan-52.19. In such conditions, entrepreneurial activity is not aimed at innovative development, but at survival, preservation of social benefits. It also contributes to inadequate enrichment.

The task of the state is to reduce the shadow economy share. The main reasons for the active participation of the state in strategies to reduce the shadow sector are:

1. Slowdown in the implementation of market reforms.
2. the need to form a middle class as the foundation of business.
3. The country's non-competitiveness in a global context.
4. Criminal shadow economy is a threat to national security.
5. A lack of effective entrepreneurship education programs, slow educational restructuring.

Creation of conditions for the development of entrepreneurship is one of the most important directions of the state policy aimed at reducing the level of the shadow economy. Diagnostic analysis has shown that the most significant factors from the point of view of innovation development are communication and social factors (labor market, education and culture). This suggests that for the development of entrepreneurship it is necessary to maintain the information infrastructure, use modern information technologies, provides access to information on the activities of innovative infrastructure facilities, access to the Internet, the development of information technology and telecommunications.

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