

**Financial and Banking Services Market**

Teodora DIMITROVA

**SHADOW ECONOMY PRACTICES
IN BULGARIA – A CHALLENGE
FOR THE FINANCIAL POLICY
OF THE STATE****Abstract**

The global financial and economic crisis in the beginning of this century resulted in certain cataclysms with destructive effects on the government's financial policy. Increasing government budget deficits, strikingly inadequate social status and deterioration of the basic macroeconomic indicators measuring the «pulse» of the national and world economy once again brought forward the issue of the scale of the shadow economy.

The presence of shadow economy is an indicator for the lack of trust in government's financial policy and the inefficiency of the national economic policy. At the same time shadow economy practices affect negatively the economic growth, the efficiency of labour, the competitiveness and the economic and financial policy of the state.

For various reasons, despite the importance and complexity of this problem, we still lack an adequate public strategy for successfully counteract it in the long run. In this context, the main goal of the study is to analyze the extent of the

© Teodora Dimitrova, 2012.

Dimitrova Teodora, Ph. D., Associated Professor, D. A. Tsenov Academy of Economics, Svishtov, Bulgaria.

shadow economy and the issues related thereto as well as examine its actual manifestations in Bulgaria and propose measures to mitigate it.

Key words:

Shadow economy practices, shadow economy, financial policy of the state, financial and economic crisis.

JEL: H30.

The volatile rates of economic development in recent years led to serious disturbances in the management of economic agents' cash flows. Meanwhile the periodic imbalances in the systems of state and corporate finance, accompanied by the poor state of the public sector and the negative trends in the main economic indicators logically infer the existence of a shadow economy.

In this aspect analyses can be based on various studies¹ showing that the share of the shadow economy in the world varies between 10 and 12 percent of the global GDP with a volume of about USD 10 trillion and 1.8 billion employees. According to the Organization for Economic Cooperation and Development (OECD)², half of the world's working population work outside the formal sector of the economy, and the forecasts indicate that this number will increase to 70% by 2020. Obviously, compared to the formal economy, the shadow economy enjoys growth rates significantly higher than the growth rate of the world's GDP. Although the above data are approximate, they show that the shadow economy ranks second in the world after the economy of the USA and is catching up fast. In this regard, according to data from the UN³, the shadow economy alone, as part of the hidden economic practices, generates incomes of USD 2.1 trillion

¹ For more details see: Център за изследване на демокрацията, «Скритата икономика в България», 2004; Schneider, F., Buehn A., Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries, University of Linz, Austria; Technische Universität Dresden, Germany, 2009; United Nations edition, World Economic and Social Survey: In Search of New Development Finance 2012.

² <http://www.csd.bg>.

³ United Nations edition, World Economic and Social Survey: In Search of New Development Finance 2012.

(3.6 percent of the global GDP), i.e. it ranks among the 20 largest economies in the world and is comparable to the economy of the UK.

In the «third world» countries the shadow economy on average exceeds 30 percent and in the economies in transition it is above 25 percent of their GDP⁴. Some studies in the EU⁵ show that the size of the shadow economy in the EU member-states varies between 8% and 32% with a marked increase since the beginning of the global financial and economic crisis. On average the volume of shadow economy in the EU is about 20 percent of its GDP (approximately EUR 2 trillion). Depending on the assessment methodology used, the shadow economy in Bulgaria in the period covered by the research (since the beginning of the transition to free-market economy) is positioned in the range between 10% and 37% of our country's GDP.

In this respect, it is not difficult to conclude that when the share of the hidden sector exceeds a certain level – about 50 percent of GDP, its impact on the national economy makes it a key factor which governs the production and distribution of the national product. Therefore the solution of the socio-economic problems arising from the «shadow economy» phenomenon is considered a high priority in the financial policy of every country.

Regardless of the topical nature of the above issues, we cannot say that there is a rational public strategy to address them. Of course, this study could hardly cover all issues related to the hidden economic practices in Bulgaria and their influence on the government's financial policy. This is why its main objective is to analyze the main parameters of the hidden economy and thus highlight the problems, the forms of manifestation and the measures that will limit its growth.

I.

Theory and practice recognize two major components of the economy – the formal and the informal (shadow) economy (see Figure 1). The «shadow economy» includes all economic activities that are either illegal or are legal but unreported by the official statistics of the relevant official authorities. Hidden economic practices are a phenomenon that persists in the global, as well as in national and regional economies, and indicates the existence of deeply rooted social problems. Despite the various manifestations of the hidden economy, the main reasons for its existence are inadequate regulations, inefficient government control, poor state government, delinquency, etc. that have a significant impact

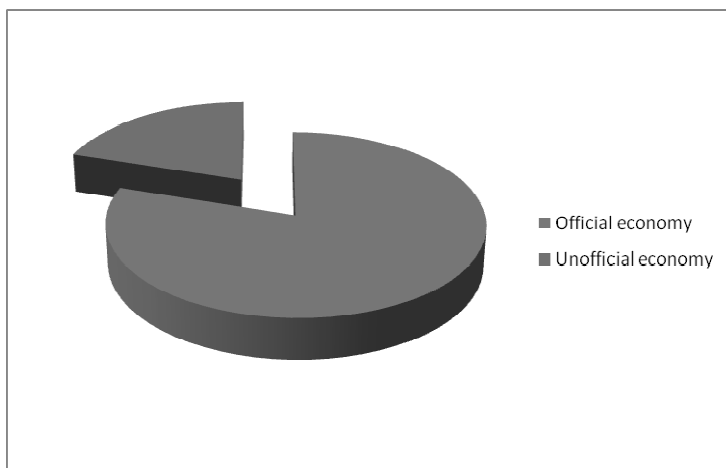
⁴ http://www.nationsonline.org/oneworld/third_world.htm.

⁵ For more details see: Schneider, F., «Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2011», 2011.

on the political, social and economic development. It benefits economic agents with various public and corporate status – employers, employees, self-employed, administrators, financial and non-financial institutions, etc.

Figure 1

Economy components

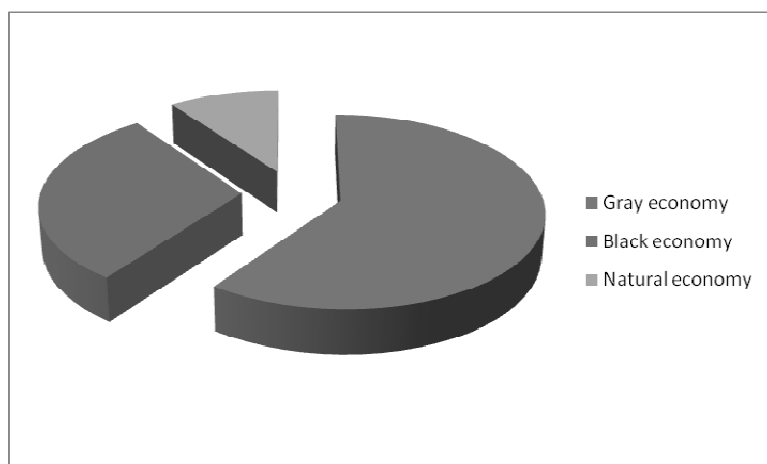


Clearly, in the national and global economy there are specific sectors in which the shadow activities have a negative effect for the economy as a whole. Such is the monetary sector (the sector dealing with money circulation), where in the absence of strict control the shadow economic practices are detrimental to the socio-economic system as a whole. Next one is the ownership of means of shadow economic activities or legalizing incomes generated through such activities mostly in the sectors of trade and catering, real estates, production and extraction of raw materials, construction, agriculture, leasing of state-owned property, etc. The foreign sector is particularly sensitive to the effects of the shadow economy when it is used for legalization of illegal incomes. The success of shadow economy activities depends on the specific characteristics of the commodities and services market, which is affected by the existing gray, black and natural aspect of the shadow economy (tax evasion, evasion of social security contributions, smuggling of goods, etc.)

The literature⁶ on the shadow economy also uses a plethora of appellations such as «hidden economy», «illegal economy», «unrecorded economy», «unreported economy», «gray economy», «black economy», «underground economy», etc., which are closely related and/or synonymous terms. However, most studies on the shadow economy focus on its three main forms – the natural economy, the black economy and the gray economy (see Figure 2).

Figure 2

Forms of unofficial (hidden) economy



The official economy includes all legal and officially reported activities in full contrast to the black economy, which applies to all illegal and unreported activities. Grey economy refers to all business activities which, while legal, are unofficial, unauthorized, or unreported. Natural economy includes legal but unrecorded economic activities. Thus, the shadow economy can be subdivided into «natural», «black» and «gray» economy, in which economic activities are not recorded officially, with a predominant share of the gray economy.

⁶For more details see: Buehn, A., Schneider F., «Corruption and the Shadow Economy: A Structural Equation Model Approach» IZA DP No. 4182, 2009; Куманова А., Манолов В., Понятието «скрита икономика» – основни подходи при неговото статистическо обхващане, сп. Статистика, бр.2/1996 г.; Garcia-Bolivar, O., «Informal economy: is it a problem, a solution or both? The perspective of the informal business», 2006.

The usual gray economic activities are associated with unreported earnings to evade taxation, unregistered employment contracts for employees to avoid personal and corporate income taxation, customs duty evasion, evasion of social security contributions, and failure to record and report economic activities, etc. The scope of the shadow economy includes illegal activities such as production and distribution of products and services prohibited by law as well as production activities that are generally permitted by law, but are conducted by unauthorized entities (e.g. organization of gambling without a license, production and sale of unlicensed audio and video copies and printed media, software piracy, etc.) It is not difficult to note that the core of the gray economy is formed in the black economy. Black economy, however, is connected mainly with drug trafficking and prostitution.

Natural economy⁷ includes household production of goods and services for personal consumption (maintenance and repair of movable and immovable property of the households themselves, home-based food processing and other activities for the use of the household itself or their friends and relatives) that are not market-oriented, are not paid for and are not reported. Despite the potential risks of these hidden economic practices, the fact that they exist means that to a certain extent they are considered normal. In terms of the global financial and economic crisis, the natural economy in Bulgaria is considered social, the gray economy – business-related and the black one – criminal.

The growth of the informal economy is the result of the inefficiency of the legal economy and the state authorities. Its illegal nature, however, aggravates the socio-economic problems because it drains funds from the public sector, creates underground labour markets and unfair competition, increases the market risk and communicates a negative image of the country to its foreign partners, leads to corruption schemes, increases the crime level, etc.

In fact, it is clear that the existence of shadow economy results from the existence of certain economic, administrative, legal and social factors. The main reason for the existence of hidden economic activities is unreported income (for tax-evasion purposes), followed by tax and social security evasion, legal regulations, the level of competence of the public administration, the state policy, the ineffective government control, etc. The analysis of various specialized and practical studies⁸ in this field shows that the shadow economy is due both to barriers to market penetration and the cost business activities (taxes, social security, etc.) Facing strong competition and stringent requirements for official economic activity, some economic agents decide to take the risk to «indulge in hidden economic activities».

⁷ For more details see: www.csd.bg/fileSrc.php?id=10423.

⁸ For more details see: Център за изследване на демокрацията, «Скритата икономика в България», 2004; Schneider, F., Buehn A., *Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries*, University of Linz, Austria; Technische Universität Dresden, Germany, 2009; United Nations edition, *World Economic and Social Survey: In Search of New Development Finance* 2012.

The high level of unemployment is the key factor for the existence of the shadow economy which distorts the indicators of the labor market. The cases of people employed without social security coverage or a coverage on the minimum wage as well as full-time or temporary employment without labour contracts (with the employer concealing the actual number of employees), misreporting of activities and incomes received by paying wages higher than the formally declared and officially reported ones, misreporting the actual type of employment through contracts for other types of job, etc. In most cases the main reason for misreporting of the actual type of employment is both the employers' and employees' desire to avoid the mandatory payment of taxes and social security contributions. In practice employers' official records do not indicate the actual number of employees and no labour contracts are signed (employees are hired through informal agreements about their remuneration and job obligations), unemployed who are not entitled to compensation are hired without employment contracts and for the minimum wage, etc. Other techniques for misreporting of employment are the non-compliance with the government standards and regulations (minimum wages, hours of work, job security) as well as failure to register the employees by filing the required administrative documents.

In fact, hidden economy overcomes some of the negative consequences of the economic crisis such as the high unemployment and the low income rates. As far as it can be considered positive, the hidden sector of the economy boosts its dynamics and efficiency, increases the level of competition and limits for state intervention in the economy. Furthermore, the informal economy contributes to the creation of markets and increases the financial resources of its agents. However, this does not mean that the underground economic activities have positive effects only. The shadow economy agents cannot officially register their financial results and thus have limited borrowing credibility. Moreover, they must carefully choose their business partners. Another fact worth mentioning is that hidden economic activities are related to additional costs because they require qualified financial personnel and maintenance of parallel cover accountancy systems. In this situation, each agent should take into account the potential risk of state sanctions, which means additional costs. Moreover, the hidden economic activities restrict the access of the underground economic agents to public services.

Hidden economic activities are known to have a serious effect on economic growth, productivity, competitiveness, economic and financial state policy. Shadow economy can be considered an indicator of a serious shortage of confidence in the existing social order and rules governing the formal economy as well as a dwindling support from the official institutions for the economic agents, which is in turn a prerequisite for increase of the volume of underground economic activities. Thus enhancing the quality of public services means that informal firms would have an incentive to move to the formal economy in order to enjoy them. Hidden economic activi-

ties result in less revenues to the state budget⁹, which does not allow the government to provide quality public services – healthcare, education, social security and services, defense and public security, public order and justice, maintenance and development of the infrastructure and the related institutions. By no means should we also ignore the fact that much of the income generated in the informal economy in fact flows into the formal economy, i. e. it creates value.

Therefore, in the short run, hidden economy has a positive impact on the economic system as a whole – tax evasion frees additional resources for investment or consumption, which can stimulate economic growth. It also ensures a certain level of consumption of goods and services at affordable prices, which reduces the level of inflation. On the other hand, however, there are difficulties related to the legalization of incomes generated by the shadow economy. Some of them are transferred abroad, while those that remain in the country and are successfully implemented in the formal economy are used for imports of goods and services rather than domestic consumption. Therefore, in the long run the underground economic activities have negative consequences for the social development and the national economy. In this respect the shadow economy is seen as part of an evolutionary process leading to an increase in the dynamics of the economic and social development. On the other hand, in the long run a society could not accept non-compliance with its regulations and a trend of increase in the level of shadow economy is a warning for a growing resistance to the existing business regulations.

Shadow economy is measured and reported through various research methods. Direct methods¹⁰ are often used on a microeconomic level and are based on data for individual economic agents engaged in hidden economic activities. A commonly used method are representative surveys of hidden economic activities which provide information about confirmed commitment to hidden economic activities and subjective assessment of the scale thereof. Direct methods also include surveys of time budgets which provide information about the time people spend to perform various activities, including both formal work and unreported economic activities. Tax audits are another direct method to measure the shadow economy. They measure the difference between reported incomes and actual incomes estimated through verification.

Indirect methods¹¹ are based on macroeconomic indicators that show the volume of shadow economy. They use official information about the level and dynamics of different natural and value-based economic indicators to estimate its size, structure and dynamics. Commonly used indirect methods are estimates of the shadow economy through consumption of electricity, monetary approaches to measuring its relationship with the circulation of money («contract-intensive-

⁹ For more arguments see Figure 6/part II, based on data from:

www.epp.eurostat.ec.europa.eu.

¹⁰ www.minfin.bg/document/9726.

¹¹ *ibid.*

money», i. e. the ratio of cash held outside banks to the total money supply, aka «broad money»), GDP statistics, etc. There are econometric models which show the dynamic relationships between multiple variables and the size of the shadow economy through the use of indicators. Indirect methods produce summary estimates of the size of the shadow economy, but do not specifically assess its scale, structure, trends, etc.

II.

A survey published by the European Commission¹² (EC) regarding the levels of tax fraud and tax evasion in the 27 member-states of the European Union (EU) in 2011 ranks Bulgaria first with «unreported economic activity» volume of 32.3% of its GDP. According to the survey the volume shadow economy in Bulgaria is comparable to that in Romania, Lithuania and Estonia, where it is about 30% of GDP, but far off the average EU level of 19.2%.

In comparison, Greece with its destabilized economy ranked ninth in 2011 with a shadow economy volume of EUR 52.2 bln. (24.3% of GDP). Among the EU member-states Austria has the lowest level of shadow economy (7.9% of GDP), followed by Luxembourg and the Netherlands with shadow economies below 10% of their GDP. These figures are indicative for the size of scale of shadow economy activities in the individual EU member-states.

What is the situation in Bulgaria? The crisis has changed the dynamics of the hidden economy in Bulgaria. In the period up to 2008, there was gradual but steady decrease in all its manifestations (see Figure 4) monitored by the European shadow economy monitoring system of – from 35.9% in 2003 to 32.1% of GDP in 2008. In the aftermath of the global financial and economic crisis the revival of the official economic activity in 2009 caused a slight increase in the size of the shadow economy to 32.5 percent. This trend continued in 2010 when its size reached 32.6% of GDP and reversed in 2011 (32.3%).

Despite the downturn in 2011, Bulgaria ranks first in the EU in terms of hidden economic activities. Moreover, since its accession to the EU, Bulgaria has maintained a level of the informal economy of 32% of GDP compared to the EU average of slightly below 20%. The informal economy in Bulgaria in 2011 reached a third of its GDP, which means that over BGN 20 bln. were unreported. Although Bulgaria has the lowest tax rates in Europe, the level of its shadow economy remains high due to the lack of mutual benefit for the economic agents to participate in the official economy.

¹² For more details see: European commission, Communication from the commission to the European parliament and the Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries, 27/06/2012.

Figure 3

Shadow economy in the EU member-states in 2011 (% of GDP)¹³

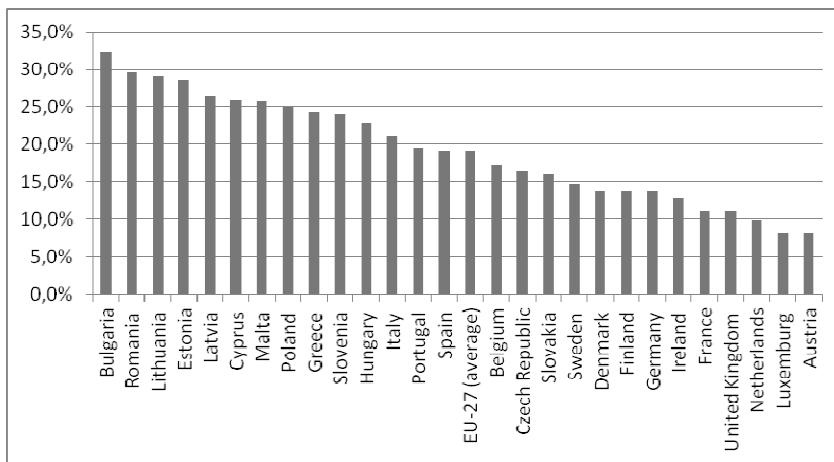
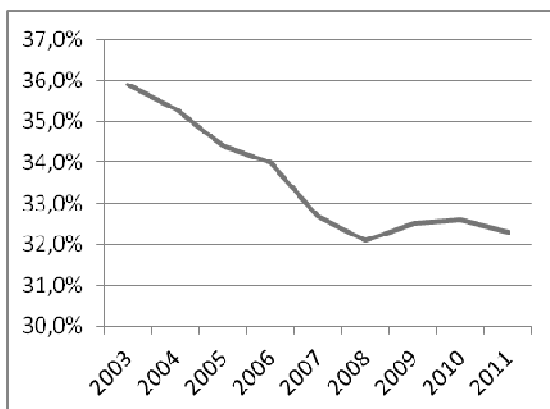


Figure 4

Shadow economy in Bulgaria for the period 2003–2011 (% of GDP)¹⁴



¹³ The figure is based on data from Schneider, F. (2011), «Size and development of the Shadow Economy from 2003 to 2012: some new facts».

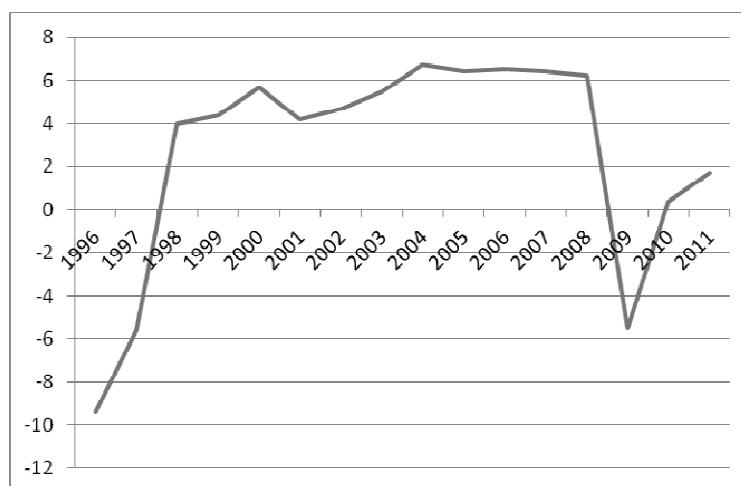
¹⁴ The figure is based on data from Schneider, F. (2011), «Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2011».

The global financial and economic crisis the beginning of this century affected negatively the economic growth of Bulgaria's economy for over ten year (see Figure 5) with economic growth rates in the period 2008–2009 similar to those of the 1997–1998 crisis in terms of GDP. The period until 2008 was characterized by an increase in the values of state budget revenues and foreign investment, which automatically resulted in employment growth to over 70% of the economically active population of the country in the period 2007–2008. Due to the crisis, in 2009 Bulgaria's budget revenues (including those of taxation) decreased (see Figure 6) and this trend remained until 2011, when they accounted for slightly more than 30 percent of the country's GDP. The foreign trade operations also shrank due to the crisis, mainly in terms of the volume of Bulgaria's exports. Instability in the banking sector resulted in a sharp decline in lending in late 2008, which resulted in contraction of both production and consumption of the economic agents in the country.

The complicated macroeconomic environment in Europe, the current socio-economic policy of the government and the rise of the unemployment level in Bulgaria (see Figure 7) are factors that facilitate the increase of the share of informal employment. Presently there are many evidences that labour and capital resources in Bulgaria are used inefficiently, which is indicative for the existence of hidden economy.

Figure 5

Economic growth in Bulgaria, 1996–2011 (% of GDP)¹⁵



¹⁵ The figure is based on data from www.epp.eurostat.ec.europa.eu

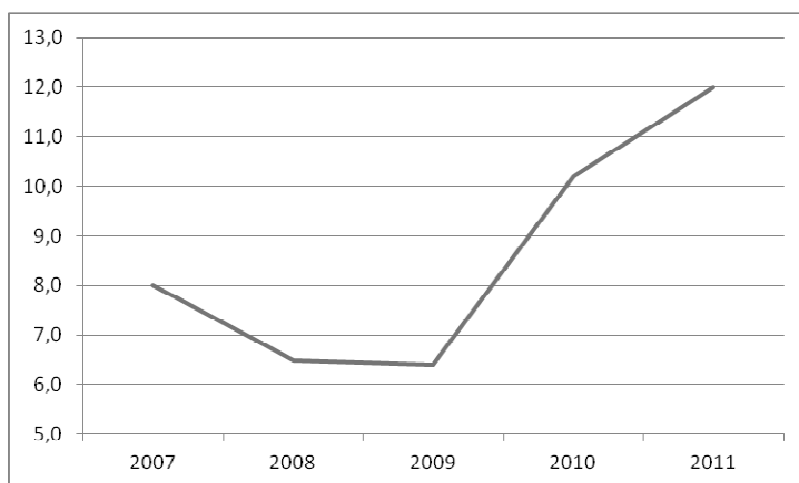
Figure 6

Bulgaria's state budget revenues in the period 1995–2011 (% of GDP)¹⁶



Figure 7

Unemployment rate in Bulgaria in the period 2007–2011 (active population above 15 years of age/first quarter data)¹⁷



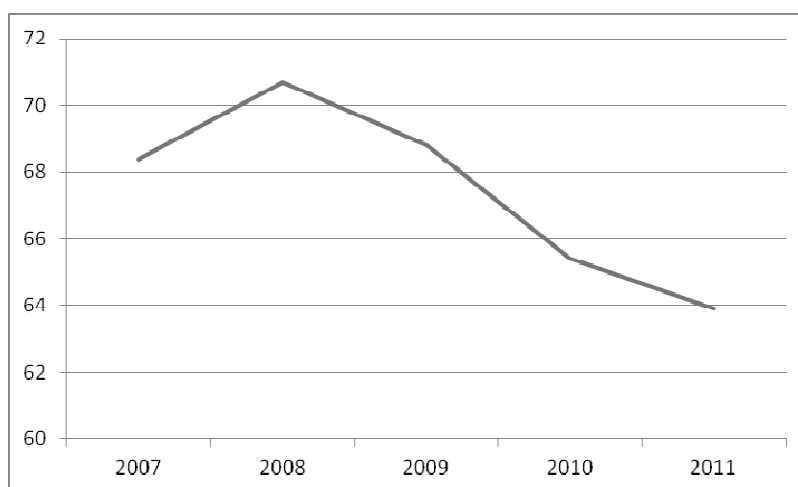
¹⁶ The figure is based on data from: www.epp.eurostat.ec.europa.eu

¹⁷ The figure is based on data from: www.nsi.bg

In 2011 the employment rate decreased sharply to 64% (see Figure 8), and the official unemployment doubled reaching over 12% in the first half of 2012. On the grounds of the official employment and unemployment statistics we may claim that over 20% of the economically active population is employed by the shadow economy, which raises serious concerns for a long and slow recovery of the economy without rapid improvement in the level of employment.

Figure 8

Employment rate in Bulgaria in the period 2007–2011
(active population above 15 years of age/first quarter data)¹⁸



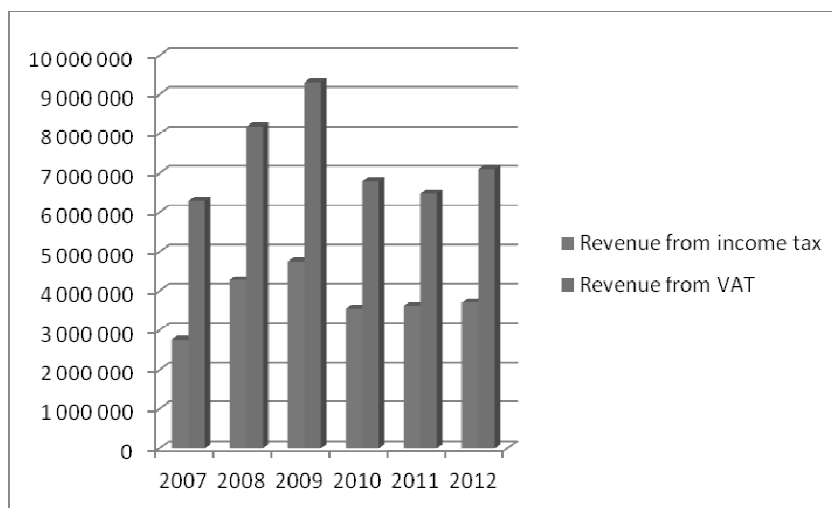
Practice points to the fact that in some sectors Bulgarian business has resorted to the shadow economy to survive the economic crisis. The figures quoted above show that the shadow economy in Bulgaria must be monitored counteracted constantly in order to prevent its disruptive effects. Regardless of the differences in the methods applied, the size of the hidden economy in Bulgaria since 1990 is estimated to range between 10% and 35% of GDP, affecting mostly the sectors of building construction, tourism, healthcare, agriculture and services, and less the production sectors (mostly the sectors producing excise

¹⁸ The figure is based on data from: www.epp.eurostat.ec.europa.eu

goods), the textile and the transportation sectors.¹⁹ Along with phenomena such as corruption, the gray economy in Bulgaria continues to grow – a fact confirmed in the State Budget Law (2007–2012)²⁰ in which the expected revenues from income taxes (corporate and individual) and value added tax (VAT) (see Figure 9) show a gap between the incomes of economic agents and their consumption as VAT indicates the increase in final consumption. Therefore we may assume that the additional resource for consumption will be covered by the hidden economy, i. e. the labor market in the hidden sector is expected to grow.

Figure 9

Fiscal revenues (income taxes and VAT) according to Bulgaria's State Budget Law 2007–2012 (in BGN thousand)²¹



Due to imperfect legal regulations, corruption, inefficient government control, inadequate public administration, lack of penalties for illegal economic activities, inefficient judicial system, the presence of organized crime, lack of long-term government policy to counteract the hidden economic practices and other fac-

¹⁹ For more details see: «Скритата икономика в България», Център за изследване на демокрацията, 2004.

²⁰ www.minfin.bg.

²¹ The figure is based on data from: www.minfin.bg.

tors, the state is considered the major factor for the existence of hidden economy. According to a research²² conducted by the World Bank among Bulgarian companies in 2007, the shadow economy ranks first among the barriers to corporate investment in Bulgaria.

The methods used to estimate the hidden economy in Bulgaria are based on the assumption that the unreported economy includes all cash transactions made in order to avoid tax liabilities. They give rough idea especially on the structure of the hidden sector and the importance of various aspects of the problem – unreported incomes, unreported turnovers, unreported labour, unrecorded sale of household farm products, etc. In general, none of the known methods for estimation of the hidden economy (based on the system of national accounts, electricity consumption, a process known as «mirror statistics», etc.) can provide an absolutely accurate estimation of the share of the informal sector, but gives a rough idea of the proportion of the unrecorded economy and allows to monitor the dynamics of the problem.

One of the indicators used most often by the National Statistics Institute (NSI) to measure the shadow economy is the share of the unreported GDP in the value of the official index. This indicator is monitored since the beginning of the transition period and the results published by the NSI show that hidden economy existed in Bulgaria in the period from 1990 to 2010.²³ (see Figure 10).

Although the National Statistics Institute covers the hidden economy in the national accounts only partially, its findings send a clear signal that the informal economy is a major challenge to the economic development of Bulgaria. The size of the hidden economy in Bulgaria reported by the national statistics for the period until 2000 were in the range of over 30% (32.2% in 1990, 34.4% in 1996, and 30% of GDP in 1998, calculated on 1989 base) and have been decreasing ever since. During the period 2001–2002, the informal economy estimated by the NSI experts was 14.7% of GDP, after which it slightly increased to 14.8% in 2003 and from 2004 to 2010 the hidden economy in Bulgaria decreases steadily at a rates between 2.8 and 4.8% in 2005 (14.8%) to 2010 (10 to 12%). According to the estimates of the National Statistical Institute, the hidden economy in Bulgaria for the period 1998-2010 was reduced by about 20%.

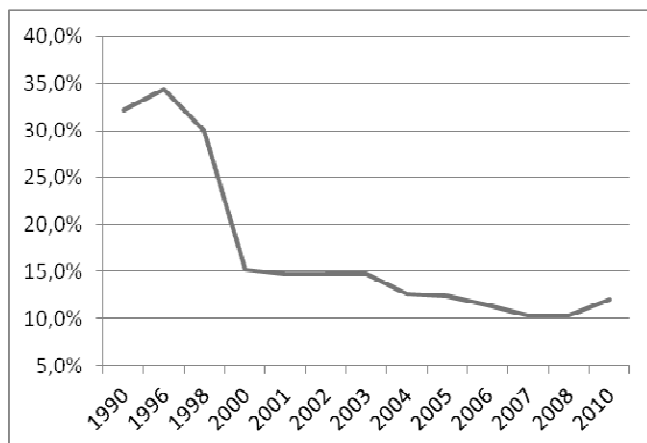
Unlike the NSI, in 2010 the employers' organizations reported a hidden economy level of over 50-60% of GDP. The discrepancy in these estimates is due to the fact that NSI reports the cost of goods in BGN in the country in terms of GDP in the informal sector, while the various professional organizations, sociologists and NGOs mostly conduct surveys focused on specific sectors.

²² For more details see: Център за изследване на демокрацията, «Динамика на скритата икономика в България по време на криза», 2011

²³ Since 2000 the NSI applies the EUROSTAT methodology to measure the unofficial economy. See: www.nsi.bg; www.epp.eurostat.ec.europa.eu/portal/page/portal/statistics

Figure 10

Hidden economy in Bulgaria in the period 1990–2010 according to NSI data (% of GDP)²⁴



In this context, the National Center «Business to the Rules» publishes the composite index «Business to the Rules»²⁵, which shows that the share of the official economy in Bulgaria has grown from 63.97 points in 2010 to 67.40 points in 2011²⁶. Generally, the composite index (through its constituent indices) measures the percentage of the country's legal GDP. The surveys of the centre show that in 2010 the share of the hidden economy in the country was slightly above 36%. According to the National Centre the sectors of tourism, building construction and healthcare have the highest share of gray economy – about 70%. The sectors of mechanical engineering and postal services have the lowest levels of gray activities. The index for 2011 reports a decrease of the hidden economy in Bulgaria in the retail sector, while its level in the sector of services remains high. The hidden economy levels reach 50 to 60% in the sectors of building construction, tourism and healthcare. The levels in the sectors of mechanical engineering and postal services remain low (10–12%).

²⁴ The figure is based on data from: www.nsi.bg.

²⁵ In 2008 the Bulgarian Industrial Capital Association (BICA) and the National Center «Business to the Rules» started measuring the formal economy with the «Business to the Rules» index. The main method of measurement is through surveys, the results are based on the opinions and estimates of population and employers about the share of the shadow economy in the country.

²⁶ <http://www.bica-bg.org/index.php?id=1077&lang=BG>.

The discrepancy in the levels of the shadow economy measured by the «Business to the Rules» index and the index of the evaluation of NSI is explained by the fact that sociologists estimate the frequency of occurrence of gray practices rather than their importance in terms of value, while the NSI estimates how much they would add to the GDP of the country if they were reported. The methodology used by the NSI and the one used in for the composite index are quite different, but both indices provide important information.

In 2011 the Ministry of Finance published an analysis²⁷ according to which the share of the gray economy in Bulgaria measured by the method of energy consumption was about 20% of GDP after 2000. According to a survey²⁸ conducted by the consultancy firm A. T. Kearney on request by Visa Europe, in 2010 the informal economy accounted for 37.7% of Bulgaria's GDP. According to a survey²⁹ conducted by Tax Research UK, about EUR 12.7 bln. or 35.5% of Bulgaria's GDP in 2009 was not subject to taxation, which ranks our country first in terms of hidden economy in the European Union (the average level for the EU being 20%). Thus Bulgaria cannot collect fiscal revenues exceeding its health-care budget.

In 2008 the Centre for the Study of Democracy (CSD) used opinion polls conducted by Vitosha Research to calculate an index³⁰ of the hidden economy in Bulgaria, which showed that the share of the unofficial economy in the country was between 20 and 35% of its GDP³¹. At the end of 2009 CSD reported that the greatest volumes of unreported labour costs existed in the sectors of services and retail trade.

Figure 11 shows the estimates of the hidden economy in Bulgaria in 2010 based on the analyses conducted the various institutions that are by no means unanimous in their estimates but this is due to the fact that they use different survey methods. According to these institutions, the share of the informal economy in Bulgaria varies widely (12% – 37%) – from 12% according to the NSI, through 32.6% according to the survey of the hidden economy in the EU³² conducted by Prof. F. Schneider) to 37.7% according to A. T. Kearney consultancy and 36.03%

²⁷

<http://bnr.bg/sites/horizont/Shows/Current/BeforeEveryone/Economy/Pages/2710cid.aspx>

²⁸ For more details see: A. T. Kearney, The shadow economy in Europe, 2011.

²⁹ <http://profit.bg/news/Tax-Research-UK:-40-siva-ikonomika-v-Bulgariya//nid-88658.html>;
<http://www.taxresearch.org.uk/Blog/reading/>

³⁰ In 2002 the Centre for the Study of Democracy (CSD) and the sociological agency Vitosha Research created an index of the hidden economy which tracks the dynamics of the hidden economy in Bulgaria on an annual basis through national representative opinion polls among the population and business entities.

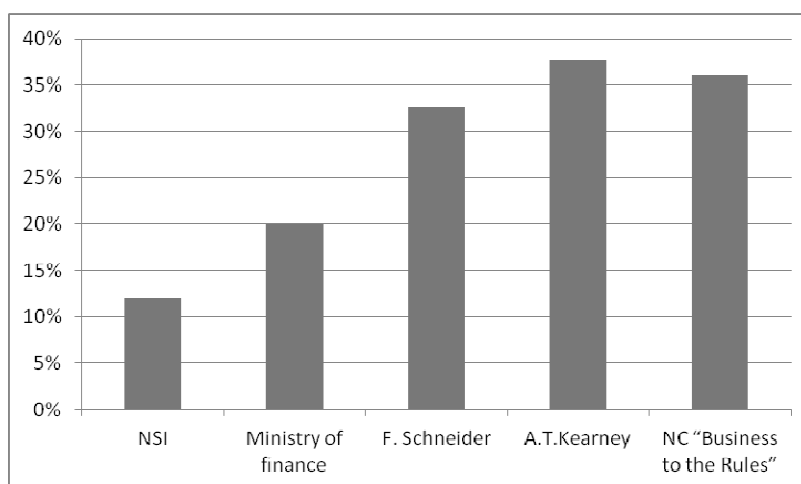
³¹ The Hidden Economy Index is available at <http://www.vitosharesearch.com/artShow.php?id=5486>.

³² Schneider, F. (2011), «Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2011».

according to the National Center «Business to the Rules». It is worth noting that the level of hidden economy measured and presented using the methodologies adopted by the government institutions are lower than that measured by private institutions. Of course, in the interest of the government is to show a better performance of the economy it controls, but the alternative studies that clearly indicate a significant level of hidden economy in the country should also be taken into account.

Figure 11

**Bulgaria's gray economy in 2010 according to various institutions
(% of GDP)³³**



Regardless of the differences in the above estimates, it is clear that Bulgaria lacks an adequate policy to reduce the level of its hidden economy as well as an effective system for assessment and evaluation of the impact of proposed action against the underground economic practices. Shadow economy is a restrictive factor for attracting foreign investors, because they require not only fa-

³³ The figure is based on data from <http://www.bica-bg.org/index.php?id=1077&lang=BG>; Schneider, F. (2011), «Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2011»; A. T. Kearney, The shadow economy in Europe, 2011; www.minfin.bg; www.nsi.bg.

avorable taxation and low social security costs but also stability, transparency and predictability in order to avoid potential risks and uncertainties. There is an increasing trend of growing inter-company indebtedness, which triggers a chain reaction of indebtedness and drives many business entities to the informal economy. The widely proclaimed efforts of the control authorities to combat the shadow economy and the numerous incidences of breaching the national legislation related to unreported business activities are stark examples of the scale of the problem faced by the government's financial policy. The control measures taken and the lack of long-term effect thereof are a sound argument that alternative solutions should be sought because the informal economy is a major challenge to economic development.

Since 1999 Bulgaria has been implementing not only institutional reforms but also various ambitious preventive measures to reduce the shadow economy, but very few of them, however, have had a lasting effect on the share of the shadow economy. Most of these measures were limited to changes in the Labour Code and the Law on Compulsory Social Security (regarding the control over employment and incomes), the Law on Corporate Income Tax and the Law on Taxation of the Income of Natural Persons (regarding the control over transformations of legal entities and the control over direct and indirect taxation – taxes on the sale and purchase of real estate properties, electronic excise reporting). The result is the Act on Restriction of Cash Payments, cancellation of the existing economic regimes³⁴, adoption of lower tax rates and social security contribution rates, control procedures, etc.

In comparison the best international practices advocate fewer but more effective measures for combating the shadow economy. In this context, the European Commission (in a communication³⁵ published in 2012) proposes a series of national and supranational measures against the informal economy, including improving the administrative capacity to collect taxes, the introduction of a tax identification number, establishment of a quick reaction mechanism on VAT frauds and common minimum penalties for tax fraud and tax evasion.

The analysis of the hidden economy in Bulgaria and the lack of effects from the measures undertaken to curb it are solid proof that the illegal economy remains a major challenge for the government's financial policy. In this respect, the responsible state institutions should analyze the best international practices in terms of the specific characteristics of Bulgaria's economy and develop and implement adequate and effective policies to fight the hidden economic activities

³⁴ For more details see: Антикоруptionните реформи в България, Център за изследване на демокрацията, 2005.

³⁵ For more details see: EUROPEAN COMMISSION, COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries, 27/06/2012.

in the country. More specifically, the efforts of the state should be focused in the following priority areas:

- Development of a transparent and coherent set of policies for each of the main manifestations of the hidden economy, along with an estimate of the expected impact of the implementation of the projects, programs, activities, and measures included therein and the potential risks related to their implementation/ failure.
- Development of a system for monitoring the effectiveness and efficiency of the policies and evaluation of implemented programs and activities through implementation of best practices and successful mechanisms for reducing the shadow economy.
- Adoption of rational changes in laws and regulations, and the establishment of effective mechanisms for monitoring of their implementation and the enforcement of legal sanctions.
- Optimization of the activities of state institutions and administrative bodies (including with respect to control and judicial authorities) through a system for monitoring and evaluation of the performance of state authorities and public administration capacity, assessment of potential risks, administrative and operational control over the activities of state institutions.
- Improving the quality of public services to meet the requirements of the economic agents and restoring the confidence in the state institutions in order to reduce the volume of hidden employment and informal economy.
- Constant interaction between the state and the economic agents in order to create effective state institutions and reduce the administrative burden on legal economic activities.
- Implementation of adequate information technologies for control over a range of key categories, sectors and areas of the national economy in order to detect and sanction economic agents engaged in hidden economic activities.
- Establishment of a system of incentives to transform the informal economic activities into formal ones. In certain cases such incentives would have a better effect in terms of reducing the shadow economy than legal sanctions.

* * *

Shadow economy is an indicator for the lack of trust in government's financial policy and the inefficiency of the national economic policy. At the same time shadow economy practices affect negatively the economic growth, the efficiency of labour, the competitiveness and the economic and financial policy of the state.

The fact that the volume of the hidden economy in Bulgaria is alarmingly high calls for implementation of a completely new and rational state policy to counteract its various manifestations. On the other hand, in the period of a global financial crisis and the subsequent recession, the shadow economy was a «means of last resort» for some economic agents. In this regard, in order to achieve sustainable results in reducing the manifestations of the hidden economy, we have to constantly assess the degree of perfection of the existing national regulations, the effectiveness of government policy and the efficiency of its implementation by the state administration as well as the level of public awareness. Shadow economy will always exist unless the rational expectations of the economic agents are economically substantiated and justified.

Bibliography

1. Белев, Б. The Informal Economy in the EU Accession Countries, publ.: Център за изследване на демокрацията, NBKM, 2012.
2. Куманова А., Манолов В., Понятието «скрита икономика» – основни подходи при неговото статистическо обхващане, сп. Статистика, бр. 2 / 1996 г.
3. Център за изследване на демокрацията, «Скритата икономика в България», 2004.
4. Център за изследване на демокрацията, «Антикорупционните реформи в България», 2005.
5. Център за изследване на демокрацията, «Динамика на скритата икономика в България по време на криза», 2011.
6. A. T. Kearney, The Shadow Economy in Europe, 2011, publ.: A. T. Kearney Inc., 2011.
7. Buehn, A., Schneider F., «Corruption and the Shadow Economy: A Structural Equation Model Approach» IZA DP No. 4182, 2009.
8. EUROPEAN COMMISSION, COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on concrete ways

to reinforce the fight against tax fraud and tax evasion including in relation to third countries, 27/06/2012.

9. Garcia-Bolivar O. E. «Informal economy: is it a problem, a solution or both? The perspective of the informal business», Northwestern University School of Law, Law and Economics Papers, USA, 2006.
10. Schneider, F. (2011), «Size and development of the Shadow Economy from 2003 to 2012: some new facts».
11. Schneider, F. (2011), «Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2011», Department of Economics, Johannes Kepler University, Austria, 2011.
12. Schneider, F., Shadow Economies and Corruption All Over the World: What Do We Really Know, Institute for the Study of Labor (IZA), IZA DP No. 2315, 2006.
13. Schneider, F., Buehn A., Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries, University of Linz, Austria; Technische Universität Dresden, Germany, 2009.
14. World Economic and Social Survey: In Search of New Development Finance 2012 United Nations edition, Department of Economic and Social Affairs, UN, New York, USA, 2012
15. www.minfin.bg.
16. www.epp.eurostat.ec.europa.eu.
17. www.nsi.bg.
18. <http://www.vitosharesearch.com/artShow.php?id=5486>.
19. <http://www.csd.bg>.
20. http://www.nationsonline.org/oneworld/third_world.htm.
21. <http://bnr.bg/sites/horizont/Shows/Current/BeforeEveryone/Economy/Pages/2710cid.aspx>.
22. <http://profit.bg/news/Tax-Research-UK:-40-siva-ikonomika-v-Bulgariya//nid-88658.html>.
23. <http://www.taxresearch.org.uk/Blog/reading/>
24. <http://www.bica-bg.org/index.php?id=1077&lang=BG>.
25. http://www.nationsonline.org/oneworld/third_world.htm.
26. www.csd.bg/fileSrc.php?id=10423.