



The Hidden Economy in Bulgaria after the Economic Crisis

Policy Brief No. 28, April 2011

The dynamics of the hidden economy is an important indicator of the state of a country's institutions as well as of its competitive potential. The hidden economy has a serious impact on private sector activities, the productivity and competitiveness of the workforce, on economic development and growth, as well as the social security and support systems of the country. According to different estimates about a third of the world's GDP is within the "shadow turnover". It is argued that the current financial and economic crisis will result in an increase in the hidden economy in most European countries.¹ The recent debt crisis in Greece has exposed drastically the need to better account for and to grasp the implications of the existence on large hidden economy on economic performance. This is even more pressing in the light of achieving Europe 2020 results and calculating each country's contribution to the European Stability Mechanism and the Euro Plus Pact.

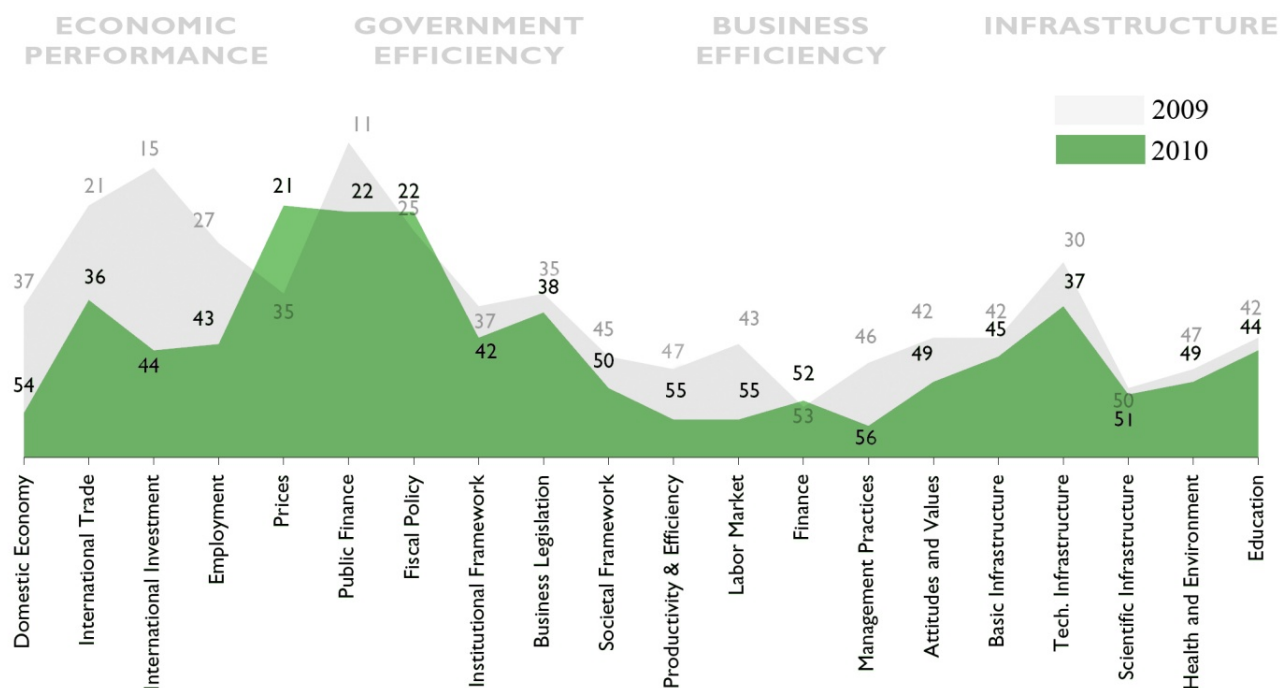
MAIN POINTS

- The hidden economy has grown among businesses, but declined among the population. The social cost of the economic crisis is a declining employment among the groups with the lowest qualifications.
 - There is a rise in cases involving tax evasion, avoidance of customs, fees, and excise duties, as well as VAT fraud. As businesses suffer through the recession, they become more likely to not declare part of their revenue and economic activities.
 - There is a slight decrease in the incidence of undeclared payments - in 2010, 11.6 % of the population reported having received a remuneration higher than the one stated in the contract with their primary employer .
- Governmental measures to reduce the hidden economy do not seem to have produced the desired results.
- The general economic situation and development are more important for the dynamics of the hidden economy than government control measures.

¹ Olga Pavuk, 2009, "Shadow economy in the Baltics and around the world," February 25, 2009, Riga.

Figure 1. Competitive Landscape of the Bulgarian Economy

(numbers show the position of Bulgaria in the ranking of 58 economies)



Source: World Competitiveness Yearbook, IMD, 2009 and 2010.

Recent Economic Developments and Hidden Economy Prospects

In Bulgaria the pre-crisis period was characterized by a sharp increase in revenues (especially tax revenues on goods and services) and large capital inflows that fueled employment growth between 2001 and 2008. Yet in 2009, tax and non-tax revenues slumped, with only a few Baltic countries experiencing higher revenue losses than Bulgaria.² As Bulgaria's trading partners suffered through the recession, the volume of exports fell (especially at the end of 2008 and the first quarter of 2009) and the credit boom came to an end in 2009, with credit flows coming to a halt in the fourth quarter of 2008. The latter affected businesses and households alike, and in 2009 the full impact of the above shocks manifested itself in a drop in the

² Reports show an increase in total employment by 20 percent during the period, largely owing to the construction, real estate, wholesales, and financial service sectors.

country's GDP for the first time since the crisis in 1996-1997.³ As a result employment slumped, unemployment rose sharply and consumption declined leading to fears of protracted jobless recovery in 2011 – 2012.

Together with Latvia and Lithuania, businesses in Bulgaria saw the largest declines in sales, while the share of businesses that have accumulated debt or were behind in their financial obligations increased during 2009 to 2010.⁴ There are warning signs for an increase in the number of "non-performing" loans across all sectors (i.e. corporate, consumer, and mortgage), and the International Monetary Fund forecasts an upsurge in the ratio of "bad and restructured" loans by 4 to 6.5 percentage points in

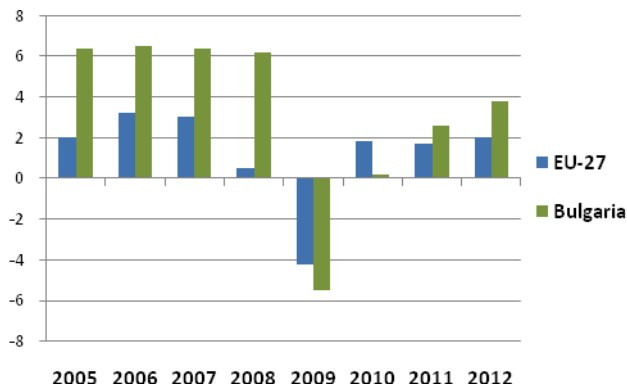
³ IMF Country Report No. 10/159.

⁴ World Bank, 2010, "The Impact of the Global Economic Crisis on the Corporate Sector in Europe and Central Asia: Evidence from a Firm-Level Survey," Enterprise Surveys Enterprise Note Series.

2010 and up to 1 percentage point in 2011.⁵ It is yet unclear when and how these non-performing loans will affect the economy but there are signs that the excess capacity they leave weigh on the economic recovery, which started in the second half of 2010.

While capital inflows and investments are expected to even out at levels below the “boom years”,⁶ the expectations are for a slow but gradual recovery of the Bulgarian economy. Signs of recovery were already evident in the second quarter of 2010, when a rebound in exports significantly reduced the pace of contraction in real GDP. In spite of the existing depressed consumer confidence that negatively affects domestic demand, a slight economic improvement is forecasted, with real GDP growth turning positive in 2010⁷ (see Figure 2 below), current account deficit declining further,⁸ and inflation remaining moderate.⁹ Moreover, a more visible recovery is expected in 2011, with real GDP growth to 2-2½ percent (Figure 2) primarily driven by external demand.¹⁰

Figure 1. Real GDP Growth (% change on annual basis)



Note: data for 2011 and 2012 are estimates.
Source: Center for the Study of Democracy using data from Eurostat.

⁵ IMF Country Report No. 10/159.

⁶ Ibid.

⁷ Both Eurostat and IMF forecasts foresee a real GDP growth between 0 to 0.4 percent in 2010.

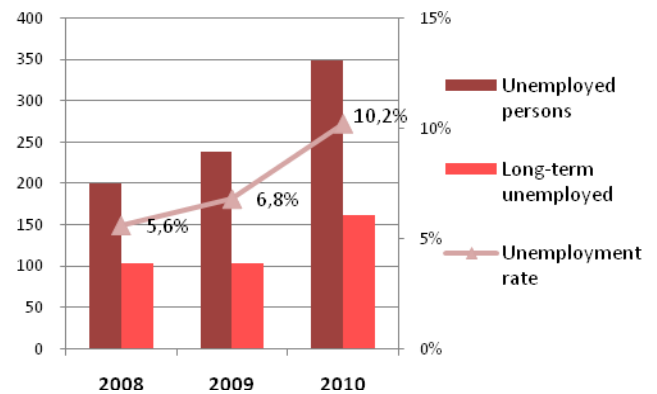
⁸ According to the IMF, coming to just below 3 percent of the country’s GDP by the end of 2010.

⁹ IMF, 2010, Bulgaria—September 2010 Staff Visit, Concluding Statement, Sofia, October 5, 2010.

¹⁰ IMF, 2010, Bulgaria—September 2010 Staff Visit, Concluding Statement, Sofia, October 5, 2010; see also Eurostats’ estimates.

The recent financial and economic crisis affected the real economy of European countries, in terms of both GDP and employment.¹¹ According to the World Bank (2010), the drop in “average permanent employment” was greatest in Bulgaria. During the third quarter of 2010, the share of employed persons (15 years and over) out of the population (of the same age group) was 47.5%. Compared to the same period in 2009, the number of employed persons dropped by 175.8 thousand and the correspondent drop in the employment ratio was 2.3 percentage points. During the same quarter of 2010, the share of unemployed persons was 9.5% of the economically active population, an increase of 2.8 percentage points from the third quarter in the previous year. The latter translates into an addition of over 92 thousand unemployed individuals in the third quarter of 2010, compared to the same period in 2009.¹²

Figure 2. Number of Unemployed (in thousands) and unemployment rate (%) in Bulgaria



Source: Center for the Study of Democracy using data from the National Statistical Institute.

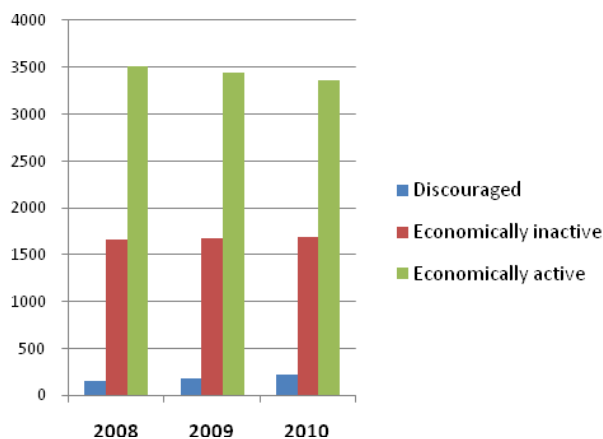
There seems to be a vast untapped potential among the share of the population that is of economically active age. A significant proportion of the population of active age (i.e. 15 to 64 years) is not

¹¹ Friedrich Schneider, 2010, “The Influence of the economic crisis on the underground economy in Germany and the other OECD-countries in 2010: a (further) increase.”

¹² The National Statistical Institute, 2010, “Key Indicators for Bulgaria as of 30.12.2010”: (<http://www.nsi.bg/KeyInd/KeyInd2010-12.pdf>).

productively employed leaving this human capital available for hidden economic activities, which traditionally have lower levels of productivity and higher rates of loss of qualification. As shown in Figure 4 below, the number of people of active age (15 to 64 years old) left outside the official labor market either because they declared they do not seek employment (economically inactive) or because they were discouraged increased in comparison to 2009 and reached approximately 1.69 million in 2010.

Figure 3. Workforce Dynamics (in thousands)

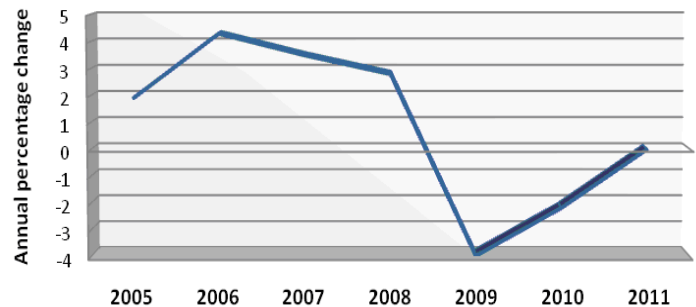


Source: Center for the Study of Democracy using data from the National Statistical Institute.

While the Bulgarian GDP is expected to grow again in 2011, the level of employment during the same year is likely to stagnate (see Figure 5 below). Unemployment may continue rising and remain higher than current levels as bankruptcy procedures kick in and enterprises considered viable in 2009 / 2010 are forced to leave the market. As it is unlikely that an economic boom similar to the pre-crisis period will occur, forecasts warn that a considerable time is needed before excess labor and resources are absorbed by other sectors in the economy.¹³

¹³ IMF Country Report No. 10/159

Figure 4. The Growth of Employment in Bulgaria (annual percent change)



Source: Center for the Study of Democracy using data from IMF.

At a company level, the crisis led to an increase in job loss, bankruptcy, and closure of businesses. Common measures adopted by firms in 2009 were the so-called “soft measures” (e.g. unpaid leaves, wage and work time reductions) aimed at preserving the business while also retaining selected employees.¹⁴ It was also associated with a quick shedding of undeclared labor. Companies dismissed workers without contracts immediately and stopped paying undeclared (envelope) wages, which led to a reduction in hidden economy in the end of 2009/15. In addition it can be expected that the firms operating in the informal sector will go out of business at a higher rate and quicker as a result of the crisis.

All of the above factors add up to a complex macroeconomic environment, in which it is realistic to expect a rise in the proportion of the hidden economy due to:

- A notable drop in businesses’ revenues that makes firms more likely to avoid taxes and reduce social security contributions so as to preserve their profit margins and

¹⁴ European Industrial Relations Observer (<http://www.eurofound.europa.eu/eiro/studies/tn1004019s/bg1004019g.htm>).

¹⁵ CSD Policy Brief 20, “Policies to Counter the Effects of the Economic Crisis: Hidden Economy Dynamics 2009.”

competitiveness on the market (or simply to avoid bankruptcy);

- A continuous increase of labor costs throughout 2010.¹⁶ Though considered normal given Bulgaria's relatively low pay levels compared to the EU average, in the context of the crisis such a tendency may lead to rising unemployment and a pressure to underreport employment and actual remuneration (thus also leading to a loss of social protection);
- In light of the increase in unemployment, it is expected that a number of people will attempt to make up for their loss of income in the formal economy through participating in the hidden economy;
- Shrinking business activity is related to a drop in state budget revenues. The latter may, in turn, translate into a poorer implementation of regulatory compliance, control, and audit procedures. In addition it may lead to increasing pressure on the state administration to "do something" to counter hidden economy through administrative measures, which usually is counterproductive.

The existence of hidden and illegal activities in Bulgaria is also related to the formation of organized crime structures and the establishment of informal social and economic systems. The price of entrepreneurship is high and is coupled with a heavy administrative burden, while consumer demand is weak and unsophisticated¹⁷, thus involvement in the informal sector becomes an important means for a business start-up. Moreover, informal employment in Bulgaria seems to be socially accepted.

¹⁶ As of the fourth quarter of 2010, the Labor Cost Index of Bulgaria marked the highest value in the EU – 126.7, against the EU-27 average of 105.4. Eurostat's labor cost index shows the short-term development of the total cost for employers, on an hourly basis, of employing the labor force (2008 = 100).

¹⁷ Bulgaria is the poorest member of the European Union, which means that other things being equal, the pull force of consumer demand is comparatively lowest in this country.

Hidden Economy Index 2010: Components and Dynamics

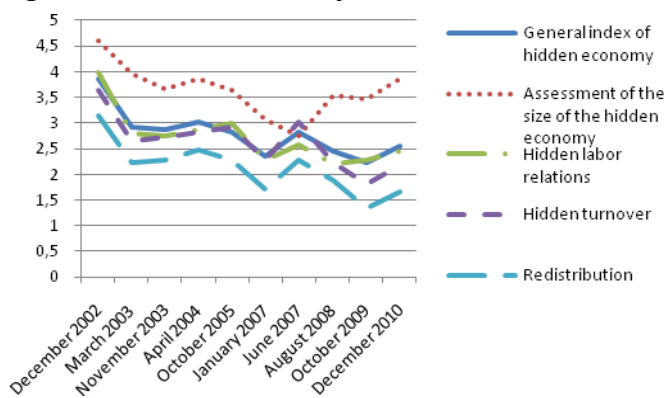
The current brief is a part of a series of studies commissioned by the Center for the Study of Democracy and carried out by Vitosha Research, which have been calculating and disseminating i) the hidden economy index of businesses and ii) the index of unreported economic activity of the population since 2002. Comparing the size and dynamics the Hidden Economy Index (for both businesses and the population) over time allows for assessing the actual impact of implemented policies to tackle hidden economic activities. Consistent with previous analyses, the 2010 Index includes the following elements:

- 1) The **size of the hidden economy** summarizes the subjective perceptions of business representatives of the scope of hidden economy in the country in general, as well as in their respective sectors.
- 2) **Hidden employment** captures the practice of hiring workers without formal employment contracts or under contracts with underreported remuneration (i.e. envelope wages).
- 3) **Hidden turnover** includes the incidence of various practices of concealing turnover in the respective industry or sector.
- 4) **Hidden redistribution** encompasses the practice of tax, customs and excise duty evasion or non-payment, as well as the existence of VAT fraud schemes.

The 2010 Hidden Economy Index for the businesses and the Index on Unreported Economic Activity of the population display opposing trends, which mirror the situation in 2009. While in 2009 a decrease in overall hidden economy was observed in the case of businesses vs. an increase in the index of unreported economic activity of the population, 2010 reveals the opposite trend. The overall index of hidden economy in the case of businesses (and all its components – i.e. hidden economy size, hidden labor relations, hidden turnover, and

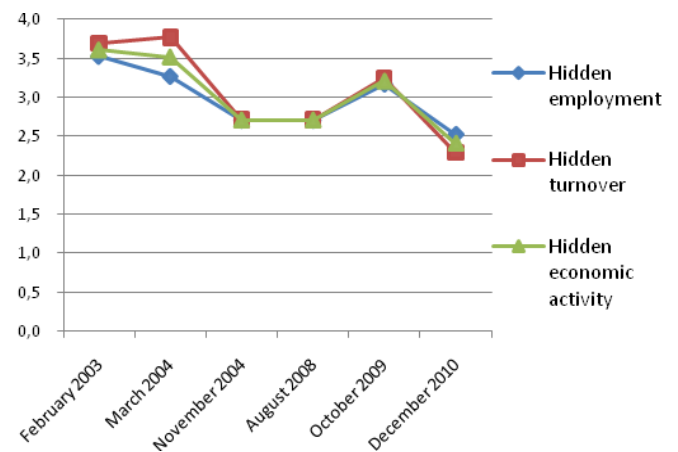
redistribution) was on the rise, while the index of unreported economic activity of the population (and all its components – i.e. hidden employment, turnover, and economic activity) actually decreased (Figures 6 & 7). These opposing trends can be explained through the different effects over time that the crisis has on the businesses vs. the population. As mentioned earlier, the notable drop in businesses’ revenues has likely prompted a process of laying off the share of employees with no formal contracts in an attempt to stay afloat in the beginning of the crisis in 2009. As the latter group has no legally binding relations to their employers, the termination of their employment seems to be a logical and simple step towards preserving the business’ profit margins. Furthermore, the fall of businesses’ revenues renders tax avoidance and reduction of social security contributions more, likely, which may, in turn, explain the increase observed in the case of the index of hidden economy for businesses. These results point out to the preeminence of economic and social policies in tackling hidden economy as compared to administrative and control measures, which seem to have been the instrument of choice for the Bulgarian government during the crisis.

Figure 5. Hidden Economy Index 2002-2010



Note: The 2008 Index values are based on telephone interviews. All other values are based on data from face-to-face interviews.
 Source: Hidden Economy Survey on Businesses 2010, Center for the Study of Democracy, Vitosha Research.

Figure 6. Index of Unreported Economic Activity of the Population 2003-2010



Source: Hidden Economy Survey on Population 2010, Center for the Study of Democracy, Vitosha Research.

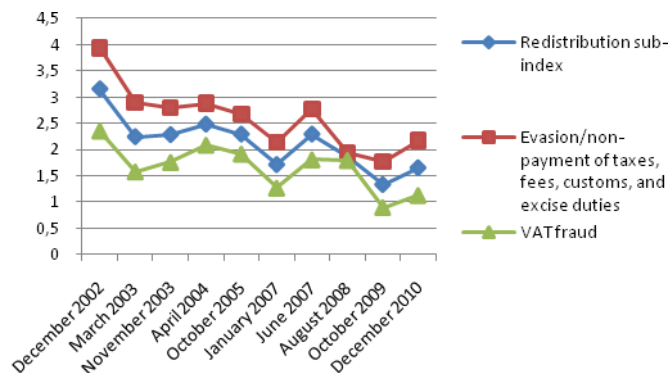
The dynamics of the sub-indexes reveal in a greater detail the actual trends in the hidden economy in Bulgaria, including the potential impact of government measures to counteract informal economic activities:

Tax Evasion and Avoidance of Fees, Customs, and Excise Duties

There has been a notable increase in sub-index “Redistribution” in 2010 (Figure 8), including a rise in the incidence of cases involving tax evasion, avoidance of customs, fees, and excise duties, as well as VAT fraud. This trend confirms the suggestion that, as businesses suffer through the recession, they become more likely to not declare part of their revenue and economic activities, so as to avoid paying for taxes and social security contributions. In addition it is likely that returning to business growth in 2010 has not been smooth but has rather occurred deal by deal, which has motivated businesses to resort to the more flexible and cost reducing practices of the hidden economy. It should also be mentioned that policy wise the results show that increased controls in 2009 and 2010 have not prevented the hidden economy from increasing. This comes at the backdrop of an unsound increase in excise duties in 2010, which has created huge smuggling pressure in some consumer markets, such as cigarettes. It is likely that publicly voiced and revealed

misunderstandings between the Ministry of Finance and the Ministry of Interior have additionally helped reduce the positive impact of introduced controls.

Figure 7. Dynamics of Sub-index Redistribution and its Components



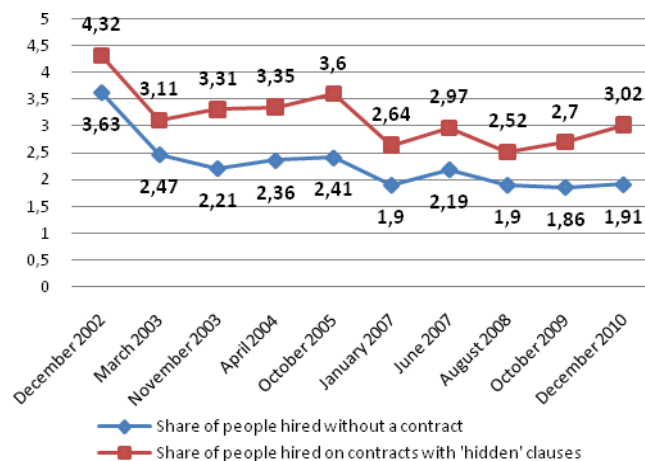
Source: Hidden Economy Survey on Businesses 2010, Center for the Study of Democracy, Vitosha Research.

Hidden Employment

As regards the population, and in line with the overall increase in official unemployment, the index results for 2010 confirmed that hidden employment has decreased in Bulgaria during 2010. Once again, a possible explanation is businesses' initial reaction to counteract the effects of the crisis on them, by laying off employees with no formal contracts. This, in turn, has also reduced the incidence of hidden economic activities among the population.

The practice of hiring of workers with no labor contract flattened out and saw little change from 2009 to 2010. However, instances of employment under a contract with hidden clauses (envelope wages) have been on the increase since 2008 (Figure 9). As mentioned above, in the context of a downturn, the fastest way to reduce costs to businesses is to terminate unreported or informal contracts first and then proceed to cutting down official employment and concealing a share of the officially declared remuneration. Thus, in the longer run, both business and population indexes on hidden employment are expected to converge and return to the general trend of decline in line with improving business climate and economic conditions.

Figure 8. Dynamics of the Indexes "Hired Without Contract" and "Hired Under Contract with Hidden Clauses" in the respective sectors over the period 2002-2010 (min = 0, max = 10)



Source: Hidden Economy Survey on Businesses 2010, Center for the Study of Democracy, Vitosha Research.

Table 1. Share of Employed under no Employment Contract under Primary and Secondary Employment (%)

(Share of those who responded with a "No" to the question "Do you have a signed contract with your employer?")

	February 2003	March 2004	August 2008	September 2009	December 2010
Without labor contract – primary employment	6.0	5.9	5.6	5.9	3.4
Without labor contract – secondary employment	77.4	59.1	51.48	50.96	38.1

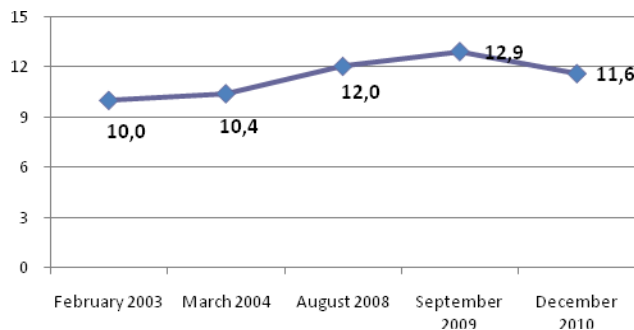
Source: Center for the Study of Democracy, 2010.

In 2010, 11.6 % of the population reported having received a remuneration higher than the one stated in their contract with the primary employer (Figure 10). This represents a slight decrease in the incidence of undeclared payments since 2009, when the respective share of the population receiving higher than declared remuneration was close to 13 %. Taking into account the contraction in economic activity in 2010, businesses have actually registered this decline as a relative increase of the share of envelope wages in their costs (Figure 9). The

tendency to underreport actual remuneration has important implications for the social security system, as underreported remuneration is also related to reduced payments of social security contributions. Failing to tackle such issues in time leads to hasty and unpopular policy decisions for correcting social security imbalances such as the transfer of payments from private to the public social security fund in 2010. Bulgaria needs to account for the lost income and design a comprehensive set of long-term economic and enforcement measures to tackle hidden employment. Alternatively it must be prepared to face social security deficits and crises with each economic downturn in the future.

Figure 9. Incidence of Payment of Remuneration Higher than the Stated in the Contract under Primary Employment in the Past Month (%)

(“In the past month, have you received remuneration higher than the stated in the contract with your primary employer?”)



Source: Index of the Hidden Economy on Population 2010, Center for the Study of Democracy, Vitoshka Research.

Trends in Social Security Contributions

The share of the employed that are socially insured on pay rates lower than their actual remuneration had almost doubled by 2009 since the onset of this index in 2003. In 2010 there has been a notable drop in the share of the employed insured in accordance to the amount stated in their contract, while receiving a higher (undeclared) remuneration. The same though to a much lesser extent applies to the proportion of employed insured only on the basis of the minimum social security threshold, while actually receiving a higher remuneration (Table 2). The proportion of

employed persons that are insured on the minimum social security threshold, which also corresponds to their actual remuneration has also declined (from 12.9 % in 2009 to merely 5.9 % in 2010). This reveals the higher social insecurity of undeclared employment and income, which was immediately shed by the firms in the face of the downturn. Hidden Economy Index data shows that the share of undeclared social security income in total social security payment of companies might have remained unchanged or might have even increased, as it was lower paid, lower qualified persons that have suffered the most in the downturn. This is in line with the very modest increase in the average social security income in 2010 as reported by the National Social Security Institute.

Table 2. Base Amount for Payment of Social Security Contributions under Primary Employment (%)

(“What is the base amount for social security contributions under your primary employment contract?”)

	February 2003	March 2004	August 2008	September 2009	December 2010
The minimum social security threshold, although the total sum of my remuneration is higher	12,1	13,4	13,5	12,9	10,3
The minimum social security threshold, which is what I am actually paid	10,3	14,3	9,5	12,6	5,9
The amount stated in my contract even though the total sum of my remuneration is higher	6,7	8,3	15,0	15,5	8,4
The amount stated in my contract, which is what I am actually paid	68,3	63,4	61,8	56,2	67,0
Other	2,6	0,6	0,3	2,8	1,5
Base	348	314	378	395	466

Source: Center for the Study of Democracy, 2010.

Policy Actions on Hidden Economy: Effects and Recommendations

The bulk of the measures undertaken by the government in 2010 to counteract the hidden economy were largely targeting the hidden business turnover and hidden remuneration. Examples of measures directly or indirectly affecting the hidden economy in 2010 include:

- checks and revisions carried out by the National Revenue Agency and the Chief Labor Inspectorate;
- a restriction to cash payments of over 5000 to be carried out only through a bank transfer (applicable to all legal and natural persons);
- the bill limiting cash payments also introduced changes to the Labor Code; these changes involve the requirement for payment of employees' wages through a non-cash bank transfer;
- as of 2011, each cash registry/fiscal device in Bulgaria will be connected to the computer system of the National Revenue Agency. Information from fiscal devices will be automatically available to NRA, allowing for a remote access to data and instantaneous inspections;
- eased start-up for businesses through a reduction in the minimum capital requirement from 5,000 leva to 2 leva, and a reduction in the rates for employer contributions to social security.¹⁸
- a proposal to prohibit persons, who are proven to have managed poorly a commercial property, from managing another enterprise;
- suggested measures to include electronic payments for public sector services, which requires the existence of POS terminals in hospitals and other medical centers,

academic institutions, post offices, offices of municipalities, etc.¹⁹

- the introduction of more controls on excise goods trade: (a) direct connection between all petrol stations' pumps and the National Revenue Agency for real time data communication; (b) introducing stricter licensing for cigarette retail outlets; (c) installing monitoring devices on alcohol producing facilities with direct connection to Customs agency control system, etc.

Although past lessons have clearly demonstrated the importance of prevention and stimulus measures in countering the hidden economy, the Bulgarian government has continued to show preference for punitive and corrective measures. While this might be understandable in the face of mounting criticism on Bulgaria for failures in its law enforcement, it has created an additional administrative burden for compliant companies and citizens and has strained the limited resources of regulatory bodies. The Hidden Economy Index results show that these seem to have not produced the expected results. Moreover, increased regulatory checks, in particular of the National Revenue Agency, the Food Safety Agency, the National Construction Control Directorate, etc. have targeted too broad constituencies, which is unlikely to produce tangible results outside temporary media campaigns. The overall financial results of such actions for the implementing agencies remain unclear, while their deterrence effect – questionable.

Economic and financial policies, which have a much higher potential positive impact than administrative pressure, have not been used effectively to aid increased controls in 2010. In effect many of the budget policies have put more incentives for hiding economic activity than for entering the official economy. The two most exemplary cases in this

¹⁸ IFC, (2011), "Doing Business 2011: making a difference for Entrepreneurs", the World Bank Group.

¹⁹ Forum on "Electronic Payments Against the Grey Economy", Proposed measures by VISA Europe and its Bulgarian members to counteract the grey economy in Bulgaria, Sofia, 14 February, 2010.

direction, which have created high public interest in 2010, have been:

- the sharp increase in excise duties, which has created incentives for smuggling of excise goods, most notably cigarettes;
- the raising of social security thresholds for agricultural producers and self-employed persons.

Bulgaria has managed to preserve macroeconomic stability during the crisis without external help, which is a success in itself. But the government's financial and budgetary policy in 2010 has been unclear, at times appearing contradictory and chaotic, which has caused uncertainty among business leaders, increasing their incentives for engaging in hidden economic activity. This use of EU programs for business development in the country as an instrument for reducing informality has remained low. Many companies have given up support from European funds because of burdensome procedures and extremely risk averse public administration. As in the country's regulatory control and compliance system at large, increased control on the use of EU funds has been rather formalized, resulting in across the board rise in compliance costs for beneficiaries, while not addressing the gravest risks and irregularities.