

## 2. THE HIDDEN ECONOMY IN BULGARIA – STATE, DYNAMICS, AND POLICIES IN THE CONTEXT OF THE ECONOMIC CRISIS

Limiting the **hidden economy becomes a central point of discussion in the public space** every time when there is a change in the economic legislation, and especially prior to elections and/or the adoption of the annual state budget. Yet, with the exception of the **annual *Hidden Economy Index*** composed by the Center for the Study of Democracy, and some sporadic analyses by other non-governmental, academic, or business organizations, there is no adequate governmental system for prior or subsequent assessment of the impact of suggested measures for tackling the hidden economy. The continuous publicly declared efforts of control authorities to counteract the hidden economy and the disclosure of tens of thousands of breaches of the regulations in the country every year (the latter related to concealment of economic activity), are a testimony to the scope of the problem, which the Bulgarian economic policy is faced with. **The intrusive and repetitive nature of the control actions and their inability to produce any long-term effects** testify that hidden economic activity has become business as usual in Bulgaria. Thus, alternative solutions to administrative control should be sought. The effects of underestimating similar problems became evident during the 2009 crisis in Greece, which is still ongoing and threatens the integrity of the whole Eurozone. The lack of a clear idea about the exact amount of the country's debt and the innovative bookkeeping of the Greek government were only the beginning of the problem. As the crisis unfolded, it became clear that neither the international investors had confidence in the Greek authorities or the European Commission, nor the citizens had any respect for the official authorities. The Greek case should serve as a signal for action within the EU, and even more so for Bulgaria.

**The National Statistical Institute (NSI) estimates the share of the gray economy in the Gross Domestic Product** within the framework of the System of the National Accounts. These estimates are rarely publicly announced or disseminated. Moreover, they do not serve as a basis for decision making in the design and implementation of public policies. In 2011, the Ministry of Finance published an analysis<sup>9</sup>, according to which the share of the hidden economy was about 20 % of the GDP in the years following 2000. It is, however, hard to follow and reconcile the different assessments of the size of the hidden economy and its components, given that such estimates occur at various points in time and use various methodologies.<sup>10</sup> Even if one assumes that the share of the hidden economy in the country

<sup>9</sup> The analysis estimates the share of the hidden economy using a model based on the consumption of energy, <http://www.minfin.bg/bg/page/549> [last accessed on 09.25.2011].

<sup>10</sup> Estimates provided to CSD by several NSI experts for the publication *The Hidden Economy in Bulgaria*, 2004, a study by the Center for the Study of Democracy, show that the share of the hidden economy in Bulgaria in 2000 was 16 % of the GDP. Data supplied by the same experts show that in 2007/2008 this share was about 9 %.

that remains unaccounted for by the NSI is between 10 – 15 %<sup>11</sup> of the GDP, which most observers would call an understatement, the bulk of the macroeconomic indicators on which national policies are based would change significantly. For example, the widely discussed ceiling on total consolidated state expenditures of 40 % of GDP, as part of introducing more stringent fiscal rules, would be rendered meaningless in terms of policy relevance if production that is part of the hidden economy was accounted for. For 2008, the total government expenditures would have been 33.2 % of the GDP, and for 2010, 34.5 % – way below the proposed ceiling. Accommodating for the hidden economy would require significantly change in the government policies. In the case of budget expenditures, considering the very low income levels in the country, such changes to the ratios would not be an indication of fiscal soundness, as they are commonly misinterpreted now, but rather of serious underfunding of social services (security, education, healthcare, infrastructure, etc.). Such an interpretation of the hidden economy's contribution to changes in macroeconomic indicators is too simplistic but still telling. In reality, the hidden economy's effect on the macroeconomic indicators would be much more complex, if it were estimated in terms of the transformation of hidden/unrecorded activities into official economic activities. In the case of such transformation, part of the business would cease to exist, workplaces would be lost, and there would be an increase in the demand for social services, which, in turn, would increase state expenses. However, incomes would also go up, whereas illegitimate use of social wealth would go down.

Similar underreporting on the size and the impact of the hidden economy are evident throughout the EU. **Eurostat does not maintain a comparable database of the share of the hidden economy in member states' GDPs.** Although the methodology for estimating the hidden economy (or non-observed economy as statistical offices prefer to call it) as a share of GDP was standardized in the EU, there are still relatively large differences in the way of assessing the non-observed economy, including the hidden economy.<sup>12</sup> For example, only Bulgaria and the Czech Republic estimate all seven types of non-observed activities (as per Eurostat's definition), while the Netherlands assesses only two, and Romania, Sweden, and Finland assess only three.<sup>13</sup> In countries where the national statistical offices are not sufficiently independent, governments could be tempted to manipulate the numbers on the size of GDP growth using estimates of the non-observed economy. In this sense, it is necessary to significantly improve the coordination of the national statistics and the role of Eurostat, so that the adoption of stricter fiscal rules can be implemented effectively, as envisioned in the Euro Plus Pact.<sup>14</sup>

The official estimates of the share of the hidden economy in GDP in Bulgaria show **a continuous downward trend** from 15.2 % in 2000 to 10.4 %, most recently. It is interesting that frequent and significant annual fluctuations in the

<sup>11</sup> According to the latest available estimates of the NSI, the share of the hidden economy for 2008 was 9 %, whereas external estimates of the hidden economy (or of some of its components) for the same year varied from 18 % to 32 %.

<sup>12</sup> UNECE (2008), Non-Observed Economy in National Accounts: Survey of Country Practices. Available at <http://www.unece.org/stats/publications/NOE2008.pdf> [visited on May 18, 2011].

<sup>13</sup> According to the latest available data for 2000 – 2002.

<sup>14</sup> Passed by a motion of the European Council EUCO 10/1/11 of March 25, 2011.

**Table 1. Hidden Economy's Share in GVA and GDP as Estimated through the Exhaustiveness of the System of National Accounts (%)\***

Economic Sectors	2000	2001	2002	2003	2004	2005	2006	2007	2008
Agricultural sector	18.2	18.7	23.0	25.1	22.6	21.9	20.1	20.9	16.6
Industry	16.1	17.6	21.2	20.4	12.4	11.3	10.9	10.3	11.0
Services	17.8	16.0	13.3	13.9	14.8	15.2	14.2	12.6	12.8
<b>Share of GVA</b>	<b>17.4</b>	<b>16.8</b>	<b>16.6</b>	<b>17.0</b>	<b>15.0</b>	<b>14.7</b>	<b>13.6</b>	<b>12.3</b>	<b>12.5</b>
<b>Share of GDP</b>	<b>15.2</b>	<b>14.7</b>	<b>14.7</b>	<b>14.8</b>	<b>12.7</b>	<b>12.4</b>	<b>11.4</b>	<b>10.4</b>	<b>10.4</b>

Note: \*The term used by statistical offices is "non-observed economy".

Source: National Statistical Institute, 2011.

share of the non-observed economy by sectors (agrarian economy, industry, and services) are observed. There are a number of reasons to believe that **the share of the hidden economy in the GDP is higher than the official estimates of the NSI**. For example, the real estate bubble of 2003 – 2008 included a sizable share of hidden economy along the whole value added chain of construction. Yet, this share does not seem to have been included in the official estimates of the hidden economy. Moreover, an increase in the real estate prices has led to an increase in the so-called imputed rent (the rent an owner would have had to pay had she not owned the real estate), which is also incorporated in the official GDP estimates. However, it is possible that these data are closer to reality than assumed, if concurrent with the real-estate bubble there was a significant escalation of money laundered through bogus deals, legalizing part of the undeclared money. Although there are no specific data about the scale of the money laundering during this period aside from several court cases, this factor was evident during the real estate bubble, as well as in some other sectors.

In most cases, the discussions at governmental level about the size of the hidden economy are exercises in rhetoric or serve special aims and interests different from the stated instituting of measures to limit the hidden economy. Such an approach risks achieving the opposite effect to what was intended: a constant escalation of control and regulatory measures and a consecutive increase in the hidden economy. **An increase of the administrative control usually suggests a larger number of audits, enforced sanctions**, etc. Such measures seek a quantitative effect – demonstrating action to the public, rather than a qualitative effect – improving the business environment. As a result, the audits inevitably focus on the large number of micro and small enterprises, the potential benefit or real loss to the state budget from which is lower than the expenses for the control actions. So far, the authorities have never publicized whether or not they know the size and consider the additional burden on enterprises of such audits. There is also no evidence of the benefits from such control measures versus the additional costs to the public and the private sector related to these measures. The final result usually is an increase in corruption pressure, social dissatisfaction, and a reduction in the

margin of beneficial action of the government. It is necessary that measures against the hidden economy adopted by the government are: (a) directed at improving law enforcement and the rule of law as their foremost priority; (b) supported by administrative compliance and control system reforms, aimed at higher institutional efficiency; and (c) assessed through a costs – benefits analysis.

**After Bulgaria’s accession to the EU, several national employers’ associations and trade unions have started large-scale projects on tackling the hidden economy in Bulgaria.**<sup>15</sup> These projects have the potential to significantly improve the available knowledge on the manifestations and effects of the hidden economy at a firm or employee level. However, if these projects aim to limit the negative effects of the hidden economy, their promoters need to cooperate more closely and efficiently with state institutions, presenting new recommendations for adequate measures to counter the hidden economy at a national level. So far, the self-regulation in Bulgarian employers’ organizations and/or trade unions has not produced results in terms of reducing the shadow economy and/or exposing cases of regulation breaches by members. The full effects of these projects can only be estimated as early as 2013.

The current analysis provides a framework for assessing the policies and measures aimed at tackling the hidden economy in Bulgaria by presenting: 1) an overview of the basic macroeconomic imbalances related to the existence of hidden economy; 2) the *Hidden Economy Index* compiled by the Center for the Study of Democracy for the period 2002 – 2010; and 3) a summary of the measures for countering the hidden economy suggested and/or implemented in the past three years, as well as an assessment of the efficiency of the latest packages of measures proposed by the Bulgarian government.

## 2.1. THE HIDDEN ECONOMY AND MACROECONOMIC IMBALANCES

The hidden economy in Bulgaria has several specific characteristics:

- **The public sector contributes** to the creation of hidden economic activities. Even large state enterprises participate in both the formal and the informal sector (Eilat and Zinnes, 2002). A typical example is the education sector, as well as practically all activities of state enterprises prior to their privatization.
- **Hidden economic activities are sometimes of large scale and visibility**, although by definition they should be hidden.
- The gray sector is mostly non-violent and non-criminal, however, where regulation evasion is at the core of the business model (e.g., avoidance of excises dues on cigarettes and alcohol), **lasting relations between organized crime and the gray businesses** have formed.

<sup>15</sup> For more details, see the National Center “Икономика на светло” /No-shadow Economy/ of the Bulgarian Industrial Capital Association and the Confederation of the Independent Trade Unions in Bulgaria, and the project “Raising Social Intolerance to the Informal Economy in the Employment and Social Security Contracts and Preventive Measures for Its Restriction” of the Bulgarian Chamber of Commerce and Industry.

- Firms operating within the hidden economy are not deprived of access to social and public services or state subsidies.
- Hidden activities are relatively sensitive to economic measures implemented by the government (Eilat and Zinnes, 2002).
- The processes of the restructuring of the economy and the privatization are related to financial crimes, illegal enrichment, and consecutive actions to legalize the appropriated funds (Teneva, 2003).

Though there has been some improvement in recent years **the price of entrepreneurship in Bulgaria remains high** and is combined with a high administrative burden. Transition to the gray sector is considered part of the survival strategy or a means for starting a business, while undeclared employment is widely accepted. The broad political control over the economic activities decreases the possibilities for forming small and medium private businesses, as well as for sustainable economic growth. The political control decreases the stimuli for entrepreneurship's profitability, therefore, having a negative effect on entrepreneurial activities, competitiveness, and economic growth (Johnson et al., 1997). When real or potential profit is decreased or taken away from the entrepreneur, the latter opts to either not start a business, or start a business within the hidden economy. This is why the politicization of the economy leads to a significant increase in the hidden economy, which has profound effects on the structure and rate of the economic growth in the country. The prevalence of gray and illegal organizations feeds organized crime structures and the formation of an informal social and economic tissue.

**It is not apparent that the Bulgarian state can offer better protection and support to businesses than the criminal gangs or the political parties.** The government often cuts from relevant public services to redirect expenditure to subsidizing unproductive activities and/or transfer payments to friends' or political allies' businesses. In addition, the government's regulatory compliance system is much more complex, including for example safety and pollution regulations, than the one usually enforced by organized crime. Finally, there is a wide spread public perception that regulations are selectively adopted and applied usually benefiting business entities that are part of criminal or party-political networks.

Hidden economy is on the rise worldwide, as shown by the available internationally comparable surveys (Mallet and Dinmore, 2011). The relative share of the hidden economy in the world, as a whole, is estimated at about 10 – 12 % of GDP. In some less-developed countries reaches over 30 – 40 %, and in the transition economies in Central and Eastern Europe it ranges from 25 % to 30 % (Center for the Study of Democracy, 2004). When the hidden economy's share exceeds the critical level of 40 – 50 % of GDP, it becomes a social norm. This is why issues related to **the hidden economy are of uttermost importance for the process of economic transition.** The task of resolving these issues is particularly pressing for Bulgaria today, especially in the context of the country's membership in the EU.

There are dozens of empirical and theoretical studies on the hidden economy in Bulgaria. Although it is difficult to measure, it is experienced by the businesses in its daily encounters with partners and/or competitors operating outside the



law. Manifestations of the latter are, for example, avoiding taxation and social or healthcare security payments, not disclosing the actual number of employees, evading requirements for product quality, safety regulations, and/or environmental standards, as well as violating intellectual property rights. According to a Bulgarian enterprises survey conducted by the World Bank, in 2007, **the hidden economy was the main barrier to business investment in Bulgaria**. In fact, unfair competition, perceived by the firms as a key manifestation of gray economy and corruption, has been quoted as the key obstacle for business development in Bulgaria in the past 14 years.<sup>16</sup>

Ignoring the methodological disparities between various studies, the size of the hidden economy in Bulgaria since 1990 has been estimated at between 16 % and 38 % of GDP (Belev, 2002, Feige, 2004, Center for the Study of Democracy, 2004, Schneider, 2006). This ranks Bulgaria among the “grayest” economies among the new EU member states. According to different assessments, the size of the hidden economy in Bulgaria for the period 2007 – 2008 was between 20 % and 35 % of the GDP, with some sectors like construction and real estate reporting less than 50 % of the real value of their transactions (Center for the Study of Democracy, 2007). The perceptions of the business and the population measured by surveys, using a sample showed even higher levels of hidden economy (50 % to 60 %).<sup>17</sup> It is likely that perception estimates have been influenced by the Bulgarian society’s common distrust with the official state institutions, thus reflecting not only real encounters with hidden economic activity, but also a subjective perception of the overall quality of the business environment. Therefore, a certain level of subjectivity characterizes the available data on the hidden economy, which is due to the very characteristics of the phenomenon. Yet, despite this degree of subjectivity, **the hidden economy is a significant challenge to the economic development of Bulgaria**. The most affected sectors are the labor-intensive, low technology sectors, such as construction, tourism, agriculture, textile and sewing, and services like repair works, private education, healthcare, etc. A typical feature of most of these sectors is the large number of micro firms or various forms of self-employment. In many cases the overall level of employment could not be sustained if one were to follow all regulations, thus, the existence of such alternative forms of employment. Yet, alongside these relatively more socially acceptable forms of hidden economic activity, there are others, which are more detrimental to the state budget, such as VAT fraud or public procurement fraud. Despite many attempts of the control authorities to adequately intervene, there are serious reasons to believe that a large gray sector still exists in the excise goods markets (e.g., production of alcohol, cigarettes, and fuels). In addition, significant issues with the gray economy also exist in other highly regulated sectors, such as the transport sector.

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<sup>16</sup> Data is from the *Corruption Monitoring System* of the Center for the Study of Democracy, 1998 – 2011.

<sup>17</sup> Project “Restriction and Prevention of the Informal Economy”, Bulgarian Industrial Capital Association and Confederation of Independent Trade Unions in Bulgaria, 2011.

Although difficult to distinguish from the overall effects of economic growth, there is clear evidence that the recent years' (i.e. before the 2009 – 2010 crisis) transformation of some hidden economic activities into activities within the official sector contributed to the increase of budget revenues. The latter allows for improving investment in public programs and reducing the social inequality. Prospective growth of financial inflows through European funds would allow for further improvements of public services, while fostering the restriction of the hidden economy. Yet, a **strategy based on decreasing taxes and social security contributions (or keeping them at current levels), while increasing control, is not sufficient** for a sustained success in limiting the hidden economy in Bulgaria. Analyses of the Center for the Study of Democracy for the past ten years have shown that the hidden economy in Bulgaria encompasses three different areas, each involving specific motivations and mechanisms, thus requiring specific instruments for counteraction: social (the informal/commodity-exchange economy); economic (the gray economy); criminal oligarchy (the black economy). Therefore, it is necessary for the Bulgarian government to seek a better balance between punitive administrative control policies and financial economic stimuli, as well as a better interaction with businesses, and the non-governmental sector in tacking the negative effects of the hidden economy.

After eleven years of uninterrupted growth, the Bulgarian economy was hit by a recession in 2009. The pre-crisis period was characterized by a steep increase in budget revenues (especially tax revenues on goods and services – VAT, excise duties related to imports) and by a growing inflow of external capital, which led to a stable growth of employment in the period between 2001 and 2008.<sup>18</sup> In 2009, the tax and non-tax revenues dropped rapidly. Within the EU-27, only the Baltic States experienced higher revenue losses than Bulgaria. Moreover, the crisis hit Bulgaria's trade partners, and the level of exports also fell down (especially noticeable in the last quarter of 2008 and the first quarter of 2009). **The credit boom was followed by a credit crunch.** Practically all credit flows froze in the fourth quarter of 2008. This led to a significant contraction of both enterprise activities and household consumption. The real scope of the crisis became apparent, as in 2009 Bulgaria's GDP dropped for the first time since the 1996 – 1997 crisis.<sup>19</sup> The volume of GDP dropped by 5.5 % in real terms in 2009 on an annual basis and growth remained flat in 2010.<sup>20</sup> Employment plummeted, whereas unemployment doubled reaching 10.3 % in February 2010 (as per official estimates).<sup>21</sup> These factors caused a decline in consumption, which remained slumped in 2011 leading to fears for a slow and prolonged economic recovery (estimates foresee economic recovery occurring as late as 2012 – 2013 in the absence of a rapid improvement in employment). The recovery is strongly contingent on developments in the Eurozone.

<sup>18</sup> Total employment rose by 20 %, which was mainly due to a boom in the construction, real estates, wholesale, finance, and service sectors.

<sup>19</sup> IMF Country Report No. 10/159.

<sup>20</sup> Preliminary data from the NSI show a growth of merely 0.2 % for 2010. Available at: <http://www.nsi.bg/otrasal.php?otr=10> (last accessed 20.11.2011)

<sup>21</sup> Data is from the 2010 Yearbook of the Bulgarian Employment Agency.

A number of indicators show that **Bulgaria's labor and capital resources are used unproductively – a sign of the existence of a hidden economy.** In 2010, the number of economically inactive Bulgarians of working age (i.e. 15 – 64 years old) was over 1,600,000. The number of students and people with disabilities (within the same age group) are about a half of the total group of inactive population. Out of the remaining 834,000 economically inactive people, 225,000 have declared they are discouraged to participate in the formal labor market, 250,000 do not work due to personal or family reasons, and 78,000 do not provide a reason for their inactivity.<sup>22</sup> Providing these people were employed at the average salary in the private sector for 2010 would have brought additional employment revenue of BGN 6.1 billion<sup>23</sup> or 8.7 % of the 2010 GDP.<sup>24</sup> At the same time, the level of capacity utilization in the manufacturing industry lags behind by 10-15 percentage points compared to the EU average. Thus, Bulgaria remains the country with the lowest labor productivity – 41.5 % of the EU-27 average, which is 6 percentage points lower than the next lowest ranking country – Romania. The crisis created an opportunity for the country to catch up with the other member states. The latter, however, has so far occurred mainly for “mechanical reasons”: enterprises have laid off a number of employees, but have maintained the actual volume of production. On average those, who were laid off had lower formal salaries than the rest of the employees. The working hours for those who remained were automatically cut down during the downturn. Thus, the crisis allowed many enterprises to optimize their production and activities, but at the same time, it created conditions for additional pressures on the labor market.

Together with their Latvian and Lithuanian counterparts, **Bulgarian firms experienced the largest declines in sales** during the crisis. Seventy percent of firms surveyed in 2010 by the Center for the Study of Democracy reported decreased income. The average rate of decline was 37 %. At the same time, the share of enterprises, which accumulated debt or defaulted on their financial obligations, grew between 2009 and 2010 (The World Bank, 2010). The International Monetary Fund (IMF) warned against an increase of “non-performing” loans across all sectors (corporate, consumer, and mortgage) in the country. IMF also forecasted an increase of the share of “bad and restructured” loans by 4 to 6.5 percentage points (for all loan types) in 2010, and by an additional 1 percentage point in 2011.<sup>25</sup> The effects of such an increase of non-performing loans on the economy is still unclear, but there are signs of its burdening effect on economic recovery, which started in the first half of 2010.

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<sup>22</sup> Data is from NSI's annual Labor Force Survey for 2010.

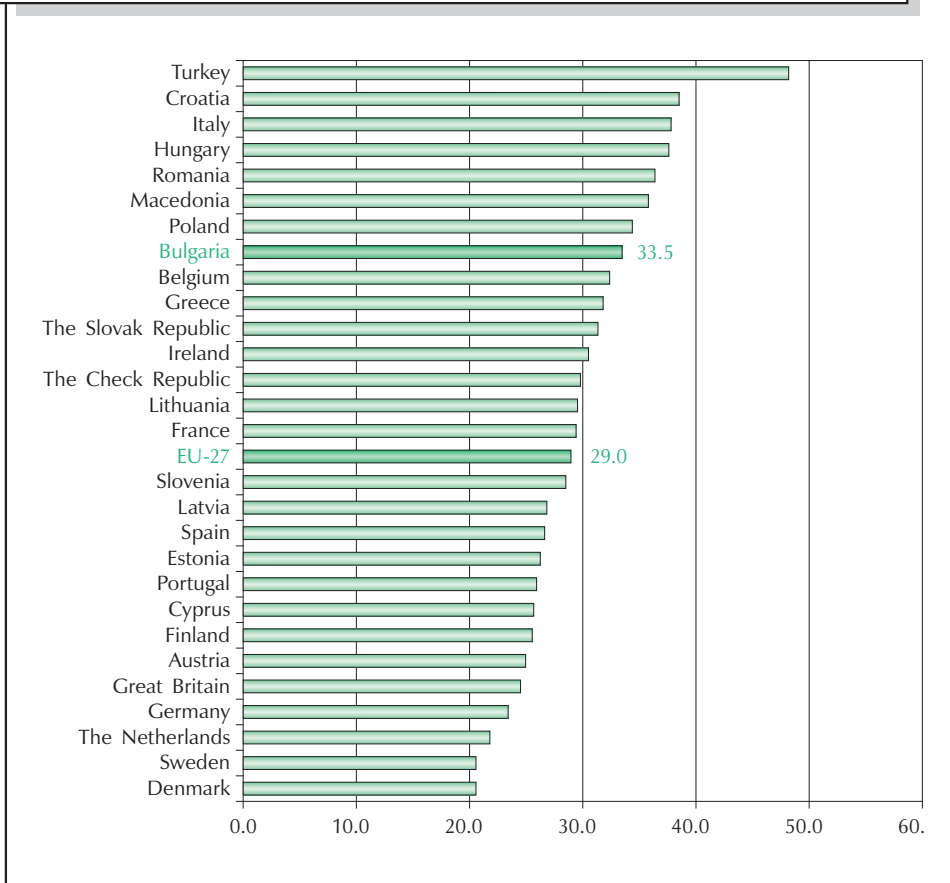
<sup>23</sup> Calculations have been simplified for the purpose of this analysis. The average salary for 2010 in the private sector, calculated on the basis of quarterly data by NSI, was BGN 606. In reality, it is likely that salaries within the hidden economy are much lower. The effects of taxation were also not considered.

<sup>24</sup> According to preliminary data of the NSI, the Bulgarian GDP in 2010 was BGN 70,474 million.

<sup>25</sup> IMF Country Report No. 10/159.



**Figure 2. Inactive Population as a Share of the Total Population Aged 15 – 64**



Source: Eurostat, 2011.

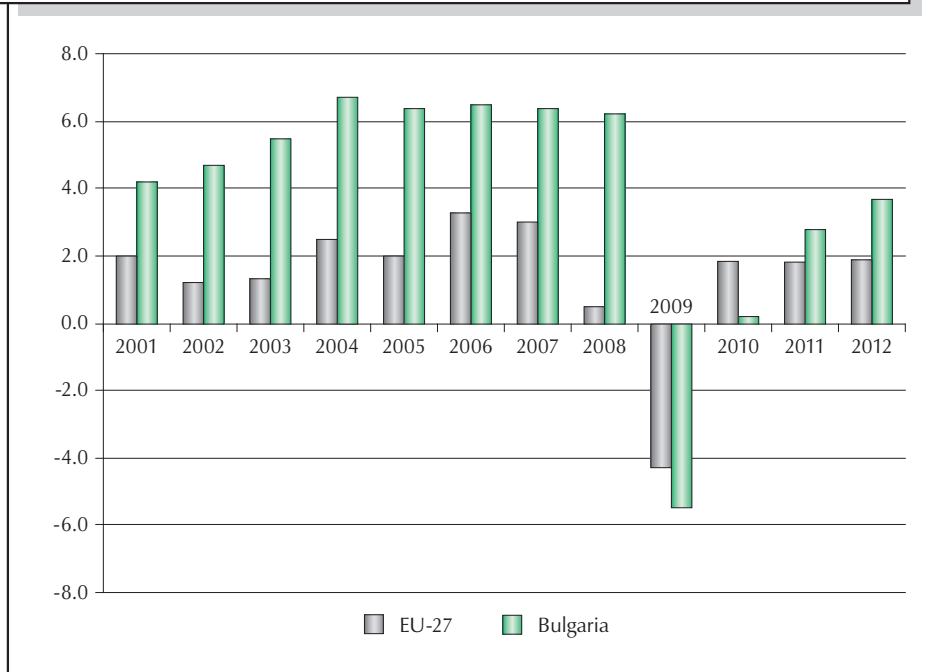
In the second quarter of 2011, a rebound in exports significantly reduced the pace of contraction of real GDP. The existing low consumer trust continues to negatively affect domestic demand, and the GDP virtually stagnated in 2010 and early 2011.<sup>26</sup> Meanwhile, current account deficit decreased<sup>27</sup> and inflation significantly slowed down. In 2011, a more visible recovery process is expected, with a real GDP growth of 2.5 to 3 percent, mainly driven by an increase in external demand.

The financial and economic crisis affected the real economy in Europe in terms of GDP and employment (Schneider, 2010). According to the World Bank (2010), **the fall in the average permanent employment was greatest in Bulgaria.** During the third quarter of 2010, the share of employed people aged 15 and above out of the same-aged population was 47.5 %. Compared to the same

<sup>26</sup> Eurostat and the IMF predicted a real GDP growth between 0 and 0.4 % in 2010. NSI's preliminary data indicated 0.2 %.

<sup>27</sup> According to the IMF, by the end of 2010, the fall in the current account deficit would be 3 % of GDP.

**Figure 3. Real GDP Growth (% Change on an Annual Basis)**



Note: Data for 2010 are preliminary, and 2011 – 2012 data are estimated.

Source: Eurostat, 2011.

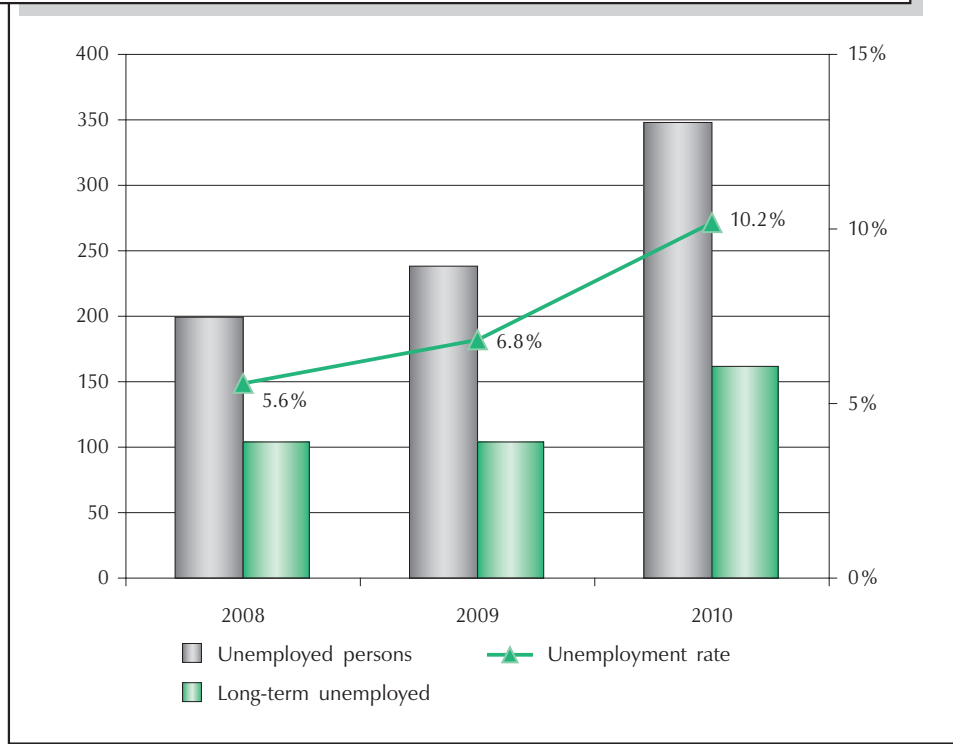
period of 2009, the number of employed people dropped by 175,800, and the respective fall in the employment ratio was 2.3 percentage points. During the same quarter of 2010, the share of unemployed persons was 9.5 % of the economically active population, which is an increase by 2.8 percentage points compared to the third quarter of the previous year. The latter results in 92,000 additional unemployed individuals in the third quarter of 2010 compared to the same period in 2009.<sup>28</sup>

A key feature of the current global economic crisis has been the impossibility to make accurate predictions on its evolution over time. The uncertainty over the economic future of the European Union has increased in 2011 against the backdrop of an increasing number of highly-indebted member states like Greece and Italy in need of debt restructuring. In such a complex external environment, **it would be realistic to expect an increase in the share of the hidden economy in Bulgaria** due to several concurrent factors:<sup>29</sup>

<sup>28</sup> NSI, Key Indicators for Bulgaria, December 30, 2010, <http://www.nsi.bg/KeyInd/KeyInd2010-12.pdf>.

<sup>29</sup> See a more detailed discussion on the factors and expectations of the dynamics of the hidden economy in 2009: *Levelling the Playing Field in Bulgaria: How Public and Private Institutions Can Partner for Effective Policies Targeting Gray Economy and Corruption*, Policy Brief 15, Center for the Study of Democracy, May 2008, and Round Table: The Gray Economy of Bulgaria in a Time of Economic Crisis, <http://www.csd.bg/artShowbg.php?id=9514>.

**Figure 4. Number of Unemployed (Thousands of People) and Unemployment Rate (%) in Bulgaria**



Source: Center for the Study of Democracy using data of the National Statistical Institute, 2011.

- Pressure on businesses' revenues **increases incentives to evade taxes and social security contributions** in order to improve businesses' economic position and competitiveness on the market. In 2009 and 2010, a share of the newly unemployed actually maintained their employment at the enterprises off the books, saving the latter contributions to the state budget, while making up for reduced income through receiving unemployment benefits.
- Shrinking economic activity leads to a fall in government budget revenues. This, in turn, can limit the quality of public services and result in poorer implementation of the administration's control and audit measures. Stockpiling public expenses in 2009 and 2010 on large infrastructure projects only led to a negligence of projects in the realm of competitiveness and innovation. Related to the latter, payments on formerly approved obligations to firms fail to materialize, which additionally worsened the economic situation and forced some of the firms to evade payments to the state. Such evasions were perceived as morally justifiable: "I do not pay what the state owes me."

On the other hand, during a crisis there are **factors, which work in the opposite direction – toward a decrease of hidden economy:**

- The hidden economic activity connected to the official economy is shrinking faster than the general rate of decrease related to the lower expenses associated with downsizing of unrecorded activity. For example, it is much **easier to**

**terminate informal contracts with undeclared employees, suppliers, and/or clients and hide turnover**, rather than terminating formal contracts.

- The rate at which economic entities enter the hidden economy as a result of the crisis is likely lower than the rate of going out of the market or transferring to another hidden economic sphere.

To a great extent these processes depend on the quality of control and law enforcement activities in the country, on the duration and severity of the crisis, as well as on government measures in place.

## 2.2. THE HIDDEN ECONOMY INDEX

Hidden economy surveys in Bulgaria have been carried out by the Center for the Study of Democracy and the market and social research agency Vitosha Research since 2002. Based on data from these surveys, **a system of synthetic measurements in the form of composite indices for assessment of the hidden economy** was developed. The reason for choosing these particular indicators was to reduce the multiple aspects of the hidden economy phenomenon to a manageable number of illustrative and easy to interpret the indices. The value of each indicator, which reflects a separate segment of the hidden economy, is standardized in the interval between 0 and 10, so that there is comparability among the different variables comprising the indices.

A comparison between the values and dynamics of the hidden economy indices of the business and the population enables researchers to draw important conclusions about the effects of government policies on tackling the hidden economy for a specific year or historically. The indices help focus the public attention on the successes and failures of public policy. An analysis of specific sub-indices enables the detailed assessment of the effectiveness of several types of public policies in countering the hidden economy: labor market, taxation, social security, regulatory, and others. It should be noted that the indices measure the dynamics of the changes in the hidden economy and its components and not their size.

Similar to 2009, in 2010, the *Hidden Economy Index* for the business and the *Index of Hidden Economic Activity of the Population* show opposing trends. 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 Hidden Economic Activity of the Population* (and all its components – i.e. hidden employment, turnover, and economic activity) actually decreased. These opposing trends can be explained through the **different effects over time that the crisis has on the businesses vs. the population**. 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 to preserving

**Box 7. Elements of the *Hidden Economy Index* of Businesses and the *Index of Hidden Economic Activity of the Population***

The *Hidden Economy Index* consists of the following indices:

1. Size of the hidden economy – this index summarizes subjective perceptions of business representatives of the scope of the hidden economy in the country as a whole, and by sector. It includes two sub-indices:
  - 1.1. subjective assessment of the share of the hidden economy in the country as a whole;
  - 1.2. subjective assessment of the share of the hidden economy by sector.
2. Hidden labor relations – reflects the practice of employing workers without formal contracts, or under contracts which do not reflect actual remuneration. It has two sub-indices:
  - 2.1. the share of employees without a contract in the respective sector;
  - 2.2. the share of the employees under contracts with “hidden clauses” in the respective sector (envelope wages).
3. Hidden turnover – captures the extent to which different ways for hiding turnover are prevalent in the respective sector. The index includes the following sub-indices:
  - 3.1. not issuing of receipts for certain sales;
  - 3.2. reporting lower than the actual turnover;
  - 3.3. reporting lower than the actual profit;
  - 3.4. illegal import/export.
4. Hidden re-distribution – covers the businesses’ practice of hiding/not paying taxes, duties, and/or excises, as well as VAT fraud using accounting tricks. It is comprised of the following two indices:
  - 4.1. hiding/not paying taxes, duties, and excises;
  - 4.2. VAT fraud.

Similar indicators and indices were also constructed on the basis of data from surveys of the Bulgarian population. For example, for the undeclared work/employment a sub-index “Undeclared Employment Relations” of the *Index of the Hidden Economic Activity of the Population* is used, gathering data on the share of employees without a registered labor contract or a contract with “hidden clauses” (envelope wages), as well as the level of unpaid social security and healthcare contributions. This index is comprised of several basic indicators:

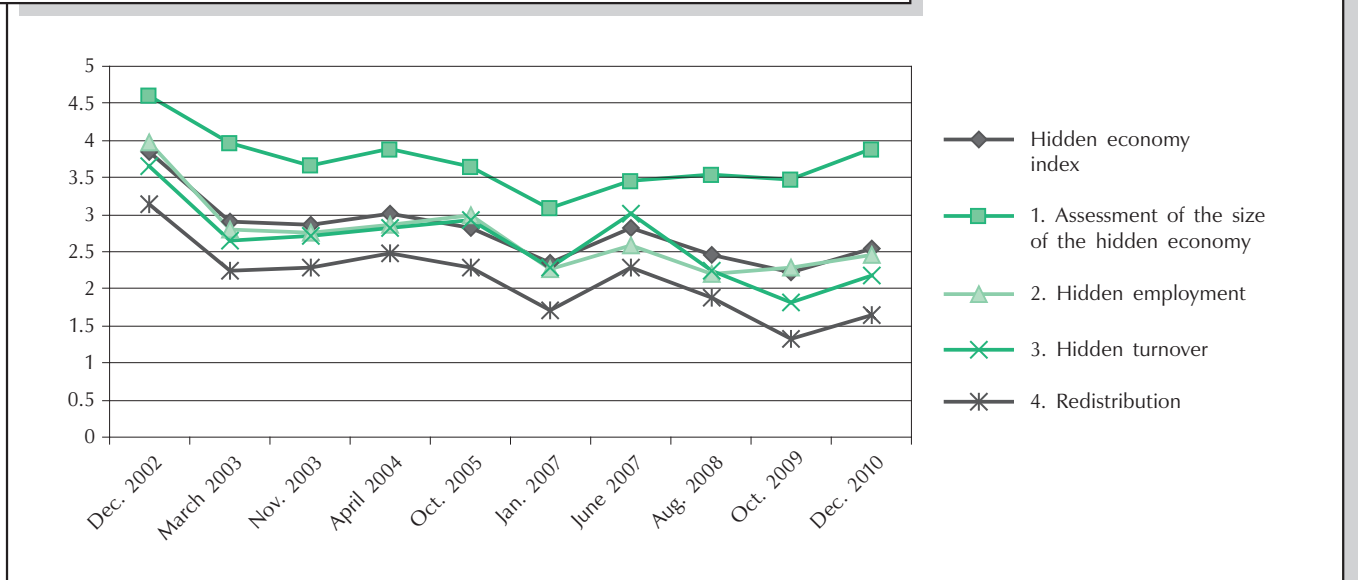
- share of workers without a registered labor contract (for primary or secondary employment);
- share of workers under a contract with “hidden clauses” (for primary or secondary employment) (envelope wages);
- share of workers with no social security;
- share of workers with no healthcare security;
- size of remuneration, on which social and healthcare contributions are paid.

Source: Center for the Study of Democracy.

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 index of the hidden economy for businesses. These results point to the preeminence of economic and social



**Figure 5. The Hidden Economy Index, 2002 – 2010**  
(min = 0, max = 10)<sup>30</sup>



Note: The index values for 2008 are based on telephone interviews. The rest of the values are based on "face-to-face" interviews.

Source: Hidden Economy Survey on the Business (HESB), 2010, Vitosha Research and Center for the Study of Democracy.

policies in tackling hidden economy over administrative and control measures, which seem to have been the instrument of choice for the Bulgarian government during the crisis. Furthermore, the indices for the population are more sensitive to labor market changes than to commodity market changes, while also more often resulting from a victimization (i.e. actual encounters) rather than subjective perception/assessment, which is more typical for business indices.<sup>31</sup> The dynamics of separate sub-indices reveals in greater detail the exact economic processes in the country, including the effect of governmental measures on countering the hidden economy.

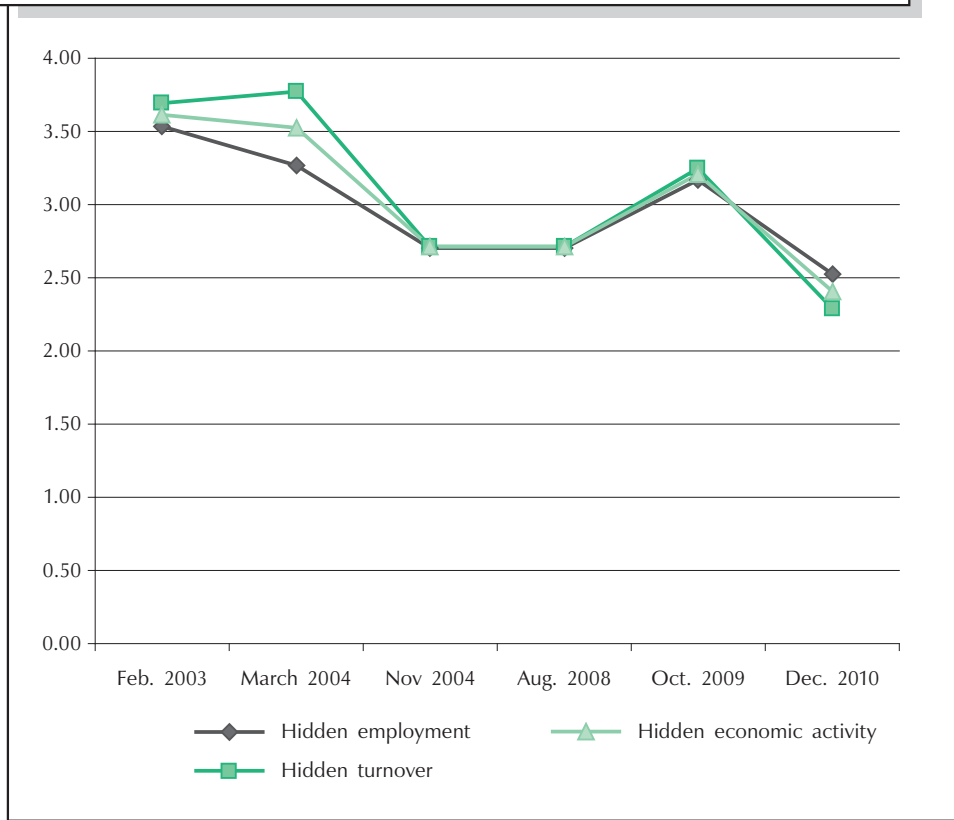
#### *Assessing the Size of the Hidden Economy*

Predictably, the sub-index measuring the subjective assessment of business representatives of the share of the hidden economy in the country, as a whole, has a higher value than all remaining sub-indices. This is so because enterprises usually believe that other businesses outside their sector are more engaged in the hidden economy than is the case in their own sector. Two thirds of the enterprises assessed the hidden economy share in the country as higher than the one in their

<sup>30</sup> Data in this publication might differ marginally from previously published versions of the indices as a new, more precise methodology has been employed and some inconsistencies have been corrected. These changes have not influenced the validity of this or previous analyses based on the indices.

<sup>31</sup> Victimization surveys reveal more accurately the actual situation and the behavior of the surveyed individual. Perception surveys contain a higher degree of personal opinion and attitude.

**Figure 6. Index of the Hidden Economic Activity of the Population, 2003 – 2010 (min = 0, max = 10)**



Source: *Hidden Economy Survey among the Population (HESP), 2010, Vitosha Research and Center for the Study of Democracy.*

branch, 23 % assessed them as equal, and merely 9 % were more critical to their own sector. **On average, businesses assess the share of the hidden economy in their own sector at 24 %, while estimates for the country as a whole stood at 40 % in 2010.** It is alarming that businesses’ assessment of the extent of the hidden economy at the end of 2010 remained at the same levels as in 2003 and 2004. Yet, other sub-indices (namely, labor relations, hidden turnover, and re-distribution) display a significant decrease. The dynamics in the assessments of the hidden economy mirror the dynamics of public trust in the government, which at the end of 2010 is at roughly the same level as in 2003<sup>32</sup>. A growing trust in the government is associated with a corresponding decrease in the hidden economy (as assessed by respondents), while failing trust leads to an increase in the index.

Almost 80 % of firms believed that the blame for hidden economy lay with “the others”, who are seen as hiding their economic activity more often than enterprises from one’s own branch. Over 20 % of firms pinpoint identical sectors as having the highest share in the hidden economy. These sectors are **construction, retail sales, restaurants and hotels, and tourism**. Curiously enough, sectors that

<sup>32</sup> According to Vitosha Research/Center for the Study of Democracy poll of polls.

**Figure 7. Dynamics of the Sub-index on Businesses' Perceptions of the Size of the Hidden Economy, 2002 – 2010 (min = 0, max = 10)**



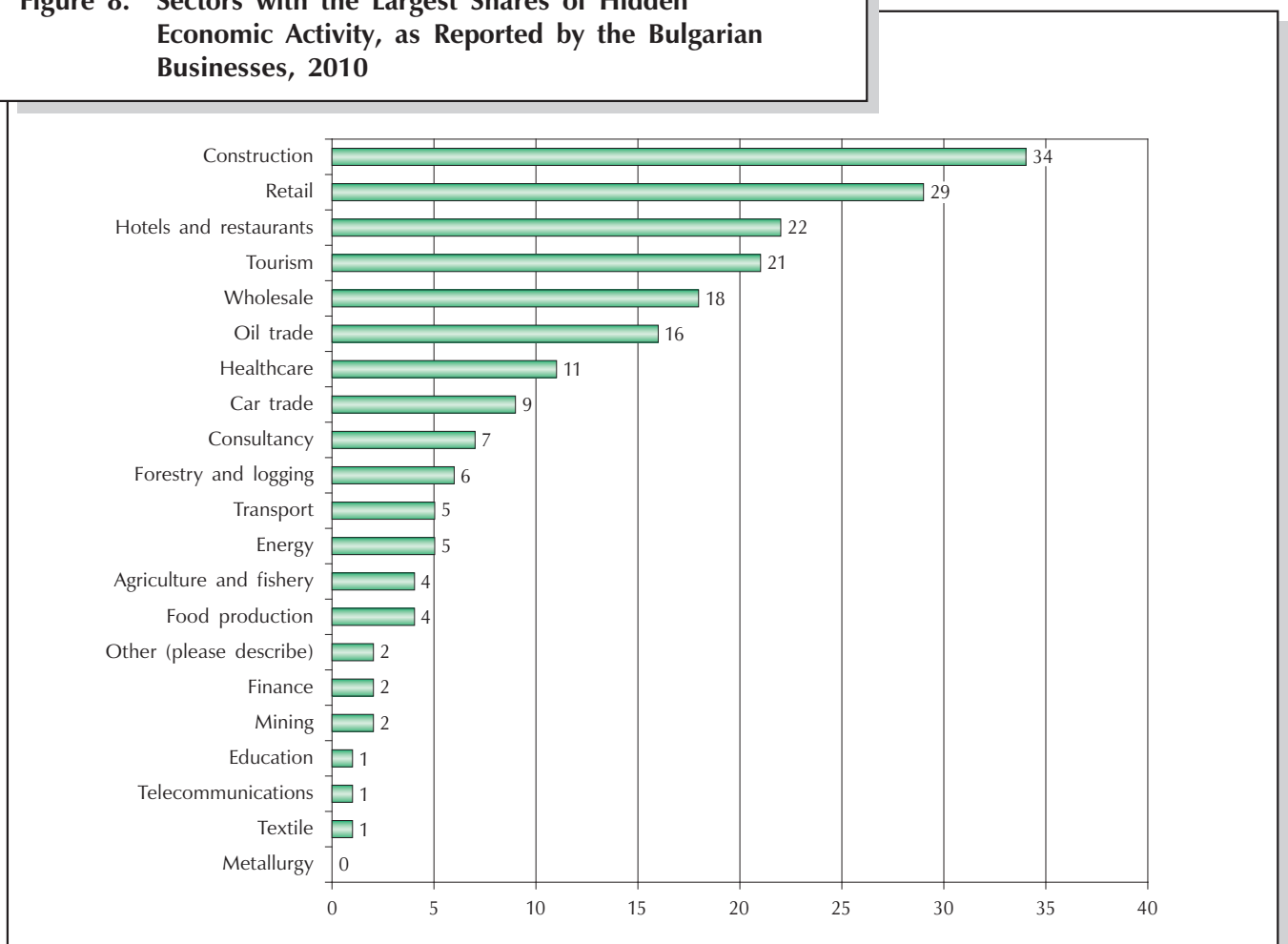
Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

are highly socially sensitive – fuel retail and healthcare – also appeared among the top ten sectors with the highest shares of hidden economy.

*Hidden Employment Relations*

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. A possible explanation is businesses' initial reaction to counteract the effects of the crisis on them, by laying off employees with no registered contracts. This, in turn, has also reduced the incidence of hidden economic activities among the population. Comparing unemployment data from the NSI to the Employment Agency's data shows that, between 2008 and 2010, the statistical institute estimates an increase in unemployment with an additional 32,000 individuals more than the officially registered in the employment offices. It can be assumed that some of these unemployed people, who did not register with the employment offices, have been previously working in the hidden economic sphere. Therefore, **the effects of the crisis on the Bulgarian economy are significantly greater than suggested by official data.** The loss of hidden employment, alongside the contraction of official employment, likely explains, at least partially, the stagnation of household consumption during 2010 and 2011, despite the fact that the government has officially claimed that Bulgaria has exited the crisis in the second half of 2010.

**Figure 8. Sectors with the Largest Shares of Hidden Economic Activity, as Reported by the Bulgarian Businesses, 2010**

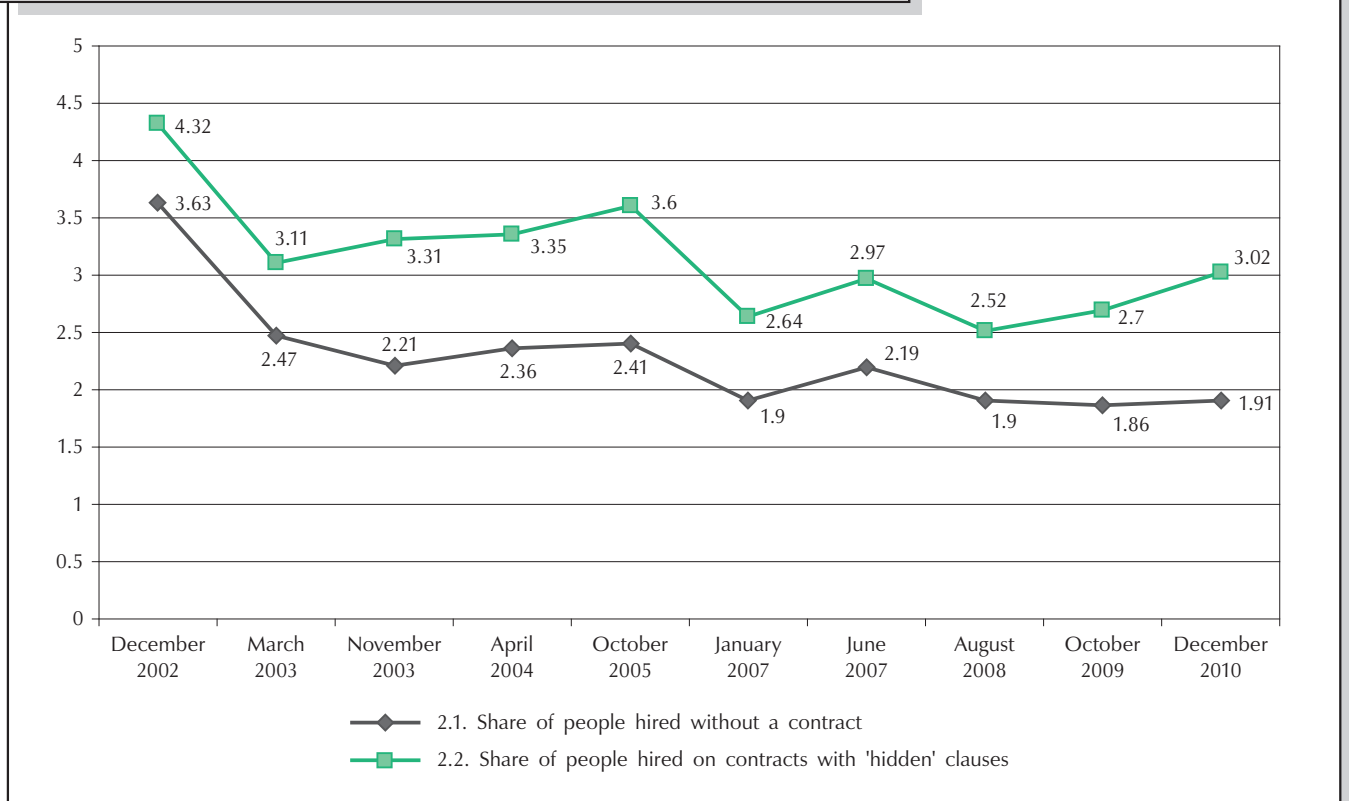


Note: Percent of firms considering that the respective sector has a higher share of hidden economy than the average for the country.

Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

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**. At the beginning of the crisis in 2009, businesses rapidly terminated unregistered contracts and then proceeded to cutting down official employment. This way, as exports started to pick up in April 2010, a number of enterprises realized they had significant savings in their wage funds, which they could re-distribute as hidden/unreported bonuses to stimulate their reduced personnel. With the stabilization of the economic situation, it is expected that the share of these hidden bonuses will go down due to a gradual increase in official employment. Therefore, in the long run, both business and population indices of hidden employment are expected to converge and return to the general trend of decline in line with improving business climate and economic conditions.

**Figure 9. Dynamics of the Sub-indices “Employed without Contract” and “Employed under a Contract with Hidden Clauses”, 2002 – 2010 (min=0, max=10)**



Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

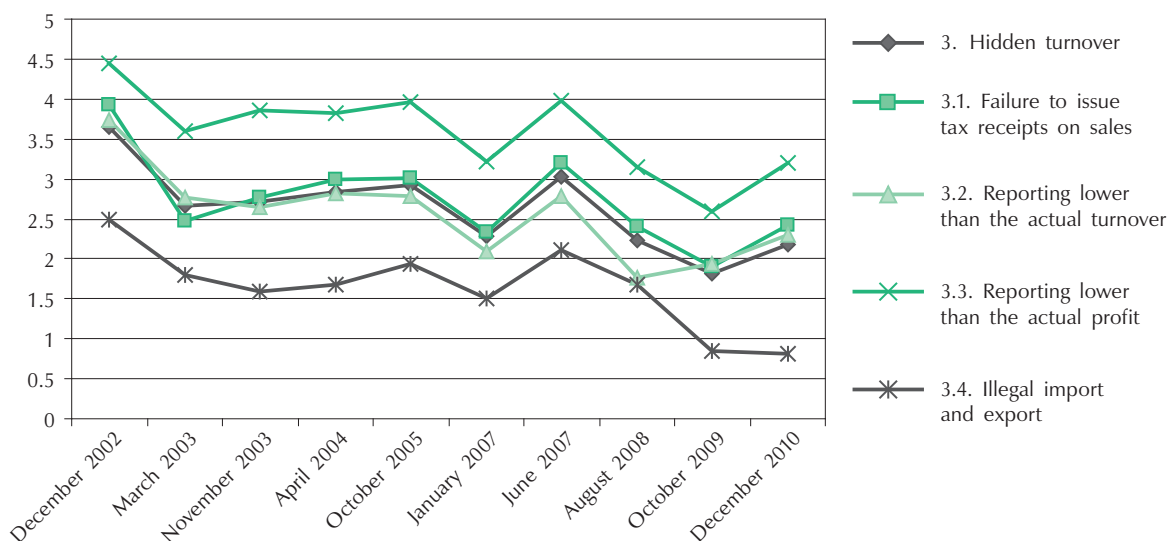
### Hidden Turnover

The “Hidden Turnover” sub-index uses four different methods to measure non-reporting of enterprises’ turnover. Not issuing receipts for sold items directly leads to reporting lower than the actual turnover, and, thus, to underreporting real profit. At the same time, underreporting the profit can be done through reporting higher non-taxable expenses (these are actual expenses that, however, should not be deducted from taxes, such as passing personal expenses for business expenses or bogus expenses for which a receipt was issued in the absence of any real service or product sale). Finally, reporting lower than the actual turnover can be done through issuing a receipt at a reduced price.

Apart from the concealment of foreign trade, the sub-index “Hidden Turnover” and its components display a growth pattern in 2010. Those who believe that hidden economic activity in their sector has increased as a result of the crisis (19 % of enterprises) exceed those, who think that hidden economic activity has decreased (14 % of enterprises). However, the majority of businesses either find it difficult to answer (43 %) this question, or think that there is no change (25 %).



**Figure 10. Hidden Turnover Sub-index and its Components, 2002 – 2010 (min = 0, max = 10)**



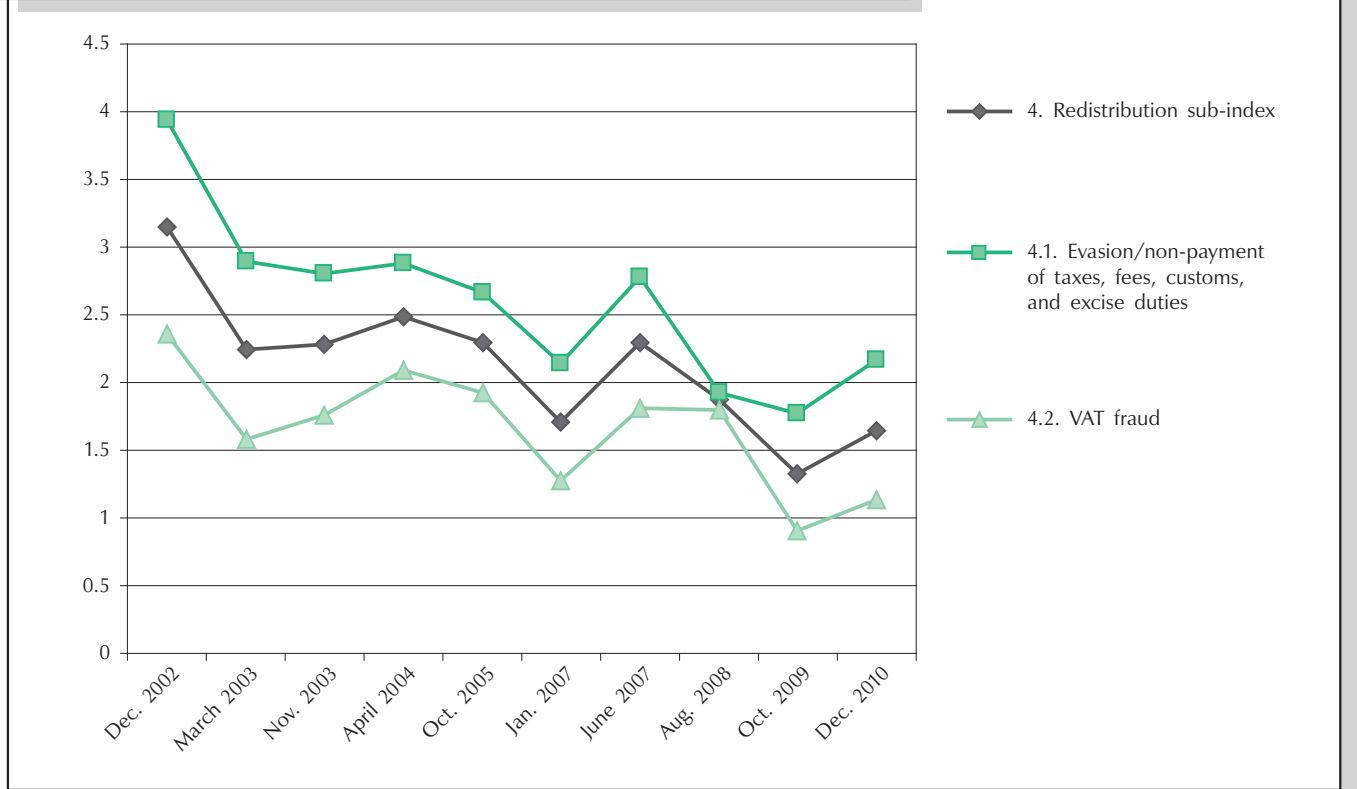
Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

*Tax Evasion and Non-payment of Duties and Excises*

Following a three-year drop, there has been an **increase in sub-index “Redistribution”** in 2010, 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 assumption 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 taxes and social security contributions. In addition, the restoring of business growth in 2010 was not a smooth, stable and predictable process, but occurred in a highly uncertain international and local environment, pushing businesses to resort to the more flexible and cheaper ways of the hidden economy to cover re-emerging employment needs. It should also be mentioned that, policy-wise, the increased administrative control measures of 2009 and 2010 have not prevented the resurgence of the hidden economy in terms of excise and VAT fraud. This came at the backdrop of a **sharp increase in excise duties in 2010**, which triggered very high smuggling pressure on some excise goods consumer markets, such as cigarettes. It is likely that the widely publicized standoff between the two deputy-prime ministers, leaders of the Ministry of Finance and the Ministry of Interior, have additionally reduced the effectiveness of the introduced control measures.

The process of hiding economic activity requires resources, strategies, and comes at a price (including transaction costs). Although the decision to hide a certain activity is not always entirely rational, and has sometimes been proven more expensive than operating within the official economy, entrepreneurs or managers

**Figure 11. Dynamics of the Sub-index "Re-distribution" and its Components (min = 0, max = 10)**



Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

usually figure out quite well what and how much to hide to remain undetected by the authorities, in particular after the introduction of a risk assessment system by the National Revenue Agency (NRA). Surveys show a direct connection between the decision to hide an economic activity and the readiness to resort to bribing for evading regulations. In this sense, strengthening the oversight on regulatory public servants responsible for inspections would be a more efficient measure to reduce the hidden economy than increasing administrative control over firms. On the one hand, it is likely that such a course would push some public administration officers to ask for higher bribes, thus increasing the price of the hidden economy and the their personal risk for being detected and punished. On the other hand, others will likely stop taking bribes. At the same time, in order to be efficient, a process of elimination of all regulations, which defy economic logic and are there only to boost administrative control performance statistics, should accompany the above-mentioned measures.<sup>33</sup>

<sup>33</sup> For example, requirements for hairstylists' shops to own a minimum of 40 towels, as well as special rubber covers for clients.

**Table 2. The Hidden Economy Index, 2002 – 2010**

	X 2002	III 2003	XI 2003	IV 2004	X 2005	I 2007	VI 2007	VIII 2008	X 2009	XII 2010
Hidden Economy Index	3.85	2.91	2.86	3.01	2.82	2.34	2.83	2.46	2.22	2.54
1. Size Assessment of "Hidden" Economy	4.60	3.96	3.66	3.86	3.64	3.08	3.44	3.53	3.47	3.87
1.1. Subjective assessment of the share of "hidden" economy in the country as a whole	5.65	5.02	4.83	5.00	4.85	4.20	4.39	5.35	4.42	4.89
1.2. Subjective assessment of the share of "hidden" economy in separate branches	3.55	2.90	2.49	2.71	2.43	1.95	2.48	1.71	2.51	2.85
2. Employment Relations	3.98	2.79	2.76	2.86	3.00	2.27	2.58	2.21	2.28	2.46
2.1. Share of employees without a contract in the respective branch	3.63	2.47	2.21	2.36	2.41	1.90	2.19	1.90	1.86	1.91
2.2. Share of employees with a contract containing "hidden" clauses in the respective branch	4.32	3.11	3.31	3.35	3.60	2.64	2.97	2.52	2.70	3.02
3. Hidden Turnover	3.65	2.66	2.72	2.83	2.92	2.29	3.02	2.24	1.82	2.18
3.1. Non-issuing of sales receipts in the respective branch	3.93	2.48	2.77	2.99	3.01	2.33	3.20	2.41	1.90	2.43
3.2. Reporting lower than the actual turnover in the respective branch	3.73	2.77	2.65	2.82	2.78	2.10	2.78	1.76	1.94	2.30
3.3. Reporting lower than the real profit in the respective branch	4.45	3.59	3.85	3.82	3.96	3.22	3.98	3.15	2.59	3.20
3.4. Illegal import/export in the respective branch	2.50	1.8	1.59	1.68	1.93	1.51	2.11	1.67	0.84	0.81
4. Re-distribution	3.15	2.24	2.28	2.48	2.29	1.71	2.29	1.87	1.33	1.65
4.1. Concealment/non-payment of taxes, duties, excises in the respective branch	3.94	2.90	2.80	2.88	2.67	2.14	2.78	1.93	1.77	2.17
4.2. VAT fraud in the respective branch	2.36	1.58	1.76	2.09	1.92	1.27	1.81	1.80	0.90	1.13

Source: HESB 2010, Center for the Study of Democracy and Vitosha Research.

### 2.3. MEASURES FOR TACKLING THE HIDDEN ECONOMY

The set of proposed and adopted measures targeting the hidden economy during the past three years in Bulgaria has been quite ambitious. But only a small part of these measures has had real potential to achieve a tangible effect on the hidden economy. In October 2009, the government approved a package of 76 anti-crisis measures that were active until April 2010. In reality the government implemented only a small share of the proposed measures, including such related to the gray economy. In 2010, the government proposed additional measures targeting the gray economy. In some cases, the 2010 measures clashed with the 2009 measures (e.g., the reduction in social security costs in 2009 and their consecutive increase in 2010 to their previous levels). International good practice in tackling the hidden economy effectively favors the adoption of a more limited set of measures followed by stricter enforcement. Therefore, **the Bulgarian government should better focus on the enforcement of a few measures, which have proven to deliver results.** This necessitates the development of an appropriate set of policies **and a monitoring system to measure each measure's costs and benefits.** The measuring the dynamics of the hidden economy in Bulgaria through the *Hidden Economy Monitoring System* makes possible a macro assessment of the effectiveness of the measures implemented by the government and/or by the private sector to counter the negative consequences of the hidden economy. For this purpose, however, a clearer understanding of the principles on which the hidden economy functions, as well as the effects of previous measures on hidden economy is needed.

Surveys of the hidden economy's behavior and its effects on the official economy confirm the existence of the so-called **double business cycle**. When the official economy grows, the hidden economy gradually decreases to a certain minimum level, which corresponds to the discrepancy between administrative regulation and economic reality. Conversely, when there is a downfall in the official economy, the share of the hidden activities goes up (Russo, 2008a, Giles, 1999, and Tanzi, 1983). These observations do not refer to the absolute size of the hidden economy, but rather to its relative share within the overall economy.

There are two basic reasons for the existence and the development of the hidden economy:

- **market entry costs**, such as registration fees, bribes, permits for operation, connecting to the electric grid, employing workers, etc.; and
- **costs of operating on the market**, covering the compliance process with all legal requirements, such as tax and social security payments, compliance with labor regulations, sector-specific regulations, and others (Enste, 2003).

There is a consensus in the hidden economy theory that the **bulk of the hidden economy is attributable to market entry barriers**, whereas a smaller share owes to market operation costs (i.e. taxes and labor legislation). (Russo, 2008b, La Porta and Shleifer, 2008, DeSoto, 1989, and Becker, 1978). These conclusions are only valid when the administrative control and law enforcement systems operate efficiently in accordance with legal regulations, providing security to firms operating within the official economy, while increasing the costs of the firms operating within the hidden economy. However, this does not hold true for Bulgaria. Ac-

cording to Bulgarian businesses, **the most important reasons for the existence of hidden economy in the country are:**

- corruption;
- lack of sanctions on illegal activity;
- inefficient judiciary;
- organized crime, etc.<sup>34</sup>

The combined effects of corruption, organized crime, lack of sanctions, and inefficient judiciary, render the rules of the game unpredictable. The way out requires an innovative approach and high political will, persistence and determination.

### ***2.3.1. Historical Review***

**Over 220 measures to counter the hidden economy have been proposed in the past five years in Bulgaria.** These include both official statements by the government and expert opinions of businesses and trade unions. Based on successful practices in the EU, the proposed measures can be grouped into four clusters (Eurofound, 2008):

- 1) administrative;
- 2) detection and deterrence;
- 3) preventive; and
- 4) corrective.

**Measures addressing detection and deterrence (64) and prevention (127)** prevail over other types of measures. Most measures have a postponed effect of at least one to two years after their introduction, considering that their results depend on the coordinated use of different instruments, and are difficult to objectively assess.

In comparison to European best practice, the following **problems with measures aimed at countering the hidden economy** can be identified in Bulgaria:

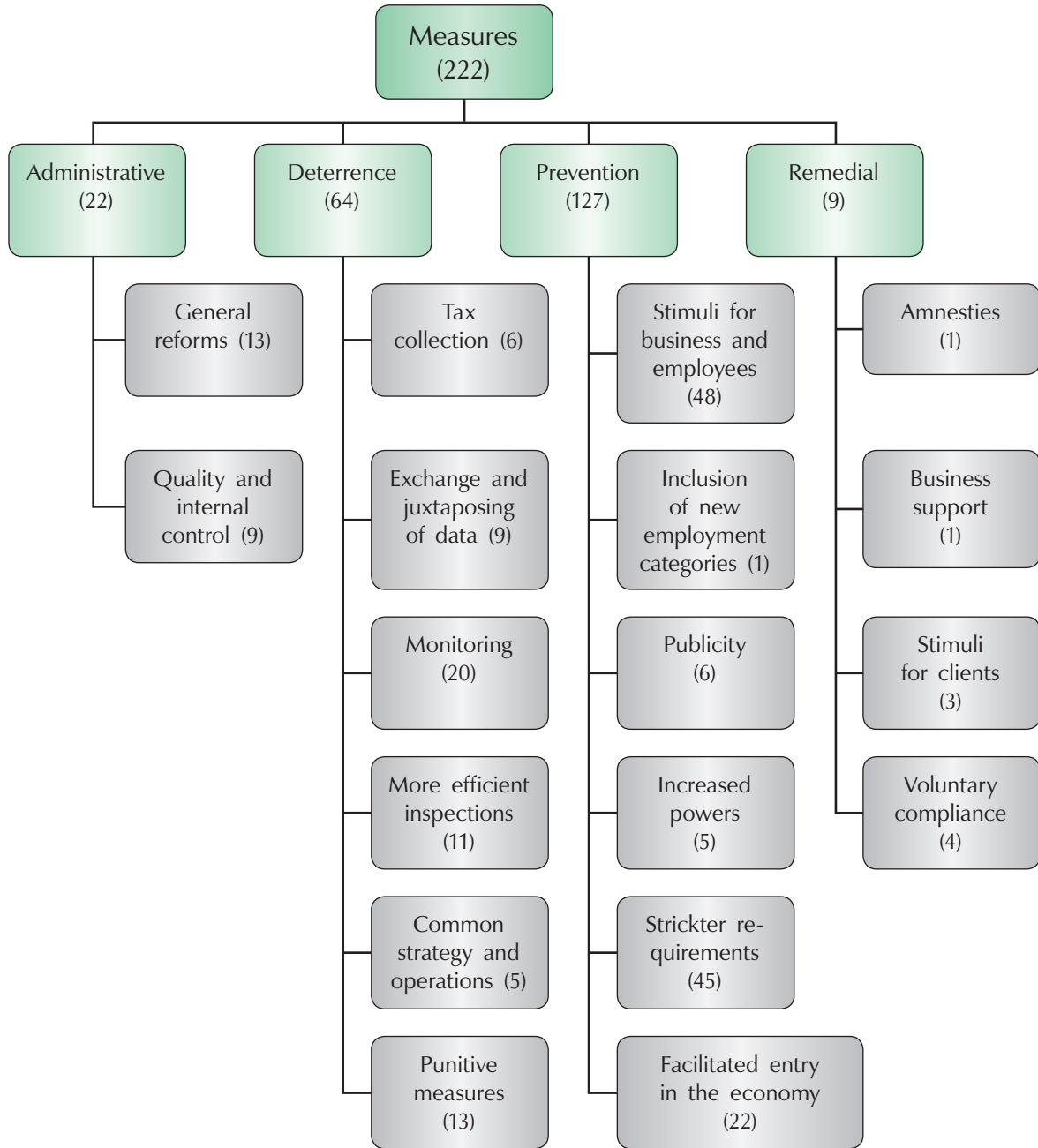
- **The absence of evaluation tradition**

Historically, there has been a tendency to implement simultaneously a number of measures for countering the hidden economy without proper evaluation of their potential and actual impact. Large packets of measures are poured directly in the public space and then officially enacted by the government without any expert appraisal. There has not been critical evaluation of the measures: Which measures have been successful in the past? What would be the cost of adopting a measure? What might be the negative consequences? In what way is their efficiency to be monitored? What would be their combined effect? Good practices show that a comprehensive program to counteract the hidden economy is comprised of fewer but very well targeted measures, which implementation is subsequently closely monitored.

<sup>34</sup> Data are from surveys of the sociological and marketing agency Vitosha Research. See also: Goev, V., Estimating the Hidden Economy in Bulgaria, South-East Europe, *Review for Labour and Social Affairs*, Vol. 12, January 2009.



**Figure 12. Measures Proposed in 2008 and 2009 to Limit the Hidden Economy**



Source: Policy Brief No. 20, Policies to Counter the Effects of the Economic Crisis: Hidden Economy Dynamics, December, 2009, Center for the Study of Democracy.

- **The economic policy measures are not in unison with the administrative control measures**

Bulgaria's experience so far, and the analysis of the *Hidden Economy Index*, have revealed that economic measures aimed at encouraging the business to enter the legal economy (like the introduction of flat tax or social security and tax rates reductions) have had a limited success at best, unless they have been accompanied by significantly improved monitoring and effectiveness of control actions. On the other hand, **measures for stimulating voluntary compliance have often been accompanied and even cancelled out by an increase in the administrative burden.** A case in point was the reduction of social security contribution rates and the increase in the minimal social security threshold in 2010. **Bulgaria is among the EU countries with the lowest overall tax rates, yet ranks worst in terms of the time necessary for voluntary compliance with tax obligations,** (IFC and PWC, 2009).<sup>35</sup> For example, though being an effective measure for administratively transforming unofficial into official economy, the continuous raising of minimal social security thresholds in all sectors of the economy has also increased the regulatory burden on businesses despite the reduction in social security contribution rates.

- **Measures are not tailored to the specific characteristics of the Bulgarian economy**

Best practices show that there is no universal solution in the fight against the hidden economy – measures which were successful in some countries, were extremely unsuccessful in others. In other words, when building a sound system of policies, national specifics (both economic and socio- psychological) must be taken into account. Measures that have worked successfully in other countries should be adapted and tailored to the national environment. For example, it has to be borne in mind that **over 90 % of Bulgarian firms are micro enterprises of less than 10 employees, which major motivation is survival rather than business growth.** What has to be taken into account when adopting measures for countering the hidden economy is the high level of public mistrust in state institutions, the poor quality of public services, as well as the limited capacity and the low remuneration of state administration.

- **Plenty of measures, no system**

A review of the existing and proposed measures has revealed the lack of a strategic approach to counteracting the hidden economy. The list of measures, which have been proposed every year, has grouped measures thematically without defining the possible synergies between them. There has been no assessment of measures' joint impact or of how they would interact. Some measures have had a short-term effect, while others have aimed at a lastingly change of

<sup>35</sup> Paying Taxes 2010: the Global Picture, International Finance Corporation, PriceWaterhouseCoopers, 2009. The report uses the "Doing Business" database of the World Bank to estimate the tax and social security burden in EU countries. As far as the total tax rate is concerned, Bulgaria is at the bottom, aside from Luxemburg, Ireland, Cypress, and Denmark. Yet, in terms of the time necessary for voluntary tax compliance, Bulgaria performs worst in the EU.

current behavioral models and their effect can only be seen in the long run. In this context, it is necessary to create a balanced and consistent portfolio of measures. Instead, Bulgaria has a list of measures that are not analyzed on cost-benefit basis and are evaluated separately, rather than as part of the whole system of measures.

- **Cost-benefit analysis**

There has been no cost-benefit analysis of individual measures. The adoption of most of the suggested measures has resulted in additional costs for the state budget and for individual businesses and citizens. There has been no public assessment of the balance between the cost for implementation and the measures' effectiveness. Such an analysis is extremely important in allocating efforts and administrative resources correctly. While publicized measures have mostly been preventive, the government has usually focused on carrying out punitive and corrective measures.

The proposed and adopted measures for reducing the hidden economy during the crisis of 2009 – 2011 have been particularly **focused on a stricter administrative control and enforcement and have introduced additional costs for the population**. Some of the negative effects of these measures' implementation have already surfaced. A glaring example in this respect has been the requirement for **cash registers to be connected to the revenue agency's system in real-time**, as well as the introduction of **additional measuring devices for traders with excisable commodities** (alcohol and fuels) irrespective of their size (i.e. even the smallest players have been affected). After the introduction of the real-time connection system to gas stations, 40 businesses, which had operated in the shadows resurfaced, but 400 others were closed down.<sup>36</sup> Although such a development might be considered positive from the perspective of reducing the hidden economy, its overall economic effect is unclear. There was no follow-up to what happened with the employees in these 400 closed gas stations. Neither is it clear what number of them actually seized their activity altogether. In 2011, the media reported a notorious accident with a gas station explosion resulting from illegal installation, while an official cover-up was also in place. Resorting to alternative installations that carry a much higher risk for workers' safety, as well as the safety of the population at large, is a common strategy for circumventing a ban on production for regulatory reasons. Going back to the closure of 400 gas stations, no estimates have ever been done of the actual budget losses from the operation of these 400 stations, nor have these been juxtaposed to the potential loss to consumers from their closure. It is logical to expect that after the closure of such a high number of small competitors, the market power of bigger players will increase and a rise in fuel prices and related services might follow. Moreover, the fact that the only operating refinery in the country failed to comply with the regulations for installing similar measuring devices to connect to the customs' control system, provided that all the other participants in the fuel trade were forced to, raises a valid question about the efficiency of control and the level playing field of the market.

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<sup>36</sup> According to data provided by the Ministry of Finance to the Bulgarian media.

**The increase of the intensity of administrative control can have only a temporary effect on reducing the hidden economy** if it is not supported by measures to improve control efficiency and to stimulate voluntary compliance from businesses. The results from measures targeting the hidden economy in Bulgaria can only be sustainable if key large-scale politically connected law offenders are punished. In this sense, it is necessary that the sanctions of administrative control agencies be directed towards large-scale offenders, and involves cooperation with the Ministry of the Interior and the Prosecutor's Office of the Republic of Bulgaria.<sup>37</sup> Currently, the foremost priority in reducing the size and the scale of the hidden economy in Bulgaria should be the strengthening of law enforcement. The biggest challenge in this respect would be the **severing of the links between high-ranking law enforcement officials and the gray businesses**, that is, peeling the underground layers of economic activity, especially those related to the trade of excisable goods and the production of alcohol and cigarettes, as well as public procurement heavy industries such as construction, infrastructure, and energy.

**Box 8. Measures Regarding the Hidden Economy Proposed by the Government, 2009 – 2011**

- Banks to grant access to the tax authorities to firms' and citizens' files. Since this proposal breaches the *Law on Credit Institutions*, Bulgarian banks suggested an alternative: to provide to the authorities the financial statements of loan applicants, so that they can compare the numbers to the data declared to the National Revenue Agency. This option, however, would still allow co-guarantors of a loan to hide their identity.
- Ban individuals who have been declared insolvent or have participated in the management of companies declared insolvent from the right to register sole trader firms or to manage other companies, until all their previous companies' credit obligations have been met entirely.
- Widen the circle of liable people to include accountants in the cases of bankruptcies with outstanding tax obligations. The motion was rejected by the Parliament.
- Allow tax authorities to claim social security obligations by analogy. This method is already used for tax purposes. The law allows tax authorities to claim tax obligations from firms by analogy i.e. by comparing their margins, turnover, and assets to companies with similar activities.
- Limit cash payments. On February 22, 2011, the *Law on Restriction of Cash Payments* came into force, putting a ceiling of BGN 15,000 (€7,669) on cash payments. All payments of BGN 15,000 or higher, and all contracts of BGN 15,000 or a higher value, can be executed only in a non-cash form. An additional proposal to make all remuneration payments non-cash was turned down after many business associations and civil organizations objected such a measure would be discriminatory.

<sup>37</sup> For a more detailed discussion and proposals how to counter corruption and organized crime, and the related to them hidden economy, see *Crime Without Punishment: Countering Organized Crime and Corruption in Bulgaria*, Center for the Study of Democracy, 2009, and *Organized Crime in Bulgaria: Markets and Trends*, 2007.

**Box 8. Measures Regarding the Hidden Economy Proposed by the Government, 2009 – 2011 (Continued)**

- The period in which a firm's assets cannot be transferred or re-structured was extended from one week to 60 days. During this period, tax authorities can inspect its tax obligations, and if the enterprise is a debtor to the state budget, they can freeze its assets. The extended period applies only to sole traders' closures and to mergers of limited joint-stock companies;
- Increase the minimum monthly obligatory social security threshold from BGN 260 to BGN 420 for all industries, and BGN 240 for agricultural producers;
- Introduce a minimum of 3 years of home ownership as a precondition for claiming income tax exemption in case of a re-sale or a swap;
- Make obligatory the declaration of loans of over BGN 10,000 (€5,113) received and given by physical persons;
- Computerize the movement and the control of excise goods through a specialized Excise Movement and Control System;
- Connect cash registers to the National Revenue Agency's tax collection system in real time;
- Introduce a number of measures concerning the excise regime of motor fuels; management of excise tax warehouses; small-scale production of ethyl alcohol (up to 500 liters);
- Decrease the registration fee for a limited liability company to BGN 2;
- Create a centralized board for the management of concessions under strict control regulations;
- Approve new amendments to the Law on Public Procurement, aiming to eliminate controversial and non-transparent procedures and to remove "small public procurement procedures", as well as to strengthen the role and the authority of the Public Procurement Agency.

Source: Center for the Study of Democracy, 2011.

### 2.3.2. Toward More Effective Measures

The Bulgarian authorities should seek a long-term change in the cost – benefit balance of the hidden economy to reduce its negative effects. In this respect a **reform of the control system agencies** and a rise in their efficiency is of utmost importance. An important element of this reform should be the improvement of support and advisory services of the control system as well as the streamlining of inspections and sanctions. Currently, a common problem for all control agencies is that they act and are perceived by the citizens and the businesses as **repressive bodies rather than as service providers**. The emphasis of their work should shift from across the board control and sanctioning towards targeting large-scale offenders in collaboration with law enforcement authorities. At the same time they should devote most of their time and efforts to assisting citizens and the businesses understand and fulfill their rights and obligations, so as to increase voluntary compliance with the law. The reform at the National Revenue Agency has shown that achieving results requires significant expert resources and efforts through an



extended period of time (i.e. for a period of 7 to 10 years). Moreover, to counteract corruption pressure, reforms must be simultaneously carried out with the re-structuring of respective agencies and a significant increase in the remuneration of employees, so as to avoid a situation where control authority personnel's salary is times lower than their level of resistance to corruption.<sup>38</sup>

**Punitive measures by control authorities significantly increase the costs to the legally operating small business.** As a result, small businesses may resort to corruption and to concealing some of their activities to offset control-induced costs. This is why inspections should focus not on quantity (number of sanctions), but on achieving a higher quality (returns per inspection), and a higher rate of prevention (fall in the repetitiveness of violations). Although many control agencies do not provide adequate and/or timely publicly accessible information about their activities, the available data for 2008 and 2009 imply that more than 200,000 inspections are carried out per year in Bulgaria. Taking into consideration that about 6,500 firms pay 90 % of the tax revenues,<sup>39</sup> these data demonstrate **extreme inefficiency and degree of administrative burden**. For example, in 2009, the Chief Labor Inspectorate carried out over 50,000 inspections. Such across the board inspection activity cannot lead to a sustainable decrease in the hidden economy, but it is common practice for all control agencies. At the same time, in 2008, NRA increased the number of established violations from 60,163 (in 2007) to 88,600 (in 2008), while carrying out 86,000 fewer inspections than in 2007 by improving its risk analysis.<sup>40</sup> Yet again, the total number of inspections is staggering. Therefore, **control authorities should introduce systems of standardized procedures for monitoring and evaluation of the policies and control measures** implemented for reducing the hidden economy. The evaluation of each measure can use the following two criteria:

- **efficiency of execution**, i.e. rational use of resources for achieving optimal results; and
- **efficacy of output**, i.e. the widest effect from achieved results compared against clearly defined objectives.

In addition, it is necessary to **critically evaluate the performance of the government property and expenditure management agencies**. They have the power to change the structure of the markets and corrupt practices in such bodies generate sizable flows of undeclared, illegal income into the private sector. Particular attention should be paid to the authorities responsible for the management of **public procurement and concessions**, such as the Public Financial Inspection Agency, the Public Procurement Agency, the Commission for Protection of Competition, the Chief Inspectorate at the Council of Ministers and its subdivisions, and others. In 2008, the Public Financial Inspection Agency checked upon 5 % of the 18,708 officially registered public procurement procedures, and established wrongdoing in 71 % of the procedures. Moreover, in the period 2007 – 2010, the share of faulty public procurement procedures out of all public procurement has been,

<sup>38</sup> For a more detailed discussion and analysis on the topic, see *Corruption and Tax Compliance. Challenges to Tax Policy and Administration*, Center for the Study of Democracy, 2005.

<sup>39</sup> According to interviews with Krassimir Stefanov, Executive Director of NRA, to the media.

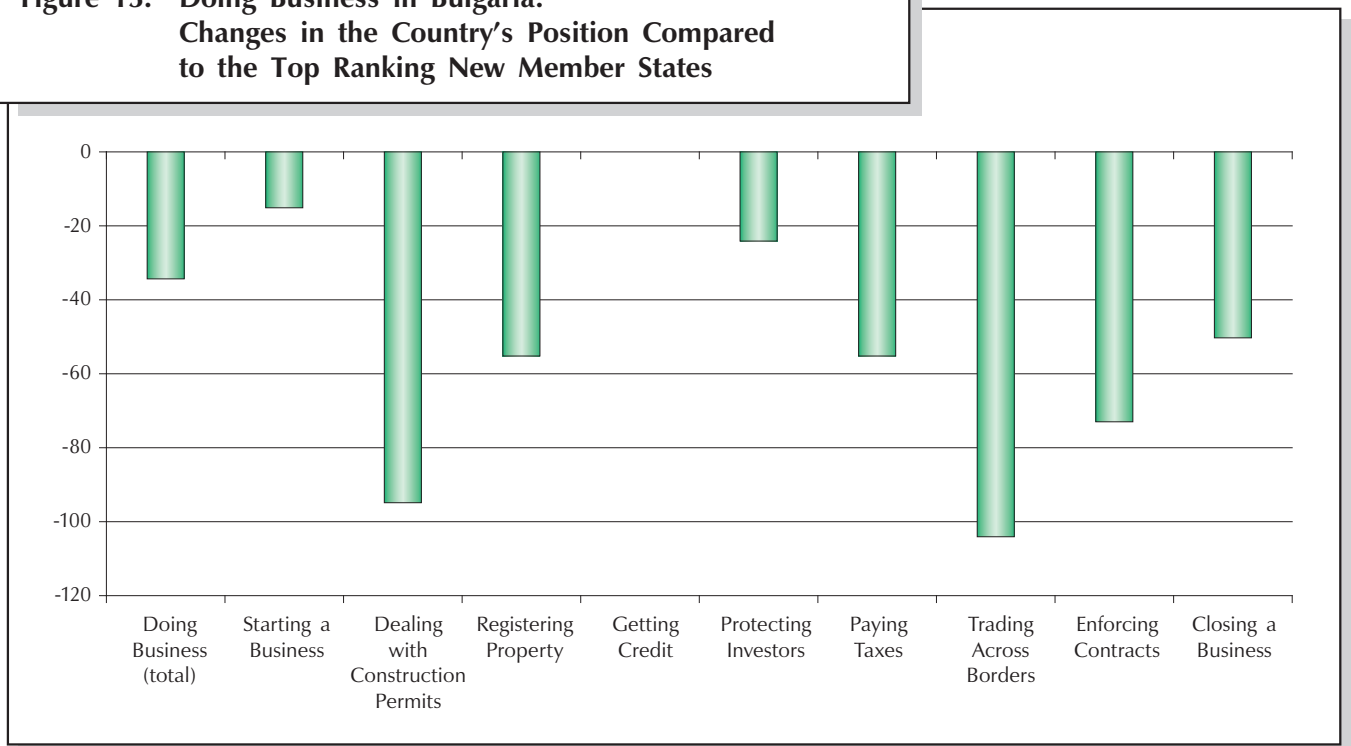
<sup>40</sup> National Revenue Agency yearbook, 2007 – 2008.

on average, 60 %. The latter implies a **systematic problem** with the Bulgarian public procurement system. As of April 2011, the Bulgarian National Audit Office found **malpractices in 70 % to 85 % of the inspected public procurement procedures**. In the face of this very high rate of law violation, the first instance appeal body, the Commission for Protection of Competition (CPC) has failed to deliver. In 2008, CPC halted the execution of less than 3 % of the appealed public procurement cases, while disregarding over 50 % of all complaints. While this is not likely to discourage large firms, for small firms it actually means forgoing access to the appealing mechanisms. The small number of appeals confirms this hypothesis – 825 (under 5 % of all public procurement procedures registered in the country). At the backdrop of the high rate of violation of public procurement legislation uncovered by the competent authorities, the low number of appeals means that **firms do not trust the Commission for Protection of Competition** as a guardian of public procurement fairness. Even for med-sized firms, the very procedure for appealing, informing interested parties, and accessing case documentation is exceptionally clumsy, expensive, and impeding. Considering the rising role of the Public Procurement Agency in prevention and in the ex ante control of large public procurements and procurements funded through European funds, CPC should focus on improving the access to appeal mechanisms for smaller public procurement participants. Another option, which should be considered, is the transfer of first instance appeals to the Regional Administrative Courts. The Supreme Administrative Court acts anyway as a second-instance appeal body to the CPC's decisions. This way appeal cases would remain within the administrative justice system, which should be cheaper and more transparent. Additionally, terms and conditions set out by the Bulgarian Administrative Procedure Code will apply, which are more favorable than those applied by the CPC. Such arrangements provide for a more balanced approach to controlling all phases of the public procurement process.

**Government's policy on the hidden economy should encompass the whole control system.** Traditionally the focus is on control authorities directly related to state budget revenues – the National Revenue Agency, the National Customs Agency, and the Chief Labor Inspectorate. It is, however, important that the spotlight is also shone on other control agencies that set the costs of businesses for entering and operating on the market. Such agencies include the National Construction Control Directorate, the Regional Inspectorates for Protection and Control of Public Health, the National Veterinary Medical Service, the Regional Inspections of Environment and Waters, the Food Safety Agency, the Control over Automobile Transport, the State Automobile Inspection, the Executive Forest Agency, and others. Publishing regular, systematic data on their performance on their websites is a prerequisite for improving the work of government control agencies. It should be emphasized that as of 2011 **only the Chief Labor Inspectorate and the National Revenue Agency have comparatively well-developed publicly accessible reporting systems on their control activities**. The rest of the control agencies have either no reporting system in place, or an incomplete and utterly outdated reporting mechanism.

Last but not least, the government can introduce measures, which can simultaneously lead to decreasing the share of the hidden economy and contribute to the modernization of the country – the so-called **administrative innovations**. Aside

**Figure 13. Doing Business in Bulgaria: Changes in the Country's Position Compared to the Top Ranking New Member States**



Source: Center for the Study of Democracy using World Bank data, 2011.

from measures directly targeting the hidden economy, policies for the development of human capital, new technologies, and innovations can create the right environment for less hidden economic activity (La Porta and Shleifer, 2008). A good example is the introduction of card payments, including the use of mobile phones chip cards.

In order to achieve sustainable results in limiting the negative effects of the different manifestations of the hidden economy, the Bulgarian government should introduce **regular evaluation of the effectiveness of conducted policies and measures and the institutions enforcing them**. This requires collection and enhanced processing of information on the work of the state administration. Such data collection and analysis can be realized fairly easy with the help of European funding (i.e. from Operational Program Administrative Capacity and Operational Program Technical Assistance).

