

HIDDEN ECONOMY IN BULGARIA: 2015 – 2016

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The correct understanding of the dynamics and the structure of the hidden economy is essential for improving the governance of the public and the private sector. Two thirds of entrepreneurs globally start their business by engaging one way or another in hidden economic activities.¹ Given the right set of circumstances (compatibility between formal and informal institutions, high level of trust in the government, the law enforcement and the judicial authorities) these entrepreneurs formalize their activities and integrate themselves quickly and effectively into the official economy. At the same time, **the negative consequences** of the hidden economy are multidimensional and their **identification and limitation** is of key importance. In Bulgaria the high level of hidden economy undermines the economic development of the country and requires **serious and persistent** political attention. The unprecedented growth in the field of digitization of economic activities, the convergence between some of them, and the emergence of brand new services creates an opportunity for achieving a desirable environment, which may reduce the hidden cash flows and boost the economic development of the country. Comprehensive reforms focused on the functioning of the market mechanisms and administrative effectiveness are needed in order to promote the process of economic convergence within the European Union and limit the harmful effects of the hidden economy in Bulgaria.

KEY POINTS

- Data from the 2015/2016 *Hidden Economy Index* showed that **hidden employment receded** according to both business representatives and the public at large. The evasion of social and health insurance payments decreased too. This dynamic contributed to the lowest level of the “hidden employment” sub-index during the 2002 – 2015 period. Nonetheless, **a quarter of the individuals employed still do not declare some or all of the social security payments.**
- The labor market’s major challenges in reducing hidden employment proved to be the **wider coverage of young employees** (18-29 years of age), particularly males, and the **increase of social security income for specific groups of employees.** One third of the young employees do not pay social security contributions on their actual earnings.
- Organized VAT fraud is among **the main threats** to the national economy as they are **the second biggest source of revenue for the organized crime** after human trafficking and before drug and illegal cigarettes trade. The danger comes from the fact that these type of frauds cause direct fiscal damage and compromise competitiveness in entire economic sectors.
- The issue with **the introduction of VAT for the personal use of premium goods/services listed as company expenses remains hanging** as the implementation of the measures proposed by the Ministry of Finance in 2016 causes costs that seem unreasonably high.
- Change in the tax morality and the behavior leading to engagement in hidden economy activities cannot be expected and achieved in Bulgaria without **significantly improving the quality of public services and achieving higher public trust in the state institutions and the allocation of public funds.**

¹ Statement made by Prof. Colin Williams of the University of Sheffield at the “Tackling the Hidden Economy: Employing Best EU Policy Practices for Growth and Jobs” policy forum held in Skopje, Macedonia on October 13, 2015.

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Competitiveness of the Bulgarian economy

Despite the fact that Bulgaria remains as one of the least competitive countries and ranks 50th out of 61 economies in IMD’s annual World Competitiveness Yearbook, there are some positive trends (an improvement of five places in 2016 compared to 2015) and a slow but steady further improvement in the rankings can be expected.

The gross domestic product (GDP) has accelerated its growth and in 2015/2016 has reached 3 % rate which seems sustainable despite the fact that it is much lower than the levels registered in the 2002 – 2007 period (6-8 % annual growth). Price competitiveness, a favorable tax environment and financial stability remain among the main advantages of the Bulgarian economy. The stress tests of the banks showed overall positive results despite the increased risk to the financial system as a result of the intercompany indebtedness and the fallout of the Corporate Commercial Bank (CCB) crisis of 2014, which has shown significant gaps in the banking supervision. The sectors of engineering and ICT export continue to develop and grow, and to serve as the main engines of economic development in the country.

Unemployment has fallen down below 9 %, which is a positive trend in view of the last couple of years but the market still remains ineffective. Between 130,000 and 140,000 people are long-term unemployed, while more than 30,000 have not worked at all over the last 8 years. The peak long-term unemployment rates

have been registered in 2013 while the decrease in the following years has been mainly due to retirement of long-term unemployed.

Education directly affects one’s ability to secure a job. The unemployment rate of college graduates currently stands at just 4.1 %, which clearly indicates that labor market stability is in place with regards to elements such as transition to self-employment, looking for a new job, starting a new business or taking advantage of the social system. At the same time, the unemployment rate among people with secondary education is close to the national average rate of 12 %, while the rates among people with primary education (23.6 %) and especially with elementary education (45.7 %) reveal a disturbing situation.

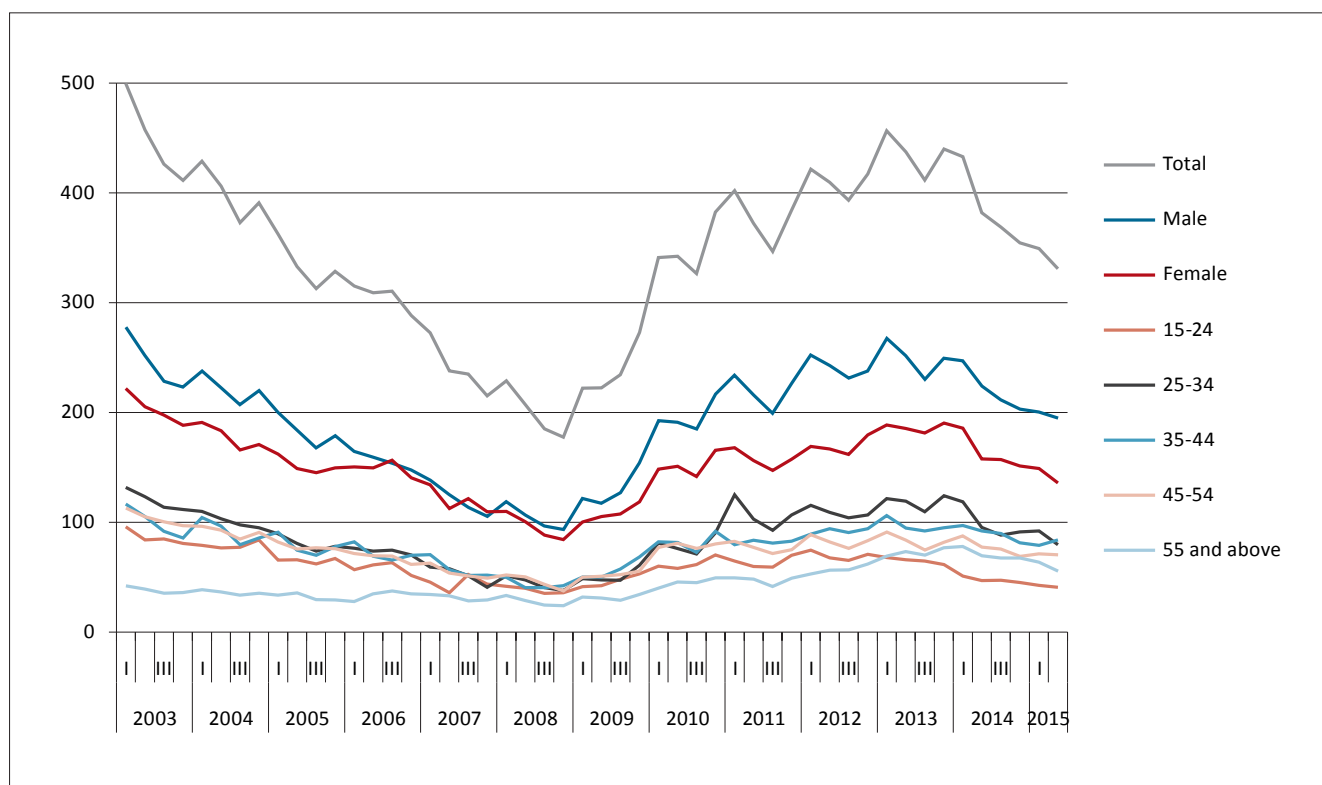
Although alarmingly high, the levels of youth unemployment (21.6 % of the people between 15 and 24 years of age) should not be viewed as disturbing because in absolute numbers they represent around 40,000 people, part of whom are taking advantage of the social system or are part of the hidden economy. In time they will be easily integrated in the labor market in case they have education. Due to differences in the fertility rates in the 80s and the 90s, the rest of the cohorts are much bigger (e.g. the number of unemployed people aged 25-34 is 80,000, but the unemployment rate stands at 10.4 %). In the long run, there are going to be more retiring workers than new entrants into the labor market. The **emigration of the highly skilled and educated** to rich countries continues to be one of the most pressing problems that the economy is facing. According to IMD’s World Talent Report, Bulgaria ranks 89th out of 93 countries in the “brain drain” category and 88th in “brain gain”.

Figure 1. Overall ranking of Bulgaria in IMD World Competitiveness Yearbook



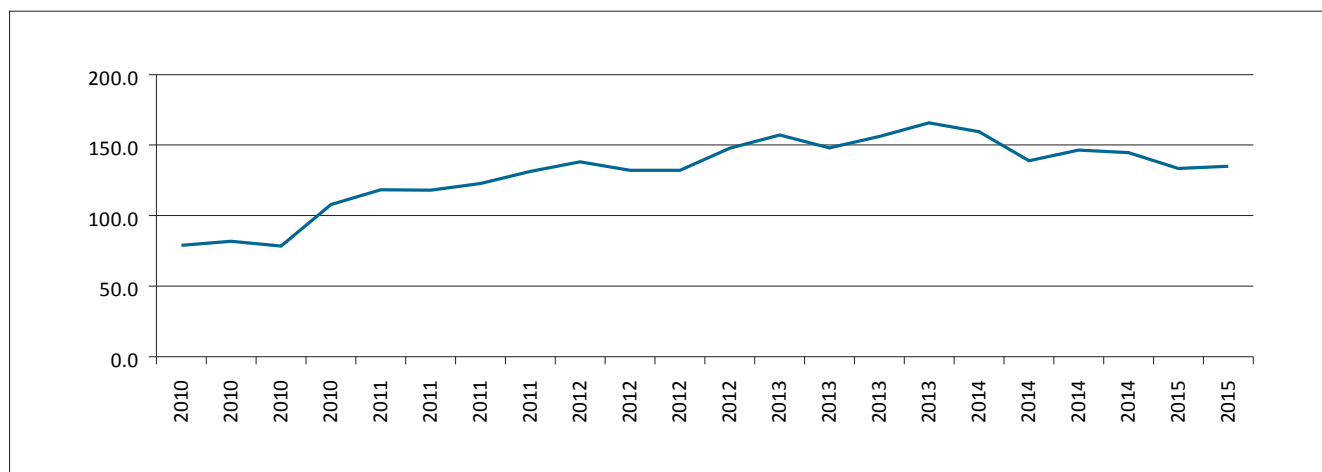
Source: IMD WCY 2016.

Figure 2. Dynamics of the number of unemployed per quarter and age group (in thousands)



Source: National Statistical Institute, 2003 – 2015.

Figure 3. Dynamics of the number of long-term unemployed (in thousands)



Source: National Statistical Institute, 2003 – 2015.

Hidden Economy Index 2015/2016: components and dynamics

In 2015/2016, the hidden economy index values for businesses and the population showed different

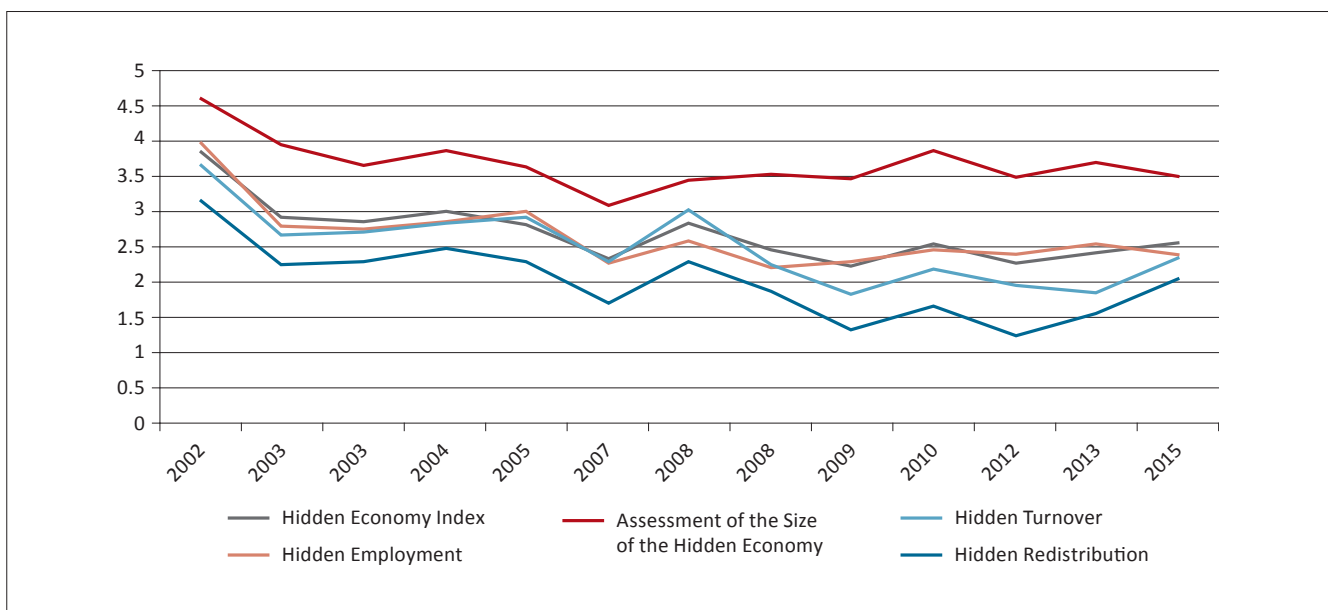
results in comparison to 2013. Data indicated there is a decrease in the incidence of hidden employment according to both the population and businesses. The perceptions among businesses in regards to the overall size of the hidden economy in the country showed a decrease. At the same time, however, their assessment on the hidden redistribution, which encompasses the practice of tax, customs and excise

duty evasion or non-payment, has increased. Among the sub-indexes of the business hidden economy index, **the share of employment without a contract had the lowest values**, which also happened to be the lowest indicator value for the whole period since 2002. A variety of factors have contributed to the result: the routine and unplanned inspections on behalf of the General Labour Inspectorate Executive Agency (GLI-EA) in high-risk sectors (retail, catering, construction, apparel manufacturing, and seasonal, e.g. hotel inspections); the widespread practice of checking for paid social and health insurance for those wishing to purchase goods on lease; checks conducted by general practitioners and hospitals during visits, etc. Much like the credit boom of 2005 – 2008, which caused the income of the middle class to come to light, the leasing of goods during the 2013 – 2015 period has added additional pressure for lower income groups to declare their employment and income.

General Labour Inspectorate Executive Agency data shows in 2014 the number of detected workers without employment contracts during inspections dropped by 26 % in comparison to the previous year. In proportion to the conducted inspections this makes 4.5 % in 2014 compared to 5.3 %, ² very close to the data obtained in the national population

survey conducted by the Center for the Study of Democracy – 5.2 % in 2015 and 6.9 % in 2013. Despite the positive effect of the inspections carried out by GLI-EA, the inspection **sample selection algorithms are obviously lacking sufficient quality** due to the fact that the number of uncovered employment contract violations are less than or equal to the preliminary mathematical estimates. Despite the fact that in 2014 the number of inspected companies grew by 25 % (first time inspections), results are raising reasonable doubts that the cost of compliance with labor regulations for a large number of companies (75 %) is increasing disproportionately with the increase in the inspections conducted by GLI-EA. A significant part of the sanctioned infringements are minor especially, when it comes to smaller enterprises (lack of holiday and working schedules, not storing those schedules for three years, lack of diverse regulations on workplace safety, etc.). The **amendments to the Labour code**, ³ which brought some bureaucracy relief to the businesses, **should be viewed as a positive change**. From the standpoint of some companies, it is economically more viable to take the risk and pay a fine in case of inspection instead of constantly keeping the relevant documentation up to date. **A negative but common practice** in Bulgarian legislation is that **all companies are being burdened with high costs of**

Figure 4. Hidden Economy Index, 2002 – 2015



Source: *Hidden Economy Survey on the Businesses, 2002 – 2015, Center for the Study of Democracy.*

² Activity report of GLI-EA for 2014 and Activity report of GLI-EA for 2013. Available at: <http://www.gli.government.bg/page.php?c=40>

³ State Gazette issue 54 from July 17, 2015.

compliance with workplace and other regulations, instead of just those that are **at higher risk** or are **government and public-sector organizations**.

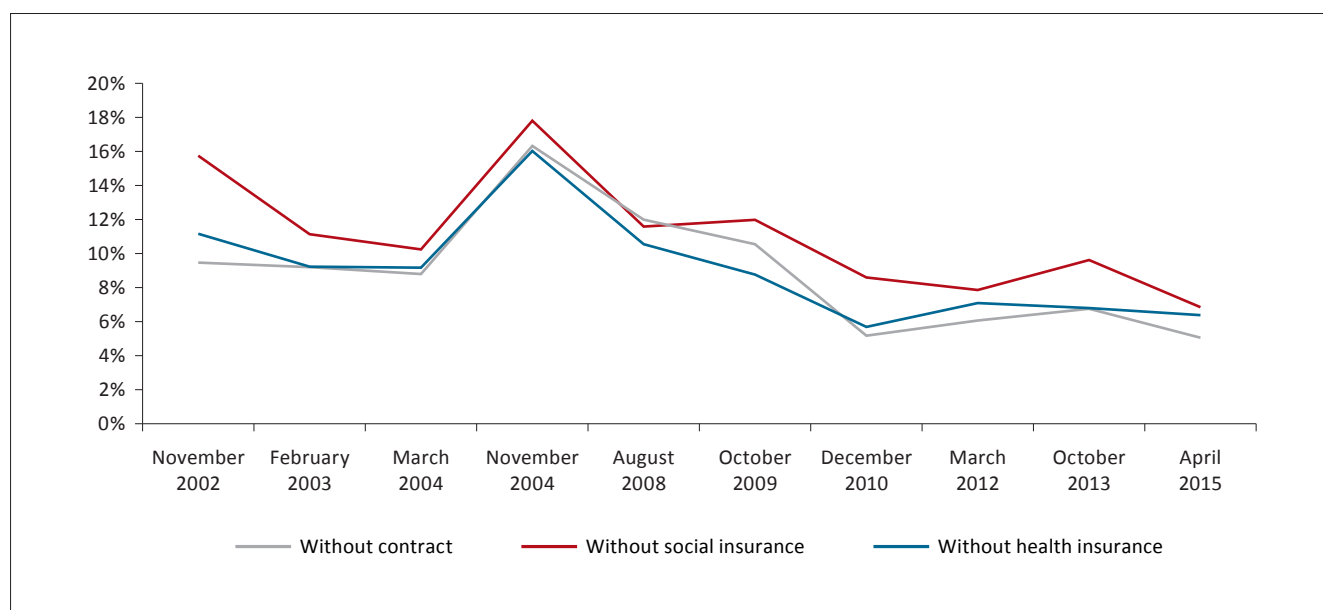
The internal management measures for logical examination of different tax declarations⁴ submitted by the business uncovering inaccurate micro data, implemented by the National Revenue agency since 2014, have reduced the evasion of social and health insurance contributions and personal income tax payments. In 2015, both **the number of workers without social and health insurance and the number of workers that do not pay social security contributions on their actual earnings dropped** in comparison to 2013.

In the 2002 – 2015 period the **share of the socially uninsured decreased more than twice** while the **share of workers without health insurance dropped more than 1.5 times**. However, within the **same period** around **one fourth** (± 5 pp) of the workers paid social security contributions on lower than their actual earnings and in total around **40 %** (± 10 pp) of all workers **engaged one way or another** (they either do not have a working contract or they do have one but it contains misleading or false clauses) **in hidden economy activities**.

If we assume that the normal rate of unemployment for the Bulgarian economy is in the range of 5-6 % (a value accepted by many economists for many countries⁵ and at the same time the lowest percentage achieved in Bulgaria during the 2002 – 2009 period, which was characterized by long-term stable growth) and it is assumed that there is a similar normal rate of hidden employment (1-2 %), the formal sector might have reached the near-maximum coverage of available employees (currently, 90 % of the workforce is employed in the formal sector). But full income disclosure is still a thing for the distant future.

There are various groups of people that can be further covered, but because of the accompanying related costs (both direct and indirect) the process would not be economically justified or at least not with the GLI-EA and NRA instrumentarium. Most often, this concerns **family employment** and involvement in wholly or partially hidden economic activity (agriculture and forestry sector, retail, waste management, construction, auto repair and maintenance activities, car washes, etc.) or **involvement in illegal business practices** – theft and fraud, drug trafficking, prostitution, etc. Income disclosure in these cases should be based on entrepreneurial development measures, social care and legal protection measures aimed at reducing crime.

Figure 5. Entirely hidden employment (as a share of the employed)



Source: *Hidden Economy Survey of the Population, 2002 – 2015, Center for the Study of Democracy.*

⁴ E.g. Forms No. 1 and 6.

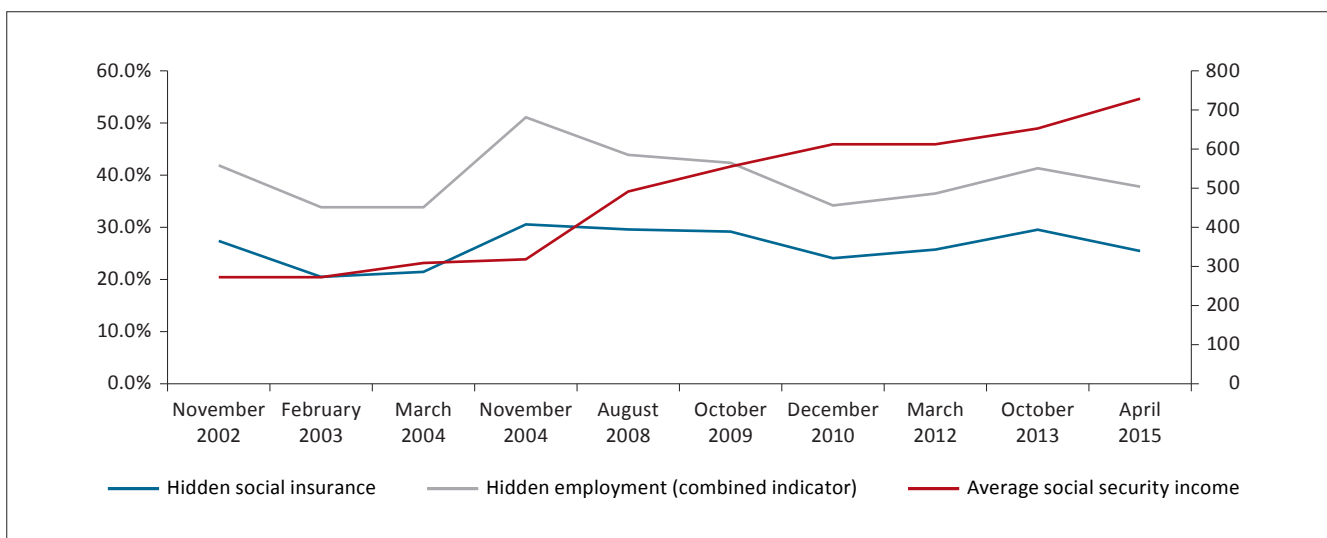
⁵ E.g. for the US see: Williams, J. (2015) Update of “What is the New Normal Unemployment Rate”, <http://www.frbsf.org/economic-research/files/el2011-05-update.pdf>

Meanwhile, **the measures aimed at increasing the amounts based on which social and health security contributions are being paid** should be continued and updated. Over the last 13 years the actual insurable income has increased roughly 3 times (2.81 times to be exact), while the GDP growth per capita in purchasing power parity terms has been a bit less than 2 times (1.92 times) for the same period. This growth trend has been partially due to the increase in the minimum and maximum social security thresholds, but mostly due to the rise of the average salary of employees under labor contract (3.5 times in the 2002 – 2015 period) and the total personal income (2.2 times). Over time, **the earnings of higher income groups come to light slower** and there is even a certain **continuing purposeful evasion** (those who are in a position to do it – self-employed, business owners) **of paying social security contributions**. That “**evasion**” is most easily seen among the wealthiest business owners and professional managers, who “**replace**” the income (on which they have to pay social and health insurance contributions and income tax) **through “corporate consumption” of goods and services paid by fellow citizens with lower earnings**. Examples of such are luxury consumption of company cars (consistently exceeding the number and vehicle classes used by comparable foreign companies) and yachts for personal use, high-end smartphones with maximum mobile internet (including overseas during holidays), as well as reporting of business trips and home energy and water costs as business or construction expenses. This calls for the introduction of tax deductible expense limits (e.g. for the use of company cars) comparable to these

in other European countries. At the same time a large share of the tax evasion by higher income groups is actually stimulated by the tax legislation, which is highly regressive in nature and full of exceptions targeting precisely the less needy groups of the population.

Although there was an improvement in 2015/2016 in both reduction of evasion of social security contributions (reaching 25.5 %, which is a decrease of 4.1 pp in comparison to 2013) and the overall **index of hidden employment** (reaching 37.8 %, which is a decrease of 3.4 pp in comparison to 2013), **additional measures consistent with the typological features of the different groups are necessary**. The **18-29 age group contains the largest share of workers without employment contract and paying social security contributions on lower than their actual earnings**. Over time as workers gradually enter the formal economy, data shows that **female workers enter quicker than male employees** and with smaller discrepancies in the social security contributions. In certain cases, they even arrange to pay these contributions on higher than their actual earnings in view of expected maternity leave. The share of women who pay social security contributions on lower than their actual earnings (23.6 %) is with 5 pp lower compared to the male workers (29.1 %). The fact that social payments are based on insurable earnings during a period preceding pregnancy (instead of being fixed) contributes to the income disclosure of women of childbearing age representing high-income groups (over BGN 1500 per month), as well as to pregnancy planning in families who can provide a better quality education for their children.

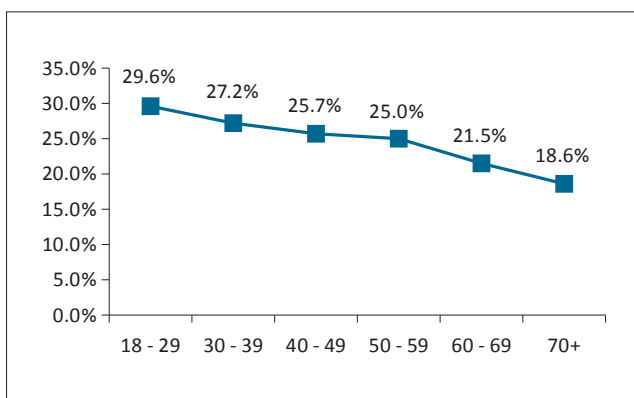
Figure 6. Dynamics of the hidden employment and the average social security income



Source: *Hidden Economy Survey of the Population, 2002 – 2015, Center for the Study of Democracy.*

The trends observed in the Hidden Economy Survey of the Population over the last 13 years shows that **disclosure of hidden economic activities increases with age**, while income growth leads to **greater inclusion** with the formal economy (through contracts). However, at the same time income growth is associated with partial **concealment of social security contributions** (especially among those earning between BGN 1500 and 2600).⁶ Quite naturally, those facing retirement have higher motivation to insist on being insured based on their actual earnings so that they can receive higher pension. That is why the largest negative decline in that area is observed in the (pre-) retirement age group.

Figure 7. Share of the population paying social security contributions on lower than their actual earnings (by age group)



Source: Hidden Economy Survey on the Population, 2002 – 2015, Center for the Study of Democracy.

Questions concerning **the increasing of the minimum and maximum social and health security thresholds** have been set forth for public debate on numerous occasions. While this increase would lead to higher income disclosure and would **considerably benefit the social and health security systems**, it is associated with certain risks. Increasing the maximum thresholds would not improve the material position of pensioners receiving the lowest pensions and could generate a higher deficit in the system. However, **measures reducing the evasion of social security contributions within the current thresholds, especially among the 18 to 29-year-olds**,⁷ would increase the revenue of public social security and would allow the pensions of the lowest-

income groups to be increased thus strengthening the sustainability of the pension system. **These measures** have to be **directly related to the expectations of the young people and the middle class** regarding the quality of government and the public services they receive in order for their **trust** in the institutions to be **strengthened and increased**. In order to foster income disclosure it is **acceptable for the government to gradually raise the minimum insurance income** among the lowest-income groups in view of the extremely low payment levels in the private sector, which further suppress consumption. However, this should be done selectively **taking into account regional specificities** (i.e. real income).

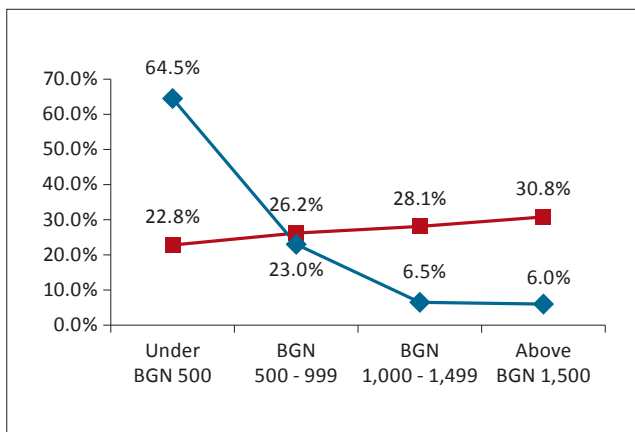
The growing dissatisfaction with the quality of public services – healthcare, education, justice, etc. and the lack of a **sense of community and solidarity** are among the factors contributing to the increased concealment of income. The wealthier have **greater opportunities to conceal income** (including the conversion of personal income into corporate consumption). So far, social services have mostly been targeted at **low-income groups**; a common practice for developed countries. But without providing quality education and healthcare to **the middle class** the state cannot expect actual and adequate social security contributions from its members. From a political point of view, it is very difficult for any party to speak publicly about the **fairness for the middle class** because it would be immediately accused of defending the rich due to the very large portion of low income groups in the population. The reality in the Bulgarian education system is that the education strategies are mostly targeting the median and even lower levels of the society, which often forces middle-class families to invest in additional education “unofficially” (in the form of undeclared paid private tutoring). In this regard, the introduced amendments in the *Law on Pre-School and School Education*, which envisage public funding for private schools, deserve admiration. However, without a reform that empowers parents to participate more actively in the management of the schools through the school boards, a higher level of satisfaction with public education is unlikely. The situation in the healthcare system is similar as the quality of the services offered and provided is well below public expectations. In this situation, **moral relativism** becomes justified

⁶ The ceiling for paying social security contributions.

⁷ The children of the parents of the so-called transition period that are facing retirement without actually having contributed to the pension system, or at least during the 90s, because of unemployment, hidden economy, low income, etc.

and hardly surmountable. **If opportunity arises, between 16 % and 41 % of the population would conceal income, social security contributions and taxes.**⁸ Furthermore, there is an internal imbalance among both the youth and the middle class regarding concealment of income, which leads to a situation where less qualified staff are earning higher net remuneration because they are occupied in the shadow economy.

Figure 8. Share of the population paying social security contributions on lower than their actual earnings (by income groups in blue) and share of the employed (by official income groups in red)



Source: *Hidden Economy Survey on the Population, 2002 – 2015, Center for the Study of Democracy and NRA, 2015 (income earned in 2013).*

There are no statistically significant differences in undeclared employment between small cities and villages, but those living in non-urban settlements have lower propensity to engage in informal economic activities (defined as grey economy; villages in Bulgaria traditionally have high shares of self-subsistence, non-market hidden economy).⁹ However, **Sofia differs significantly** from other urban settlements in terms of **the higher number of undeclared jobs** (lack of contracts or higher real incomes than officially stated in the contracts). Most often, the following groups of employed and self-employed workers engage in hidden economic activities in the big city: taxi drivers, babysitters, hairdressers, those providing private tutoring and those working in the automotive repair and construction industries, as well as the retail

and catering sectors. Meanwhile, the most negative effects that hidden economic activities have on the budget and the society can be observed in other areas (VAT and excise frauds, smuggling of goods), while **the negative effects within the listed sectors are rather economic than fiscal** – for example, lack of guarantees regarding the quality of the renovations, low quality of the services provided due to easy market entry, etc.

Effectiveness of the regulatory agencies

Very often hidden economy involvement is explained mainly by fiscal arguments, but in practice **it is not the size of the tax rates that discourages entrepreneurs from paying it, but its administration**; not the price to obtain a certain license or permit, but the compliance requirements and the high costs associated with them after their acquisition. An important factor contributing to the hidden economy in Bulgaria was the desire to hide not from the state, but from criminal groups as they have had access to the state data concerning others' businesses. The effective and efficient functioning of the regulatory agencies directly influences hidden economy dynamics, as well as related corruption payments, mainly through several specifics of their administrative functions, such as:

- **Cost of entering the formal market** (registration). In the past, when business registration was done through the courts, a lot of micro-entrepreneurs did not want to incorporate their businesses all, because it was too expensive and difficult. When operating small grocery stores or drinking and eating places, for example, it is a quite common occurrence for each outlet to be linked to a separate legal entity, because it is cheaper and easier to change the ownership of the company, than to re-apply for the relevant permits.
- **Cost of compliance with existing regulations**, including transaction costs for monitoring and inspection by the regulators. Many micro-entrepreneurs prefer to hide their business activities not because they want to avoid profit tax, VAT, social security contributions, etc. but because the

⁸ Dzhokova, R. Examining the drivers of participation in the informal economy and tax evasion in transition settings: The case of Bulgaria, Master Thesis, University of Sheffield, 2015.

⁹ Ibid.

accompanying costs of maintaining the documentation from the cash registers, diaries and the required accounting are too burdensome.

- **Mechanisms of selection of the risk companies to whom regulators apply control.** Lack of proper risk assessment in regulatory agencies leads to an unjustified burden for the majority of companies voluntarily conforming to regulations, and also to inability to fully cover and monitor systemic offenders. Undisclosed conflicts of interest or even captured regulators can intentionally use means of control to hamper or even force a competitor or business enemy into bankruptcy.

The National Revenue Agency (NRA) is the institution entrusted with the task and the highest public expectations to curb hidden economic activities. According to its 2015 Annual Report, the agency carried out 230,663 inspections, which is about 7.5 % less in comparison to the year before. The number of investigations has also declined – from 31,587 in 2013 to 23,129 in 2015, while the number of revisions dropped from 11,316 in 2014 to 10,215 in 2015. According to the latest available data, the violations that the NRA uncovered through its activities had a fiscal impact amounting to BGN 1.8 billion, roughly similar to that in previous years. It is unclear though how much of this impact has been confirmed by a court decision, i.e. has become fiscally effective. In recent years, the NRA work has been focused on the collection of social security payments (11.5 % increase in the number of checks year on year), which is an additional factor contributing to the improvement of compliance in this particular area. This trend is also visible CSD's *Hidden Economy Index* data.

It should be noted that for several years the NRA systematically carries out risk assessment of individual markets and enterprise groups. Afterwards, auditors and controllers conduct inspections on enterprise samples, identified through the risk assessment. During the 2009 – 2015 period a total of 21 assessments have been made. In general, they provide an evaluation of the fiscal damage, an estimation of the total number of companies belonging to the group and an estimation of the share of high-risk companies from which to draw samples for inspections. The high risk market niches/areas themselves are being obtained through a meta-evaluation of risk and naturally the share of high-risk companies in them is high compared to statistical expectations in case of random inspections on a random company. Thus, the risk assessment introduced by the NRA reduces transaction

costs for compliance of all companies by moving the focus to higher-risk ones, and reducing the burden on compliant entities.

Most of the risk assessments carried out by the NRA focus on **frequency** (at the expense of smaller size), which is needed in order to send a signal that the agency is actively involved in hindering hidden economy. NRA remains in debt to society for the lack of risk assessment of businesses owned by local oligarchs as well as assessment of the systemic risks threatening the economy (which have serious impact on many other economic indicators, the overall competitiveness and even the financial stability). Risk assessment is needed in the following areas: **transfer pricing** used by large multinational companies with significant market power, which can export revenues abroad and keep monopoly prices for the end user, which damages the entire local economy (e.g. the case of fuels trade), **capital networks causing financial vulnerability** (e.g. large exposures in banks to related parties or investments from pension funds to related parties; or transferring of profits from one company to another), and **football clubs**, historically linked to organized crime and hooliganism with high fiscal risk.

The General Labor Inspectorate Executive Agency (GLI-EA) is the other important public body with significant role in tackling the hidden economy. In 2015 GLI-EA decreased the number of inspections – 50,229 against 52,543 in 2014, while increasing slightly the number of secondary or follow up inspections. Unlike in previous years, the majority of the uncovered violations (50.4 % of a total of 222,245) concerned health and safety regulations, while 49.4 % were labor law violations. Non-compliance with working time regulations, working hours, and holiday entitlements represented the biggest share of labor law violations. The number of sanctions in 2015 was 9408, against 9,817 in 2013, and 13,107 in the previous year, which is an indicator (though poor) of increased efficiency, but it is quite possible that the inspected have learned to comply, since most of the inspections were carried out in companies already previously inspected (75 % of inspected enterprises have been visited before) and therefore they were able to meet the instructions. GLI-EA should develop their own risk assessment system or use the modified risk assessment for social security used by the NRA in order to reduce the price of compliance (inspections) for companies. It should also be noted that unlike the good practice of NRA, GLI-EA

Table 1. NRA Risk Assessments

Risk	Annual damage mln. BGN	Number of risk companies	Share of risk companies
Tax and goods underreporting by companies providing tourist services	102	1,000	85%
Underreporting of revenues from providing additional services and entertainment at tourist sites	26	2,000	85%
Overstating the costs of retail trade in food products by large retail chains	21	Limited number	51%
Underreporting of revenues from hairdressing and cosmetics and related activities associated with beauty and health	24	10,000	82%

Source: National Revenue Agency.

still publishes its Annual Report in a user unfriendly format, which does not allow easily further analysis of the data contained therein.

The control function of a number of other regulatory agencies in Bulgaria is very **inefficient** and should be therefore reformed. As a rule it is focused towards punishment and mass control over all entities at the expense of prevention and cooperation measures. For example, out of 136 inspections carried out by the Regional Inspectorate of Environment and Waters in Plovdiv in August 2015 just five criminal proceedings have started – 2 of them have resulted in a fiscal impact worth BGN 4,100. In the January – August 2015 period the same agency has carried out a total of 984 inspections and the average sanction per inspection amounts to BGN 212.¹⁰ The actual income from the inspections is lower because some of the imposed penalties have been successfully appealed in courts. Even just taking into account the direct investment of public resources in these inspections (excluding the price paid by those being inspected) exceeds the effect of the imposed and collected sanction multiple times. Similar cases can be observed on central, regional and local level. **Most of the regulatory institutions do not have an established risk assessment procedure**, nor can provide complete, timely and reliable information about their activities and plans, so that companies can adequately plan their strategy for compliance with regulatory requirements, an important part of which is the control applied.

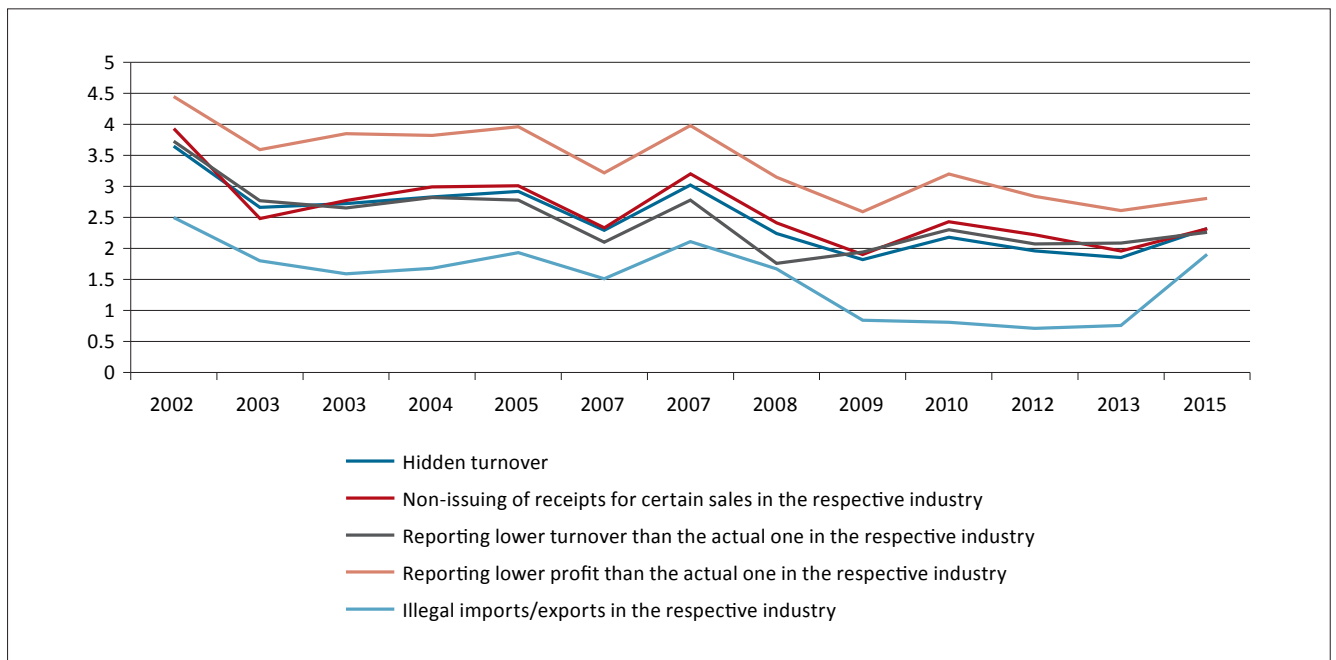
VAT Fraud: the black part of the hidden economy

According to the Hidden Economy Survey on Businesses **company executives are worried about the increase in under-declaring turnover in 2015** (including illegal import/export, reporting lower income and higher costs) and the hidden redistribution (concealment/non-payment of taxes, duties and excises) and VAT fraud. Most significant is the deterioration (with about 1 index point) in illegal import/export and VAT fraud (mostly through reporting fictitious exports). This comes amid claims by Bulgaria's public authorities that the increased effectiveness of the fiscal control¹¹ has resulted in the intersecting of fictitious intra-Community supplies (export). This claim has been backed by the 19.7 % increase (physical growth worth BGN 311 million) in the tax base of intra-Community acquisitions (EU imports) in the period January – July 2015 compared to the same period in the previous year. That increase outstrips more than three times the growth rates of imports registered by NSI (5,4 %). The data seems to contradict the official statements of the Bulgarian government that higher fiscal revenues in 2015 and 2016 have been entirely due to the improved work of law enforcement.

Until 2014, VAT and fictitious export frauds were detected and uncovered through audits and cross-checks with documents, but as ownership of **the "missing traders"** (dummy companies) started being

¹⁰ Reports on inspections carried out by RIEW – Plovdiv: http://plovdiv.riosv.com/main.php?module=info&object=category&action=list&inf_cat_id=8

¹¹ Adopted through the amendments in the *Tax Procedural Code* from 2013 – chapter XV, State Gazette issue 109 from December 20, 2013, and entered into force in the beginning of 2014.

Figure 9. Dynamics of the Hidden Turnover Sub-index and its Components

Source: *Hidden Economy Survey on Businesses, 2002 – 2015, Center for the Study of Democracy.*

transferred to “straw men” (individuals without any assets, education, etc.) the receivables became uncollectible. According to expert estimates, the average lifespan of a dummy company is 3 months, which in case of weak preliminary control allows only an ascertainment of the infringement. The role of these “missing traders” is to document fictitious sales and purchases and abscond or go insolvent without remitting the VAT to the budget. These companies have neither personnel, nor assets or any capacity for commercial activities. Usually, when tax authorities attempt to inspect or audit such companies they find only a post box at the official address declared at the time of the registration. In contrast to other EU countries, in Bulgaria “missing traders” are rarely registered by foreign citizens or by offshore owners with undisclosed identity. Bulgarian criminal networks also register “missing traders” abroad for perpetration of schemes involving intra-community deliveries to other member states. Their role is to document the fictitious importation of the goods. In this way they make the uncovering of the fraud more difficult. Other important outer circle actors are the “**accountants**”. They provide not only bookkeeping services, but also manage the bank transactions and provide tax expertise. The actors servicing the schemes typically receive from EUR 1000/2000 to 5000/7000 monthly remuneration (as a rule this is a hidden income)/ Accountants are also paid a fee in the form of monthly salary, unless an entire accounting company

is involved, which is paid with a share of the invoices issues (from 1 % to 20 % of the VAT sum siphoned).

Ring leaders of criminal networks that perpetrate organized VAT frauds usually turn out being owners of well-established legitimate businesses, which puts them among the so-called “**oligarchs**” – powerful businessmen well positioned on local or national level who accumulated their capital in the nineties through various shady or criminal practices such as siphoning state-owned companies, rigging privatization deals, insolvency frauds, excise and custom duty frauds or corrupting public procurement tenders. Their social background is usually from the old communist party nomenklatura, former high-ranking executives of state companies or high-ranking officers from the security services. They have capitalized on their political links to profit from the large scale property re-distribution in the nineties. Unlike them, small scale fraudsters are rather high-risk entrepreneurs, who have been involved in one way or another in previous excise and organized VAT frauds or other tax crimes. In most cases, they neither possess the economic capacities, nor the political links of the oligarchs. Thereby they are more vulnerable to become targets of police investigations and tax inspections.

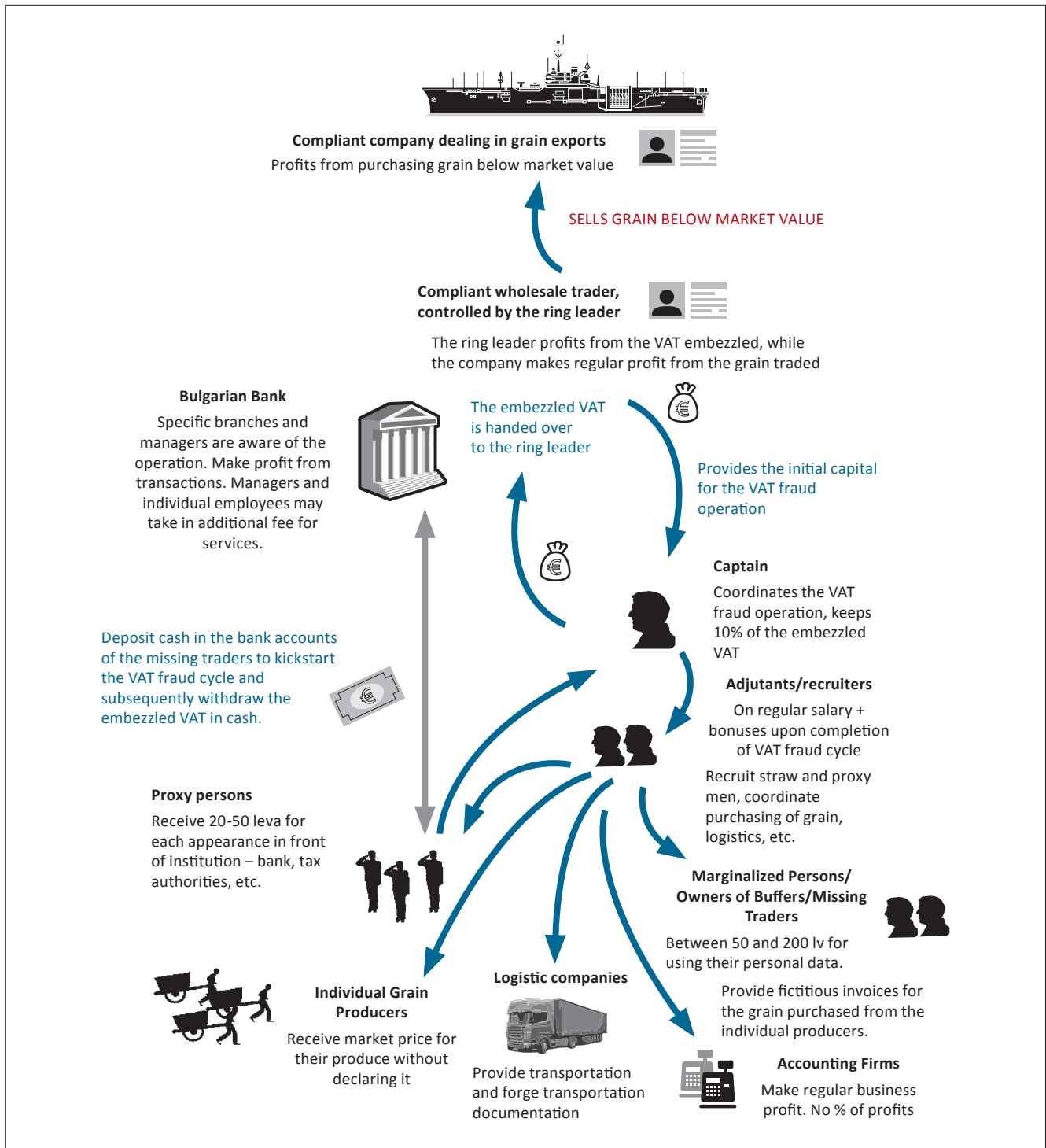
Import frauds from the EU include all fast moving consumer goods such as meat, sugar, dairy products, fruits and vegetables. The basic form of this type of

fraud includes the purchase of goods with zero VAT rate from a trader, who is based/situated in another member state. These goods are then being resold on the domestic gray market without invoice in which way the payable VAT rates are being “spared” to the state budget. Usually such a scenario resembles familiar schemes for commodity smuggling with the only

difference being that customs control is not required for movement of commodities inside the EU, which respectively means that its evasion is not required.

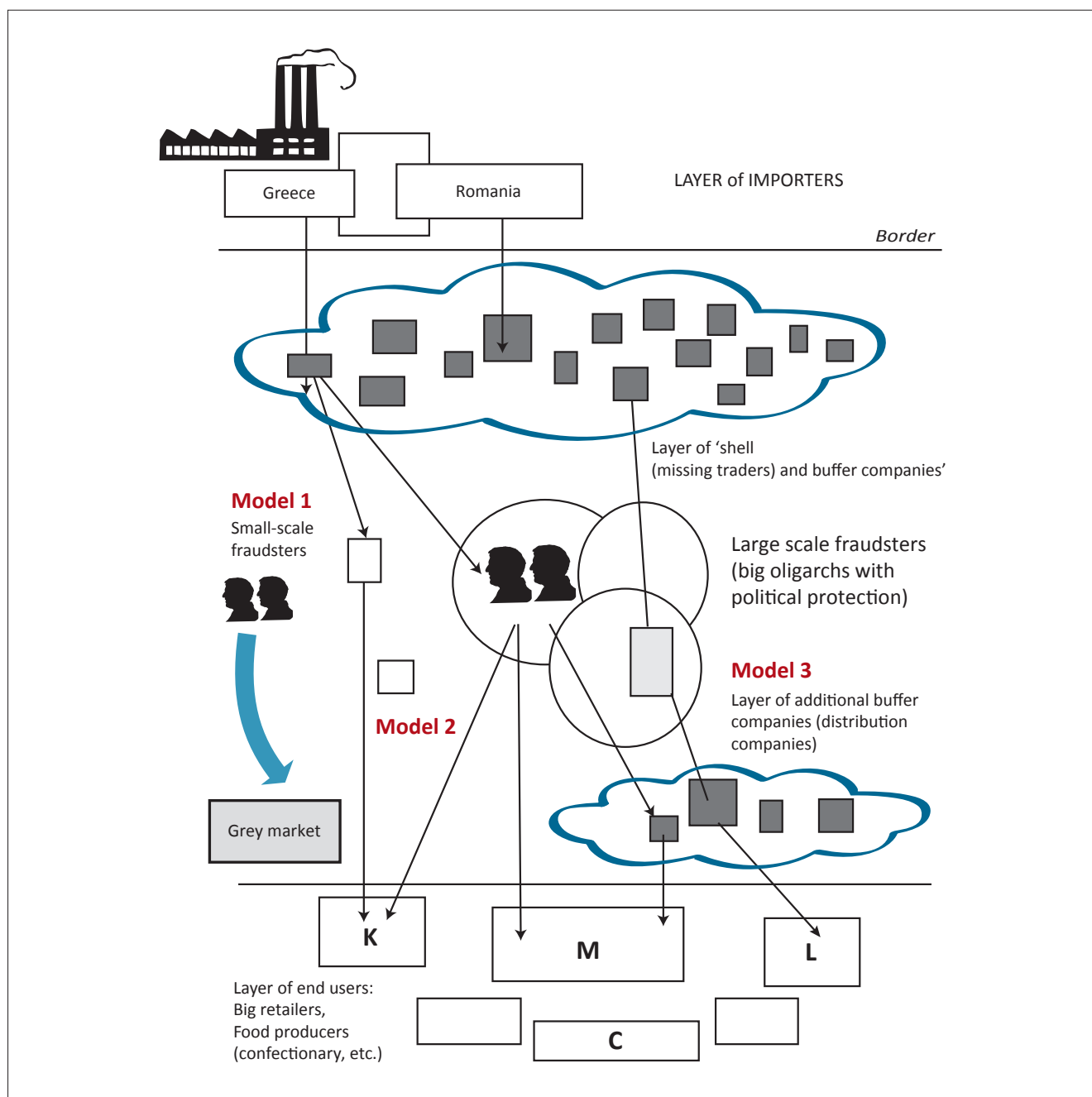
Import frauds using a “missing trader” from third countries are also to be observed, albeit on a smaller scale. In most cases they involve the import of com-

Figure 10. Example of role distribution in a missing trader scheme for the export of grain



Source: CSD, (2015). *Financing of Organised Crime, Center for the Study of Democracy, Sofia, 2015.*

Figure 11. Main fraudulent schemes concerning sugar import from other EU member states



Source: CSD, (2015). *Financing of Organised Crime*, Center for the Study of Democracy, Sofia, 2015.

modities from China and Turkey, which are two of the largest trading partners of Bulgaria outside the EU. These schemes, along with the VAT evasion, include concealment of custom duties through the implementation of different procedures such as understating the total value of the imported goods and adulteration of their origin and their actual categorization and quantity. Import frauds including a “missing trader” from third countries are carried out with goods such as vegetables, clothing, toys, home appliances, building materials etc.

VAT frauds of the so-called “**carousel**” type are more complex. They involve several cycles of cross-border transactions, through which the traded goods follow a circular movement (hence the name of the scheme). According to NRA data (2013), “carousel” type frauds do not present a large threat to the Bulgarian budget and currently account for only 2-4 % of the organized VAT frauds.

None of the schemes can be carried out for a long period of time without the compliance of **corrupted**

Table 2. Assessment of corruption expenses regarding VAT frauds

Corruption practice	Perpetrators	Charges according to the respondents
Sale of information about upcoming tax audit	Tax official	EUR 150 – 200 for information
Giving entry to a vehicle on the external border without customs control	Customs official	EUR 300 – 500 per van (Turkish cargo – clothes, perfumes)
Giving entry to a vehicle on the external border without customs control	Customs official	EUR 1,750 per truck (mobile phones)
Not carrying out customs control inside the country through a mobile customs team	Mobile customs team	EUR 250 per truck (mobile phones)
Not carrying out customs control through a mobile customs team	Mobile customs team	EUR 1,750 – 2,500 per truck (Chinese cargo)
Adulteration of false or fictitious documents for import, export and transit of goods	Customs official	EUR 250 per truck
Manipulation of the electronic system for registration of vehicles entering or leaving the country	Border policeman	EUR 400 – 600 per week
Provision of administrative protection against customs control	A senior official of “Customs” agency	EUR 25,000 per month/ EUR 300,000 per year

Source: CSD, (2015). *Financing of Organised Crime, Center for the Study of Democracy, Sofia, 2015.*

tax, custom and police officials. They can assist the fraudster in return for a reward and in some cases are getting directly involved in the criminal network. In the latter case the corrupted state official purposely gives advantage to companies, which conduct criminal activities for a long period of time. Really important is also the role of the **corrupted bank employees**, who are the only ones capable of attesting money transactions, acquired by fraudulent means, or deciding whether or not to inform authorities about suspicious financial transactions, which is an obligation, imposed on them by the anti-money laundering legislation.

The fiscal control changes adopted in 2015 now allow the state receivables collection to be ensured even before the commodity realization – either through the provision of collateral, or through the confiscation of the goods. The fiscal control disciplines not only the exporters, but also importers, drivers, and in general everyone throughout the chain. It has a stronger influence on individual players and smaller networks.

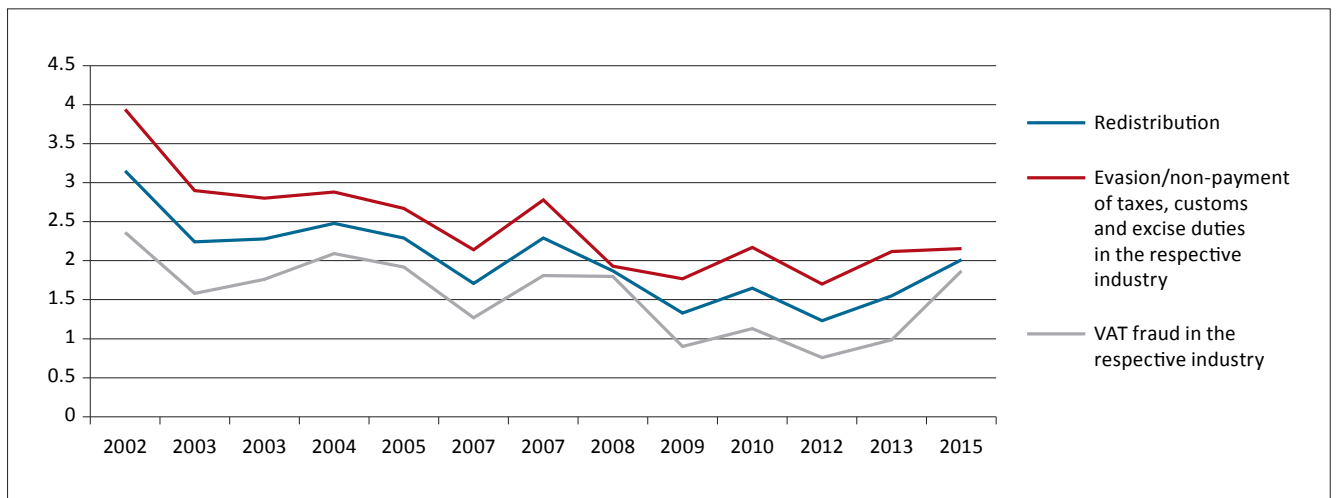
The discrepancy between the assessments made by businesses in the Hidden Economy Survey and hard data such as increase in revenues, number of inspections (fiscal control carried out on 10,000 vehicles in the first half of 2014, and on 180,000 vehicles in the first eight months of 2015), etc., can be viewed as an excuse smaller enterprises use in view of **the difficulties that they are experiencing as part of a competitive market.** This discrepancy can also be explained by the

highly likely simultaneous increase in tax collection, the underestimated official economy and the increase in the hidden economy. Very often as part of surveys managers of micro and small-sized enterprises respond to questions not as rational managers and investors but they rather share an opinion that is similar to the general public perceptions. As a result the index increase should be interpreted as a manifestation of deteriorating competitiveness similarly to the data gathered through the business observations carried out by NSI. However, it is also clear that the claim of the Bulgarian authorities that the increase in tax revenues is entirely due to the improved work of law enforcement do not reflect realities on the ground.

The **“tax gap” assessment** is one of the measured most often used for gauging the effects of evasion of taxes, excise and custom duties. It is based on the difference between the expected tax revenues in compliance with the tax legislation on one hand, and the actual taxes collected, on the other. However, such an indicator does not specifically target organized VAT frauds, since it also covers legal tax reduction methods, tax evasion as a result of bankruptcy and deferred payments, as well as statistical errors.¹² Nevertheless, this indicator remains the best available instrument for assessing those amounts, comparing the results to other countries, and identifying tax evasion trends within a certain period of time.

¹² See RECKON (2009).

Figure 12. Dynamics of the Redistribution index and its sub-indexes

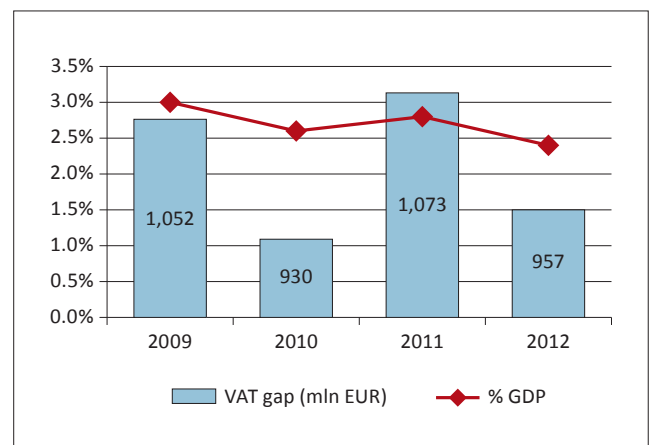


Source: Hidden Economy Survey of Businesses, 2002 – 2015, Center for the Study of Democracy.

The latest “tax gap” assessments for Bulgaria are included in two EU studies, carried out on behalf of the European Commission.¹³ According to them, the VAT gap for 2012 is 20 % of the VAT taxable activities or 2.4 % of the GNP, while the average VAT gap for the EU is around 16 % of the taxable activities. In general, Bulgaria is part of the group of countries with higher than the EU average VAT gap percentage, along with a number of countries from East Europe (the Czech Republic, Hungary, Latvia, Lithuania, Poland, Slovakia and Romania) and from South Europe (Greece, Italy, Malta and Spain).

In Bulgaria tax gap assessments have been made in 2010 and 2013 by the NRA for both the 2005 – 2009 and 2010 – 2012 periods. However, it should be taken into account that those NRA assessments include only “missing trader” type frauds, while those carried out by CASE cover also legal VAT evasion, conventional forms of VAT evasion, bankruptcy and deferred payments. The NRA analysis identifies most of the vulnerable sectors according to the type of goods and services misused through VAT fraud schemes. The majority of the latter refer to goods such as wheat, meat, sugar and fuel, which form the lion’s share of the frauds (around 40 % of all VAT frauds). The services most often associated with fraudulent schemes are in the field of construction or advertising. In an attempt to stop the increasing number of illegal VAT deduction schemes in the wheat export, the Bulgarian government adopted a reverse taxation for these

Figure 13. VAT gap size trends (2009 – 2012)



Source: CASE (2014).

goods in mid-2014.¹⁴ The analysis carried out by NRA also found out that more than 60 % of all “missing traders” have been registered in the Sofia region, which is the most economically active in the country. The tax authorities have reported that the average number of uncovered “missing traders” in the 2007 – 2012 period is 2453 companies, while the average number of the “clients” of those firms is only 14.

The overall decrease of the VAT gap during the 2008 – 2012 period can be partially explained with the strengthening of the control measures implemented by the Bulgarian authorities in regard to these type of crimes. An indicator for this is the increased number

¹³ See CASE (2013) and CASE (2014).

¹⁴ Reverse VAT rate differs from regular VAT by the fact that it is paid by the supplier and not by the client.

of indictments and convictions for those involved in them within the same period of time. It should be noted that until 2008 the General Prosecutor's Office has not closely observed crimes related to VAT frauds, which have been reported just as "tax offences". After that year VAT frauds have been included in the annual activity report of the Bulgarian Prosecution in a special chapter along with the crimes of high public interest.

In recent years the **organized VAT frauds are among the main organized crime threats to Bulgaria**. They form the second largest revenue stream for organized crime after human trafficking and before drug and illegal cigarettes trade.¹⁵ The danger coming from this type of crime stems from the direct fiscal damages and the compromising of the competitiveness of entire economic sectors. The high dependence of the state budget on VAT revenues makes it especially vulnerable to organized frauds. The extent of the criminal activities in particular economic sectors such as construction, oil, vegetables, meat, sugar and wheat has undermined private competitiveness and, in turn, has forced legal companies to commit frauds or to leave the respective market. Detection and suspension of organized VAT frauds is very difficult, as it would lead to a series of undesirable economic and social consequences such as a sharp price increase of socially sensitive goods¹⁶ or the bankruptcy of companies in the affected sector.

Tackling VAT frauds should follow a diversified strategy with respect to the different players and dominant fraud models. The sale of goods with hidden VAT taxes by large storages and wholesalers is only within the capabilities of large criminal structures and oligarchs, who have the required financing and stable political protections. Meanwhile, a large number of small and medium players are also active – they are dealing mostly with fast turnover goods, which can be sold quickly without storing.

The situation within the sugar and meat industry is indicative, as all major VAT fraud players are owners of the largest companies for production and wholesale trade of these goods. Sugar producers worldwide usually incur production losses in the range of 2-3 %. Those in Bulgaria, however, claim 9-10 % and then sell the hidden amount of sugar without invoicing.

Such schemes are also carried out when importing fruits – companies import bananas, sell them without invoicing and in 30 days declare them rotten.

For organized VAT frauds different approaches of hiding economic activity are being taken. According to expert evaluations of the Center for the Study of Democracy, **between one third and one half of the business activities of the major players is practically hidden**. This large informal economy creates a favorable environment for the emergence and continuation of fraudulent VAT schemes, as well as many other activities such as excise duty frauds and corruption. Among the mentioned hidden economy practices are various tax optimizations and conventional means of tax evasion such as non-declared labor relations, sell of excise goods without labels (for example alcoholic beverages), overstatement of losses that resulted from the producing process, declaring losses that resulted from product devaluation or scrapping (for example perishable food – fruits, vegetables), understatement of the sales or overestimation of the value.

In most cases **the revenues from VAT**, excise and custom duty **frauds** are being reinvested in new operations. Sometimes other resources obtained through criminal activities are also being reinvested. Similar is the case with former tax officials or customs agents, who invest earnings accumulated through **corruption** in new VAT frauds. At the same time, fraudsters who are part of small schemes such as "invoice factory" or whose activity is more limited, can invest money from **other criminal business activities**. For example, such has been the case of a VAT fraud network leader, who has been involved also in racketeering, usury and money laundering. It seems like criminal entrepreneurs utilize every opportunity as they move from VAT frauds to excise duty abuse or usury.

Unlike major VAT frauds players, who mainly rely on self-financing, the smaller players do not possess the needed economic resources, nor can they rely on credit access. Thus they are more often forced to use alternative sources of financing in order to execute another cycle of VAT frauds. Such alternative sources can be illegal usurers, getting a commercial credit from producers or exporters, receiving advance payments from clients, who are the final recipients of the goods, etc.

¹⁵ For more detailed information, see *CSD (2015), Financing of Organised Crime, Center for the Study of Democracy, Sofia, 2015*.

¹⁶ In such a way, for example, VAT evasion schemes in Bulgaria often affect goods such as vegetables and bread. Undertaking effective measures to fight this crime could lead to a constant price increase of these popular food products, which could have a catastrophic impact on the purchasing power of many households, especially those with low income.