

# THE HIDDEN ECONOMY IN BULGARIA AND THE GLOBAL ECONOMIC CRISIS

This publication makes a review of the hidden economy dynamics in Bulgaria in the past decade with a particular focus on the effects of the global economic crisis of 2008 – 2010. It discusses the impact of the crisis on the labor market and on undeclared work on the basis of the data from CSD's *Hidden Economy Monitoring System*. Based on a review of the experience during the last five years in Europe and Bulgaria in designing and implementing public policies for countering the hidden economy, the publication makes some specific recommendations to the Bulgarian government on improving its record in this area. One of the main conclusions is that effective curbing of the hidden economy requires a balancing and coordination of the mix of administrative control and socio-economic measures, as well as sustained structural reforms in the compliance and control administration and law enforcement bodies.

Authors:

**Professor Andrey Nonchev**, Director, Sociological Program, Center for the Study of Democracy

**Denitsa Mantcheva**, Analyst, Center for the Study of Democracy

**Dr. Evgenia Vassileva**, Assistant Professor, University of National and World Economy

**Ruslan Stefanov**, Director, Economic Program, Center for the Study of Democracy

**Todor Yalamov**, Senior Analyst, Center for the Study of Democracy

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**Professor Blagovest Georgiev**, Department of Sociology, Sofia University

**Professor Valentin Goev**, Department of Statistics and Econometrics, University of National and World Economy

Editorial Board:

**Dr. Ognian Shentov**

**Professor Alexander Stoyanov**

**Dr. Maria Yordanova**

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5, Alexander Zhendov Str., 1113 Sofia  
phone: (+359 2) 971 3000, fax: (+359 2) 971 2233  
www.csd.bg, csd@online.bg

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## LIST OF ABBREVIATIONS

<b>ATO</b>	Australian Tax Office
<b>CASSTM</b>	Administrative Commission on Social Security for Migrant Workers
<b>CoM</b>	Council of Ministers
<b>CSD</b>	Center for the Study of Democracy
<b>CPC</b>	Commission for Protection of Competition
<b>EES</b>	European Employment Strategy
<b>EIRO</b>	European Industrial Relations Observatory
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EC</b>	European Commission
<b>EU</b>	European Union
<b>EUCO</b>	European Council
<b>GDP</b>	Gross Domestic Product
<b>GNP</b>	Gross National Product
<b>GVA</b>	Gross Value Added
<b>HESB</b>	Hidden Economy Survey on the Business
<b>HESP</b>	Hidden Economy Survey on the Population
<b>IFC</b>	International Finance Corporation
<b>ILO</b>	International Labor Organization
<b>IMD</b>	International Institute for Management Development
<b>IMF</b>	International Monetary Fund
<b>SNA</b>	System of National Accounts
<b>NGO</b>	Non-Governmental Organization
<b>NRA</b>	National Revenue Agency
<b>NSI</b>	National Statistical Institute
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>HEMS</b>	Hidden Economy Monitoring System
<b>UNECE</b>	United Nations Economic Commission for Europe
<b>VAT</b>	Value Added Tax
<b>VIES</b>	VAT Information Exchange System
<b>WFS</b>	Work Force Survey



## INTRODUCTION

The steep drop in state revenues and the increase in unemployment following the international financial and economic crisis of 2008 – 2011 led to a renewed public interest in the hidden economy debate. The exposure of deeply entrenched governance malpractices in Greece and the poor quality of control and crisis readiness of EU's Southern and Eastern Member States brought legitimate concerns over the quality of the European Union's economic governance. Germany offered to introduce a number of new instruments for coordination of Member States' economic policies. Among them, the most heatedly debated measure in Bulgaria was the Euro-Plus Pact and the size of the country's potential future obligations under the European Financial Stability Fund. The Pact recommended reductions of the size of the government deficit and Member States' foreign debt, as well as closely tying public sector remunerations to the productivity of the economy. Yet, in the absence of a clear idea about the size and dynamics of the hidden economy in the member states, these measures can hardly achieve better fiscal discipline and coordination between national policies. A number of analyses estimate the share of the hidden economy in the different EU countries to vary between 8 % and 32 %. These numbers are believed to have risen due to the crisis (Mallet and Dinmore, 2011). This is problematic, not so much in terms of forgone budget revenues, but because it indicates that the EU internal market does not function properly, favoring the bigger and the more willing and able to pay. It should be noted though that from a certain tipping point, should the current Eurozone crisis spiral out of control, the existence of large hidden economies in Southern and Eastern European member states might turn into advantage, providing shelter in informal, home-made production.

The hidden economy, and its key elements (gray, black, and informal), is an essential part of the Bulgarian economy. Different sources estimate its share at 10 % (NSI, 2008) to 32 % (Schneider, 2011). In 2011, the Bulgarian Ministry of Finance published an analysis estimating the share of the gray economy in the country to be about 20 % of the GDP. Hidden economic activity of such proportions skews national economic performance indicators and poses a challenge to national policies and investors. For example, assuming that the level of the hidden economy was about 20 % of GDP would result to an increase of the Bulgarian contribution to the EU, a decrease of the actual intensity of EU funding for the country, as well as to a change in Bulgaria's energy intensity (reduction) and productivity (increase). A more accurate understanding of the hidden economy and its elements, as well as establishing its actual size, will improve public and private sector management. This was why in 2002 the Center for the Study of Democracy developed the *Hidden Economy Index*, which had since then been tracing the dynamics of the hidden economy in Bulgaria. The Index is based on data from representative surveys of

businesses and the population. The Index is the only regular and reliable source of information in the country on the trends and developments in the hidden economy and its major manifestations – hidden employment, envelope wages, and tax evasion. The current publication does not discuss issues related to the black economy. Yet, due to the black economy's very high social and economic costs for Bulgaria and the associated violence and corruption, the Center for the Study of Democracy, in cooperation with the Ministry of Interior, has developed and applied an annual National Crime Survey since 2002, which monitors the dynamics of most common crime types in the country. An upcoming publication of the Center on *The Bulgarian Organized Crime Threat Assessment* sheds light on key markets for the black economy, such as drugs, prostitution, car theft, excise goods, etc.

The lack of sufficient and adequate official information on the state and dynamics of the hidden economy in Bulgaria serves as a ground for persistent speculations by various interests (e.g., political, business, etc.). The fight against the hidden economy has often served as an excuse for implementing harsher control measures by the government and/or has veiled attempts at monopolizing or cartelizing certain sectors of the economy. Yet, in most instances, such measures and attempts have had the opposite effect in the long run. Despite the importance and complexity of the hidden economy issue for Bulgaria, there is still no adequate public policy for a long-term solution. The Bulgarian government usually wrongly assumes that the hidden economy can only be harmful to official business activity and to the people's wealth. Considering the small-scale character of the Bulgarian economy and the much smaller size of the average Bulgarian enterprise in comparison to its EU counterparts, such a simplistic understanding of the hidden economy can lead to a destruction rather than creation of added value in the process of curbing the hidden economy. The private sector's initiatives in reducing hidden economic activity are also limited and mostly focus on public awareness raising. In the past two years, employers' associations and trade unions have launched with support from the European Social Fund and the Bulgarian budget several large-scale projects targeting the gray economy. Despite their high potential for success due to a sustained, multiannual funding, these project' measures hide a risk for mushrooming bureaucracy, which in turn might lead to even more hidden economic activities in the long-run. For example, Italy's experience has demonstrated that establishing special agencies and local branches of ministries with the sole purpose of targeting the gray economy presented a problem rather than a solution. Efficiently counteracting the hidden economy calls for a balanced application of financial and economic policies rather than focusing on administrative or control measures.

The current report aims to contribute to improving the quality of public debate on the smart ways to counteract the negative effects of the hidden economy on national competitiveness and the labor market. The report is divided into three sections. The first one describes the latest developments in the definitions, causes and effects of the hidden economy. Section two presents the composition and the dynamics of the hidden economy in Bulgaria, and the policies adopted by the Bulgarian government for counteracting its effects during the recession. The third section outlines the dynamics and the different manifestations of undeclared work in Bulgaria. The report concludes with recommendations on improving pub-

lic policies for tackling the hidden economy in line with European policies and best practices. The report is based on data from CSD's *Hidden Economy Index* and IMD's *World Competitiveness Yearbook*.



# 1. HIDDEN ECONOMY – DEFINITIONS, CAUSES, EFFECTS

## 1.1. DEFINITIONS, STRUCTURE, MANIFESTATIONS

The hiding of economic activities from official authorities is increasingly attracting the attention of a wider circle of researchers, experts, politicians, and citizens. Different concepts are used to define this phenomenon – informal or parallel economy; shadow economy; gray, black, illegal, or underground economy; unregistered or undeclared economic activity, etc. Recently, the term **hidden economy** has gained popularity. The term hidden economy will be used in this report as embracing all other similar concepts. The different social, practical, theoretical, and institutional circumstances explain the plethora of interpretations and concepts. However, an empirical analysis requires precision. Thus, we clarify the concept and its manifestations next. Then, we present methods for measuring and observing the hidden economy.

The definition of hidden economy is typically based on **two interrelated criteria**:

- To what extent is a certain economic activity legal and/or performed by legally-operating economic entities; and
- To what extent is a certain economic activity and its outcomes reported and registered by the official statistics and information systems of state institutions.

The first criterion gives ground to the terms **illegal, illegitimate, black, and underground economy**. In this case, the term hidden economy designates production of commodities and activities that are not legally permitted and/or are performed by illegal economic entities. Examples include activities like drug dealing and smuggling, trafficking of people, stolen goods trade, and other types of criminal economic activities. The second criterion gives ground to the terms **undeclared, unregistered, unreported, and informal economy**. In this context, hidden economy includes economic activities and their outcomes, which are legal by nature, but are not registered or recorded partially or entirely by the respective authorities (e.g., statistical offices, tax and duty administrations, local administration, etc.). Examples include unregistered employment, unpaid work, hidden income and turnover of otherwise legitimately operating businesses, tax evasion, avoidance of social and healthcare security payments, domestic production for own consumption, volunteer work, etc.

Based on the above criteria, **four economic sectors** can be distinguished:

- **Official** economy (legal and reported);
- **Informal** economy (legal, yet unreported). It includes home-made produce and domestic labor, unpaid voluntary work, some of the activities of the self-employed and small businesses with no obligation to declare their activities, etc.;

- **Illegal (black)** economy (illegal and unreported). It includes illegal activities or unlawful production of commodities, as well as economic activities carried out by illegal economic entities;
- **Undeclared (gray)** economy (legal, yet unreported). It includes underreporting the activities of legally-operating businesses, not registering the entire staff, as well as underreporting income. This concept also covers tax evasion and the avoidance of social and healthcare security payments..

The term hidden economy covers the latter three phenomena, namely, informal, illegal (black), and undeclared (gray) economy, all three of which are not reported to the authorities.

The fact that hidden economic activity is not reported does not prevent the phenomenon from being a subject of observation and recording. There are methods for observing and measuring each of the three types of hidden economy (e.g., estimating unregistered work/employment, unreported income; unpaid taxes, social security, duties, and fees; hidden turnover; unreported expenses and investments, domestic production, etc.). The overall (total) estimation of hidden economy is usually displayed as a share of GDP.

Through the System of National Accounts (SNA), National Statistical Institutes **add estimates of the hidden economy** to the official GDP statistics, explaining that officially reported data are otherwise not exhaustive. According to this methodological framework, **the incompleteness of data stems from four sources**<sup>1</sup>:

- Unregistered economic entities;
- Unknown (not covered) entities;
- Inaccurately reporting entities;
- Others.

Within the unreported (gray) economy, most important for the SNA is the existence of a group of economic entities that deliberately hide their actual employment. This group has also the strongest influence on estimations of the share of hidden economy in GDP.

**Various methods of observing the hidden economy** and its key aspects are used serving different research purposes. Following is a short overview of the most widespread methods measuring and assessing undeclared employment and unregistered work.<sup>2</sup>

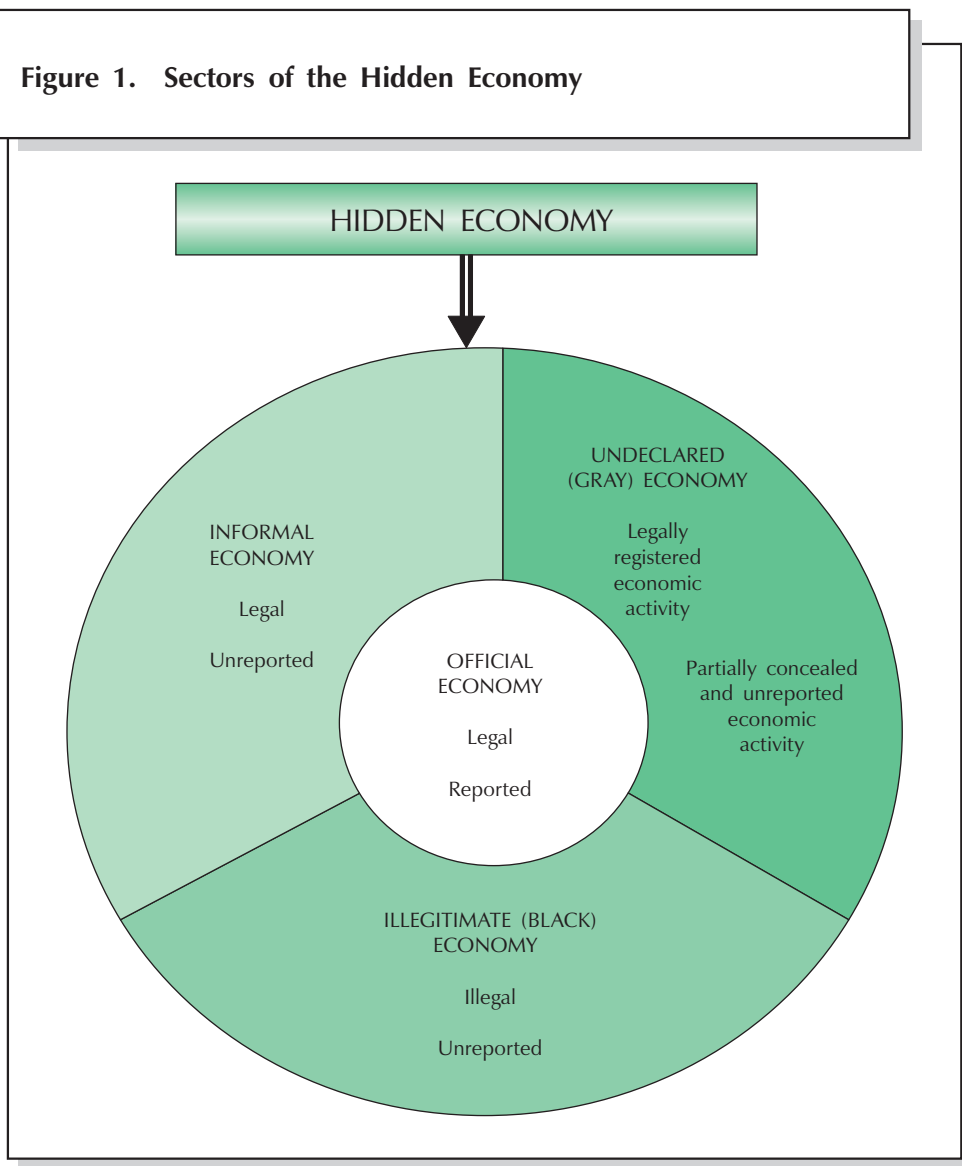
#### *Direct Approaches*

Direct approaches are mainly carried out on micro level and based on data on separate economic entities involved in hidden economic activities one way or another. Most commonly used direct methods are:

<sup>1</sup> Eurostat's Tabular framework N1 – N7. Further details can be found in Eurostat's Tabular Approach to Exhaustiveness: Guidelines, Eurostat, 2005.

<sup>2</sup> For a more comprehensive review of the methods described here see *The Hidden Economy in Bulgaria*, Center for the Study of Democracy, 2004.

**Figure 1. Sectors of the Hidden Economy**



Source: Center for the Study of Democracy, 2002.

- Representative studies of hidden economic activity;
- Studies of time budgeting;
- Tax audits.

The first group of direct approaches is used in a number of countries, including Bulgaria.<sup>3</sup> Direct approaches collect their data from surveyed respondents, who report their involvement in hidden economic activities, and from respondents' subjective perceptions of the scope of hidden economic activity. Results from these types of surveys on hidden economy and undeclared work are presented in Section Three.

<sup>3</sup> See Isachsen, Krovland, and Storm (1982) for Norway, Mogensen (1995) for Denmark, Feinstein (1999) for the USA, Schneider (2000) for 18 OECD countries, Center for the Study of Democracy (2004 – 2010) for Bulgaria, and others.

### Box 1. Types of Economic Entities, According to Their Ability to Generate Hidden Economy<sup>4</sup>

- Unregistered:

№ 1. Entities that do not register deliberately.

№ 2. Entities that do not register because their activities are illegal.

№ 3. Entities that do not register because there is no legal requirement to do so.

- Unknown:

№ 4. Entities that are outside the scope of statistical observation.

№ 5. Registered entrepreneurs, who are not surveyed.

- Underreporting:

№ 6. Economic entities, who deliberately falsify reports on their activities.

№ 7. Other economic entities:

№ 7a. whose data are incomplete, not collected, or are not under direct statistical observation;

№ 7b. for whom statistical registration and precise data collection are problematic in practice.

Source: Eurostat, 2005.

Another approach to assessing hidden economic activity is using time budgeting studies. These studies supply information on the time spent by individuals on different activities, among which are both official activities and undeclared economic activities. Information is gathered through diaries, where the time spent in all primary and additional (accompanying) activities is filled in. This method aids a complete time cross-section of certain society's economic activity, monitoring not only the official sector (registered in the national accounts), but also the hidden activities of businesses and households.

**Tax audits** are another direct method to assess the scope of the hidden economy. They detect gaps between the declared taxable income and real income (the latter is established through selective tax audits<sup>5</sup>). (Witte, 1987, Clotefelter, 1983, and Thomas, 1992) The limitations of the method are that it identifies only that part of the hidden incomes, which tax audits manage to discover.

**As a rule, direct methods underestimate the share of the hidden economy,** as they do not capture all its aspects and dimensions. But they produce higher

<sup>4</sup> For more details see Goev V., Boshnakov V. „Скритата икономика в България: статистически оценки и сравнения за периода 2002 – 2007 г.“. Университетско издателство „Стопанство“, София, 2009 /“The Hidden Economy in Bulgaria: statistical estimates and comparisons for the period 2002 – 2007“, “Stopanstvo” Publishers, Sofia, 2009/.

<sup>5</sup> In the USA, this method was implemented in practice via the Taxpayer Compliance Measurement Program of the tax administration (i.e. the Internal Revenue Service).



### Box 2. The New EU Employment Policy and CSD's Hidden Economy Index

In 2003, experts of *Coalition 2000* and the Ministry of Labor and Social Policy took part in the consultations of the European Commission and the Italian Presidency on the drafting of a separate guideline for combating undeclared work and the hidden economy in the 2004 *European Employment Strategy*. At the final conference on those preparations held in Sicily, Italy in December 2003, *Coalition 2000* presented for the first time the results of the new *Hidden Economy Monitoring System (HEMS)* and the *Hidden Economy Index*. The index is used as a major monitoring tool for tracking the dynamics of the hidden economy and its components and for assessment and adjustment of relevant public policy.

Source: Center for the Study of Democracy, *Anticorruption Reforms in Bulgaria, Corruption Assessment Report, 2005*.

estimates compared to the exhaustiveness calculations in the SNA provided by the official statistics. Furthermore, survey studies are too expensive to ensure a textbook representativeness of the data as budget constraints force them to use smaller samples. The gathered quantitative assessments of the occurrence of hidden economy depend on respondents' willingness to cooperate and provide accurate information on hidden economic activities.

#### *Indirect/Macroeconomic Approaches*

Indirect methods are mainly based on macroeconomic indicators related to hidden economy. These methods utilize official data on the level and dynamics of various in-kind and in-cash economic indicators. Using selected theoretically and/or empirically justified assumptions on the correlations between these economic indicators and the hidden economy, aids an assessment of the hidden economy's scale, structure, and dynamics. Among the most frequently used indirect methods are the assessment of the hidden economy through monitoring electricity consumption; monetary approaches measuring hidden economy's relationship with money transactions; GDP statistics, etc. Using several observable indicators, econometric models are developed to describe the dependency between a range of economic variables and the size of the hidden economy. As a rule, these methods provide general estimations of the size of the hidden economy, but they do not assess the scale, structure, and tendencies of unreported work/employment. For example, some models use as observable indicators labor market changes: the increase in hidden employment has an effect on the labor participation in the official economy (measured by a decrease in the official reports on the number of employed and/or in the time spent working).

## 1.2. CAUSES

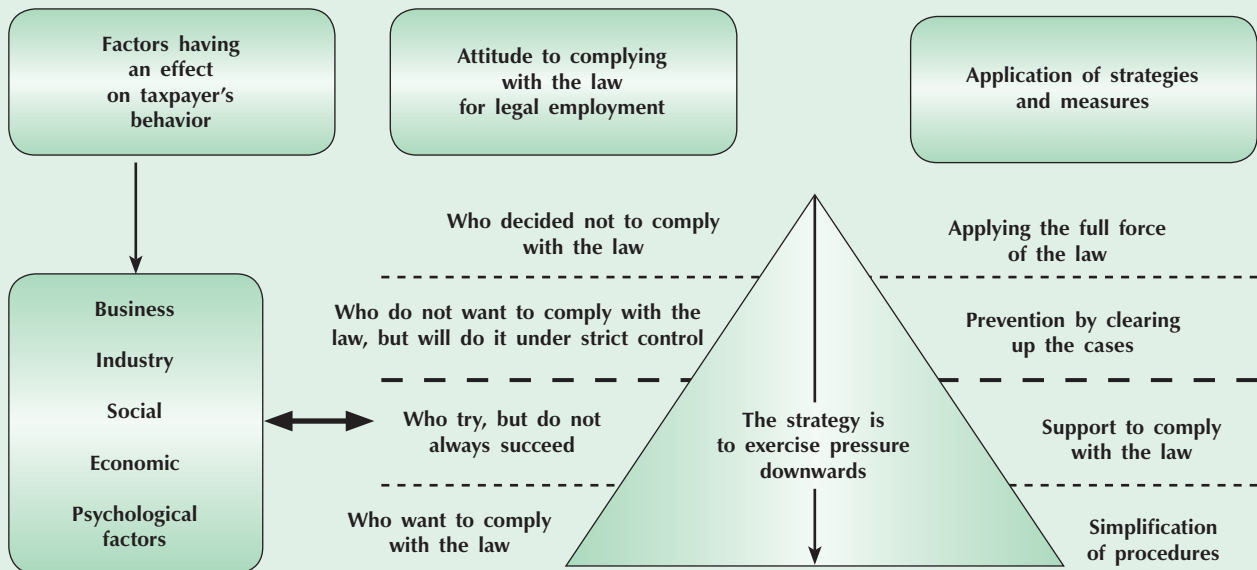
Most commonly analyses of the causes of hidden economy describe the causes of the gray economy – the activities that are legal but are purposefully hidden, evading tax laws or other regulations (e.g., labor standards, business registration

requirements, etc.). Based on the understanding of the complex nature of the phenomenon, an increase in the hidden economy might be caused by many different factors. Yet among the most important and most frequently quoted in literature and public documents are:

- an increase in tax and social-security contribution burden;
- the complexity of taxation procedures;
- an increase in the number, intensity, and complexity of regulations;
- incompetence of the public administration and a drop in citizens’ loyalty to public institutions;
- diminishing tax morality;
- a decrease in the number and efficiency of civil institutions, etc.

The hidden economy is grounded in the disintegration of social and economic norms of society. The efficient counteraction of the causes and the consequences of the hidden economy requires a law abiding culture.

**Box 3. The Australian Tax Office Model “Factors – Strategies” to Counteract the Hidden Employment**



The Australian Tax Office (ATO) applies different strategies based on probable different motivations of a firm to break the laws and hide some of its activities. By applying different risk assessment systems, it tightens the control over a small group of firms, whose activities have a highly negative effect on the state budget. The price for applying different strategies on firms affected by the measures goes down from the top to the base of the pyramid. This segmentation drives firms down to the base of the pyramid, thus, lowering the total costs of fighting hidden economy.

Source: Australian Tax Office, Colin C. Williams and Piet Renooy, *Measures to tackle undeclared work in the European Union*, 2008.

### 1.2.1. Tax and Social Security Burden

An overwhelming number of studies show the increase in (or no change of) tax and social security burden as a key reasons for the expansion of hidden economy. Taxes define the choice between leisure and work, as well as the labor supply to the hidden economy. However, even major reductions in tax rates alone are unlikely to produce a significant drop in hidden economy. Instead, they would merely stabilize the level of hidden economy and avoid further increase. **Defining are not only the tax size, but also the complexity and efficiency of the tax system.** Some empirical studies on hidden economy conclude that entrepreneurs enter the hidden economy not because they want to evade taxes, but because they want to avoid bureaucracy and corruption.

Frequent changes to the tax policy and system increase entrepreneurs' perception of the unpredictability and the complexity of fiscal order. The latter are stimuli for hiding incomes and employment. In general, if the tax system and the distribution of taxes are perceived as unfair<sup>6</sup>, the share of hidden economy grows. An emphasis on separate tax measures without sufficient attention on the reform of tax administration, spell for a poor institutionalization of the tax administration system. The latter is worsened by a lack of traditions in this sphere and scarce financial resources. A serious consideration is also the extent to which tax authorities are prone to corruption.

Tax policy has an impact on both the economic activity as a whole, and on separate firms, since it determines businesses' tax burden and rate of return on investments. Moreover, the tax policy is of major importance to small- and mid-sized enterprises, which have a limited access to bank loans and a capital turnover that is an insufficient and expensive resource, thus depriving them from sufficiently balancing the fluctuations of the income flow. Therefore, **in addition to the overall tax burden, the way in which the tax administration affects businesses' income flows is of paramount importance.** The tax regime model and the quality of the tax administration are very important for businesses, particularly for those with limited capacity and resources (Stanchev, 2004).

According to a number of international organizations such as the Organization for Economic Co-operation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD), changes to the Bulgarian tax system aimed at its simplification, clarification, and stabilization are not carried out consistently (OECD and EBRD, 2003). The tax system is often altered without the necessary explanations and preliminary training for businesses and the tax administration on new procedures and regulations. The lack of information and consulting services feeds a **low level of trust between businesses and institutions responsible for implementing the tax policy.** The lack of trust means a lack of safety and predictability for the business and the tax administration, which has a negative effect on firms' strategies and the business environment. Here, the problem is not so much in the structure, which resembles the one of OECD

<sup>6</sup> Fairness here refers to equal treatment of taxpayers and the perceived equity of the system. It should not be interpreted as equal tax rates for everyone.

#### Box 4. Prerequisites for Corruption in the Tax System and the Hidden Economy

**The tax system remains strongly affected by corruption and generates hidden economy.** Half of the businesspersons and 43 % of the population believe that “almost all or most” tax officials are involved in corrupt activities. In a survey conducted by Vitosha Research Agency among tax officials, they disclosed that **corruption was most widely spread in operational tax control units, while the largest corruption deals were related to tax audits.** Tax officials consider VAT collection as most prone to fraud attempts and VAT registered companies as most likely to try to evade taxation and social security payments.

*Source: Center for the Study of Democracy, Anti-corruption Reforms in Bulgaria, Corruption Assessment Report, 2005.*

members, but in its implementation and enforcement. Frequent changes to tax regulations lead to instability. A lack of transparency and coordination between local and national authorities is evident. Also notable is the insufficiency of tax administration’s qualifications. All of these are a key factor that hampers the efficiency of the tax system, according to the business. Even though tax liability is not high in Bulgaria, **the costs for complying with the requirements and the procedures of the tax system make official business activity significantly more expensive** for entrepreneurs.

#### 1.2.2. Regulations

In general, regulation is assumed to correct market imperfections in resource allocation by altering businesses’ costs and strategies. An increase of the intensity of regulations (measured by the number of laws, regulations, and their dynamics) is another factor, which reduce the freedom of choice for employees in the official economy, and create grounds for transition to the hidden economy.

Two groups of regulations can be discerned. **The first group** addresses **requirements to the quality of products and services**, security standards, and ecological standards. They increase expenses on specific capital investments or production technologies, but they could also have a positive impact on competitiveness, since they could stimulate innovations and competition. This type of regulations is often used to avoid competition that is merely based on price due to low technological costs and investment in innovations. However, such regulations are also used sometimes to replace/eliminate small firms that do not meet the necessary product and service quality requirements or operate mainly within the hidden economy. Important preconditions for the functioning of such regulations are both an efficient regulatory climate provided by the government, and an active response from businesses in jointly solving problems that are subject to regulation (Dahl, 2004).

**The second group of regulations includes price regulations, restrictions, and requirements for access to the market**, excluding direct administrative control

and control over the production methods. These regulations increase administrative costs but not investment costs. The increase in business costs does not increase productivity, but only the value of the product and, respectively, its price. This type of regulatory policy distorts and undermines the role of the entrepreneur and the management.

**Bulgarian regulations continue to be harsh and burdensome.** The number of procedures, the long time required for complying with their requirements, the high expenses on registration, and the existence of obligations of no market logic make entrepreneurship a slow, expensive, and complicated affair. Moreover, considering the low average income in the country, these requirements appear even more burdensome. Furthermore, companies face non-transparent procedures for renewal of permits or licenses, especially in construction and public works. Thus, companies are forced to spend more on unproductive activities, which make them less competitive. The regulatory compliance costs in Bulgaria are highest for the economic activities characterized by low capital intensity and R&D investments, as well as low-qualified or unqualified work force. To a certain extent, transferring their operations to the hidden economy helps the firms stay on the market, but it does not stimulate an increase in their competitiveness in the long run. Additionally, the companies operating in the hidden economy increase the level of unfair competition to those firms that meet all regulatory requirements.

#### **Box 5. The Eternal Regulatory Regimes of Bulgaria – When Less Means More**

The activities requiring a license (and implying huge discretionary power of the state apparatus) are continually increasing in number. From 55 in 1996, to 65 in 1997, 86 in 1998, to 106 in 1999. The need to acquire a license, as a condition for starting economic activity, makes bribery a cheaper and faster way of doing business. The negative aspects of licensing are reinforced by the inefficiency of the judicial system (and respectively, of the procedures for appealing against refusals).

*Source: Center for the Study of Democracy, Corruption Assessment Report, 1999.*

There were two “waves” of reducing the regulatory burden:

- In 1999 – 2000, on the basis of a decision of the Council of Ministers, the government reported that 44 out of 400 regimes were removed or facilitated;
- In 2003 – 2004, on the basis of another decision of the Council of Ministers, the government sought to remove 75 regimes and ease the application of 117 out of 360 regimes. Necessary as it was, that process per se failed to bring about tangible reduction of the corruption pressure in the regulation of business activities because it did not address the main problem, which was the procedure, methods and mechanisms of applying the regimes.

*Source: Center for the Study of Democracy, Anti-corruption Reforms in Bulgaria, Corruption Assessment Report, 2005.*

### 1.2.3. Institutional Context

The analysis of the institutional context's impact on the hidden economy is based on the understanding that institutions are social technologies (Nelson and Nelson, 2002). Social technologies are widespread means for the governance of an economic system or society, as a whole. They operate both within certain organizational structures, and in the process of interaction between different organizational structures. Therefore, the institutional context, in which economic entities operate, determines to a great extent the distribution and use of resources. **Weakness and inefficiency of state institutions** are defined by many studies as major factors for hidden economy. A growth in hidden economy, as a result of the action of inadequate institutions, leads to a further deterioration of the quality of public services, which creates yet new stimuli for leaving the official economy.

Significant institutional changes were carried out in Bulgaria during the past twenty-five years. However, the institutional reform is uncoordinated and time-consuming, which leads to notable insecurity and uncertainty for participants in the economic system. **There is no constant and efficient dialogue between the government and businesses.** Such a dialogue would have contributed to the development of more effective institutions. There is a double-sided problem: on the one hand, the government cannot find an adequate format for dialogue with the private sector, on the other, the business cannot organize itself as efficient useful partner to the government. Similarly, there is a lack of dialogue and coordination between authorities at local and national level. That is, national measures and institutions are often incompatible with local necessities and capabilities. Moreover, entrepreneurs themselves perceive institutions as inefficient. Bulgarian institutions seem to be serving their own interest, and the interest of the respective ruling majority, rather than being a partner to the business community in boosting the economy and competitiveness. Another weakness of the institutional context is the **lack of a system for monitoring and assessing of institutions' efficiency and effectiveness**, as well as for mapping the qualifications of people working in these institutions. In the absence of a monitoring system, neither the positive tendencies, nor problem areas can be appraised adequately.

When institutions are ineffective in protecting property rights, companies are forced to minimize their risks and expenses by integrating vertically, i.e. by taking over the entire production chain – from manufacturing to delivery to servicing. The latter reduces the firms' flexibility and provides favorable preconditions for the emergence of monopolies. In addition, it harms specialization and competitiveness. Higher transaction costs in the official economy, a result of inadequate institutional structure, provides advantage to competitors operating within the hidden economy. The larger the number of firms hiding their economic activity, the heavier the competitive pressure on compliant businesses. In this environment, the latter have two alternatives. The first is to hide their activities, the second, to leave the market. However, in most cases, businesses decide to combine both unreported (gray) and reported (official) activities. The conclusion is that ineffective institutions cause an inefficient distribution of resources and production, slow-down economic growth and reduce the country's overall competitiveness. Such ineffectiveness results ultimately in the increase of the share of the hidden economy.

### 1.3. EFFECTS

The hidden economy seriously impacts the activities of the private sector, the economic growth and development, the productivity and competitiveness, the economic policies, and the democratization of developing countries and countries in transition.

Analyzing the effects of a growing hidden economy is difficult, as no straightforward empirical proof of its existence and size exists. On the one hand, the impact of the hidden economy on the official economy is portrayed through the skewed resource allocation and the inefficient use of resources. The gray economy is blamed for the lack of economic growth due to its negative effect on social capital and for large-scale tax evasion (Pippidi et al., 2000). Its distortion effects on official institutions, norms, and rules are also significant. The presence of a hidden economy is also an indicator of a serious lack of trust in the predominant social order and rules. A mirror effect is the diminished support of official institutions to participants in the economy, which is a precondition for higher crime rates. On the other hand, two thirds of the revenues earned in the hidden economy are spent (and hence taxed) in the official one, and thus, have a positive and stimulating effect on the economy. Bad management from the government is the basic reason for a growing gray economy, where entrepreneurs look for a more favorable combination between taxation and public services (Johnson, Kaufman, and Schleifer, 1997).

From a neoclassical perspective, the hidden economy supplies an unmet demand for urban services and small-scale production. The gray sector provides the economy with vigor and entrepreneurial spirit, leading to a higher competition, higher efficiency, and restricting governmental intrusion into the economy. Moreover, the hidden economy contributes to the creation of new markets, increases capital accumulation, and transforms legal social and economic institutions, which aid such accumulation (Asea, 1996). The voluntary choice between the official and the gray sector can lead to a higher potential for economic growth, and therefore, to a positive correlation between growth in the hidden economy and overall economic growth.

Based on the review of different studies it can be concluded that **the effects of a growing hidden economy cannot be directly and unambiguously evaluated**. On the one hand, the hidden economy is considered an integral part of an evolutionary process, leading to a dynamic development of the economy and the society. On the other hand, in the long run, a society should not tolerate legal violations. A rise in the size of the hidden economy is an alarming signal of a growing resistance to the existing economic norms and regulations.

#### ***1.3.1. The Economy and Government Policies***

The state of the economy is monitored through the changes in GDP, which give an indication of the macroeconomic conditions in the country. An assessment of government policies and the role of the state in the economy are also vital. The latter are measured by indicators, such as the total burden of government spending, the budget deficit, the size of public savings, the competence of state administration, etc.

Other things being equal, it is better for a country when all its business activities are within the official rather than the hidden economy. However, the proposition that it is better for an economic activity to not exist, rather than take place within the hidden economy, is not evident. This is only obvious for activities that are criminal in nature. This is so, because it is not clear what the alternatives to hidden economy are (Eilat and Zinnes, 2002). The effects of the hidden economy cannot be unequivocally defined as negative or positive. On the one hand, the size of the hidden economy is an important indicator of the maturity and efficiency of market economy institutions and the quality of the business environment in countries in transition. On the other hand, the hidden economy spreads and continues to grow, and it starts being perceived as an inherent part of the world economy.<sup>7</sup>

**There is a prevalent understanding that the gray sector has a negative effect** on the tax system and its structure, the efficiency of resource allocation, and the official economy and its dynamics. Generally, the co-existence of the two sectors of the economy, the official and the hidden one, has a negative effect on the overall socioeconomic development. However, when comparing an economy with a large gray sector with an economy, where the gray sector has been suppressed without transforming into formal economic activity, the overall effect is that the latter is left worse off than the former. There are studies, which prove that over **66 % of the incomes generated in the gray economy are spent in the official sector** (Krakowski, 2005). When there is a venue for the gray sector to transform into official economic activity, gradually suppressing the gray economy would benefit the overall economic activity within a country. In this case, a decrease in the size of the gray economy can lead to a wider tax base, which will create the conditions for lowering taxes and improving public services.

The hidden economy has positive effects on the economic system as a whole, but only in the short-run. The understanding is that the **hidden economy has a stabilizing function**. The hiding of income and production leaves additional means for higher investment and/or consumer demand, which can stimulate economic growth. The hidden economy provides households with certain necessities (goods and services) produced at a lower price, which can have an anti-inflationary effect in the process. However, if it is too difficult to legalize the means accumulated in the hidden economy they get exported from the country, usually to tax havens. It should also be noted that a large part of the hidden income, which stays in the country, after being blended with the official economy, is used for the import of goods and services, and not for internal demand. Therefore, **in the long run, persistent hidden economic activities could have lasting negative consequences for the social development** and the process of democratization.<sup>8</sup>

<sup>7</sup> In 2000, out of about 90 developing and transition economies in Europe, Asia, Africa, and Latin America, only 26 had a share of gray economy less than 30 % of GDP (most of them were in Asia). For the last 13 years, even the OECD countries have registered an increase in the share of their informal economies in GDP.

<sup>8</sup> The countercyclical character of the hidden economy has been used by governments, which have intentionally encouraged the gray sector following the logic that partial employment is better than unemployment, and life on the edge of poverty is to be preferred to starvation. However, such policies have failed to account for the high cost of the hidden economy on public morale and the long term sustainability of public law and order.



**The presence of a hidden economy deems macroeconomic measures inefficient.** Macroeconomic indicators are distorted, hampering planning, re-distribution, and governance in the economy, and providing an inaccurate picture of the dynamics of economic growth. Large amounts of money outside the banking system reflect not only the existence of a significant hidden turnover in cash but also a lack of trust in the banking system.

**The presence of a hidden economy leads to budget losses that cannot be compensated for by the law-abiding taxpayers.** Taxes are a form of social agreement between citizens and their government on the value of public services required by citizens, and the way of financing these services. Public services are vital for the functioning of society – healthcare, education, social security, defense and national security, maintaining law and order and administering justice, maintaining and improving infrastructure, the institutions, etc. A low quantity and quality of public services leads to lower economic growth (Johnson et al., 1998, Loayza, 1996) and lower competitiveness. The reasons why the government is able to offer these services to the economic agents more efficiently than private suppliers (for example, the mafia) include increasing the returns to scale of services like defense and justice. Private suppliers would have no engagement for a long-term supply of the above services.

Another negative effect of the hidden economy is that it **hinders the development of an integrated and legitimate tax and social security regulatory system** (Kaufman et al., 1996). Different researchers of the effects of corruption on the official economy show that corruption has a negative effect on growth because it leads to a lower level of investment, detrimental and inefficient allocation of resources, and a lower quality of the infrastructure (Mauro, 1995, Shleifer and Vishny, 1994, Tanzi and Davoodi, 1997). Corruption is positively correlated to the hidden economy, and hence the hidden economy displays a statistically significant negative effect on economic growth and opportunities for achieving growth in the long-run.

**Box 6. Strengthening Administrative Control and the Introduction of the Flat Tax – Effects on the Hidden Economy in Bulgaria**

In 2008, the first horizontally-integrated administrative inspections were conducted. Several control and law enforcement agencies coordinated their actions on gray markets identified as risky (e.g., second-hand car dealerships). These had limited success mainly because of their one-off campaign nature. [...] According to the *Hidden Economy Index*, **the introduction of a proportional income tax for physical persons did not lead to the expected lowering of the share of the hidden economy**, though some improvement was registered. Further lowering the size and manifestations of the hidden economy, as well as related corruption, requires precision of the measures and strengthening of law enforcement and control, together with a continuous improvement of public services offered by the state.

Source: Center for the Study of Democracy, *Crime without Punishment: Countering Corruption and Organized Crime in Bulgaria, Corruption Assessment Report, 2009.*

Hiding incomes and activities can act as a corrective for economic policy mistakes by exercising pressure to decrease the costs of voluntary law compliance and rationalize administrative services. The latter can be seen as a positive effect of the hidden economy. This argument has some grounds. However, a **decrease in the tax burden can have a stimulating effect only when it does not break competition rules by favoring unscrupulous taxpayers**, and if it generates revenue that can easily flow back into the economy through the purchase of local goods and services.

### 1.3.2. Institutional Efficiency

There are several aspects of **the relationship between the hidden economy and the institutional context**, which deserve attention. **First**, property rights institutions are the economic basis on which participants in the hidden economy establish themselves and through which they launder their hidden financial proceeds. **Second**, the hidden economy is the main source of resources for informal economic networks to influence public servants and agencies, this way threatening the stability of democratic institutions. Particularly negative in this respect is the effect from **the inflow of dirty money into politics**. In the process, networks of financial dependence are formed, which limit the autonomy of the politicians, while creating preconditions for organized crime to develop. **Third, the hidden economy aids corruption and the criminalization of the economy**, thus hindering the functioning of market mechanisms. This is a source of insecurity in the business environment, which is detrimental to a country's economic vitality. A large gray sector is an indicator of a low level of trust in and insufficient legitimacy of official economic institutions (Bojicic-Dzelilovic, 2004). **Fourth, the hidden economy hinders efficient resource allocation** and diminishes productivity. Entrepreneurs act rationally within the existing framework of institutional rules using different combinations of labor and capital in order to minimize their cost of production. If the legal and regulatory framework does not function efficiently, the economy cannot reach its growth potential. **Fifth**, if the property rights protection system is not accessible for all due to overly expensive and clumsy procedures and regulations, many assets will remain outside the formal economy and will not reach their maximum potential value. **In the absence of formally-protected property rights, assets in the gray sector cannot be combined, organized, and productively used** to create value and higher productivity (Kuchta-Helbling, 2000).

The lack of or the inefficiency of institutional rules of the game creates uncertainty for the companies' decentralization, specialization, subcontracting, risk taking, and investment decisions. In addition, institutional inefficiency hinders the development and use of more sophisticated and complex combinations of assets aimed at attracting long-term investments and/or achieving economies of scale. As a result, the economy cannot compete globally and risks losing its competitive positions on international markets.

### 1.3.3. Business Efficiency

It is typical for studies of the hidden economy to treat problems faced by the business as factors, which lie beyond the firm itself. The firm's own actions and

strategies for tackling these problems are ignored. If the business environment deteriorates or remains unchanged, there are two alternatives a company may choose to follow – closing down the business or entering the hidden economy. Operation within the hidden economy would ensure the survival of the company and might even lead to profit in the short-run. **The main problem, which firms operating in the shadows face, is the enforcement of contractual obligations.** This is why contracts are usually signed with trusted partners on the basis of reciprocity (Stanchev, 2004). In the hidden economy partners are evaluated in terms of the strength of their informal relations, not in terms of their potential contribution to raising a firm's competitive position. Very often potentially profitable business deals fail because of the lack of sufficient or adequate information. This restricts the firms' access to potential markets and partners. It disallows adequate assessment of a company's own competitive position in relation to firms operating in other countries, this way having a negative effect on the firm's strategies. Only informal channels are used as a source of business intelligence, which reinforces the reciprocal character of the relationship. On the one hand, this is an indicator of a firms' limited flexibility and freedom of action and the existence of mutual dependence between the negotiating sides. On the other hand, when a firm is operating on a market, where exchanges are direct and are easily done through personal contacts, in the short term this firm cannot expect to benefit much from the formal protection of official institutions if it decides to declare its hidden activities. However, when a firm operates using complex specialized transactions, its long-term security requires formal protection of its property rights and contracts. When a firm is active in the hidden economy, it aims at being as invisible as possible, which affects its development strategy. Its strategy would be directed towards debt re-payment and the accumulation of reserves to meet unexpected future risks.

Interpreting **the effects of the hidden economy on business efficiency can be done in two ways.** First, the hidden economy skews the allocation of public services costs so that the number of taxpayers paying for their provision decreases continuously. This stimulates rent seeking rather than profit maximization and eventually suffocates entrepreneurial spirit. The principles of fair competition and free private initiative are undermined. Second, the hidden economy distorts market relations and mechanisms. The breaching of the law becomes a significant competitive advantage, which builds additional barriers for new firms to enter the market and for inefficient firms to leave the market. It renders the survival of law-abiding businesses difficult and distracts entrepreneurs from the shortest way to productivity gains.

On the other hand, **the existence of a hidden economy allows the realization of additional entrepreneurial potential,** which will otherwise remain unused due to the high costs of access to the formal sector. Very often entire markets emerge precisely through breaking existing regulations. If the state decides to exercise full control over the development of these markets, they will most probably develop extremely slowly. Furthermore, theoretic studies (Kunin, 2001) and empirical observations (in Bulgaria and other economies in transition) show that large international companies are often inclined to tolerate breaches of their property rights (mostly intellectual property rights) at the onset of the development of markets in third countries. Examples of such strategies include the video rental markets, cable television, Internet-access provision, etc.

Another effect of the hidden economy on business activity often cited in studies is that **during periods of recession, the hidden economy helps keep employment at pre-crisis** levels while cutting wages. The hidden economy absorbs unemployment, limits impoverishment, and thus lessens social pressures. However, in the long run, hidden employment does not reduce the social price of the hidden economy; it rather postpones its due date to the future, when those who are currently not socially insured or are only partially insured will claim retirement and healthcare resources.

In conclusion, the hidden economy is not always stagnating, and it is not a characteristic of stagnating economies, but growth within the hidden economy is lower than the growth in the formal sector (Dasgupta, 2003). Countries with higher income levels are characterized by a lower share of the hidden economy in GDP, and countries with higher levels of corruption have higher shares of hidden economy (Johnson et al., 1998). This implies that the nature of the hidden economy depends on the economic context under which it operates. If there is macroeconomic growth with effect on employment in the official economy, it will stimulate the creation of decent work places. It has been established that there is a significant negative correlation between GDP growth rates and employment in the hidden economy (ILO, 1998). Furthermore, a negative correlation has been observed between employment growth in the official economy and employment growth in the gray economy (Dasgupta, 2003). Fast economic growth leads to a swift growth in the demand for labor in the official economy, which means that the size of the labor force available for employment in the gray sector shrinks.

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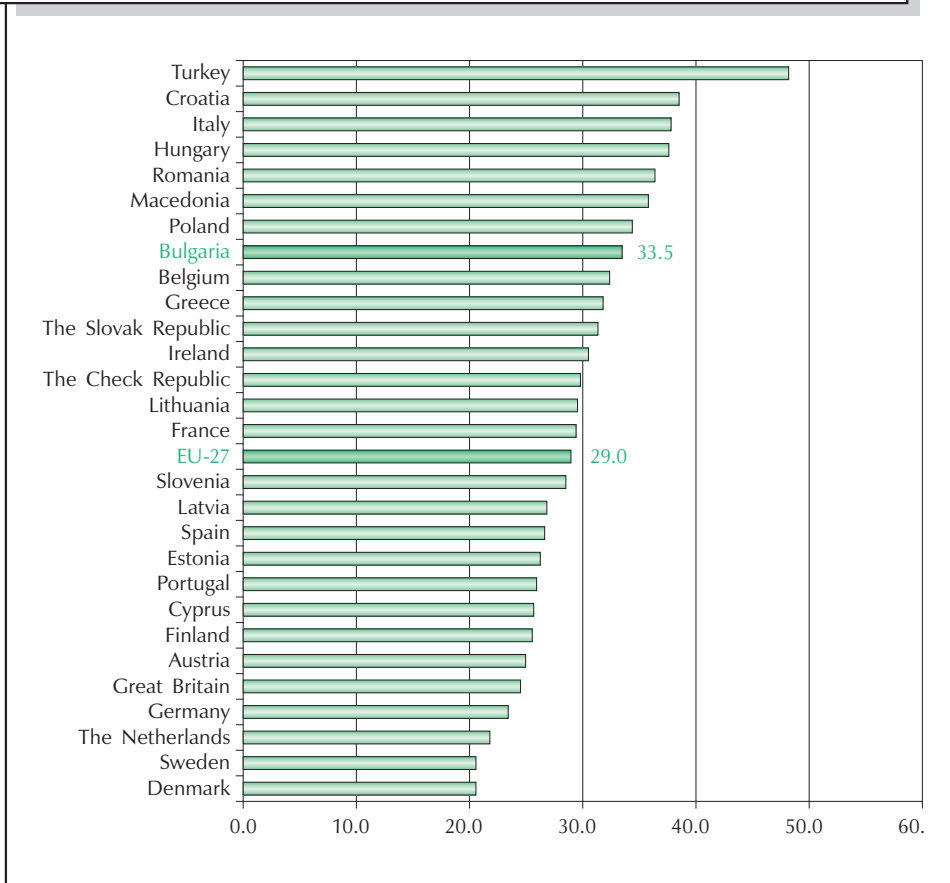
<sup>22</sup> Data is from NSI's annual Labor Force Survey for 2010.

<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.

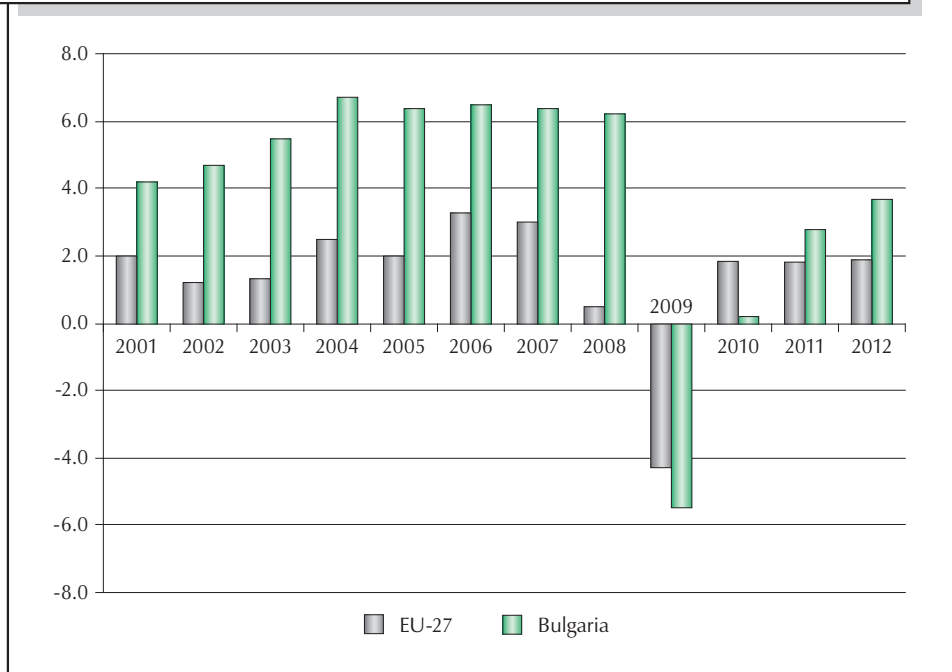
In the second quarter of 2011, a rebound in exports significantly reduced the pace of contraction of real GDP. The existing low consumer trust continues to negatively affect domestic demand, and the GDP virtually stagnated in 2010 and early 2011.<sup>26</sup> Meanwhile, current account deficit decreased<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.

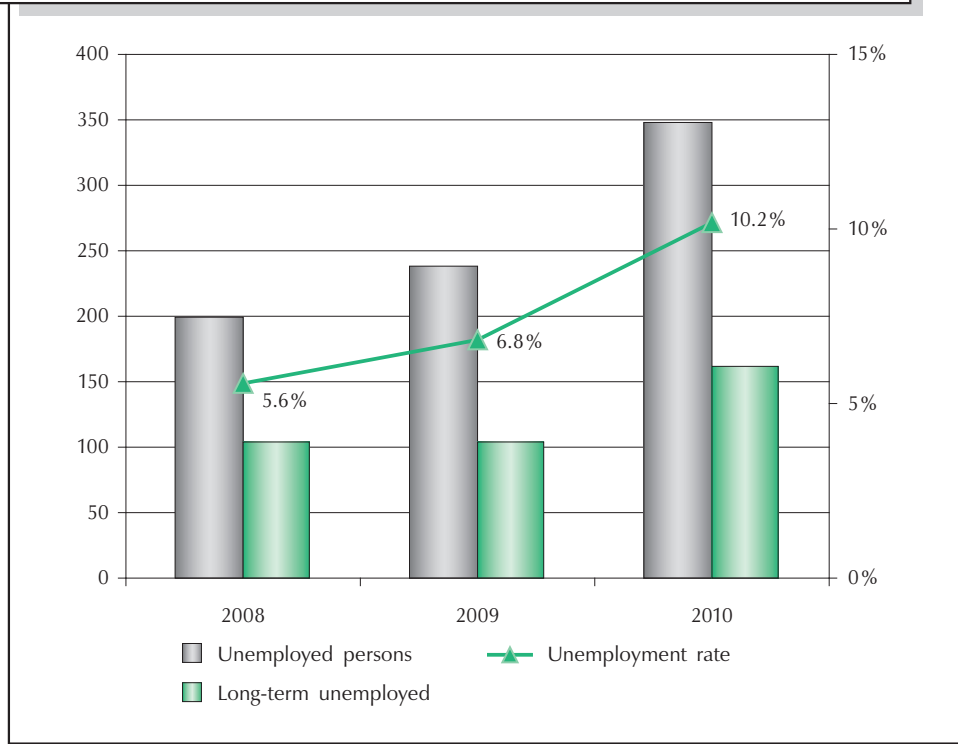
period of 2009, the number of employed people dropped by 175,800, and the respective fall in the employment ratio was 2.3 percentage points. During the same quarter of 2010, the share of unemployed persons was 9.5 % of the economically active population, which is an increase by 2.8 percentage points 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.

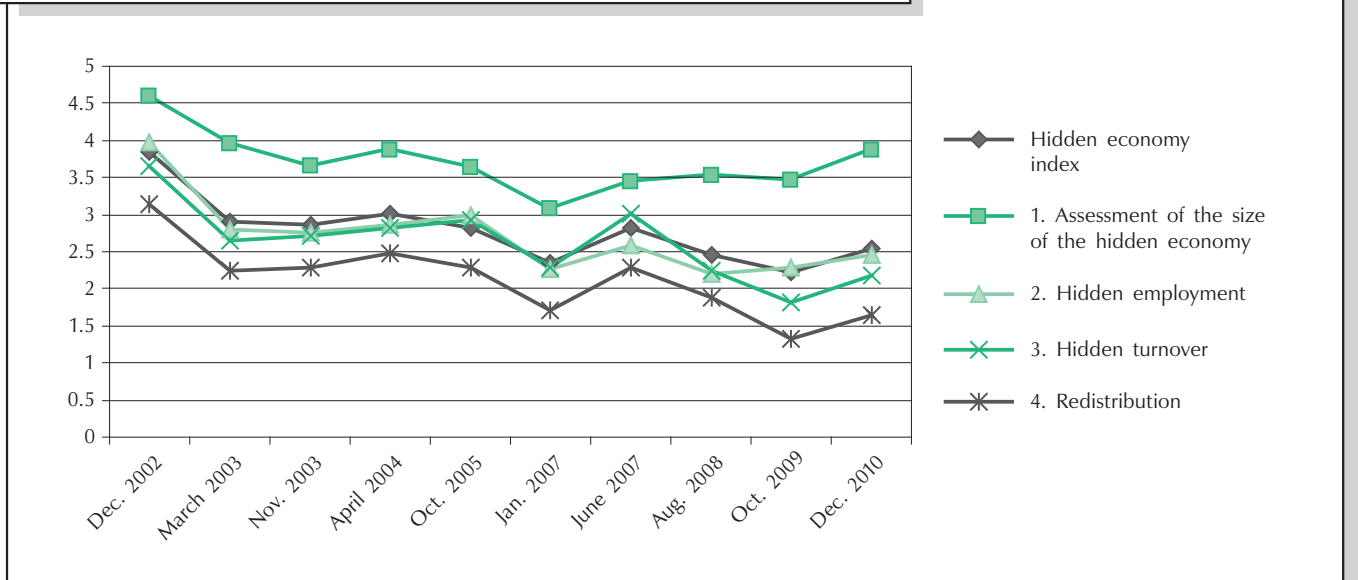
Similar indicators and indices were also constructed on the basis of data from surveys of the Bulgarian population. For example, for the undeclared work/employment a sub-index “Undeclared Employment Relations” of the *Index of the Hidden Economic Activity of the Population* is used, gathering data on 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.

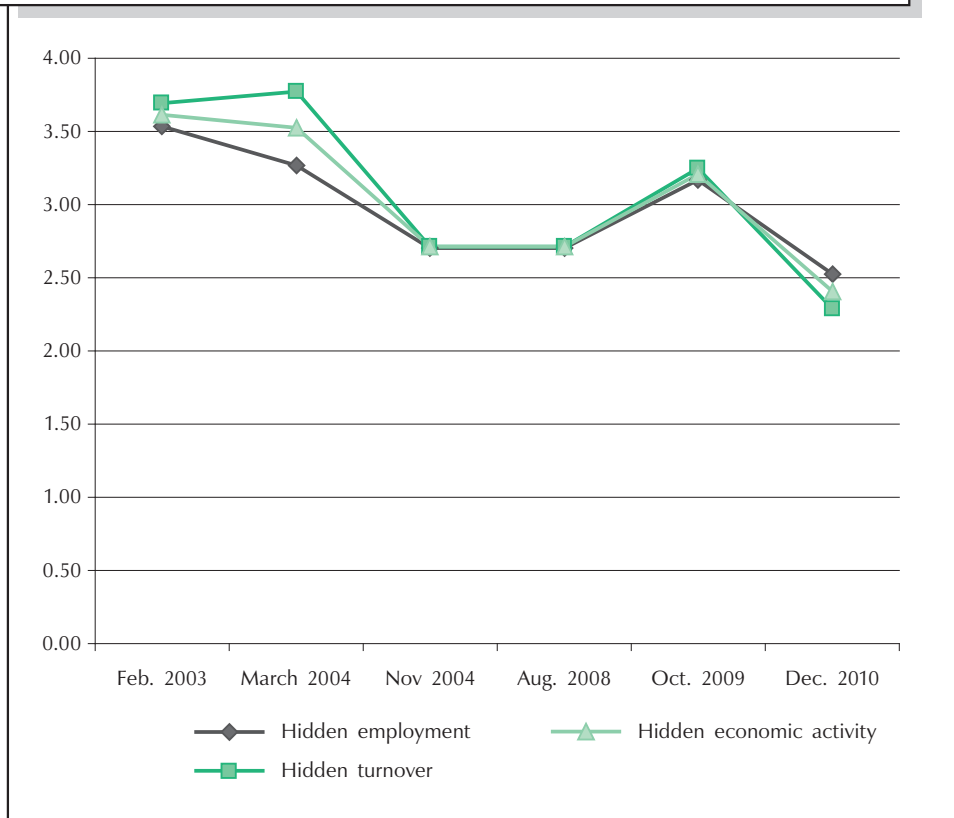
#### *Assessing the Size of the Hidden Economy*

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)**



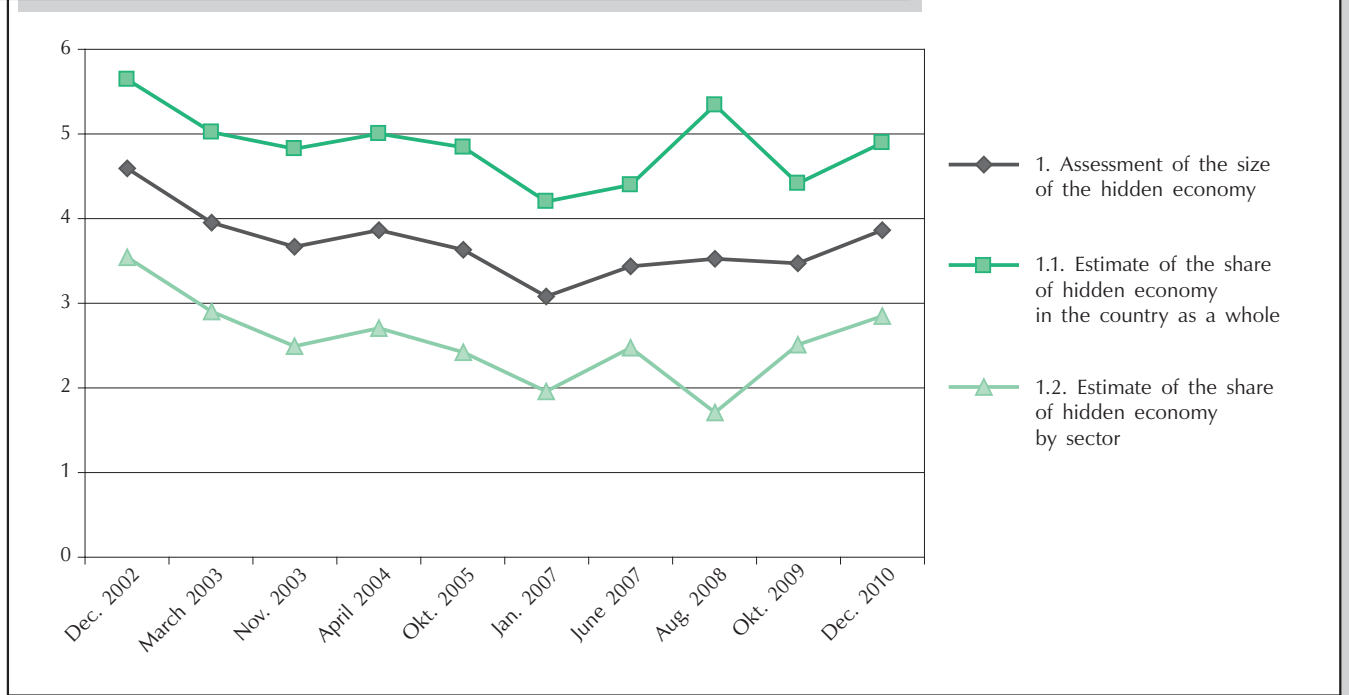
Source: *Hidden Economy Survey among the Population (HESP), 2010, Vitosha Research and Center for the Study of Democracy.*

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)**



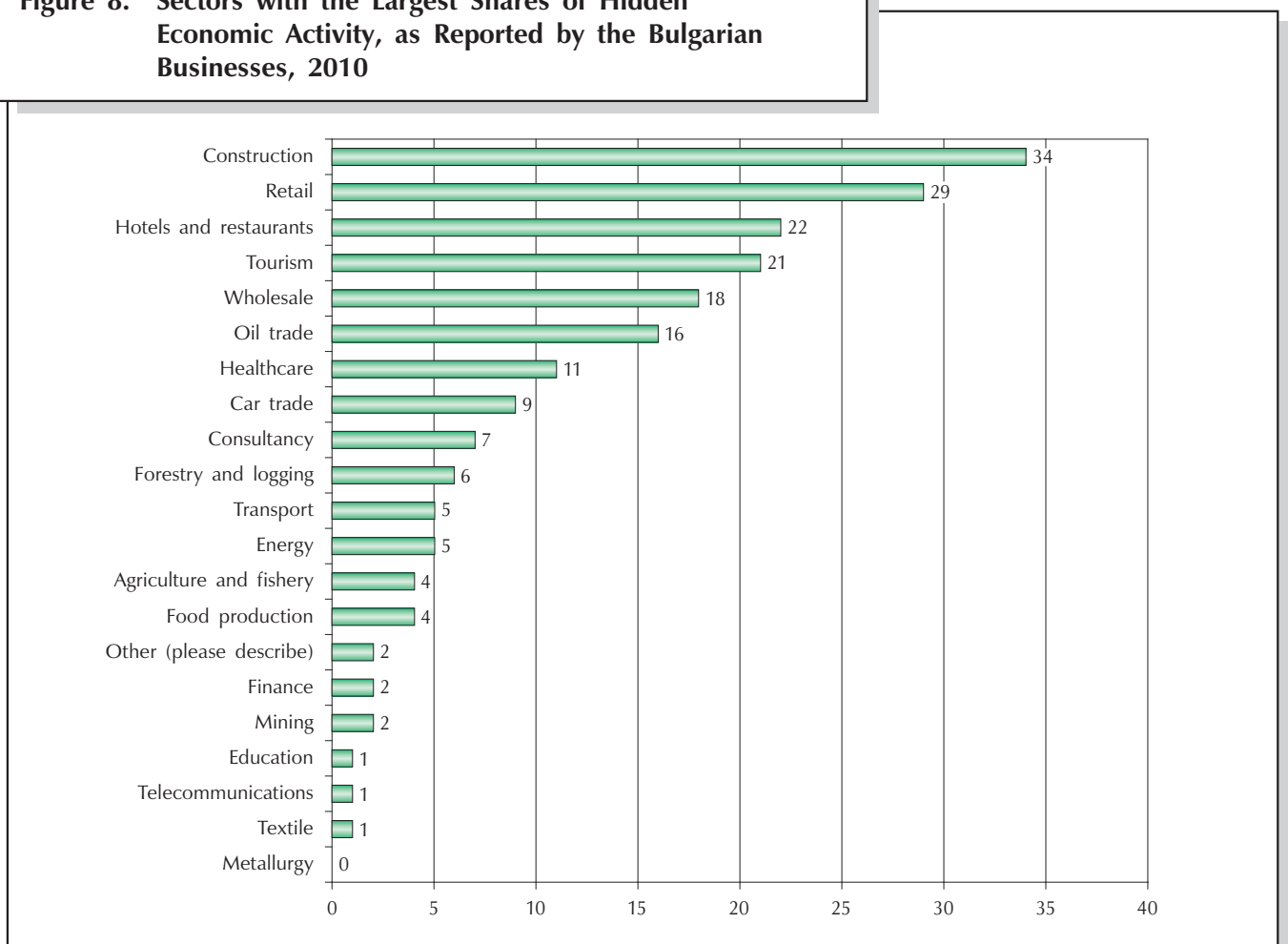
Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

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**

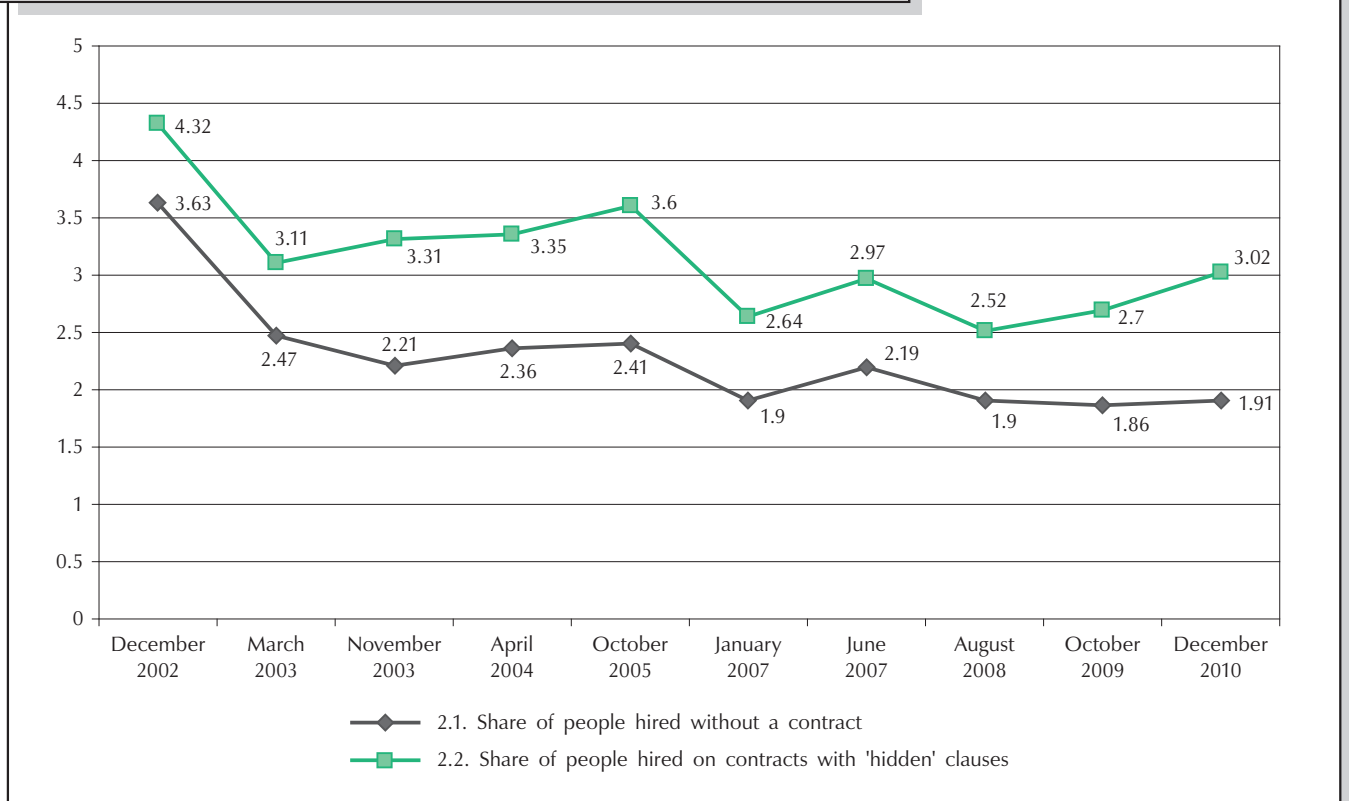


Note: Percent of firms considering that the respective sector has a higher share of hidden economy than the average for the country.

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)**



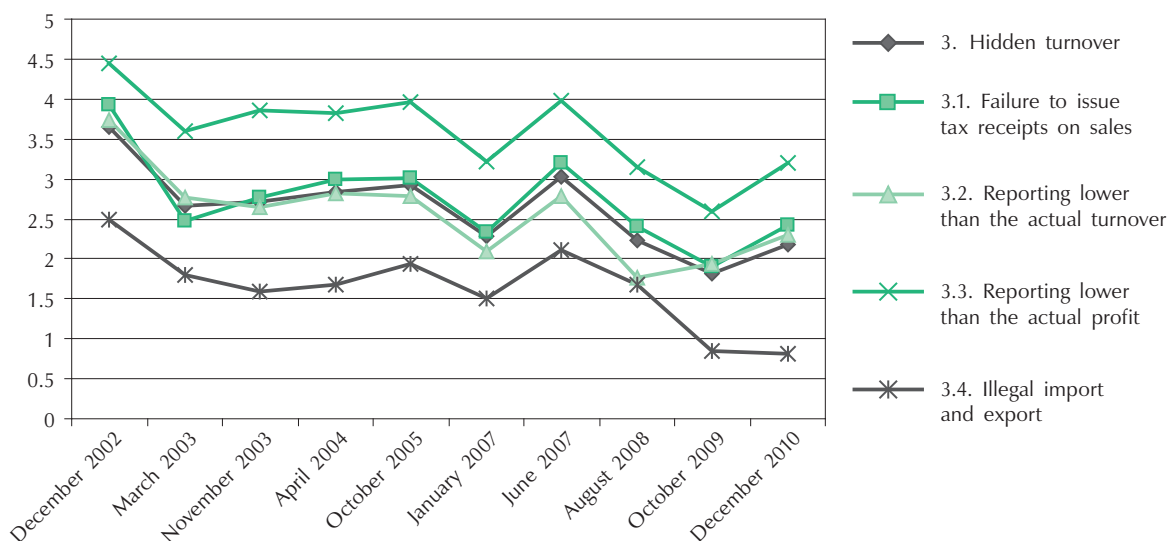
Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

### 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)**



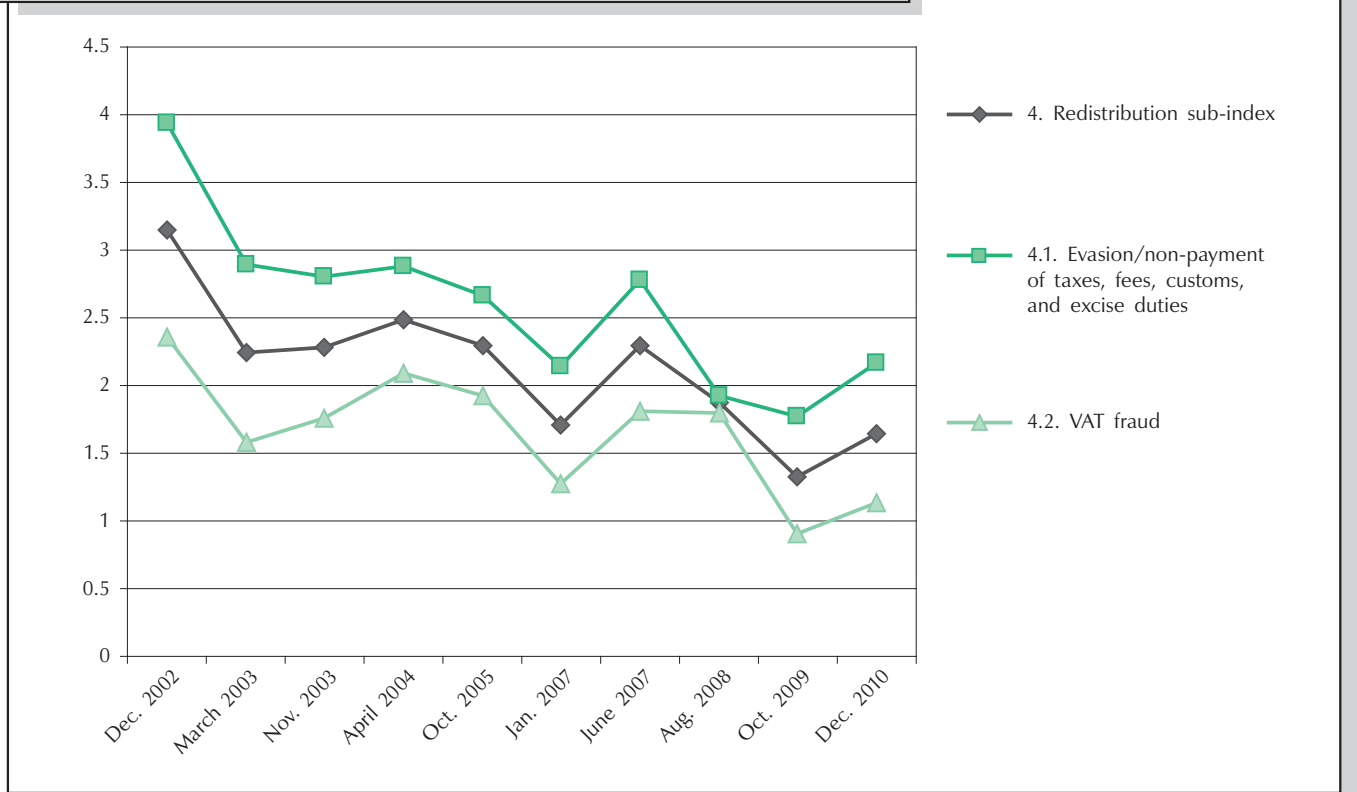
Source: HESB, 2010, Center for the Study of Democracy and Vitosha Research.

*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-

According 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.

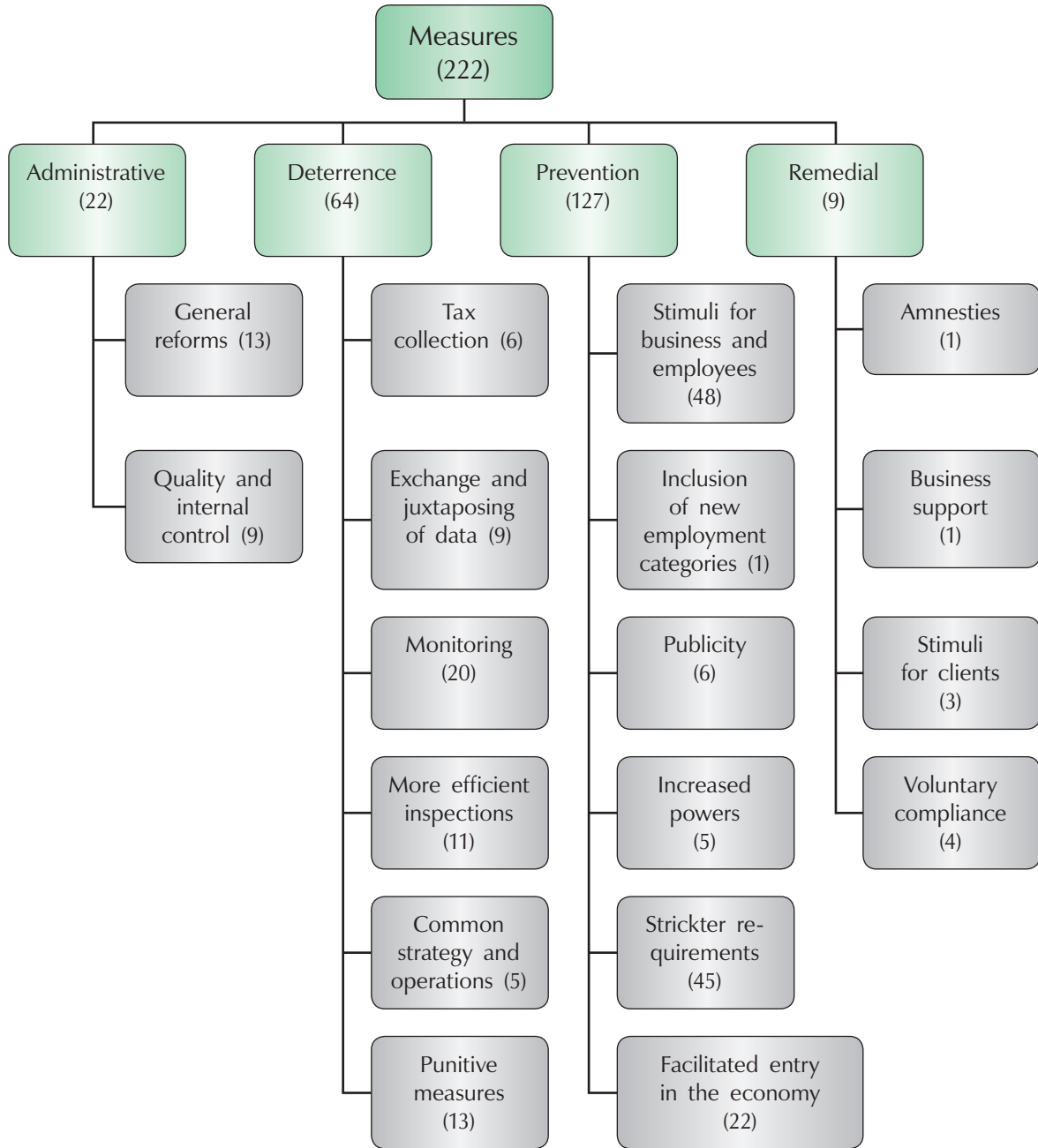
In comparison to European best practice, the following **problems with measures aimed at countering the hidden economy** can be identified in Bulgaria:

- **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.

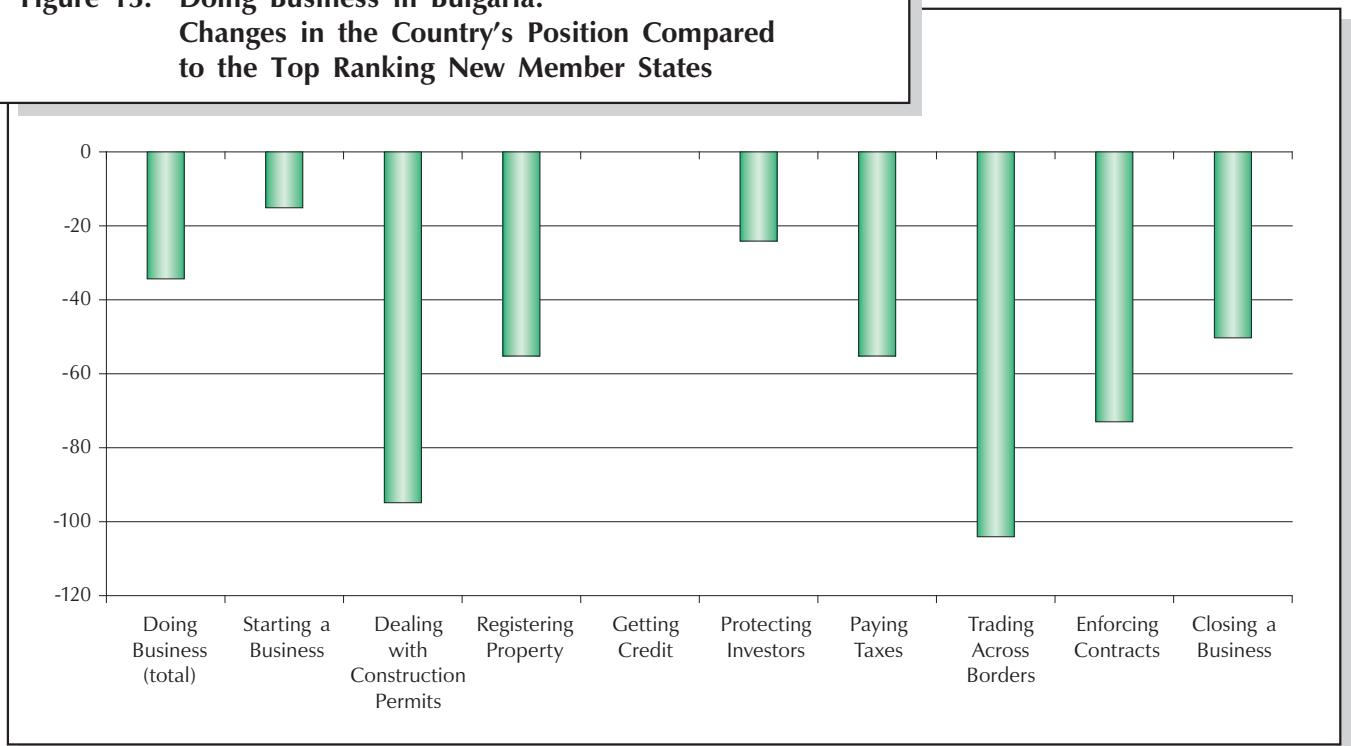
<sup>40</sup> National Revenue Agency yearbook, 2007 – 2008.

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).



### 3. UNDECLARED WORK IN BULGARIA: TRENDS AND CHALLENGES TO PUBLIC POLICIES

Bulgaria's accession to the European Union provided a new context for the assessments of the hidden economy and undeclared work/employment. The factors determining the scope of and the effects from the hidden economy are increasingly international. The efficiency of the national initiatives to limit the hidden economy and undeclared work/employment are becoming more and more dependent on coordinated international efforts. This calls for a new approach to measuring and estimating these phenomena, which is based on a **unified European standard allowing for credible international comparisons**. The collection of credible empirical data on the structure, size, and the dynamics of undeclared work is a prerequisite for assessing policies and activities on its restriction, and will contribute to the effectiveness of policies.

#### 3.1. UNDECLARED WORK – DEFINITIONS AND METHODS FOR ASSESSMENT

Undeclared work is one of the most important and socially significant aspects of hidden economy. Still, even within the European Union, **there is no unified terminology and accepted definition of undeclared work**. For example, the National Reform Programs of EU Member States use many similar concepts:

- *Undeclared work* in Denmark, Austria, Greece, Finland, Cyprus, and Estonia;
- *Undeclared employment* in Latvia and Hungary;
- *Unregistered employment* in Poland;
- *Illegal work* in Lithuania, Slovakia, France, and Sweden;
- *Illegitimate employment* in Malta and others.

This plethora of concepts reflects two discerning criteria of hidden employment – whether or not it is legal and/or reported. It is common that the terms *work* and *employment* are used interchangeably reflecting two aspects of the hidden economic activity. The term *work*, as a rule, refers to the activity, whereas *employment* to the people who do it. Thus, these two terms will be used interchangeably in the analysis to follow. Following the logic when defining hidden economy, **three basic segments of hidden work/employment** can be discerned to aid a more precise definition.

- **Informal work/employment.** This term stands for work that is legal yet not officially reported. Examples of informal employment could be working at one's own farm, when the produce is not intended for the market; domestic labor and work done at home; voluntary labor among friends, neighbors, or relatives; the labor of people, who define themselves as economically inactive

(unemployed, retirees, housewives, students), but work without a contract; and others.

- **Illegal work/employment within the black economy.** This concept encompasses all people engaged in the production of commodities and activities prohibited by the law. This includes people engaged in illegal economic organizations, who have no permission to perform certain activities. Examples of the illegal work include drug production and trade, trafficking people and arms, smuggling activities, illegal gambling and prostitution, and others. In the 1980s, the International Labor Organization (ILO) defined illegal employment as “employment, which does not comply with the requirements of national laws, regulations and practice” (ILO, 1984). Although the scope of illegal economic activity and the associated incomes are significant, they are not officially reported.
- **Undeclared work/employment within the gray economy.** This term includes employment that is legal, yet not declared to state authorities. Thus, undeclared employment is related to the avoidance of paying taxes, social security, or healthcare security. The evasion of income taxes, social security, and healthcare security payments is the basis of the unregistered economic activity.

Different definitions of undeclared work/employment have been proposed. The Organization for Economic Co-operation and Development (OECD) defines hidden employment as work that “although not illegal in itself, has not been declared to one or more administrative authorities” (OECD, 2004). **The European Commission describes undeclared work** as “any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account differences in the regulatory systems of Member States. This definition excludes criminal activities and work which does not have to be declared.”<sup>41</sup> The definition of the EC was used for the development of a special employment strategy for transforming undeclared work into regular employment, which then re-affirmed the goals of the *European Employment Strategy*.<sup>42</sup> The same definition is used in a number of publications by European organizations, such as the report “Undeclared Work in an Enlarged Union” (Renooy et al., 2004).

Approaches to measuring hidden employment are based on the estimates of different indicators – share of the labor force engaged in gray, black, and/or informal economy; working hours spent on hidden labor activities; undeclared incomes from hidden economic activity; and others. Most frequently, data about official and hidden employment are compiled through Work Force Surveys (WFS), the SNA, business statistics (of enterprises), and representative surveys of the population and business. **The hidden employment is estimated as the difference between the officially reported and the actual level of employment in a national economy.** This difference is seen as a result of hidden economic activities,

<sup>41</sup> Communication of the European Commission on undeclared work, April 7, 1998, COM(98) 219 – not published in the Official Journal of the EU.

<sup>42</sup> The 2003 Council resolution on transforming undeclared work into regular employment aimed at strengthening employment guideline 9 (2003 – 2005) and guideline 20 (2005 – 2008) on the transformation of undeclared work into regular employment in the framework of the European Employment Strategy (EES).

undeclared work places, and unreported employment activities. Data from other countries with a similar level of economic development and analogous economic structure serve as a base for determining the actual number and share of the employed. National employment data for previous years is also used in dynamic series. The possibility that the economically active population, whose employment is officially registered, can be involved simultaneously in undeclared work activities should be taken into account. Some countries (e.g., Slovenia, Poland, Lithuania, Romania, and others) use the so-called *Italian method* to assess the actual employment through sampling surveys, which are then compared with other sources of employment data (e.g., official observations of the workforce and/or the census). As of 2002, the Bulgarian NSI is using a system of indicators (e.g., the structure of wages by occupation, maintenance of the work force, time spent working, and others) to additionally assess the size of the hidden employment.

### 3.2. POLICIES TO LIMIT UNDECLARED WORK – SUCCESSSES AND CHALLENGES

Over the past twenty years, **undeclared work is emerging as an increasingly important element of employment policies, necessitating the adoption of effective measures for transforming undeclared into regular employment.** The European Union focused its attention on undeclared work in 1993 in the *White Paper on Growth, Competitiveness, and Employment*. A Communication of the Commission in 1998<sup>43</sup> analyzes the economic reasons that motivate employers, workers, and self-employed individuals to participate in the hidden economy. In 2003, the Council of the European Union passed a resolution on undeclared work,<sup>44</sup> which called upon Member States to work in cooperation to limit the phenomenon. The resolution emphasized the role of social partners, whose joint efforts will contribute to transforming undeclared work into legal/registered employment. In 2003, EU's guidelines on employment<sup>45</sup> include recommendations to Member States on how to develop and apply a wide range of measures and initiatives to limit undeclared work. These measures include improving the business environment, simplifying administrative procedures, developing tax incentives for operating within the official economy, restricting factors that bring about undeclared work, as well as enforcing compliance with the law and imposing serious sanctions for non-compliance. A wider use of incentives and preventive measures in reducing undeclared work is recommended by the consecutive Communication of the Commission on undeclared work.<sup>46</sup>

<sup>43</sup> European Commission, Communication of the Commission on undeclared work, COM (98) 219, [http://europa.eu.int/comm/employment\\_social/employment\\_analysis/work/com98\\_219\\_en.pdf](http://europa.eu.int/comm/employment_social/employment_analysis/work/com98_219_en.pdf).

<sup>44</sup> Council of the European Union, Resolution on transforming undeclared work into regular employment, Official Journal of the European Union, C260, October 2003, [http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/c\\_260/c\\_26020031029en00010003.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/c_260/c_26020031029en00010003.pdf).

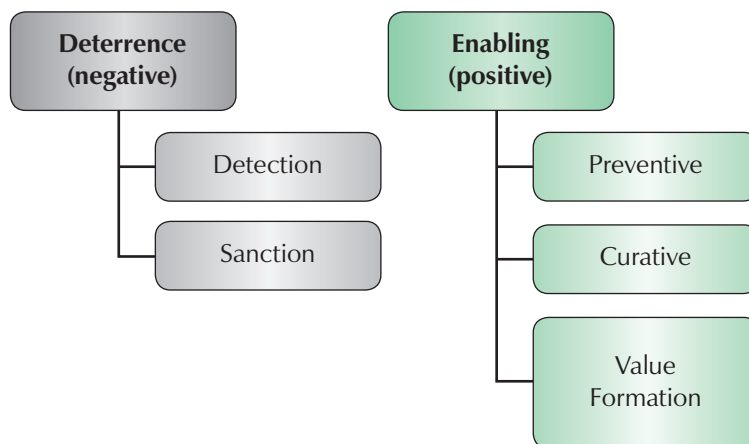
<sup>45</sup> Council Decision of 22 July 2003 on guidelines for the employment policies of the Member States (2003/578/EC).

<sup>46</sup> European Commission, Communication of the Commission on undeclared work "Stepping up the fight against undeclared work", COM (2007) 628.

### 3.2.1. Measures for Counteracting Undeclared Work in the EU

EU Member States have proposed and tested a number of concrete measures to limit undeclared work (see, for example: European Employment Observatory, 2004 and 2007, Renooy et al., 2004, Williams and Renooy, 2007). Generally, **two main approaches and types of interventions** can be distinguished – deterrence and enabling. They have been analyzed and interpreted differently by different authors: *deterrence vs. tax morale* (Ahmed and Braithwaite, 2005); *deterrence vs. enabling* (Williams, 2006); *a model of deterrence vs. a model of compliance* (Murphy, 2005, 2008); and others. The first approach focuses on the exposure and punishment of undeclared employment instances, while the second approach stresses on the provision of conditions and stimuli for compliance with the law, registering economic activity, and paying taxes and social security. So far, the administrative practice is traditionally dominated by the first approach; however, the second approach has been utilized more and more frequently in recent years.

**Figure 14. Approaches to and Types of Measures for Counteracting Undeclared Employment**



Source: Center for the Study of Democracy using of Williams and Renooy (2007), 2011.

The latter provides a context to the logic behind and the content of adopted measures, which use these two approaches:

- **Precluding law violations** related to undeclared employment. The logic of this approach is that economically rational individuals evade tax and social security payments when the benefits from these actions exceed the anticipated losses in case of exposure and punishment of the illegitimate behavior. The purpose of these types of measures is to increase the probability of establishing violations, while also increasing the sanctions. These actions would make the non-registration of work and the concealment of payments to the state disadvantageous to economically-rational individuals (see, for example, Bardach and



Kagan, 1982, Milliron and Toy, 1988, Gramsick and Bursik, 1990, Hasseldine and Li, 1999, Dodd and Hutter, 2000, Richardson and Sawyer, 2001, Job and Honaker, 2003). This approach could be defined as a “negative” imposition of compliance with the law, hindering, and restricting illegitimate behavior. Among the most frequently used measures of this type are:

- A. Measures to **expose undeclared employment**, aimed at increasing the efficiency of inspections. Such a measure is, for example, the registration of all employees and employment contracts signed. Another possibility is introducing photo-IDs/personal identification cards. Yet another way for advancing the activities of control organs is perfecting their strategic and operational coordination, as well as the data exchange between different inspection agencies. New coordinating institutions are being established to serve as connecting elements between labor inspectorates, tax and duties services, social security institutions, and others. In some countries, in order to facilitate the exposure of unregistered work (especially in the service sector), consumers are obliged to keep their receipts or other documents verifying payments for commodities or services (e.g., construction, repairs, maintenance, and others). In addition, international organizations were founded (e.g., the European Network against Undeclared Work, which includes public institutions in Belgium, Germany, Italy, Romania, and France) to support the exchange of experience and expertise in policies and measures counteracting undeclared employment.
- B. Measures to **sanction undeclared employment**. Most commonly, these measures entail serious sanctions for uncovered instances of undeclared employment, of employing workers without a contract, of non-registration of the employed and the signed contracts, and others. In some Member States (e.g., Finland), companies hiring subcontractors are to ensure that the subcontractor is registered in the registry of employers and the tax register (including the VAT register). It is also required that the subcontractor has no unpaid tax or social security obligations, and that the subcontractor abides by the legal work standards and collective labor agreements. Contractors not complying with these obligations are fined according to the seriousness of their violation.

Critics of deterrence measures argue that **there is no reliable evidence of these measures’ effectiveness** (Williams, 2001, Feld and Frey, 2002, Chang and Lai, 2004, Murphy, 2008, and others). It is argued that these measures may increase the unwillingness of individuals or businesses to abide by the law, while potentially encouraging the creativity in violations. These measures, it is argued, may also hinder the voluntary cooperation between state institutions and economic entities. In addition, these measures are often related to high expenses for uncovering and sanctioning the offenders. This is why in the last few years a greater attention is paid to the second, “positive”, approach to restricting undeclared employment.

- **Stimulating compliance with the law**, declaring employment, and paying tax and social security obligations. In the last few years, this approach gained popularity and attracted a number of supporters (see, for example, Slemrod,

1992, Renooy et al, 2004, Williams, 2006). It takes into account not only the short-term economic rationality, but also the willingness of social actors to observe “the rules of the game”, thus their long-term interests (Kagan and Scholz, 1984, Murphy, 2008). In this case, the aim is to support willingness and facilitate law-abiding behavior, which in many cases seems to be more efficient than imposing sanctions. The role of the public institutions and the state administration is not so much in punishing “bad” behavior, but rather in providing accessible and adequate services to encourage a voluntary compliance with regulations. “Positive” measures may have different features:

- A. Measures **to prevent undeclared employment**. These measures can be aimed at simplification of the regulatory requirements and procedures; providing direct and indirect tax incentives; introducing new categories of legal employment; providing expertise and consultation to businesses and the employed, etc.
- B. Measures **to encourage and ease the transition to regular/official employment**. These measures offer direct and indirect incentives for declaring one’s employment; grant amnesty to employees who register their employment within a certain time-frame; provide services and consultations on employment opportunities and procedures for legalizing one’s work; provide stimuli to consumers for using legal services and products, etc.
- C. Measures **to form law-abiding values and culture**. These measures encourage observing the law and order, as well as labor standards, taxation and social security legislation (Alm et al, 1995, Cullis and Lewis, 1997, Torgler, 2003). These measures also include pro-active campaigns encouraging honesty, justice, and integrity of economic activities; an increase of information on the advantages of declared economic activity and its accessibility to employers and employees; as well as building a culture of paying taxes that requires educated economic actors.

The two approaches to decreasing undeclared work/employment are not mutually exclusive and their coordinated use is recommended. For example, simplifying the legislation and administrative procedures, decreasing the tax and social security burden, and campaigning for the transition to legal/ registered employment are entirely compatible with stricter control measures, increased efficiency in the work of inspection agencies, and stricter sanctions for offenders. **Using mutually reinforcing “positive” and “negative” measures** was recommended by the Second Communication of the Commission on undeclared work in 2007,<sup>47</sup> with an emphasis on the wider use of initiatives forming sustainable values and attitudes toward complying with labor, tax, and social security laws.

Currently, **the lack of reliable assessment of the effectiveness of various measures in restricting undeclared work** poses a serious problem to national economic and social policies. In an attempt to solve this problem, the study *Tack-*

<sup>47</sup> Communication of the Commission on undeclared work “Stepping up the fight against undeclared work” (European Commission, 2007), [http://ec.europa.eu/employment\\_social/news/2007/oct/undeclared\\_work\\_en.pdf](http://ec.europa.eu/employment_social/news/2007/oct/undeclared_work_en.pdf).

*ling Undeclared Work in the EU*<sup>48</sup> assesses the measures adopted in five Member States – Belgium, Great Britain, Denmark, Italy, and Poland (Williams, Horlings and Renooy, 2008). Another step in this direction was a study commissioned by the European Foundation for the Improvement of Living and Working Conditions (Eurofound) in the 27 EU Member States and Norway, which enabled the creation of a database that contains assessments of a minimum of three measures adopted in the surveyed countries.<sup>49</sup>

**Table 3. Estimates of the Share of Undeclared Work in the GNP (%)**<sup>50</sup>

Country	Data reported to EIRO			Data reported to the EC		
	Share	Year	Source	Share	Year	Source
Austria	10 %	2003	University of Linz	1.5 %	1995	Austria Statistics
Belgium	20 %	2004	Government of Belgium	3-4 %	1999	National Bank of Belgium
Bulgaria	25 %	2007	Center for the Study of Democracy	22 % 30 %	2003	National Statistical Institute Institute for Market Economics
Great Britain	1.5 %	2003	National Employment Action Plan	2 %	2000	Rockwool Foundation
Germany	17 %	2004	Federal Government of Germany	6 %	2001	Rockwool Foundation
Greece	25-40 %	No data	No data	Over 20 %	1998	Unconfirmed press data
Denmark	No data	No data	No data	5.5 %	2001	Rockwool Foundation
Estonia	No data	No data	No data	8-9 %	2001	Eurostat
Ireland	5-10 %	1998	No data	No data	No data	No data
Spain	No data	No data	No data	No data	No data	No data
Italy	17 %	2000	No data	16-17 %	2001	National Institute of Statistics

<sup>48</sup> European Foundation for the Improvement of Living and Working Conditions (Eurofound), "Tackling undeclared work in the European Union", <http://www.eurofound.europa.eu/publications/htmlfiles/ef0813.htm>.

<sup>49</sup> Eurofound, "Tackling undeclared work in the European Union", <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>.

<sup>50</sup> The data provide a general idea about the scope of undeclared work in some European countries. Estimates are based on different methods provided by various institutions, and refer to different periods. Thus, estimates are used only as an illustration.

**Table 3. Estimates of the Share of Undeclared Work in the GNP (%) (Continued)**

Country	Data reported to EIRO			Data reported to the EC		
	Share	Year	Source	Share	Year	Source
Cyprus	No data	No data	No data	4.2 %	2003	Greek Cypriot Administration
Latvia	No data	No data	No data	18 %	2000	Central Statistical Bureau of Latvia
Poland	27.4 %	2000	Institute for the Study of Labor (IZA), Bonn	14 %	2003	Central Statistical Office of Poland
Romania	20 %	2003	Alliance for the Economic Development	21 %	2000	National Institute of Statistics
Slovakia	18 %	2003	Friedrich Ebert Foundation	13-15 %	2000	Friedrich Ebert Foundation
Slovenia	17-25 %	1997	Government Commission for Detection and Prevention of Undeclared Work	17 %	2003	Government
Hungary	25-35 %	2004	Ecostat, Hungary	18 %	1998	Borboli
The Netherlands	13.8 %	2002	European Commission	2 %	1995	Statistics Netherlands
Finland	4.2 %	No data	No data	4.2 %	1992	Finnish Ministry of Finance
France	10-20 %	2003	Central Agency of Social Security	4-6.5 %	1998	Rockwool Foundation
Sweden	4.6 %	1998	Swedish National Audit Office	2 %	2000	Rockwool Foundation

Source: European Commission report CE-V/1-04-021-EN-C; EIRO Thematic Feature, Industrial Relations and Undeclared work, <http://www.eiro.eurofound.eu.int/thematicfeature8.html>

International comparisons allow us to draw several conclusions on the undeclared work in Europe. *First*, according to data from the European Industrial Relations Observatory (EIRO), Dublin, the share of the **undeclared work in Bulgaria (about 25 % for 2007) is among the highest in the EU**. Compatible levels of unregistered work are observed in Greece (25-40 %), Hungary (25-35 %), Poland (over 25 %), Romania (20 %), and Slovenia (17-25 %).

*Second*, the countries with the lowest levels of undeclared work are Sweden (2 %), the Netherlands (2 %), Great Britain (2 %), and Finland (4.2 %). The level of undeclared work in these countries is times less than in Central and Southern Europe.

*Third*, data on undeclared work reported to the European Commission are, as a rule, lower than the real level of the phenomenon, as detected by independent surveys. This indicates some **serious problems with the reliability of the official statistics on hidden economic activity and the methods for its observation**.

### 3.2.2. Measures to Restrict Undeclared Work in Bulgaria

Proposed and adopted measures to restrict undeclared employment in Bulgaria focus on its manifestations and the reasons for the re-occurring phenomenon. Different manifestations include:

- employing workers for permanent or temporary work without signing a contract, whereby the employer conceals the real number of employees;
- incomplete reporting of the work done and the received revenues, whereby the employer pays its employees higher wages than formally declared and officially reported;
- covering up the actual character of the employment by signing contracts for other kinds of activity.

The basic reason for not declaring actual employment is **the avoidance of taxes and social security payments** by employers or workers. Examples of such avoidance include inaccurate accounts of the number of employees in employers' official reports; oral agreements in place of signed contracts on the size of remuneration and the job description; or hiring unemployed individuals without a labor contract for a minimum payment. **Additional motives to not declare employment** are:

- non-compliance with state standards and norms on production processes – minimal wages, working hours, safety at the workplace;
- refusal of registration, including providing information for the required administrative forms and statistical questionnaires.

Policies and measures restricting undeclared work/employment are directed toward restricting the factors and incentives for its existence. Since 2002, Bulgaria has taken many steps to restrict undeclared employment:

- At the end of 2002, the *Labor Code* was amended by introducing **compulsory registration of individual labor contracts** at the National Social Security Institute. This measure had a positive effect on the number of signed labor contracts and newly registered employers, which saw an increase. In 2003, the number of registered labor contracts rose by over 300,000 and about 60,000 new employers were reported.
- Parallel to *Labor Code* amendments, there were changes to the *Code for the Obligatory Public Social Security*. **Obligatory social security thresholds** were introduced in all sectors and branches, as well as for nine types of professional

groups. This measure restricted the widespread practice of paying social security contributions on the basis of the minimal salary. In 88 % of the cases, the minimal social security thresholds were negotiated between representatives from trade unions and employers' organizations in each sector. In 12 % of the cases minimum thresholds were introduced by the administration due to a failure of negotiations. The thresholds were accepted as obligatory for the respective sector, branch, and/or professional group. These thresholds are negotiated every year via a three-partite dialogue between social partners. As a result of these measures, in 2003, the revenues from social security rose by BGN 405 million compared to 2002. **In 2004, the increase was by BGN 305 million**, and in 2005 by BGN 183 million. Gradually, **the positive effects of these measures began subsiding**, especially in the context of the world economic crisis.

- **Introducing a flat tax on incomes and corporative profits.** The high tax and social security burden on citizens and businesses is seen as a basic incentive for not declaring employment and incomes. Thus, classical basic measure to decrease hidden employment and incomes is lowering tax levels and social and healthcare security. In the past few years, Bulgaria followed this policy by: first, lowering the total level of tax and social security burden, and second, introducing a flat rate on income and corporate taxes, which, with a few exceptions, were reduced to 10 %. **The results from these measures are not one-sided and are a subject to controversy.** For example, the average income on which social security is paid for the self-employed remains in the range of BGN 250-260, notwithstanding drastic decreases of the total income tax from a maximum of 24 % to a 10 % flat tax in 2008. This indicates that the flat tax does not lead to a significant transformation of economic activity from hidden to official. In another instance, the weak effect of the flat tax on hidden economic activity is demonstrated by the persistence of a heavy social security burden despite several decreases in the past few years. As noted, it appears that cumbersome administrative and regulatory procedures greatly affect the level of social burden and hidden economy, while taxation and social security rates have a marginal effect.
- **Organizing public campaigns** on restricting hidden economy. In 2007, The Bulgarian Industrial Association initiated an "Out of the Shadow" campaign directed toward restricting the hidden economy in Bulgaria. Partners in the program included governmental institutions (Ministry of Labor and Social Policy, Ministry of Finance, National Revenue Agency, Chief Labor Inspectorate, etc.), trade unions and NGOs (e.g., the Confederation of Independent Trade Unions of Bulgaria, the Confederation of Labor "Podkrepa", the Bulgarian Economic and Social Council, and others), business organizations, major national media (e.g., Bulgarian National TV, Bulgarian National Radio, "Darik" Radio, "Trud" Newspaper, "24 Hours" Newspaper, "Sega" Newspaper, and others). A special website was created gathering and summarizing suggestions for coping with the challenges of hidden economy. Although difficult to evaluate the actual impact of the initiative, it attracted public attention on the phenomenon and sparked public debate for reducing the size and share of the hidden economy in the country. After 2008, the Ministry of Labor and Social Policy launched the campaign "Work Legally". Then, at the end of 2009, these initiatives were followed by projects launched by employers' and trade-unions' organizations that were financially supported

through the European Social Fund. The focus of these projects was on examining and restricting the manifestations of hidden economy and undeclared employment. They all share one and the same shortfalls, such as their short-term, campaign character and/or the lack of credible enforcement mechanisms.

An on-going problem is that business associations actively supporting measures to decrease the hidden economy predominantly offer suggestions for altering the legislative and executive powers, yet **there is no single suggestion for self-regulation**. In practice no firm has ever been sanctioned (for example, by excluding it from the association) for hiding its economic activity. It is hardly realistic that all members of business associations operate entirely “out of the shadow”, while those breaking the rules of fair competitions are not among their members. To the contrary, a 2003 study shows that members of business associations are more inclined to offer a bribe (if asked) and less likely to report (e.g., by filing a complaint to the police, courts, media, or another channel) than non-members. The results are statistically significant (Yalamov, 2003). Though this gap in inclination of members vs. non-members is shrinking in the last few years, it does not reverse. Business associations still do not believe in the ability of self-regulatory mechanisms to counteract and reduce the hidden economy.<sup>51</sup>

- **Enhancing administrative control and increasing sanctions.** Certain steps are taken to detect and punish offenders as part of the traditional approach to countering hidden economic activity. For example, in 2006, representatives from the government and nationally representative employers’ organizations and trade unions signed a *Pact for Economic and Social Development of the Republic of Bulgaria until 2009*. It puts foreword the restriction of hidden economy as a priority and presents measures encouraging the strict observation of normative requirements (taxation, duties, financial, etc.) by economic entities. Among the suggested measures are also a harsh treatment of economic entities, who violate tax or social security regulations, as well as improving the control of and measures against violations of social security legislation. Similarly, suggestions by the NRA aim at enabling its control organs to sanction offenders of the Labor Code. The campaign “Work Legally” advocates for increasing the fines on employers who employ workers without a contract from BGN 1,000 to BGN 15,000. Inspectors from the Chief Labor Inspectorate (CLI) were given the authority to temporarily freeze the activities of firms that violated the Labor Code. In 2008, the CLI carried out a total of 34,558 inspections and established 183,871 violations of the Labor Code, labor laws, and normative acts.<sup>52</sup> Some 758 violations were established in relation to registering labor contracts.<sup>53</sup> Highest is the share of such violations in the following economic activities: retail sales, restaurant and hotel keeping, as well as construction.<sup>54</sup>

<sup>51</sup> Y. Hristoskov, The Pension System is about to be Nationalized, Interview, September 9, 2009, <http://www.bia-bg.com/Христосков%2B+Пензионната+система+е+пред+национализация-Анализи/1/MIW-gRWHIVS-MZKfQhK3gSrcNKXMVeJJOnMJOjUhO-gBKnQtOfg1aXUtKDIFmHc5ivgB>.

<sup>52</sup> Social Security in Bulgaria in 2008, NSI, Sofia, 2009, p. 122.

<sup>53</sup> Under article 62 and 913, and under article 63 of the *Labor Code*.

<sup>54</sup> It is these sectors that the business pointed out as having a higher share of hidden economy than the average for Bulgaria, according to the Hidden Economy Survey on the Business (HESB) by the Center for the Study of Democracy and Vitosha Research.

A key issue in countering hidden economy and undeclared employment in Bulgaria is the **lack of reliable monitoring and assessment of implemented programs', initiatives', and measures' results**. In the absence of analysis of the effectiveness of various measures, it is impossible to figure out successes and failures, the cost of adopting each measure and the balance between costs vs. benefits, potential unexpected or negative effects, etc. As a rule, the practice of preliminary assessing each measure's expected impact is not established in Bulgaria. Also not assessed are the risks from increasing the work load and the expenses of the control organs and whether or not such additional load would aid the expected results. Finally, there is no analysis of good international practices tailored to the Bulgarian economy's specifics, despite common knowledge that some measures are successful in one country, while fail in another. In the absence of a viable evaluation system in place, there is no logical continuity and accord between measures. The time-frames for achieving results are also not under scrutiny, as is the complex impact of measures. In this context, it is of utmost importance to introduce the practice of systematically monitoring and assessing policies, programs, and measures restricting hidden economy and undeclared work. Moreover, evaluation mechanisms should be paralleled by on-going reliable observations of the state and tendencies in hidden economic activity.

### 3.3. UNDECLARED WORK IN BULGARIA – STATE AND TRENDS

#### 3.3.1. Empirical Assessment of Undeclared Work in Bulgaria

The **Hidden Economy Survey on the Business** (HESB) by the Center of the Study of Democracy provides a general idea of the scope of employing workers without a signed contract in Bulgaria. The study is based on representative surveys on firms in Bulgaria. It should be noted that these studies identify only the share of employed individuals without a formal contract. They do not include undeclared work of entrepreneurs, self-employed, and/or freelancers.

According to representatives from the Bulgarian business, **for the last eight years, the share of people working under a formal contract more than doubled** (i.e. from 21.2 % to 44 %). This positive tendency was sustained throughout the whole eight-year period. To a certain degree, the obligatory registration of employment contracts, as introduced in 2003, gave an initial boost to this positive tendency. With the introduction of this measure, the number of the registered labor contracts got closer to the number of labor contracts reported in NSI's "Employment and Unemployment" labor-force survey. For the last four years (2007 – 2010), no statistically significant change was observed in the assessment of businesses of the workers without a contract (rather, there are insignificant changes in the intervals). According to Bulgarian businesses, the economic crisis did not lead to a significant increase in the share of the workers without a contract in the country.

**A more serious and worsening problem** ensuing from the crisis is signing labor contracts for minimum payment, on the basis of which social security rates are calculated. Meanwhile, the remaining remuneration is provided in cash in the form of the so-called **"envelope wages"**. For example, a classical scheme is pay-



**Table 4. Managers' Assessment of the Share of Employed Workers without a Signed Contract**

	December 2002	November 2004	April 2005	January 2007	September 2009	December 2010
Up to 10 %	18.9	34.2	38.6	37.4	22.8	29.6
10 % to 25 %	21.4	23.0	16.8	12.9	11.2	9.9
25 % to 50 %	23.5	9.9	11.5	6.8	17.4	13.6
50 % to 75 %	10.1	3.1	2.8	4.1	1.7	1.6
Over 75 %	4.9	0.9	1.2	0.3	0.0	1.2
No such employees	21.2	28.9	29.0	38.4	46.9	44.0
Base	387	322	321	294	241	243

Note: The survey question was "In your opinion, what is the share of the employed without a signed contract in your economic sector?"

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

ing a larger salary than officially reported, which is usually of the same value as the minimal social security threshold. Another way of hiding employment activity is reporting individuals as seasonal workers, thus, employing them under seasonal contracts or part-time contracts. Thus, the employer pays employment insurances only for the period stated in the contract, while the employee works longer hours than formally set by the contract.

**Table 5. Managers' Assessment of the Share of Employed Workers with Underdeclared Payments**

	December 2002	November 2004	April 2005	January 2007	September 2009	December 2010
Up to 10 %	14.4	23.6	25.6	26.6	22.9	22.8
10 % to 25 %	12.6	24.6	18.7	11.7	14.2	10.1
25 % to 50 %	27.3	16.5	18.4	15.5	19.3	24.1
50 % to 75 %	15.2	8.1	7.8	6.6	3.6	4.4
Over 75 %	12.3	6.8	7.5	4.8	7.3	8.3
No such employees	18.2	20.4	21.9	34.8	32.7	30.3
Base	374	309	347	290	248	228

Note: The survey question was "In your opinion, what share of the employed in your branch work under contracts with "hidden clauses", i.e. receive payments larger than the ones stated in the contract?"

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

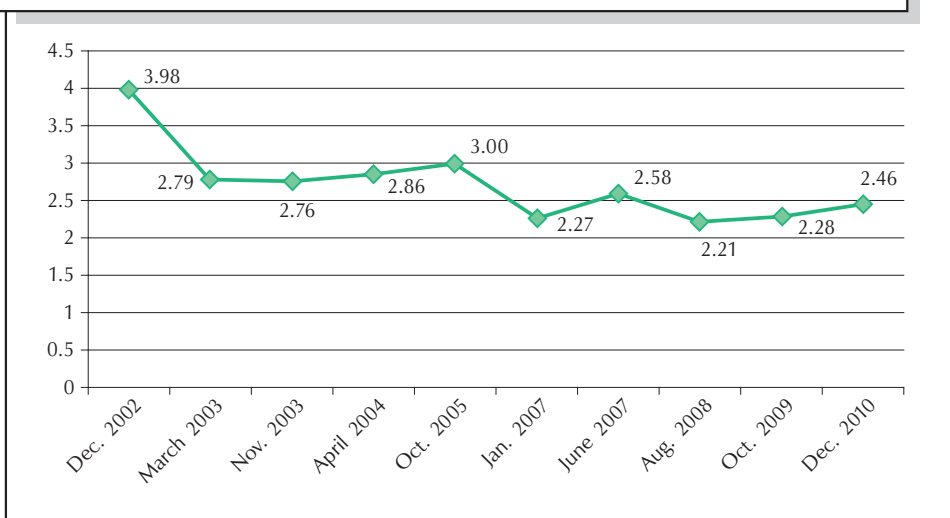
Until 2007, **the share of employees receiving additional hidden payments is decreasing**, according to the assessments of business representatives. In 2009 and 2010, however, the share of managers, who think that such practices do not exist in their branch, goes down. Meanwhile, managers who believe that over 25 % of the employees in their sector receive undeclared payments/envelope wages, goes up. Congruent with these assessments are data from surveyed businesses claiming that almost a quarter (23 %) of the salaries come in the form of “envelope wages”. Hiding the actual size of remuneration is most common in the service sector, as well as among retail-sales businesses. The share of hidden income from salaries is highest in the construction and services sectors, while lowest in the industrial sector.

The data show that **employers have the tendency to under-report actual salaries more frequently than to hire workers without a contract**. This is due to control authorities are able to establish and sanction employment without a contract more easily than concealment of income. As a result, both businesses and workers profit from not paying social security and taxes, yet in the long-run, avoiding social security payments has a backlash on employees through their pensions.

Similar assessment of undeclared labor is done through the **Hidden Economy Survey on the Population (HESP)** by the Center for the Study of Democracy and Vitosha Research. People are asked whether they work without a labor contract and whether they get paid higher than the official salaries. The level and dynamics of sub-index “Undeclared Employment Relations”, part of the Index of the hidden economic activity of the population, summarize the labor market dynamics.

More and more people are getting a **second job** in addition to their primary employment. A tangible (twofold) decrease is observed in cases of non-declaring

**Figure 15. The Dynamics of Sub-index “Undeclared Employment Relations” among Businesses, 2002 – 2010 (min = 0, max = 10)**



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

additional employment in the last eight years. Tendencies are harder to follow in the case of primary employment, where the notion of not declaring one's primary employment decreases, yet the decrease is likely within the range of the statistical error. Consequently, undeclared primary employment runs at naturally low levels of 3-5 %.

**Table 6. Share of Workers Reporting No Signed Contract with Their Primary or Secondary Employer**

	February 2003	March 2004	August 2008	September 2009	December 2010
Without a contract – primary employment	6.0	5.9	5.6	5.9	3.4
Without a contract – secondary employment	77.4	59.1	51.5	51.0	38.1

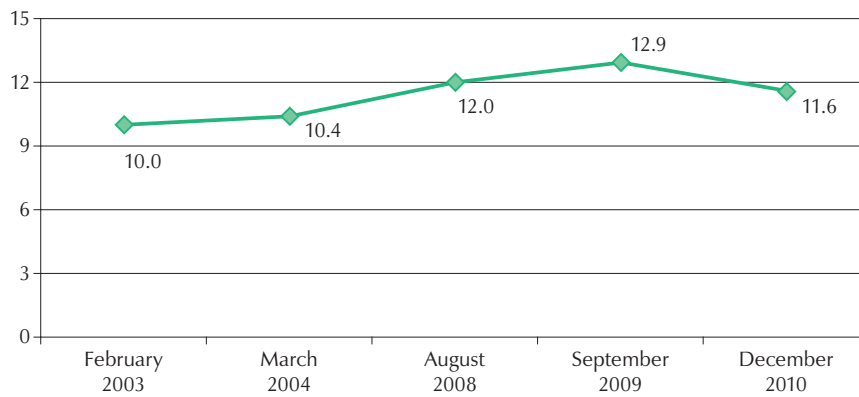
Note: In the survey, this is the share of respondents, who answered "No, I do not." when asked "Do you have a signed contract with your employer?"

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

In 2010, 11.6 % of the population reported having received a remuneration higher than the one stated in their contract with the primary employer. This represents a slight decrease in the incidence of undeclared payments since 2009, when the respective share of the population receiving higher than declared remuneration was close to 13 %. Taking into account the contraction in economic activity in 2010, businesses have actually registered this decline as a relative increase of the share of envelope wages in their costs. **The tendency to underreport actual remuneration has serious implications for the social security system**, as underreported remuneration is also related to reduced payments of social security contributions. A failure to tackle these issues in time leads to hasty and unpopular policy decisions for correcting social security imbalances, such as the 2010 transfer of payments from private to public social security funds. Bulgaria needs to account for the lost income and design a comprehensive set of long-term economic and enforcement measures to tackle hidden employment. Alternatively, it must be prepared to face **social security deficits and crises along every future economic downturn**.

For the period 2008 – 2009, a slight increase in the share of workers receiving remuneration higher than the stated in their contracts was observed. These data are congruent with the most common (the modal) estimation of business representatives that the share of employed under contracts with hidden clauses and the share of envelope wages was 10 %. Thus, a well-grounded conclusion can be drawn that at least **every tenth person is paid higher than officially stated in their contract**.

**Figure 16. Incidence of Payment of Remuneration Higher than the Stated in the Contract under Primary Employment in the Past Month (%)**



Note: The survey question was "In the last month, were you paid a higher amount of money than the declared in your contract with your primary employer?"

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

**Table 7. Sum on the Basis of which Social Security Payments are Calculated, for Primary Employment (%)**

	February 2003	March 2004	August 2008	September 2009	December 2010
On the minimal social security threshold, though the total amount of my salary is larger	12.1	13.4	13.5	12.9	10.3
On the minimal social security threshold, which is the real salary I get	10.3	14.3	9.5	12.6	5.9
On the sum set in my contract, though the total amount of my salary is larger	6.7	8.3	15.0	15.5	8.4
On the sum set in my contract, which is the real salary I get	68.3	63.4	61.8	56.2	67.0
Other	2.6	0.6	0.3	2.8	1.5
Base	348	314	378	395	466

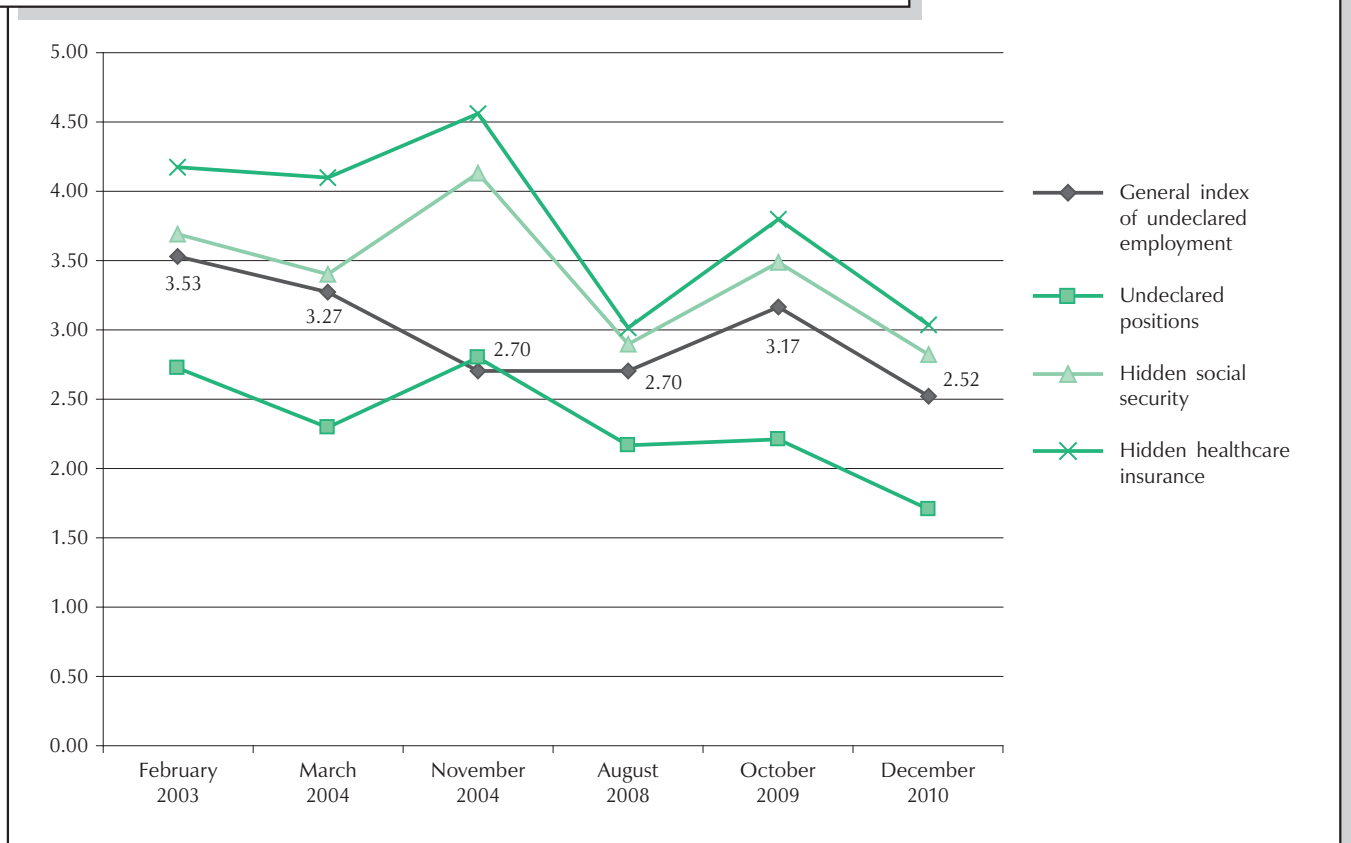
Note: The survey question was "What is the sum on which you are socially insured?"

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

Undeclared payments for labor are also connected to a **non-payment of the full size of social security and healthcare contributions**. Since the onset of the *Hidden Economy Index* in 2003, the share of the employed that are socially insured on pay rates lower than their actual remuneration had almost doubled by 2009. In 2010 there was a notable drop in the share of the employed insured in accordance to the amount stated in their contract, while receiving a higher (undeclared) remuneration. The same, though to a much lesser extent, applies to the proportion of employed insured only on the basis of the minimum social security threshold, while actually receiving a higher remuneration.

Despite some fluctuations, the period between 2003 and 2010 saw no difference in the population's estimations of the rate of avoidance of social security payments. About **one fifth admit to being insured on the basis of a lower value than their real salary**. These data are in contrast with businesses' estimations of the rate of avoidance of tax and social security payments in their sector. The reason might be that people fear admitting to hiding incomes. A more plausible explanation is the difference in samples. The sample of surveyed employees includes not only the private, but also the public sector, NGOs, etc.

**Figure 17. The Dynamics of Sub-indices Measuring Undeclared Employment in the Population, 2003 – 2010 (min = 0, max = 10)**



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

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

A key problem in the country is the **low social solidarity and the lack of confidence in state institutions**. Until recently, measures to increase the collectability of social security payments have been predominantly control and administrative. It is not likely that these measures will change the motivation of businesses and the population to pay their social security. Quite to the contrary, it is expected that the current economic situation of low-quality social services and tightened control will have the opposite effect. The problem is that the avoidance of social security payments has its clear economic logic. Keeping in mind that the average life expectancy of Bulgarian men in 2009 was 70 years, there is no rationale in paying social security contributions in order to get pension transfers for 5 years post one's retirement. Existing voluntary tiers of pension insurance and an option to inherit part of one's pension by one's family are motivating elements. Yet, they do not change the above stated realities. **The Bulgarian government needs to radically and sustainably improve the quality of social services** and appeal citizen's social solidarity, rather than insisting on control and administrative measures.

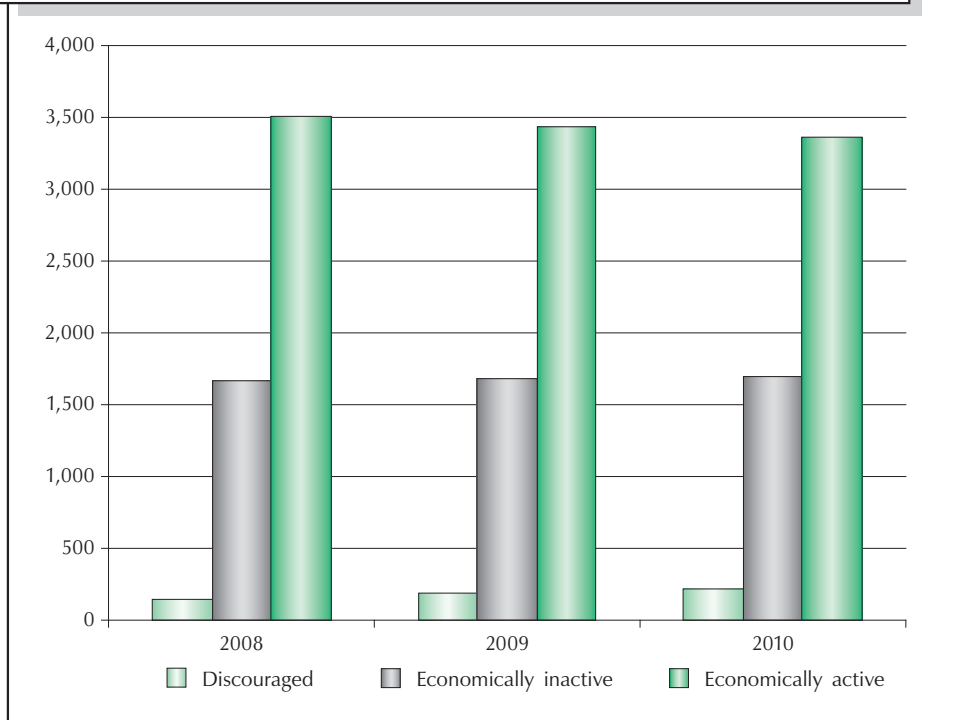
### **3.3.2. The Crisis and Perspectives for the Labor Market**

There seems to be a vast untapped potential among the share of the population that is of economically active age. A significant proportion of the population of active age (i.e. 15 to 64 years) is not productively employed leaving this human capital available for hidden economic activities, which traditionally have lower levels of productivity and higher rates of loss of qualification.

While the Bulgarian GDP is expected to grow again in 2011, the level of employment during the same year will likely stagnate. Unemployment may continue rising and remain higher than current levels, as bankruptcy procedures kick in and enterprises considered viable in 2009 and 2010 are forced to leave the market. As it is unlikely that an economic boom similar to the pre-crisis period will occur, forecasts warn that a considerable time is needed before excess labor and resources are absorbed by other sectors of the economy.<sup>55</sup> Heightened insecurity about the long-term health of the European economy will most likely lead to freezing the salaries in certain labor market segments and increasing the incentives for undeclared work in 2011 – 2012. There are indications that employers are very cautious in hiring people, commonly giving preference to more flexible forms of employment, including undeclared employment.

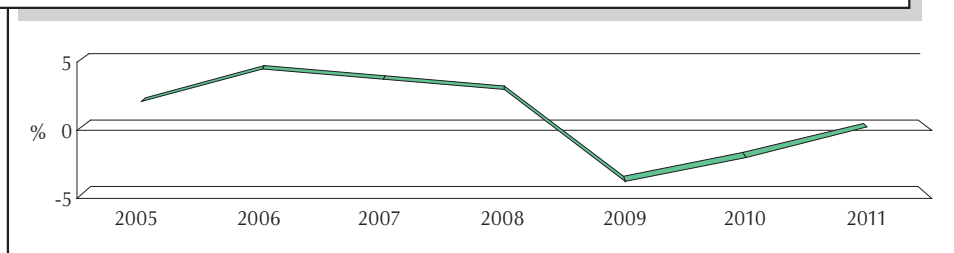
<sup>55</sup> IMF Country Report No. 10/159.

**Figure 18. Labor Force Dynamics (Thousands of People)**



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

**Figure 19. Level of Employment in Bulgaria (Annual Percentage Change)**



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

At a company level, the crisis led to an increase in job loss, bankruptcy, and closure of businesses. In 2009, firms undertook measures to tackle the crisis. Such measures included involuntary unpaid leaves, decreased salaries and working hours, and others, aiming at preserving the business, while also retaining the qualified personnel.<sup>56</sup> Many Bulgarian firms, especially in the construction sector,

<sup>56</sup> European Industrial Relations Observer, <http://www.eurofound.europa.eu/eiro/studies/tn1004019s/bg1004019q.htm>.

**Box 9. Sustainable Practices in the Concealment of Income in Construction**

[In 2011], an inspection – of a large construction site was carried out on Sofia’s beltway. At the time, the construction project is carried out by one main contractor and 29 sub-constructors. During inspection, 158 workers were at the scene. As inspectors arrived and began their inspection, some of the workers ran away. Eight of the remaining employees declared that their salary was in the range of BGN 550 to BGN 1,500. After a check at the NRA, it was established that they had been insured on the basis of amounts smaller than the declared ones and under the minimum social security threshold.

*Source: A press release by the Executive Agency “Chief Labor Inspectorate”, April 1, 2011.*

swiftly dismissed workers without contracts and seized payments of undeclared (envelope) wages, which led to a reduction in hidden economy in the end of 2009.<sup>57</sup> The complex macroeconomic environment in Europe and the rise in unemployment in Bulgaria are factors, which will likely increase the share of the hidden economy in 2011 – 2012. Whether this would happen in reality depends on the government’s social and economic policies and the pace and structure of economic recovery in the private sector.

<sup>57</sup> Center for the Study of Democracy, 2009, Policy Brief 20: *Policies to Counter the Effects of the Economic Crisis: hidden economy dynamics 2009.*



## CONCLUSION

The austerity and the depth of the global economic crisis renewed public interest in the hidden economy and its manifestations in Bulgaria and in Europe. The exposure of the deep penetration of hidden economic activities into the Greek economy, which is at the epicenter of the ongoing economic crisis in the Eurozone, triggered a debate among the media, international analysts, and European governments about introducing special measures to improve accountability and illuminate the role and the effects of the hidden economy:

- An important first step for Europe would be to establish **unified practices for reporting on the hidden economy** in each member – state's national statistics. A comparative assessment of the process of gathering information on the share of the hidden economy in each member state would be useful.
- So far, Brussels's primary focus has been undeclared work. The latter has been studied through direct observation of samples of the population and led to comprising a unified **Eurobarometer** on the size and manifestations of undeclared work in the EU-27. It is advisable that such a survey is carried out at least every four years in order to provide a reliable assessment of the dynamics of the observed phenomenon.

**The crisis changed the dynamics of the hidden economy in Bulgaria.** Between 2002 and 2008, there was a gradual but sustained decrease of all manifestations of the hidden economy, as captured by the *Hidden Economy Monitoring System* of the Center for the Study of Democracy. This tendency continued throughout 2009. An abrupt crisis-related drop in the economic activity of businesses forced many companies to cut down on both hidden and official employment. By February 2010, the official, registered unemployment doubled, despite the fact that over 30,000 people of those who lost their jobs did not register with the Employment Offices. In 2010, over 800,000 Bulgarians aged 15 – 64 remained economically inactive in the absence of any reported health problems or ongoing education. Bulgarians remain the most unproductive workers in the EU. The revival of economic activity in April 2010 led to a slight increase in the levels of hidden economy, as businesses started hiring again. This increase is expected to continue well into 2012 before dropping in 2013 in line with the long-term trend. All data show that **hidden economy remains a serious challenge to the financial and economic policies** of the country. An analysis of the Bulgarian government's measures to restrict the hidden economy in the past five years has led to several important conclusions and recommendations:

- The government should **adopt an official national estimate** of the size of the hidden economy, which should be used to correct all the relevant macroeconomic and fiscal performance indicators of the country. On the basis of such

an estimate, the government should present adequate measures to limit the negative effects of the hidden economy in at least a three-year framework.

- **Administrative control measures can only have a temporary and limited deterring effect.** The business cycle and the structural characteristics of the national economy have a much more significant effect on the hidden economy than government policies. Therefore, the adoption of wider financial and economic measures has to be sought to complement administrative control efforts. For example, the increase of excise dues on cigarettes in 2010 in practice offset measures tightening the control over smuggling channels in the country, thus in effect nullifying the impact of government policies on the hidden economy.
- **A priority should be given to positive (stimulating) measures over negative (punitive) ones in order to restrict the hidden economy.** The level of non-compliance with regulations in Bulgaria is so high, that the adoption of punitive measures deems the authorities' control efforts piecemeal, while leading to repeated violations and an increase of corruption pressure on economic actors, thus reinforcing the stimuli for hiding economic activity. This vicious circle of "violation – control/regulation – new violation – tighter control" can be broken by:
  - **Increasing the incentives for starting and developing official business activity**, while minimizing the regulation on the micro and small firms. The latter are more important for their social function of creating employment than for providing revenues to the state budget.
  - Implementing the **concept of the service character of the state administration**. The business, especially the micro and small firms, ought to see the administration not as a sanctioning authority, but as a service one. Fewer, but more focused, audits of high-risk activities than the current across the board approach, would improve the effectiveness of the control authorities and increasingly motivate their employees.
  - **Improving the quality of public services**, including various infrastructures. The Bulgarian society has no confidence in state institutions, which is reinforced by the proliferation of mass corruption and hidden economy. As a result, the culture of tolerating and even justifying these negative phenomena is resistant. Only a perception of constant and notable improvements of public service quality can restore social solidarity. The latter is a prerequisite for restricting the hidden employment and the hidden economy.
  - Carrying out more complex and strategically focused **structural reforms for reducing the tax and administrative burden**. Experience has shown that the introduction of popular, yet superficial, measures, such as a decrease of tax rates, have a limited effect unless they are accompanied by an improvement in services for citizens and businesses. For example, low tax rates do not help start up businesses if they cannot obtain a construction permit.
- The gray and black economy interact and blend with the official economy, giving rise to corruption, illegitimate influence on politics, and stimuli for reproduction of the hidden economic activity. Severing these links requires a complete **administrative reform of the control and juridical systems**. To achieve

this, the Bulgarian government should develop **systems for assessing the efficiency** of its administrative control authorities, which will allow public recognition of the work done and the accomplished results. Taking into account the ubiquity of the observed negative phenomena, these institutions must have working systems for risk assessment and prioritization of their activities.



## APENDIX 1.

# INSTITUTIONAL STRUCTURE AND POLICIES TO COUNTER UNDECLARED WORK IN ROMANIA, GREECE, AND THE CZECH REPUBLIC

## ROMANIA

The basic institution responsible for the detection and regulation of undeclared work is the Romanian Labor Inspection (Inspectia Muncii, IM). The Labor Inspection is specialized governmental agency founded in 1999, subordinated to the Ministry of Labor, Family and Social Protection (Ministerul Muncii, Familiei si Egalitatii de Sanse, MMFES), which has 41 territorial offices. It is the responsibility of another institution, the Financial Guard (Garda Financiara, GF) and the financial controllers, to observe the non-declaration of incomes. The Financial Guard is a control agency subordinated to the Ministry of Economy and Finance (Ministerul Finantelor, MF), responsible for the prevention and investigation of tax frauds, including the ones related undeclared work. Social partners such as the Builders' Social Fund (Casa Sociala a Constructorilor, a non-governmental organization founded in 1998) are also active in the fight for decreasing undeclared employment. Under the Fund's initiative, the Romanian Association of Employers in the Construction Sector and the trade unions signed an agreement on December 27, 2006, called Social Agreement of the Construction Sector 2007 – 2009 (Acordul Social Sectorial pentru Constructii 2007 – 2009), which assesses the undeclared work in the sector as being one third of the labor force and suggests measures to solve the problem. The fund provides social support to the legally employed during the winter when activity in the construction sectors decreases. In 2006, a Permanent Commission for Control on Undeclared Work was established within the Fund in cooperation with the Ministry of Economy and Finance and the Labor Inspection. The Commission conducts an instructive campaign concerning the negative consequences of undeclared work. The 12 years of its existence makes the Builders' Social Fund the only private operator for social protection in the construction sector of Romania.

The policies to counter undeclared work in Romania include on-the-spot inspections by the Romanian Labor Inspection in higher risk sectors such as construction, textiles, services, industry, foods, carpentry, trade, security, gambling, and activities at the resorts. In 2009, the inspectors carried out a total of 101,407 checks and sanctioned 57,238 employers. 81,241 inspections (80 % of all the inspections in 2009) were in the sphere of undeclared work. Some 8,500 were proven to have used the undeclared labor of 17,464 people. The Labor Inspection has also developed information campaigns focused on the economic sectors where undeclared work is widespread. The Romanian government lowered the social security contributions by 8 percentage points, compared to the levels of 2002, as a measure to tackle undeclared work. The new Labor Code of 2003

acknowledged and regulated the temporary labor contracts, and introduced the conception of temporary employment. This decreased the scope of use of civil contracts (an important instrument of undeclared work in Romania) down to the cases allowed by the *Civil Code*.

Sources: *Labor Inspection* <http://www.inspectmun.ro/>; *Eurofound*, <http://www.eurofound.europa.eu/>; *Builders' Social Fund* <http://www.casoc.ro/>

## GREECE

The Labor Force Employment Organization (OAED) is the basic public institution responsible for the employment policy in Greece. The organization was wholly re-structured in 2001 with the purpose to meet the new challenges described in the European Employment Strategy, including the problem of undeclared work. The Corps of Labor Inspectors (SEPE) was established in December 2000 and subordinated to the Ministry of Labor and Social Security. Its competences include the monitoring of illegal employment. The Corps has the right of free access to the premises of all workplaces in the private and public sectors at any time of the day, even without a preliminary notification. It can temporarily cancel the activity of the whole enterprise or institution, or part of them, if it decides that the safety and health of the workers are at risk. The labor inspectors are divided in three groups: social inspectors, technical inspectors, and sanitary inspectors. An important role in countering undeclared employment is played by the Social Security Fund (Ιδρυμα Κοινωνικών Ασφαλισεων), which is in charge of the social security status of residents, including the immigrants. According to Greek legislature of 2005 and 2006, the valid-residence-permit card of an immigrant can be re-issued only after a certificate by the Social Security Fund is issued. This document certifies the number of socially insured days during a year by using special stamps, the number of stamps required depends of the professional category of the immigrant.

The policies to counteract undeclared employment include: decreases in taxes and social security payments in 2001 and 2003; legalizing and stimulating temporary employment; regulating the process and the necessary conditions for temporary employment to become permanent employment; measures adopted by the Ministry of the Interior to regulate and register the status of immigrants (foreigners and returning ethnic Greek migrants) through simplification of the procedures.

Sources: *Eurofound*, <http://www.eurofound.europa.eu/>; *European Employment Observatory, Review: Autumn 2004*, [http://www.econbiz.de/archiv1/2008/51903\\_european\\_unemployment\\_observatory.pdf](http://www.econbiz.de/archiv1/2008/51903_european_unemployment_observatory.pdf)

## THE CZECH REPUBLIC

In the Czech Republic, several institutions act to counter undeclared work. The Ministry of Labor and Social Affairs (Ministerstvo prace a socialnich veci Ceske Republiky) is responsible for all issues concerning the labor market and social security contributions. The State Labor Inspection Office (Statni urad inspekce prace, SUIP) has detected and controlled undeclared employment in the local population under the guidance of the Ministry of Labor and Social Affairs since 2005. Within the framework of the Interdepartmental Body for Repressing Illegal Employment of Foreign Workers, founded in 2000, representatives of the government, social partnerships, private and research institutions work in a joint effort to tackle the problem of the illegal labor of foreigners. The institution monitors and makes suggestions for legislative changes, coordinates joint operations by different state organs, and proposes preventive measures. Traditionally, in the Czech Republic, the problem of illegally employed foreign workers has been more emphasized than the illegal employment of the local population. Foreigners participate in the gray economy to a greater extent. The Ministry of the Interior of the Czech Republic (Ministerstvo vnitra Ceske republiky), the Ministry of Labor and Social Affairs through its employment offices, and the Border Police (Cizinecka policie) control the status of the foreigners on the Czech labor market using, for example, on-the-spot inspections carried out by the employment offices. However, the coordination among these institutions is not always efficient.

The first political measures against illegal employment were adopted at the beginning of the 21st century. The 2004 *Employment Law* gave a definition of the notion of illegal labor and strengthened the mechanisms for control over them. The Law introduced sanctions against the offenders. Transforming illegal labor into legal employment is one of the aims of the Czech National Action Plan for Employment for 2004 – 2006. A special Assistance System for the employment of Ukrainian citizens in the Czech Republic was developed. Despite this, the detection of illegal and undeclared labor and law enforcement in this direction are difficult to accomplish in practice. According to the current labor legislation, partial employment is allowed, i.e. the citizens of the Czech Republic have the right to an additional income even when they receive unemployment benefits, provided the additional income is not more than half of the minimal salary and it does not comprise more than 20 hours per week. It is considered that this method is relevant for keeping the labor habits, for decreasing the illegal and unregistered employment, and that it has a positive effect on tax revenues. There are financial sanctions on undeclared labor, which in the Czech Republic has an illegal status. Sanctions are paid both by the worker and the employer. The employment offices exclude from their lists people working without labor contracts and their re-registration as unemployed can occur only after six months and after cutting part of their unemployment benefits.

Sources: Eurofound, <http://www.eurofound.europa.eu/>; The Czech State Labor Inspection Office, <http://www.suip.cz/default/drvisapi.dll?Mlval=/www/index.html>; the Czech Ministry of the Interior, <http://www.mvcr.cz/>; the Czech Ministry of Labor and Social Affairs, <http://www.mpsv.cz/en/>; Project for Legal Migration, <http://www.imigracecz.org/?lang=en&article=home>

## APENDIX 2.      **EXAMPLES OF INTERNATIONAL COOPERATION IN THE FIGHT AGAINST UNDECLARED WORK AND SIMILAR AREAS<sup>58</sup>**

At the moment, there is no network or an organization which meets entirely the criteria of the European or international cooperation in the fight against hidden economy. However, the cooperation is carried out through different commissions and/or networks studying other areas related to hidden economy, such as tax frauds, illegal migration, labor inspectorates, preservation of rights to receiving social security benefits when changing one's permanent residence in Europe, providing for the employees on business trips abroad, etc.

### **1. Administrative Commission on Social Security for Migrant Workers – CASSTM**

One of the most common reasons for the low mobility of workers in Europe is people's unwillingness to move to another Member State because they fear they and their families will lose their social security benefits. This is why EU legislation allows national authorities to take measures to guarantee the social security rights of migrant-workers and the people, who are under their custody.

The Administrative Commission on Social Security for Migrant Workers consists of one representative from the government of each Member State. When necessary, its work is supported by expert advisors. The Commission aims to encourage and develop the cooperation among Member States in the field of social security with a view of modernizing the procedures of information exchange among institutions and speeding up the provision and payment of benefits. The decisions taken by the Commission include the creation of a common framework of data collection on retirement payments, as well as technical specifications in support of the introduction of the European Health Insurance Card.

### **2. Comet**

Comet is a web-based informational and coordination network of the offices of management of migration processes in the Member States. It is used for the exchange of information on illegal migration flows. The European Commission is in charge of the maintenance of the network.

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<sup>58</sup> Source: Empirical Report to the project "Feasibility Study on Establishing a European Platform for Cooperation between Labour Inspectorates, and Other Relevant Monitoring and Enforcement Bodies, to Prevent and Fight Undeclared Work", Regioplan, February 2010. In order to prepare this report, the Center for the Study of Democracy coordinated the experience studies of the cooperation against undeclared employment in South and Central Europe.



### **3. EUROFISC**

EUROFISC was created by the EU Economic and Financial Affairs Council, aiming to enhance the cooperation among Member States in their fight against VAT frauds. It functions as an early warning system, facilitating the information exchange on individuals, who are suspected of having committed fraud. The purpose is to quickly identify the fraud cases and swiftly get the information to the respective taxation authorities.

### **4. VAT Information Exchange System – VIES**

When the Common Market was established on January 1, 1993, the fiscal customs control on the internal borders of the EU was lifted, and a new VAT control system was introduced for the trade within the Community. The most significant benefit from it was a decrease in the administrative burden on enterprises, by eliminating 60 million customs documents annually. According to the EU VAT system, commodity deliveries within the Community are VAT-free for the Member State that sends them, when commodities are to reach a taxable person in another Member State. VAT is calculated and reported only in the importing country at the point of arrival of the commodity. Each taxable person, who executes these deliveries, needs to be able to check easily and quickly whether their clients in another Member State possess a valid VAT identification number. This is why each taxation administration maintains an electronic database, containing information on traders' registration according to VAT. A VAT information exchange computer system was established (VIES), which is to secure the data flow across the internal borders of the EU. The European Commission maintains this database and provides access to it to taxable persons, who execute inter-community deliveries and must check their clients' VAT identification numbers.

### **5. Intra-European Organisation of Tax Administrations – IOTA**

The Intra-European Organisation of Tax Administrations is an intergovernmental non-profit organization, which provides a forum to Member States to improve their tax administrations. The Organization was founded during the Third Conference of Tax Administrations of Central and Eastern Europe and the Baltic Countries (Warsaw, October 28 – 30, 1996). It consists of 44 members from the tax administrations of Europe and Kazakhstan. Its mission is supporting the discussions of practical issues, encouraging cooperation among tax administrations in the European region, and enhancing their development in accordance with their individual needs.

### **6. Senior Labour Inspectors' Committee – SLIC**

The Senior Labour Inspectors' Committee was set up by Decision of the European Commission on July 12, 1982. Its aim is to provide statements by the Commission on all issues related to Member States' adoption of the right of the Community to health protection and safe labor conditions. It must be taken into consideration that not all countries in the European economic area are Member States. Norway and Iceland are observers, as well as Cyprus, Slovenia, Romania, Lithuania, the

Czech Republic, Latvia, Poland, and Slovakia. The Committee consists of two representatives of the inspection services from each Member State. They meet every six months, encouraging the information exchange among the respective national organs. The purpose is to achieve common principles of inspection in the area of professional health and labor safety.

### **7. Committee of Experts on the Posting of Workers**

The Committee was set up by Decision 2009/17/CE of the European Commission. It works with the social control organs (for example, the labor inspectorates), engaging social partners in its activities, especially in the sectors with high frequency of posting workers. The Committee of Experts supports and assists Member States in identifying and exchanging, good practices of information exchange and in the practical application of legislation related to workers' posting. It also closely monitors the advancement in the access to information and the administrative cooperation. The Committee analyses the practical issues of transborder control legislation, aiming at the solution of current problems, the adoption of the existing legal instruments, as well as improving the cooperation among Member States. The Committee was founded by experts representing national organs. Each Member State appoints two representatives to the Committee. Each one of them may choose two deputies.

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