

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*.

