

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**¹:

- 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.²

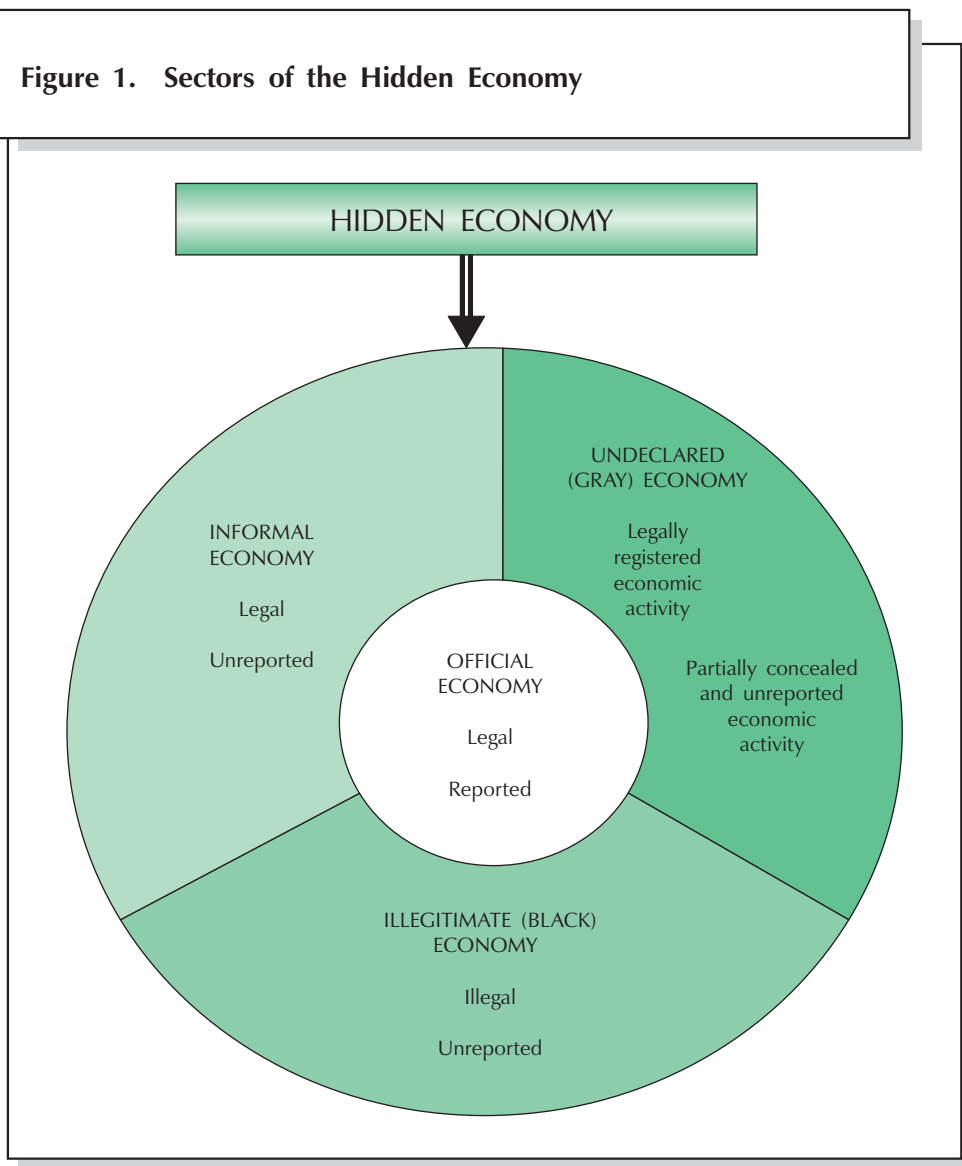
Direct Approaches

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:

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

² 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.³ 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.

³ 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 Economy⁴

- 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 audits⁵). (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

⁴ 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/.

⁵ 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

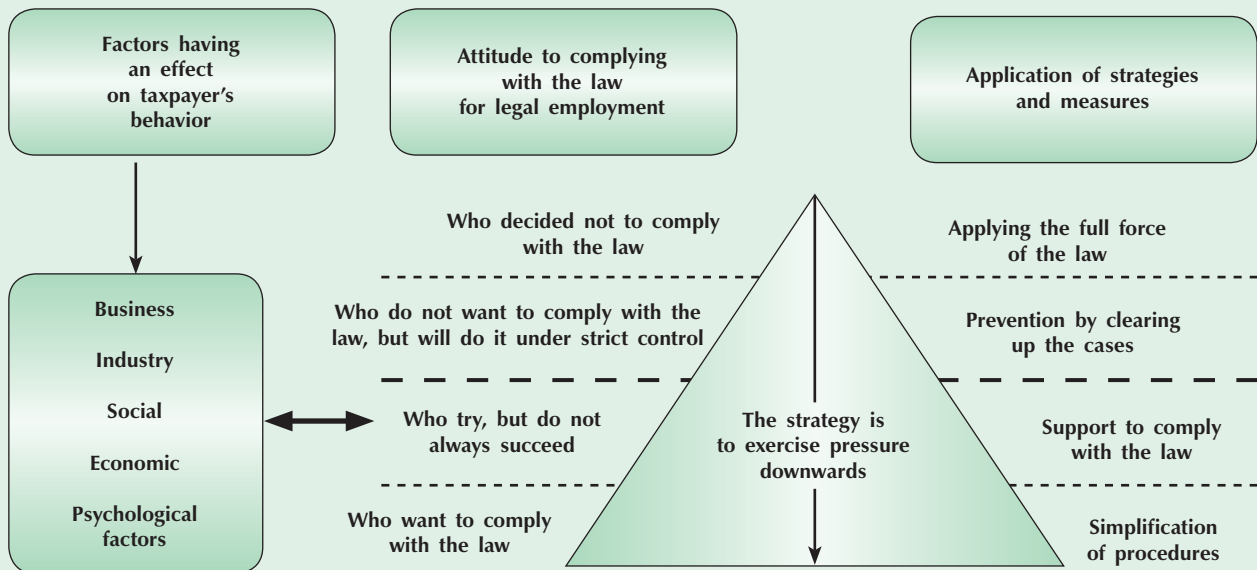
Most commonly analyses of the causes of hidden economy describe the causes of the gray economy – the activities that are legal but are purposefully hidden, evading tax laws or other regulations (e.g., labor standards, business registration

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 unfair⁶, 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

⁶ 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.⁷

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.⁸

⁷ 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.

⁸ 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.