

## THE HIDDEN ECONOMY IN BULGARIA: 2011 – 2012

Policy Brief No. 37, January 2013

### Introduction

The deep penetration of hidden economic activities in Greece and other peripheral Eurozone members – a development which is at the epicenter of the continuing Eurozone debt crisis, has demonstrated that accurate understanding of the dynamics of the hidden economy is essential for improving public and private sector management. In the case of Bulgaria, an assessment of the hidden economy is an issue of particular importance as **the country is facing serious challenges in all of its aspects – gray, black and informal economy**. It is even more pressing in the light of the country's current low level of competitiveness and its aspirations for participation in the European stability and sustainable growth initiatives such as Europe 2020 and the Euro-Plus Pact.

### Macroeconomic Overview

Bulgaria is one of the 24 countries that **improves its competitiveness** in the period between 2011 and 2012 **but is still one of the least competitive economies** from the 59 countries ranked in the IMD's 2012 World Competitiveness Yearbook report.<sup>1</sup> Bulgaria's competitiveness is based on very few factors, such as the country's relative fiscal stability and the low labor and production costs, which is a narrow base for the many challenges the country faces. The increase of productivity on the back of rising

<sup>1</sup> CSD Policy Brief 34: Bulgarian Economy Competitiveness 2012, Sofia, CSD, presenting 2012 IMD World Competitiveness Yearbook.

#### KEY POINTS

- **The hidden economy in Bulgaria has decreased in 2011 – 2012** among both businesses and the population. Yet, the registered gains are modest. Deep structural labor market problems and long-term business environment issues continue to constitute favorable conditions for the development of hidden economic activities in Bulgaria. The Hidden Economy Index results show:
  - **decrease in the incidence of undeclared employment** due to rising unemployment and lack of re-entry of labor force; the decrease has also come partially from the **increase of employment in the informal (self-subsistence) economy**;
  - **decline in tax evasion** as a positive result of the government's focus on administrative and control measures in the tax compliance area.
- In the short-run, government measures countering the hidden economy seem to be more productive in the tax evasion area while the economic environment positively affects the undeclared work situation. Publicized frequent statistical errors recently raised concerns about the quality of the supplied statistical data for decision-making.
- While implementation of control measures has achieved some success, **very little has been done for the introduction of positive reforms** to reduce incentives for the development of the hidden economy. Implementation of structural (e.g. changing the regressive character of social security and tax system) and administrative (e.g. promoting better service delivery as opposed to more controls) reforms is lagging behind.

unemployment has let Bulgarian businesses slowly recover profitability in the aftermath of the economic crisis, resulting in a slow export-led growth in the 2010 – 2012 period. Yet, the continuing instability in the Eurozone as well as the shallow labor market in Bulgaria, **corrupt management practices and weak institutional framework** in the country seriously undermine Bulgaria's future progress. For example, Bulgaria has so far failed to tackle decisively the lack of incentives for citizens to pay voluntary social security and healthcare contributions, and the falling quality of education, including in management. Another significant challenge that directly affects the size of the hidden economy in Bulgaria is the size of private debt. According to some estimates it is close to 170 % of the country's GDP, and it can contribute to companies seeking settlement off the books, while leaving their balance sheets for creditors to worry about.<sup>2</sup>

In terms of the main macroeconomic components, in 2011, Bulgarian GDP grew by 1.7 % compared to 2010 year-end results (Figure 1).<sup>3</sup> The real volume of GDP for the first nine months of 2012 in current prices is BGN 56,445 mln combined for all three quarters and BGN 21,374 mln for Q3 2012 alone. On price adjusted basis, that results in 0.9 % increase y-o-y for Q3 2012. External demand was the main driver of growth in the Bulgarian economy in 2011 while the gradual recovery of domestic demand has galvanized the slow growth in 2012 with private consumption expanding 3.1 % on annual basis in Q3 2012. According to the 2012 Autumn Economic Forecast, published on November 7, **the EC revised upwards its projection for Bulgaria's growth in 2012 by 0.3 pps to 0.8 % compared to the Spring Forecast.**<sup>4</sup> This came against the backdrop of more pessimistic expectations of the Commission for the EU and the Eurozone. In spite of the adverse economic setting in the EU and the overall weak labor market in Bulgaria, the Commission expects that the upward trend of economic growth in the country will continue, with domestic demand being the main growth driver in the coming years.

GDP is projected to grow by 1.4 % in 2013 and by 2 % in 2014, indicating expectations of a stable domestic economic environment and relatively strong public finances.

Although there was a slight increase in credits to the private sector, credit in the country continued to be expensive, which has led to **an increase in out-of-banks lending operations** and could potentially lead to an increase in unlicensed financial operations or unusual collection practices (e.g. loan sharks and unlicensed money lenders). In these conditions of continued credit limitations and foreign investment scarcity, **EU funds have become the main source of financing** in both the public and the private sector. The drive towards faster absorption as the time for committing funds draws nearer in the end of 2013 coupled with **continuing weaknesses in the administrative framework** and with inefficient EU-funds absorption mechanisms have increased the risks of corruption and illicit income flows.

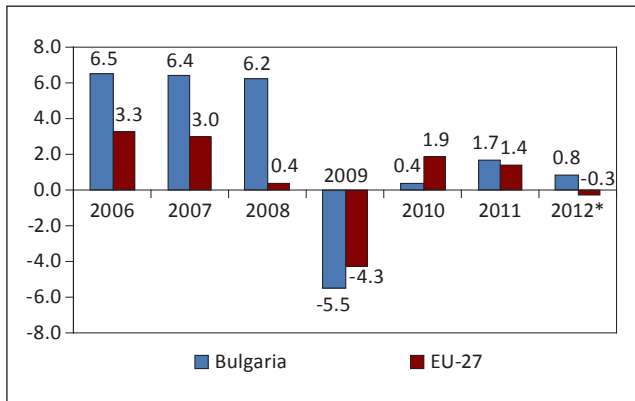
The **sharp rise in unemployment** during the financial crisis, especially amongst the young and lower skilled was not reversed in 2011 and 2012 as GDP recovery did not translate into growth and jobs. Unemployment stood at 11.5 % at the end of Q3 2012 (Figure 2). Long-term unemployment also continued growing (Figure 3), representing 56 % of total unemployment while youth unemployment slightly decreased but is still standing well beyond pre-crisis levels (Figure 4). The effects of stubbornly high unemployment, weak employment market and skills mismatch between demand and supply of labor have been somewhat offset by **the rise in informal employment** in the self-subsistence economy, in particular in smaller towns and villages. Thus, the Bulgarian economy seems to have entered a **paradox situation** of simultaneous existence of high unemployment and labor shortage in terms of highly – qualified workers. According to the National Statistical Institute business surveys in June 2012, "8.9 % of the industrial enterprises pointed out

<sup>2</sup> BNP Paribas: World Economic Outlook 2011.

<sup>3</sup> CSD using data from NSI, most of the macroeconomic data in this section comes from NSI; other sources are specifically stated in footnotes.

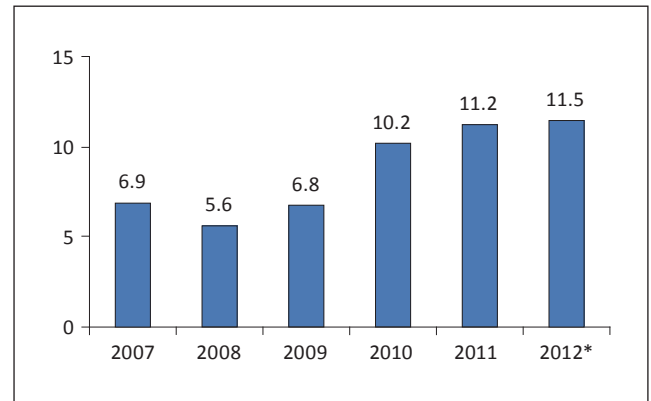
<sup>4</sup> European Commission. Autumn Economic Forecasts. 07.11.2012, available at: [http://ec.europa.eu/economy\\_finance/eu/forecasts/2012\\_autumn\\_forecast\\_en.htm](http://ec.europa.eu/economy_finance/eu/forecasts/2012_autumn_forecast_en.htm)

**Figure 1. Real GDP Growth – Bulgaria vs. EU (% Annual Change)**



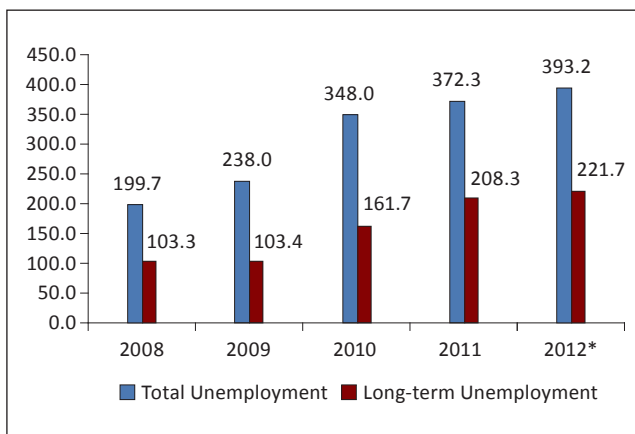
Note: \* projected.  
Source: Eurostat.

**Figure 2. Rate of Unemployment (%)**



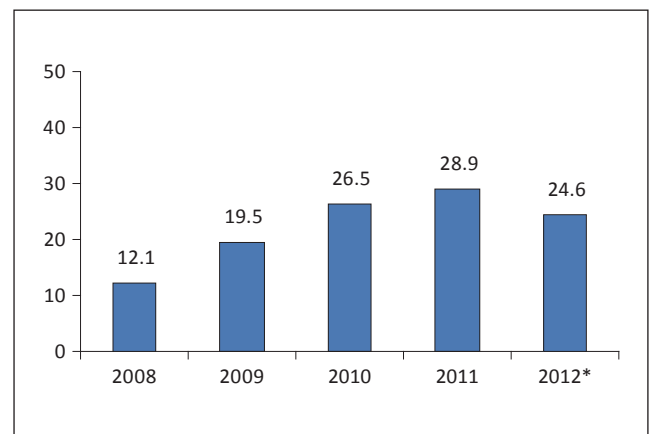
Note: \* as of Q3 2012.  
Source: NSI.

**Figure 3. Total Unemployment vs. Long-term Unemployment (in thousands)**



Note: \* projected.  
Source: NSI.

**Figure 4. Youth Unemployment (% of unemployed people aged 15-26)**



Note: \* as of Q3 2012.  
Source: NSI.

the labor shortage as a factor limiting their activity” in an environment of growing unemployment in recent years.

The macroeconomic environment, although remaining complex has improved in the 2011 – 2012 period, setting out favorable conditions for a decline in the proportion of the hidden economy in Bulgaria. Some of the key economic trends shaping the hidden economy developments in 2011 – 2012 can be summarized as follows:

- Continued **high unemployment** in a moderately growing economy. While this has limited

opportunities for large re-entry of unregistered workers back into the grey economy it has pushed people into the informal economy. Although there are notable differences among sectors, generally, the situation has strengthened the bargaining power of labor demand over supply, in particular in low-skilled segments, which implies that **measures against the hidden economy targeting employers might be more effective** than measures targeting employees, at least in the short to medium run.

- **Labor costs** in Bulgaria remain among the lowest in Europe, but productivity gains do not imply opportunities for big pay rises for the bulk of the

population.<sup>5</sup> This coupled with the entrenched structural problems of the Bulgarian labor market, e.g. the high proportion of long-term and youth unemployment, are likely to **continue to provide incentives (or rather low deterrence) for people to engage in hidden economic activities** in Bulgaria in the long-run.

- The crisis has squeezed government discretionary spending and bank lending, leaving the tightly controlled EU funds as the primary source of fresh financing. Thus **the lee way for waste in public procurement has narrowed**, while the incentives for companies to register their full economic activities have increased.

## Hidden Economy Index 2012: Components and Dynamics

The current brief is a part of a series of studies by the Center for the Study of Democracy, which have been calculating and disseminating i) the Business Hidden Economy Index and ii) the Population Unreported Economic Activity Index since 2002 – the longest available series on the hidden economy in the country. Comparing the size and dynamics of the indexes over time has allowed observations to assess the actual impact of implemented policies to tackle hidden

economic activities. The information from the two indexes completes as businesses and the population face different constraints and respond in a different manner to surveys, thus providing a comprehensive overview of the actual situation in the economy.

In 2012 the values of **the Business Hidden Economy Index and the Population Unreported Economic Activity Index decreased**, indicating a mild decline in the share of the hidden economy in Bulgaria. The Indexes are based on 2012 surveys and are indicative of developments between 2010 and 2012. In 2010, the two indexes diverged – there was an increase in the overall hidden economy in the case of businesses but a decrease in the unreported economic activity of the population.<sup>6</sup> The 2012 results reveal an overall decrease in both indexes, which reinforces a continuous downward trend since 2002. Moreover, the components of the Business Hidden Economy Index – hidden economy size, hidden labor relations, hidden turnover, and hidden redistribution, and those of the Population Unreported Economic Activity Index – i.e. hidden employment, turnover, and economic activity also registered a decline (Figures 5 & 6). However, **perceptions among the businesses as to the overall size of the hidden economy in the country remain roughly flat and are still higher than their all time**

### Box 1. Components of the Business Hidden Economy Index

The Business Hidden Economy Index includes the following elements:

- 1) The **size of the hidden economy** summarizes the subjective perceptions of business representatives of the scope of hidden economy in the country in general, as well as in their respective sectors.
- 2) **Hidden employment** captures the practice of hiring workers without formal employment contracts or under contracts with underreported remuneration (i.e. envelope wages).
- 3) **Hidden turnover** includes the incidence of various practices of concealing turnover in the respective industry or sector.
- 4) **Hidden redistribution** encompasses the practice of tax, customs and excise duty evasion or non-payment, as well as the existence of VAT fraud schemes.

*Source: Center for the Study of Democracy.*

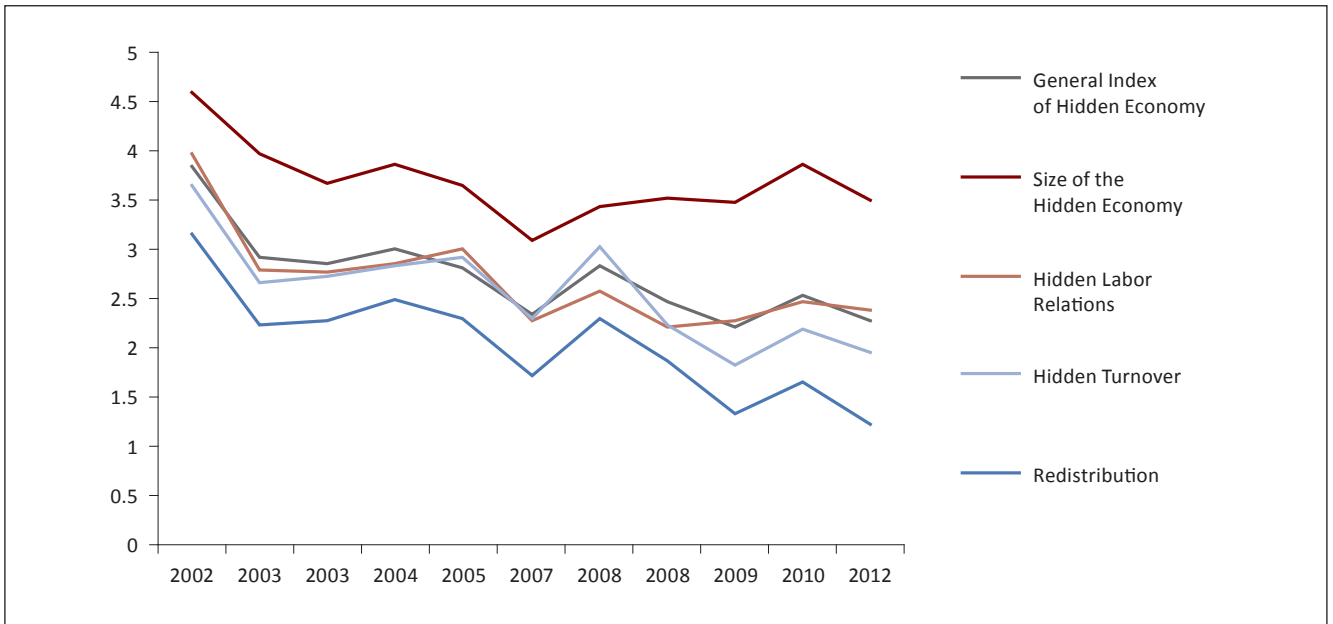
<sup>5</sup> IMF Working paper. Productivity Growth and Structural Reform in Bulgaria: Restarting the Convergence Engine, IMF, May 2012.

<sup>6</sup> CSD Policy Brief No. 28: The Hidden Economy in Bulgaria after the Economic Crisis, Sofia, 2011.

low in 2007. Such perceptions are an indication of the still harsh economic environment in the country, in terms of both market prospects amid continuing uncertainty in Europe and regulatory environment and law enforcement within the country. The divergence between the reality, as indicated by the

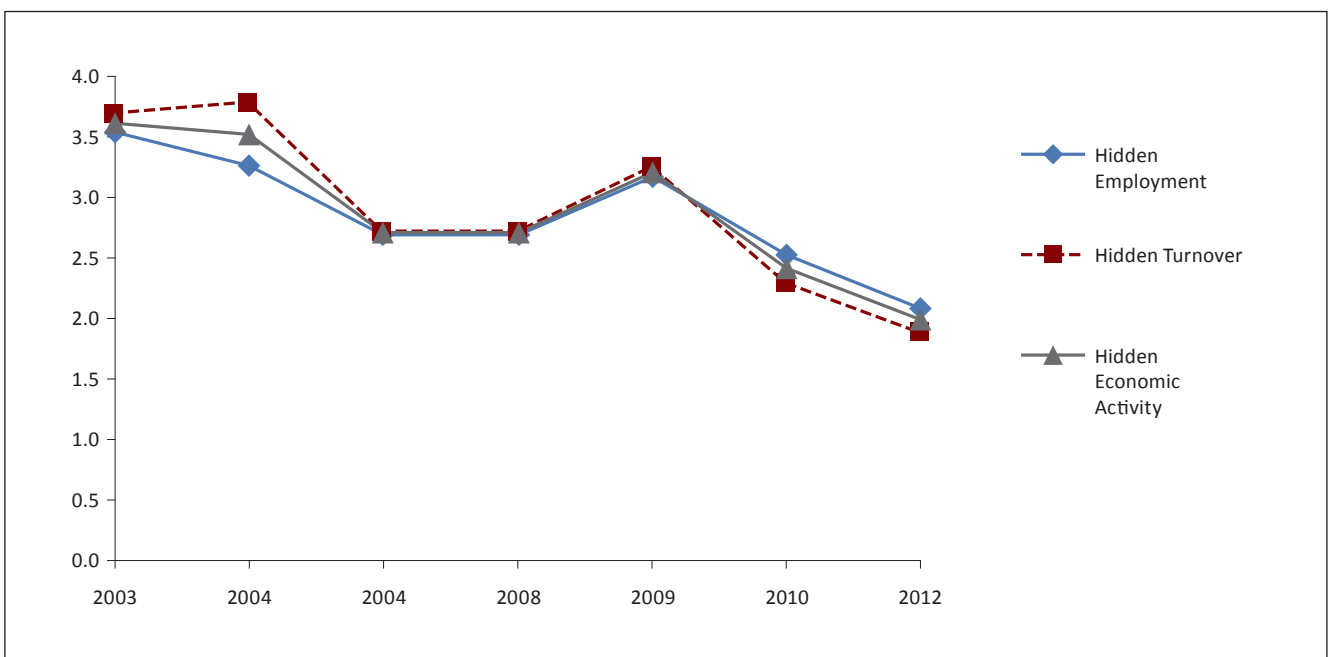
decline in the other sub-indexes, and the perception, as indicated by the “Size of the Hidden Economy” sub-index might be interpreted as an increase in the competitive pressure on the market but also as an indication of the rising unwillingness to share specific information on such sensitive matter.

Figure 5. Hidden Economy Index 2002 – 2012



Source: CSD, Hidden Economy Survey on the Business.

Figure 6. Unreported Economic Activity of the Population 2003 – 2012



Source: CSD, Hidden Economy Survey on the Population.

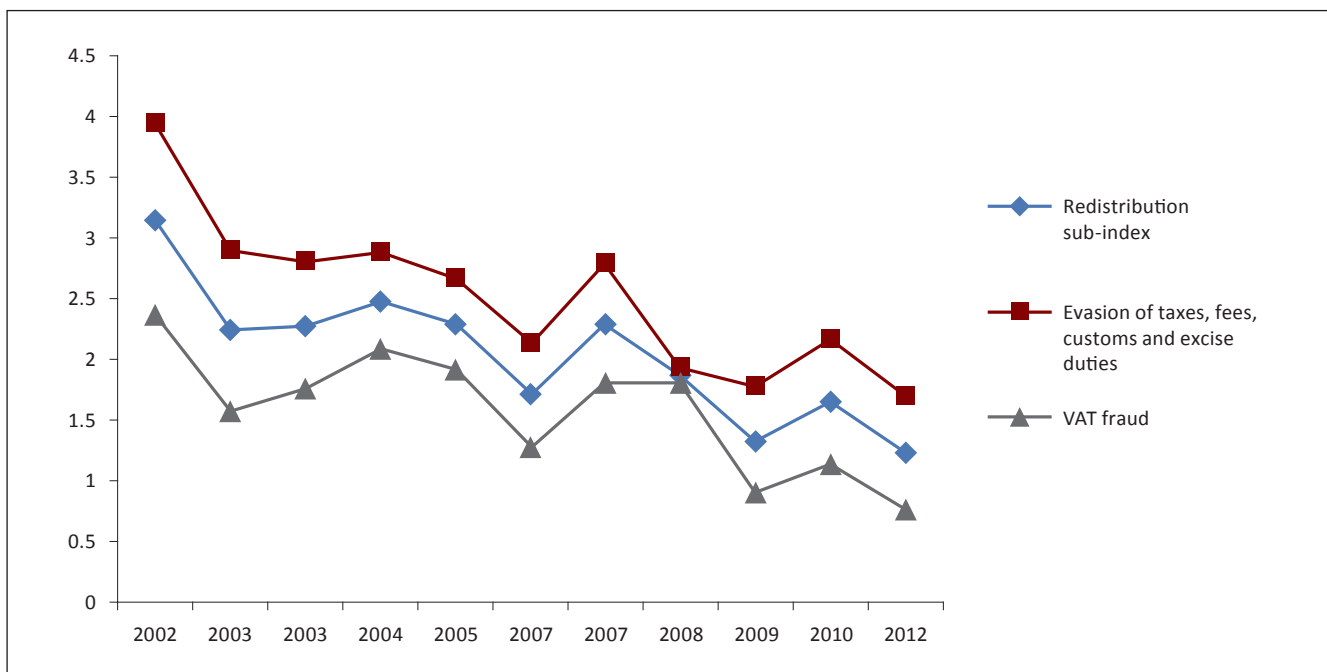
## Tax Evasion and Avoidance of Fees, Customs, and Excise Duties

There has been a notable decrease in the sub-index “Redistribution” in 2012 (Figure 7), including a fall in the incidence of cases involving tax evasion, avoidance of customs, fees, and excise duties, as well as VAT fraud. This trend confirms the suggestion that, as businesses slowly grow out of recession (especially in certain export oriented sectors), their higher profits transfer into higher tax revenue and they eventually become more likely to fully report their economic activities. The data from the Business Hidden Economy Index on improved tax collection is in conformity with the findings of the International Monetary Fund on Bulgaria. In the IMF’s conclusion statement after a visit in May 2012, it was confirmed that “reforms to improve VAT compliance are yielding commendable results.”<sup>7</sup> This finding apparently referred to the introduction of a mandatory real time link between fiscal devices and NRA servers, which concluded by April 2012 and

was showcased repeatedly by the NRA as a success.<sup>8</sup> In addition, according to the National Revenue Agency’s Annual Report 2011, business revisions implemented by the NRA increased by 9 % in that year, while the success rate of revealing tax evasion cases grew by 24 % on yearly basis, indicating an increase in the control efficiency of the agency.<sup>9</sup> This trend is likely to continue beyond 2012 as the NRA makes better use of the data collected through the real-time connection. It can then be concluded that **the focus of the Bulgarian government on control and administrative measures has reaped some positive results.**

A closer look at the tax revenues data reveals a more mixed picture of the results of government action to counter the hidden economy, and calls for further sustained action on the part of the Bulgarian authorities to reduce the hidden economy’s negative effects. There has been a positive trend of higher tax revenues since 2009, but for 2011 they were still 11 % lower than at their highest point before the crisis, in

Figure 7. Dynamics of Sub-index “Redistribution” 2002 – 2012



Source: CSD, Hidden Economy Survey on the Business.

<sup>7</sup> IMF. Statement at the Conclusion of a Staff Visit to Bulgaria. 10.05.2012, 07.01.2013, <http://www.imf.org/external/np/sec/pr/2012/pr12169.htm>

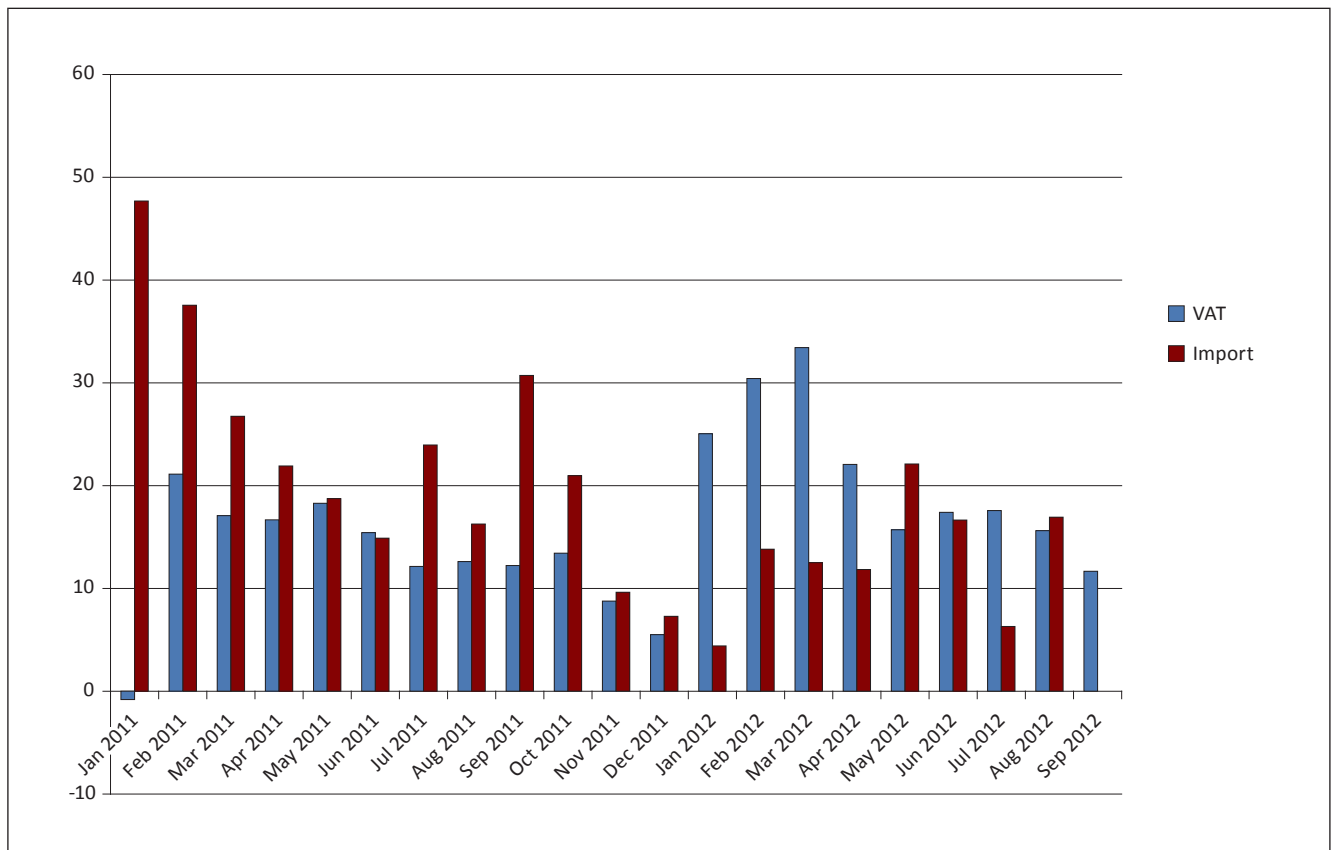
<sup>8</sup> Стоилова, Е. Отчетен е 3 млрд. лв. ръст в оборотите след свързването на касовите апарати, Investor.BG, 27.04.2012. 07.01.2013, <http://www.better-investing.org/>

<sup>9</sup> NRA. Annual Report 2011.

2008. The 2008 tax revenue was achieved at a lower nominal GDP base but with a much higher proportion of imports and lower proportion of exports, which explains to a large extent the difference between 2011 and 2008. More detailed macroeconomic data analysis suggests that VAT revenues have deteriorated in 2011 in line with falling consumption and imports, and that the implied **improvement in tax discipline has come from authorities refusing tax credits to businesses**. The latter has created a lot of pressure on business turnover and has drawn a lot of criticism from enterprises. In 2012 VAT revenue growth was particularly buoyant in the first quarter of the year when the deadline for the introduction of real time link between fiscal devices and NRA servers expired. In each of the first three months VAT revenues increased on average by more than 30 % year on

year, while imports, a major driver of VAT revenues, grew by roughly 10 % on average over the same period. However, it seems that the initial effect of the introduction of the real time link might have cooled off in the rest of the year. The trend of faster VAT revenue growth moderated after April 2012. By September 2012, accumulated VAT tax revenues had increased by BGN 549 mln, which was only slightly more than the BGN 513 mln annual increase registered in the same period of 2011 (Figure 8).<sup>10</sup> Although, the rise in VAT revenues comes at the backdrop of lower annual GDP and import growth, it also comes with lower export growth (i.e. VAT refund claims). This seems to confirm the finding that **administrative measures to reduce the hidden economy have only limited time effect** and need to be supplemented by more positive stimulus to produce lasting results.<sup>11</sup>

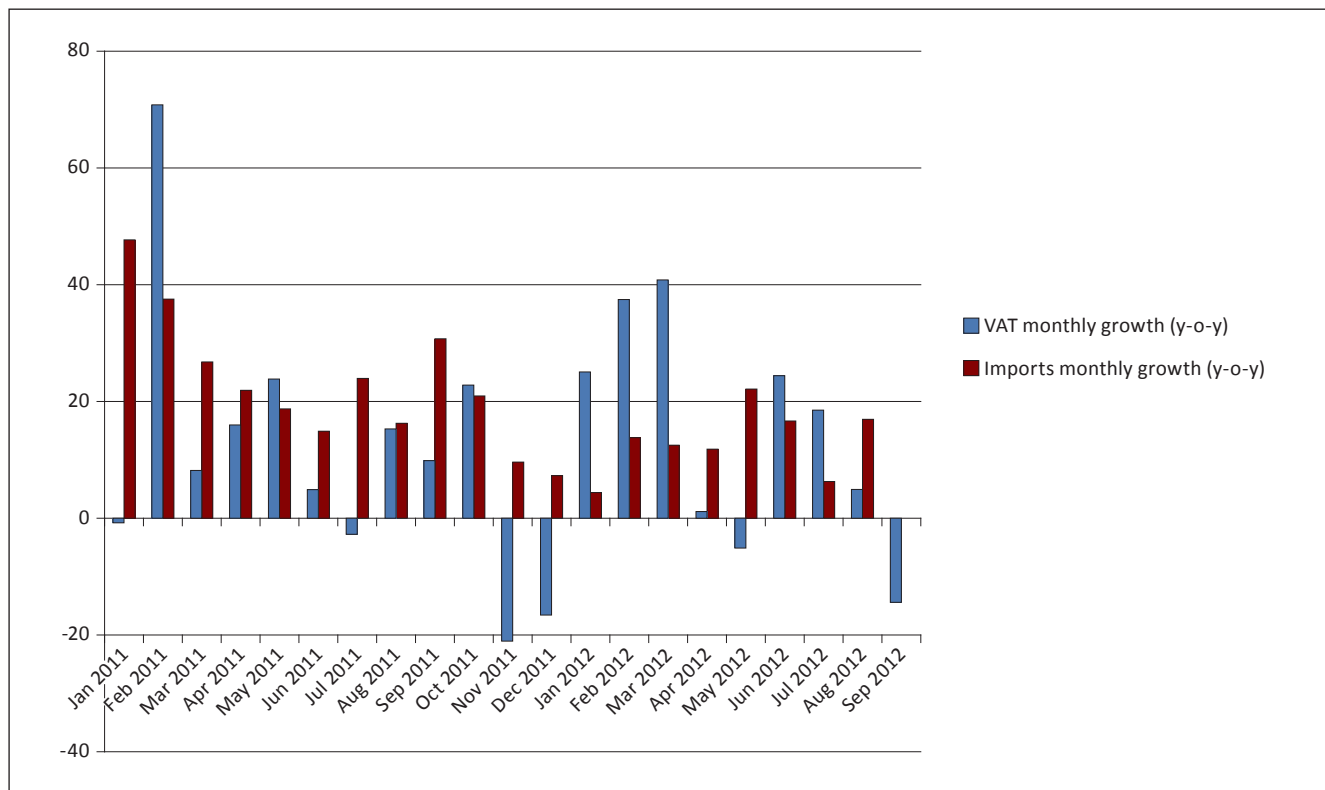
**Figure 8. Monthly Cumulative VAT Revenue and Import Growth (y-o-y, %)**



Source: CSD based on data from the Ministry of Finance and BNB.

<sup>10</sup> CSD, using Ministry of Finance Budgetary Statistics 2012.

<sup>11</sup> The Hidden Economy in Bulgaria and the Global Economic Crisis. Sofia, CSD, 2012.

**Figure 9. Monthly VAT Revenue and Import Growth (m-o-m, %)**

Source: CSD based on data from the Ministry of Finance and BNB.

## Hidden Employment

In line with the overall increase in official unemployment and corresponding decline in employment based on the Hidden Economy Survey on the Business, the Population Unreported Economic Activity index results for 2011 – 2012 confirmed that **hidden employment has decreased in Bulgaria**. One possible explanation is businesses' initial reaction to counteract the effects of the crisis on them, by laying off employees with no formal contracts. The lack of labor force re-entry after the end of the recession has not revived hidden employment activities but has been transferred into productivity rise and in turn temporary reduction

of labor costs. In addition anecdotal evidence and index data suggest that **there has been an increase in employment in the informal (self-subsistence) economy**. In fact, data suggests that informal (often also unpaid) employment has more than doubled between 2008 and 2012, which reflects the rise in long term unemployment and the population at risk of poverty share. The continuing economic hardships and increased control from the authorities has led to a further decline in the incidence of hiring without a contract and even bigger decline in the share of people employed without labor contract in secondary employment (the incidence of such cases has decreased by 9 %) (Table 1).

**Table 1. Share of Employed under no Employment Contract under Primary or Secondary Employment 2003 – 2012 (%)**

Type	2003	2004	2008	2009	2010	2012
Without labor contract- primary employment	6.0	5.9	5.6	5.9	3.4	3.0
Without labor contract- secondary employment	77.4	59.1	51.5	51.0	38.1	29.0

Source: CSD, Hidden Economy Survey on the Population.

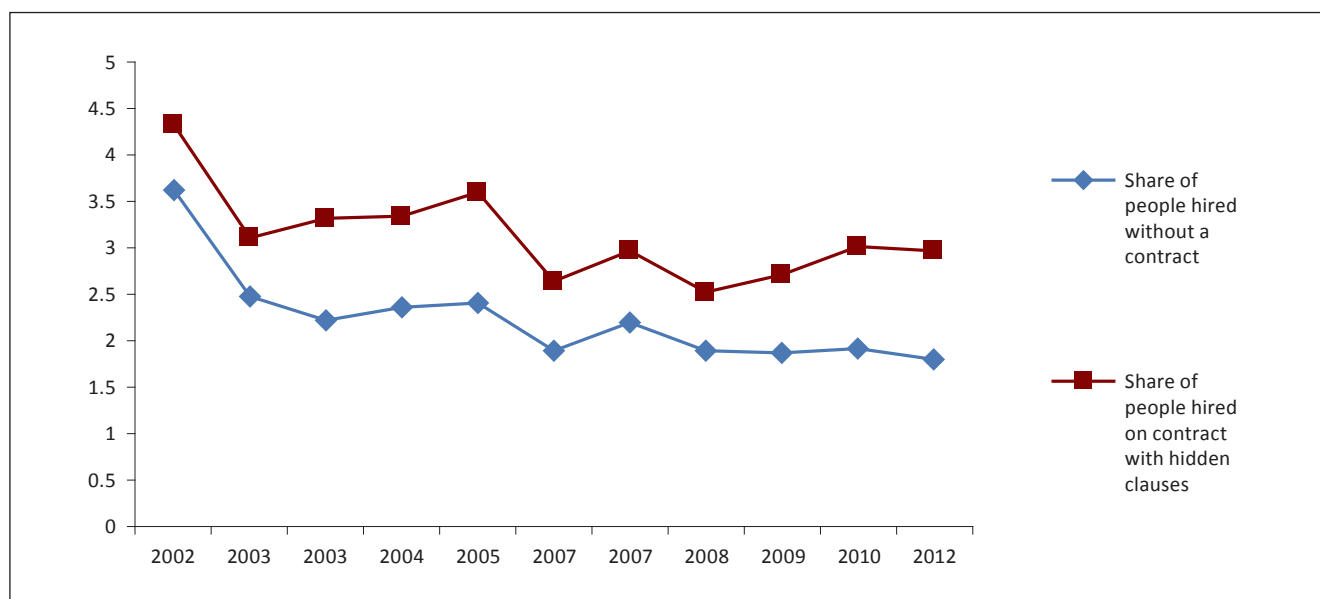


The practice of hiring of workers with no labor contract flattened out and saw little change downwards from 2010 to 2012. Instances of **employment under a contract with hidden clauses (envelope wages) have also been on the decrease since 2010** but remained higher than all time lows registered in 2007 (Figure 10). In the context of the recent economic downturn, the fastest way to reduce costs for businesses was to terminate unreported or informal contracts first and then proceed to cutting down official employment and concealing a share of the officially declared remuneration. As slow growth has been registered for 2011 – 2012, both business and population sub-indexes on hidden employment have converged and returned to the general trend of decline in line with improving business climate and economic conditions. In 2011 – 2012, 10 % of the employed reported having received remuneration higher than the one stated in their contract with the primary employer (Figure 11). This represents a decrease in the incidence of underdeclared payments from 2010, when the respective share was close to 11.6 %. Despite relative positive gains in terms of decreasing incidence of envelope wages, **hidden employment continues to be a pervasive problem for the Bulgarian economy**, indicating the existence

of stable imbalances in the structure of employment incentives in the country.

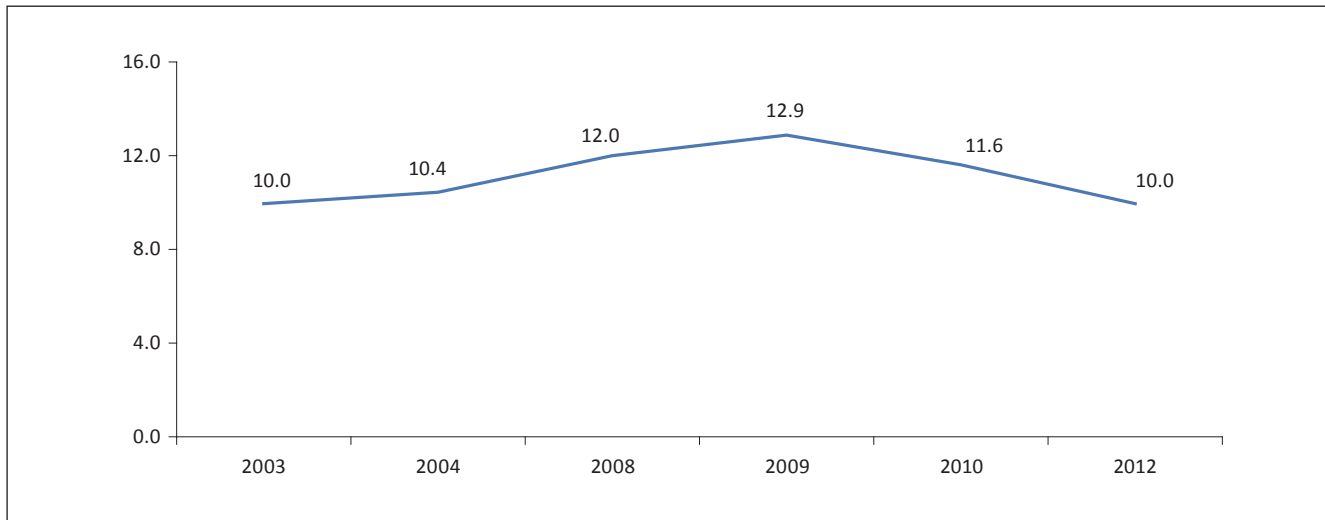
**Informal labor relations are largely socially accepted in Bulgaria**, while the high rate of long-term and youth unemployment only contributes to the negative phenomenon. The tendency to underreport actual remuneration continues to be pervasive and it has important implications for the social security system, as underreported remuneration is also related to reduced payments of social security contributions. Failure to tackle labor market inefficiencies and social security income gaps might result in significant social security deficits and crises with each economic downturn in the future. While increasing the pension age and reducing benefits is unavoidable in the medium term, it will do little to change the picture in the long-term. **A more fundamental reform of the tax, social security and healthcare contribution incentives is much overdue.** The current structure continues to penalize lower income earners who bear most of the burden and hence have very strong incentives to hide all or part of their income. At the same time, the perceived low and continuously deteriorating quality of state health, pension and general public services prompts the better off to try to withhold as much income as possible from the tax authorities.

**Figure 10. Dynamics of Indexes “Hired without Contract” and “Hired under Contract with Hidden Clauses” (2002 – 2012)**



Source: CSD, *Hidden Economy Survey on the Business*.

**Figure 11. Incidence of Payment of Remuneration Higher than the Stated in the Contract under Primary Employment in the Past Month 2002 – 2012 (%)**



Source: CSD, Hidden Economy Survey on the Population.

## Trends in Social Security Contributions

There were two budgetary measures taken in 2011 – 2012 period in regards to social security contributions that sparked discussions on their effect on informal employment although they raised 13 % more revenues in 2011 (or additional BGN 365.6 mln):

- 1.8 percentage points increase of the pension contributions;
- increase of the minimum social security thresholds.

The additional revenue these measures brought in came lower than the **estimated BGN 430 mln losses in social security payments from the underreporting of income from hidden employment** in 2010. The hidden economy data for 2011 – 2012 suggests the size of this loss is unlikely to have declined palpably.

Although there are various opinions on the actual long-term effect of these measures in terms of their hidden economy implications, it is clear that higher pension contributions and thresholds mean higher costs and hence possibly more hidden employment, other things being equal. For the time being, the data seems to suggest this has not been the case in 2012 though results might have been influenced by the very steep decline in employment (Table 2).

In the 2011 – 2012 period, according to CSD's Hidden Economy Survey on the Population, the proportion of employed insured only on the basis of the minimum social security threshold, while actually receiving a higher remuneration decreased to 9 % from 10.3 % (Table 2). The proportion of employed persons that were insured on the minimum social security threshold, which corresponds to their actual remuneration, has increased from 5.9 % in 2010 to 7 % in 2012, reflecting continuing stagnation in the labor market. **The most troubling development** in 2012 has been the resurgence in the share of employed who have admitted they have been **insured on the amount stated in their contract even though they receive higher remuneration – an increase from 8.4 % in 2010 to 13 % in 2012** as of CSD's Hidden Economy Survey on the Population. This seems to be a very harsh sentence on the trust of the middle class in the viability of the Bulgarian social-security system. It also reflects the very low social cohesion and compassion in the Bulgarian society. The results come to underscore that the system is unlikely to close existing gaps and deficits by itself without the mandatory government induced increases in minimum social-security payments.

**Table 2. Base Amount for Payment of Social Security Contributions under Primary Employment 2003 – 2012 (%)**

Type	2003	2004	2008	2009	2010	2012
The minimum social security threshold, although sum of my remuneration is higher	12.1	13.4	13.5	12.9	10.3	9.0
The minimum social security threshold, which is what I am actually paid	10.3	14.3	9.5	12.6	5.9	7.0
The amount stated in my contract even though the total sum of my remuneration is higher	6.7	8.3	15.0	15.5	8.4	13.0
The amount stated in my contract, which is what I am actually getting paid	68.3	63.4	61.8	56.2	67.0	67.0
Other	2.6	0.6	0.3	2.8	1.5	4.0
Base	348	314	378	395	466	420

Source: CSD, *Hidden Economy Survey on the Population*.

## Countering the Hidden Economy in Bulgaria: How Efficient Are Regulatory Agencies

Although the hidden economy has shrunk since 2002 and in the last two years, its size **continues to be a serious developmental obstacle for Bulgaria**. Most of the decline has been brought about by the rise of the official economy, e.g. the deepening of the credit markets. But important changes in the regulatory environment have also resulted in breakthroughs, e.g. the introduction of mandatory employment contract registration in 2003 or the real-time linking of fiscal devices with NRA servers, etc. The latter have demonstrated how important the transparency and the efficiency of the work of regulatory agencies are in countering the hidden economy. In fact, regulatory agencies are both a critical element of ensuring a level playing field in the economy but can also induce hidden economy, if their officers are corrupt or inefficient.<sup>12</sup> There have been numerous signs that overall the **Bulgarian regulatory agencies continue to be overstaffed, corrupt and inefficient,**

**which calls for a radical administrative reform.**<sup>13</sup>

In its recommendation on the Bulgarian National Reform Program 2012 the Council of the European Union noted that administrative capacity remains low, administrative reform limited, and costs for the businesses for complying with regulations – high. At the same time, the two venues for reforming the national regulatory agencies – the Operational Program Technical Assistance and the introduction of e-government, are not used effectively and/or have registered a number of delays.<sup>14</sup>

When it comes to countering the hidden economy two agencies have been front-stage and have faced increasing scrutiny – the National Revenue Agency and the Chief Labor Inspectorate (CLI). Following repeated public and international pressure, the two agencies have consistently increased their capacity to detect and punish hidden economic activity. They have also started developing more and more prevention and education measures, and in the case of NRA – using more e-services to increase customer satisfaction. Still both agencies remain far from achieving the transformation from control into customer and service centric bodies. **The NRA is the most advanced agency**

<sup>12</sup> The Hidden Economy in Bulgaria and the Global Economic Crisis. Sofia, CSD, 2012.

<sup>13</sup> CSD Brief No 35: Corruption and Anti-Corruption in Bulgaria (2011 – 2012). Sofia, 2012.

<sup>14</sup> COUNCIL RECOMMENDATION on the National Reform Programme 2012 of Bulgaria and delivering a Council opinion on the Convergence Programme of Bulgaria, 2012 – 2015, Brussels, 6 July 2012.

in that respect but a lot remains to be done. Both NRA and CLI publish detailed annual reports, which contain data on their control and enforcement activity. The NRA has also tried to come up with some more complex and telling efficiency and risk management indicators, a tendency, which should be encouraged and broadened. Still, the number of control checks performed by the NRA and the CLA remain so many that they demonstrate both the limitations of such instruments in curbing a pervasive hidden economy and the inefficiencies within the agencies. In 2011 the NRA registered 227 thousand control checks, which was an 18 % increase over the previous year. During the same year the CLA visited 37,556 enterprises and carried out 53,195 control checks, which uncovered over 235 thousand infringements of the law. The data on the control functions of CLA shows that it did visit each and every large enterprise (above 250 employed) at least once, and that it visited almost all medium-sized enterprise (from 50 to 249 employed).<sup>15</sup> This is a very stark indication of the level of penetration of the hidden economy in Bulgaria – it has become universally accepted, as well as of the level of inefficiency of regulatory and control instruments in bringing down the hidden economy – the enterprises pay the low, on average fines, and carry on transgressing the law. At the same time it shows that **the regulatory burden on compliant businesses is very high.**

While the NRA and the CLI are the two agencies that come most often into the spotlight when it comes to countering the hidden economy in the country, there are many more other agencies that influence the decision of businesses to operate in the official or the unreported economy. Below are just a few examples, which confirm the findings that **the Bulgarian regulatory bodies still seek scale and reporting rather than impact and results**, and that they remain primarily control and not service oriented:

- *Bulgarian Food Safety Agency.* The agency was created in 2011 and boasts a staff of 2,396 people.<sup>16</sup> Although it has considerable power to influence the foods market it has yet not produced a publicly available report on its activities and their impact. It is noteworthy that half of the agency's specialized directorates contain the word control in their name. The agency also has a separate center for risk analysis, which has not provided public information on its work yet.
- *Executive Forest Agency.* It is best known for being responsible for authorizing hundreds of land-swaps at below market prices, which have allegedly cost the state more than a billion<sup>17</sup> in forgone revenues. The European Commission is still investigating the issue as unwarranted state aid, which is likely to result in at least partial remedy of losses. The agency still does not publish a regular annual report on its activities.
- *National Construction Control Department.* Traditionally one of the most heavy-handed control bodies in the country, which oversees an area of doing business, in which the World Bank has consistently ranked Bulgaria worse than in any other area.<sup>18</sup> The number of complaints to the directorate and respectively follow up checks on law infringements has increased in the last two years to close to hundred thousand. With its 419 people<sup>19</sup> staff it seems that the directorate is understaffed, but at the same time its work has apparently not deterred infringements. The directorate published an annual report on its work but it does not contain targets and indicators for meeting those targets;
- *Regional Health Inspectorates.* There are 28 inspectorates, one in each of the district centers of Bulgaria, which control among other things pharmacies, medical activities, occupational health, etc. There is no publicly available common

<sup>15</sup> According to the National Statistical Institute, the number of large enterprises in 2011 was 756, while CLI reported visiting 988 enterprises of such size (most probably the agency visited some enterprises two or more times).

<sup>16</sup> Министерски съвет. Административен регистър [Council of Ministers. Administrative Registry], <http://ar2.government.bg/ras/index.html>

<sup>17</sup> Crime without Punishment: Countering Corruption and Organized Crime in Bulgaria. Sofia, CSD, 2009.

<sup>18</sup> Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises, Washington D.C., The World Bank, 2012.

<sup>19</sup> Министерски съвет. Административен регистър [Council of Ministers. Administrative Registry], <http://ar2.government.bg/ras/index.html>

annual report on the work of the inspectorates and how they measure their efficiency.

- *Bulgarian Drug Agency*. The agency can impact significantly a number of medical businesses, including control over clinical tests. It publishes a detailed annual report on its web site. The report does not contain clear indicators of efficiency but is rather a statistical and narrative account of activities.
- *Regional Inspectorates on the Environment and Waters*. With the drive for a greener economy in Europe, the importance of these inspectorates is going to increase, including in relation to the cost of doing business. They provide detailed monthly account of their activities on the web site of the Ministry of Environment and Waters. They reveal a pattern similar to the other control agencies: very high inspection activity, which leads to many but fairly small penalties for companies, but to no change in their behavior.

In conclusion, the overview of selected regulatory agencies has demonstrated that not all of them have built up adequate **basic public accountability mechanisms**, such as publishing an annual activity report. None of the agencies provide a comprehensive efficiency and impact analysis of its work though some, like the NRA have started reporting on some impact indicators. It is important that the focus of government regulatory and control actions is effectively channeled and information on the control activities of the respective agencies is publicly available, so transparent assessment could be implemented as to their impact on the hidden economy. This is currently not the case and the failure of Bulgarian authorities to react to the flexible nature of the hidden economy and the inability to target narrow constituencies with high degree of gray activities constitute a major obstacle in the long-term prevention of the hidden economy in Bulgaria.

Based on type of activities reported, the work of regulatory agencies greatly varies but certain elements need to be present in order for visibility and quality control to be assured. Some of these elements include:

- details about staff, budget, type of governance;
- watchdog function details including clear specification of public functions and institutions regulated;
- report on the service of information center, including fraud signals by citizens;
- actions taken as a result of citizens' signals and complaints related to informal/not allowed activities;
- report on auditing revisions and results of specific regulatory actions;
- actions taken, including results from court proceedings on decisions taken by the agency;
- reports on measures taken to facilitate service of citizens.

## Policy Actions on the Hidden Economy – Recent Developments and Recommendations

### EU Level

The European Commission has set out a three-tier approach aimed at tackling evasion and fraud in the EU – national, EU level and international. Specifically, a VAT strategy on tackling VAT fraud has been devised by the Commission and established on all three levels.<sup>20</sup>

- **At national level**, measures include setting objectives for improving tax collection within each member state, reducing undeclared work, reducing the financial attractiveness of the gray economy and strengthening surveillance and sanction mechanisms. The Commission actions target specifically the most affected countries in Central and Eastern and in Southern Europe.
- **At EU level** - enhancing cross-border cooperation between member states' tax administrations /with instruments like a cross-border tax identification number/, as well as raising awareness among the

<sup>20</sup> European Commission. Tackling tax fraud and evasion: Commission sets out concrete measures. 6.12.2012, 7.01.2013, [http://ec.europa.eu/commission\\_2010-2014/semeta/headlines/news/2012/06/20120627\\_en.htm](http://ec.europa.eu/commission_2010-2014/semeta/headlines/news/2012/06/20120627_en.htm)

public on the risks and costs to society, related to the gray economy, such as the loss health and social security protection.

- **At international level**, adopting a common European policy towards international partners, who must apply good governance standards that are equivalent to the EU's in order to fight tax fraud and tax evasion.<sup>21</sup>

Besides the fighting of fraud and evasion, the European Commission is also designing specific measures on tax havens and aggressive tax planning.<sup>22</sup>

## Bulgaria

In almost all reports on the preparation and/or the implementation of the national budget, there is general statement that one of the goals of the fiscal policy is the reduction in the scope and size of the hidden economy. With the exception of the Customs Agency, which has consistently reported in recent years on specific measures undertaken to counter the hidden economy, there is very little substance to substantiate the claims of the government. Tackling the gray economy features on the second place among the medium-term priorities of the government stated in the Report to the Draft Law on the State Budget of the Republic of Bulgaria for 2013. There are only two measures cited in the report, which follow up on this priority: (a) the Customs Agency will continue monitoring the excise goods storage and measuring devices, and (b) the rates of the direct taxes will be kept unchanged, which together with increased control will stimulate the entry into the official economy.

As a whole, **the Bulgarian government has continued to show preference for punitive and corrective measures.**<sup>23</sup> This has given some positive results in the tax evasion area as evident from the decline in the values of the redistribution sub-index of the Business

Hidden Economy Index and the 24 % increase in the success rate of preventing tax evasion claimed by NRA. Yet, regulatory action outside the NRA seems sporadic; it lacks consistency and coordination and proves to be inadequate in preventing certain types of informal economic activities in some of the most problematic sectors of the economy. The performance of most control agencies is well documented but rarely evaluated with regard to the priority of tackling the hidden economy.

Socio-economic and financial policies, which have a much higher potential for long-term positive impact than administrative pressure, have not been effectively used to aid increased controls in 2011 – 2012. Instead, administrative procedures have bulked up and little progress has been achieved in the improvement of long-term business environment – thus negatively affecting start-up and project financing opportunities. As a result, because of burdensome procedures and extremely risk averse public administration, many companies have given up support from European funds, which in the current tight credit conditions remains almost the only available funding source. As suggested by CSD before, the use of ‘carrots’ rather than ‘sticks’ could serve as the main vehicle for improving the long-term prospects in the fight against the hidden economy and all its aspects in Bulgaria. Attention should be turned towards continuing the administrative reform within executive regulatory agencies towards more service orientation. At the same time, there can be very little success in countering the hidden economy, if Bulgaria continues to have issues with corruption, organized crime and the work of the judiciary. **Successful measures to reduce the level of hidden economy may include:**

- introducing common efficiency and productivity indicators across government regulatory agencies;

<sup>21</sup> European Commission. Tackling tax fraud and evasion: Commission sets out concrete measures. 6.12.2012, 7.01.2013, [http://ec.europa.eu/commission\\_2010-2014/semeta/headlines/news/2012/06/20120627\\_en.htm](http://ec.europa.eu/commission_2010-2014/semeta/headlines/news/2012/06/20120627_en.htm)

<sup>22</sup> European Commission. Communication from the Commission to The European Parliament and The Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries. 27.07.2012, 07.01.2013, [http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/com\\_reports/taxation/com%282012%29351\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/com_reports/taxation/com%282012%29351_en.pdf)

<sup>23</sup> The Hidden Economy in Bulgaria and the Global Economic Crisis. Sofia, CSD, 2011.

tackling corruption through the introduction of e-services;

- speeding-up VAT refunds and reducing control checks on law-abiding companies;
- administrative reform to speed-up payments on European programs;
- better legal framework on late payments and business-to-business private debt; improving the work of administrative courts and targeting vigorously the practice of backdating insolvency;
- promoting free enterprise and competition through improving the enforcement of the anti-monopoly legislation.

In conclusion, the hidden economy, and the public perception of the hidden economy, has shifted downwards during 2011 – 2012. CSD's Hidden Economy Index registered these positive developments, converging to the long-term declining trend which was temporarily reversed during the 2009 – 2010 financial

crisis. Yet, the decrease was small and as a whole it was statistically insignificant. **The hidden economy in Bulgaria continues to be a major development obstacle** and practices such as undeclared work continue to be socially accepted, whereas general discontent with the business environment fuels massive tax evasion sentiments. **Traditional weaknesses of the Bulgarian economy** such as the relation between strong oligarchic-type economic structures and the establishment of informal social and economic systems motivate the existence of hidden and illegal activities throughout different segments of the Bulgarian economy. Furthermore, the price of entrepreneurship remains high, EU-funds absorption is undermined by inefficient institutional framework and administrative incapacity, while internal consumer demand stays weak and unsophisticated. Thus, involvement in the informal sector continues to be an important means for a business start-up and small and mid-size business development.

## Appendix

### Government Revenue vs. Main Macro Indicators

Indicator (BGN million)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	Q1-Q3 2012*
GDP (Current prices)	60,184.63	69,295.03	68,321.61	70,511.24	75,265.35	57,440.00
Export Total	35,790.00	40,342.00	35,248.00	40,481.00	50,061.00	36,954.00
Export Goods	26,427.00	29,736.00	22,882.00	30,435.00	39,560.00	-
Export Services	9,363.00	10,606.00	9,576.00	10,046.00	10,501.00	-
Import Total	47,656.00	54,557.00	38,493.00	41,817.00	49,552.00	41,171.00
Import Goods	40,624.00	46,581.00	31,066.00	35,878.00	43,422.00	-
Import Services	7,032.00	7,976.00	7,427.00	5,939.00	6,130.00	-
Final Consumption Expenditure	51,532.26	57,496.13	54,293.38	55,708.98	57,392.37	45,177.00
Gross Fixed Capital Formation	20,518.88	26,014.53	20,063.19	16,138.01	17,363.72	13,859.00
FDI Total	17,699.90	13,156.60	4,765.70	2,251.30	3,415.60	2,661.80
EU Structural Funding	22.10	611.90	1,878.90	1,138.30	1,098.40	202.80
Total Government Tax Revenue	13,920.60	16,124.80	14,358.00	13,500.10	14,466.60	11,426.20
Execution of the Planned Tax Revenue (%)	109.50	96.30	75.90	100.20	100.80	74.30
Profit tax	1,676.60	2,059.60	1,617.40	1,242.50	1,356.00	1,167.30
Income tax	1,808.70	1,950.60	2,029.80	2,012.70	2,162.60	1,690.20
VAT	6,598.50	7,485.60	6,432.50	6,267.10	6,611.70	5,251.40
Excises	3,315.40	4,051.60	3,844.50	3,567.90	3,860.10	3,011.60

**Note:** \* CSD estimate, to be confirmed with FY data; official data available only up until Q3 2012.

**Sources:** Ministry of Finance, NSI, BNB, Information System for Management and Observation of EU Structural Funds in Bulgaria ([www.eufunds.bg](http://www.eufunds.bg)).