

THE HIDDEN ECONOMY IN BULGARIA IN 2013

Policy Brief No. 42, November 2013

Introduction

Accurate understanding of the dynamics of the hidden economy is essential for improving public and private sector management. In the case of Bulgaria, the high level of hidden economic activities signals many deficiencies in the functioning of the public institutions and the rule of law, and undermines the economic development of the country. Limiting the grey economy ought to be an issue of imminent priority for policy makers. The recent unparalleled global growth of digitalization of economic activities provides ample opportunities to reduce hidden cash flows and directly contribute to positive economic development of the country. Comprehensive, sustained reforms focusing on improvements in market and administrative efficiency are needed to facilitate the process of economic convergence and limit the negative effects of the hidden economy in Bulgaria.

Macroeconomic Overview

In 2013, Bulgaria is one of the countries that have seen a decline in their competitiveness according to IMD's World Competitiveness Yearbook (WCY). The country is ranked at 57th position – 3 places below the position achieved in 2012 – 54th. This is the lowest ranking of Bulgaria since its inclusion in the yearbook in 2006, and it is almost 20 places lower than its highest achievement in 2009 – 38th place. The country continues to have a fiscally stable, open and export-oriented economy. However, the Bulgarian economy lags seriously behind on all long-

KEY POINTS

- According to CSD's 2013 *Hidden Economy Index*, **the share of the hidden economy in Bulgaria has increased in 2013** among both businesses and the population. Poverty, harsh labor market conditions, and bearish economic outlook all contributed to the development of hidden economic activities. These seem to have been exacerbated as a result of the shift in executive power, the related administrative reshuffling, and the overall political volatility in 2013. Tax evasion cases have increased, as have perceptions of the spread of the hidden economy in the country. The index results show:
 - **Increase in the incidence of hidden employment.** According to CSD's conservative estimates based on the index results, a total of BGN 245.6 mln in social and health security payments are lost for the treasury from underreporting and non-reporting of income for 2013 alone;
 - Increase in tax evasion and mild deterioration in terms of the government's tax collection rates. Increase in public perceptions on tax evasion fraud is indicative of public sentiments about the opportunistic behavior of businesses on the back of political volatility in 2013. The very low inflation rate (actual deflation in certain months) in 2013 and a variety of other related economic conditions contribute to lower rates of tax revenue growth.
- The 2013 Index results show that the focus on punitive measures observed in the 2009 – 2012 period led to somewhat higher tax collection rates but proved to be politically vulnerable and with a limited impact without the introduction of positive reforms. VAT changes, envisaged for 2014, constitute steps in the right direction but they need to be made part of a wider comprehensive strategy for motivating participation in the official economy and for improving the overall economic environment in the country.

term competitiveness factors. It continues to rely on the lowest living and business costs in Europe, which hurt talent attraction and retention, limit business efficiency, and reduce the quality of public institutions.

Bulgaria's GDP increased by 0.9 % in the first two quarters of 2013¹ (Figure 1). GDP growth is expected to reach 0.5 % for the year as a whole, which remains well below the estimated potential growth rate of the economy, but the growth momentum towards the end of 2013 is forecast to entail a positive carry-over effect for next year.² Exports have increased by more than BGN 1.5 bn for the first two quarters of 2013, while consumption expenditure (see Table 3) grew by BGN 903 mln for the same period due to an increase in government spending, as well as to steady growth of household expenditures. According to the European Commission (EC), **export and domestic consumption** would remain the main drivers of economic growth for Bulgaria until 2015 and beyond.³ A **rather negative tendency is the decrease in gross capital formation** by BGN 1.5 bn by Q2 2013 and the modest EUR 802.5 mln FDI inflow, both indicative of the ongoing investment crunch reinforced by the political instability in the country. Public discretionary spending is poised to increase significantly in 2013. The general government deficit is set to increase from 0.8 % of GDP in 2012 to 2 % of GDP for FY 2013. Provided public sector institutional inefficiencies it is unlikely that this fiscal stimulus will produce any tangible impact on the economy. The inflation rate is gradually decreasing with CPI rate of 3.6 % and 2.2 % for Q1 and Q2 respectively. **For August 2013, the national statistics registered -0.7 % deflation – a trend across Europe, which indicates economic troubles are not over; government revenues will be negatively affected.**

As per Q3 2013, the deposits from households and enterprises increased by 5 % on yearly basis

or by BGN 2,522 mln, continuing the upward trend in the savings of the Bulgarian private sector. **This is indicative of continued economic insecurity of the Bulgarian households and the lack of fresh investment opportunities.** On the other hand, **savings have not encouraged additional lending from the banking sector.** At the end of Q3 2013, lending to households and enterprises showed negative growth on yearly basis. This is unlikely to change unless there is a resolution at European level of the banking deadlock. It should be noted that banks in Bulgaria also face particular rule of law challenges related to the possibility of companies to backdate their bankruptcy filing, which makes lending institutions even more restrictive and cautious; on their part, banks have failed to provide more transparency of lending terms and conditions to their clients, further blocking market competition and slowing credit growth. In this situation, the exponential growth of lending from non-banking institutions creates a predatory environment as the burden of repaying payday type loans makes low-income households resort to dependency on unofficial sources of income, while hurting the national economy with millions lost in potential consumer spending.

The labor market situation remains grim. Unemployment stood at 12.9 % at the end of Q3 2013 (Figure 2), compared to 12.3 % for Q3 2012. As unemployment is a lagging economic indicator, it is important to look at annual percentage change of the rate of unemployment which although still being negative shows stabilization – for 2013 it is -1.0 %, compared to -2.9 %, -2.2 %, -2.5 % for 2010, 2011, 2012 respectively. Unemployment growth has slowed compared to the previous three years and is expected to peak out around 13 % in 2014 and to start going down to levels lower than 12 % by 2015.⁴ Long-term unemployment is stubbornly high (Figure 3), representing 56 % of total unemployment in September 2013. Youth unemployment increased slightly and is

¹ All data for macroeconomic overview comes from the National Statistics Institute and the Bulgarian National Bank, unless otherwise specifically quoted.

² EC, European Economic Forecast: Autumn 2013, available at: http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee7_en.pdf

³ Ibid.

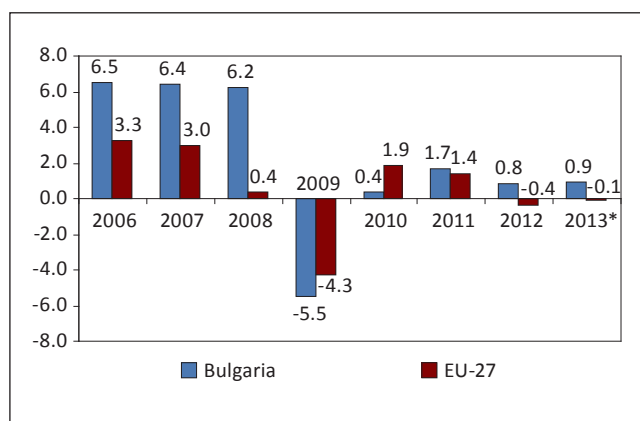
⁴ Ibid.

still well above average levels for Europe (Figure 4). The real wage has increased in the first two quarters of 2013 at an average of 2.4 %, while labour productivity has decreased in Q2 2013 by 0.9 %, indicating hidden employment pressures.

The macroeconomic environment has modestly improved in 2013, but remains bearish, setting out favorable conditions for high levels of involvement in the hidden economy in Bulgaria. Some of the key economic trends that might have had direct effect on the hidden economy developments in 2013 could be summarized as follows:

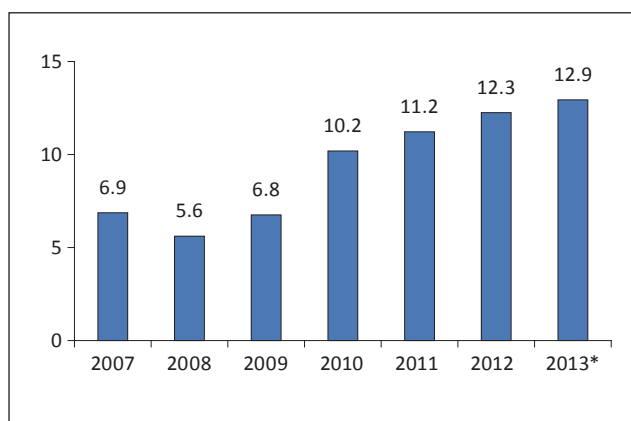
- Despite signs of stabilization, **current rates of unemployment remain very high, reaching almost 13 % in 2013**. Growth expectations have been associated with opportunities for large-scale re-entry of unregistered workers back into the grey economy but this has not been the case so far. As businesses remain cautious, there has not been any re-hiring spree observed but unofficial employment remains high, mainly due to high-levels in seasonal and semi-formal employment schemes;
- **Labor costs** in Bulgaria remain among the lowest in Europe, but productivity gains do not imply

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



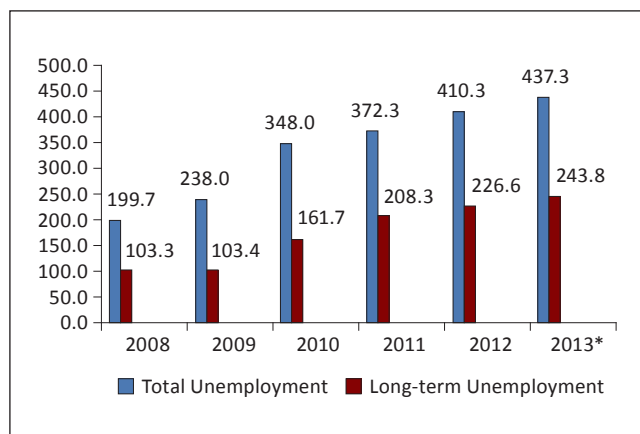
Note: * projected.
Source: Eurostat.

Figure 2. Rate of Unemployment (%)



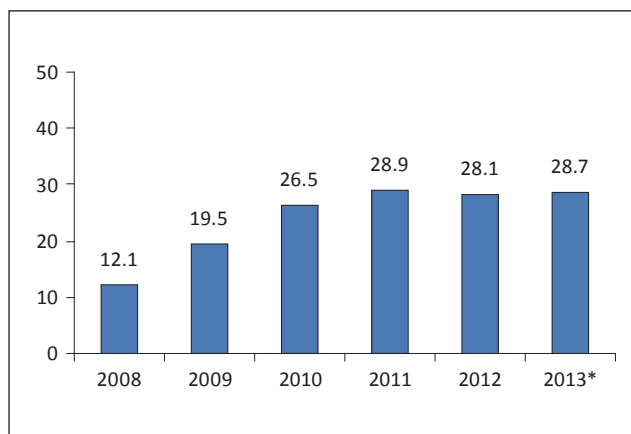
Note: * as of Q3 2013.
Source: NSI.

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



Note: * as of Q3 2013.
Source: NSI.

Figure 4. Youth Unemployment (% of unemployed people aged 15-24)



Note: * as of Q3 2013.
Source: NSI.

opportunities for big pay rises for the bulk of the population.⁵ 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.

Hidden Economy Index 2013: Components and Dynamics

The current brief is 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 assessing the impact of implemented policies to tackle hidden economic activities. The information from the two indexes complements each other as businesses and 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 2013, the values of both **the Business Hidden Economy Index and the Population Unreported Economic Activity Index increased**, indicating a rise in the share of the hidden economy in Bulgaria. The Indexes are based on 2013 surveys and are indicative of developments in 2013. The two indexes showed parallel movements – there was an increase in the perception of the overall level of the hidden economy in the case of businesses. The level of unreported economic activity of the population rose too (Figure 5). The 2013 results reveal an overall slight increase in both indexes, which however breaks the relative progress during the 2011 – 2012 period, when highly publicized efforts on punitive measures in the area of tax collection and related regulatory activities by the government, resulted in mildly higher levels of compliance and better public perceptions of the size of the hidden economy in Bulgaria. A retrospective look back to 2002 shows that the 2013 results have climbed up to the levels of 2009 and are similar to those of 2005 but are still considerably lower than the all-time highs from the beginning of the series in 2002. The overall historical trend for the last decade and the outlook for the next several years remains positive as the size of the hidden economy is expected to decline as economic growth resumes and economic convergence with the EU picks up. The speed of these processes will hinge critically

Box 1. Components of the Business Hidden Economy Index

- 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.

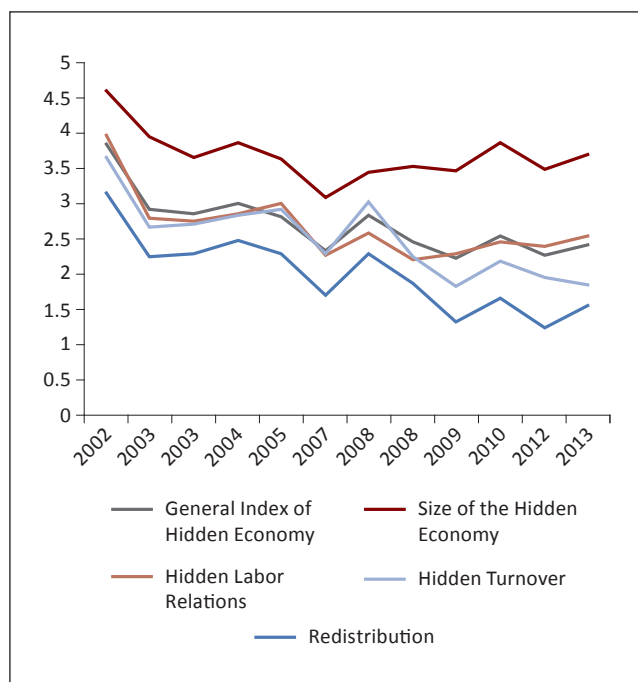
Source: Center for the Study of Democracy.

⁵ Mitra, Pritha and Cyril Pouvle. Productivity Growth and Structural Reform in Bulgaria: Restarting the Convergence Engine, IMF Working paper, May 2012, available at: <http://www.imf.org/external/pubs/ft/wp/2012/wp12131.pdf>

on reform efforts by the government, and how quickly the high levels of political volatility in recent months will be brought down. It is now clear that the pre-mature elections and the continuing political uncertainty, and the related state administration reshuffling, contributed to the decline in the level of labor and tax rules compliance, affecting in the process the overall public perceptions of the size of the hidden economy in Bulgaria.

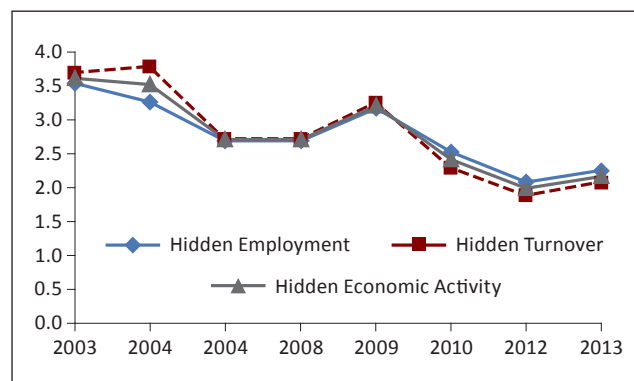
The components of the Business Hidden Economy Index – hidden economy size, hidden labor relations, hidden turnover, and hidden redistribution, and those of the Population Unreported Economic Activity Index – hidden employment, turnover, and economic activity all registered an increase (Figures 5 & 6). **Perceptions among the businesses as to the overall size of the hidden economy in the country remain high, considerably departing from the all time low in 2007.** Such perceptions are an indication of the harsh economic environment in the country, in terms of both market prospects and regulatory environment and law enforcement.

Figure 5. Hidden Economy Index 2002 – 2013



Source: CSD, Hidden Economy Survey on the Businesses.

Figure 6. Unreported Economic Activity of the Population 2003 – 2013



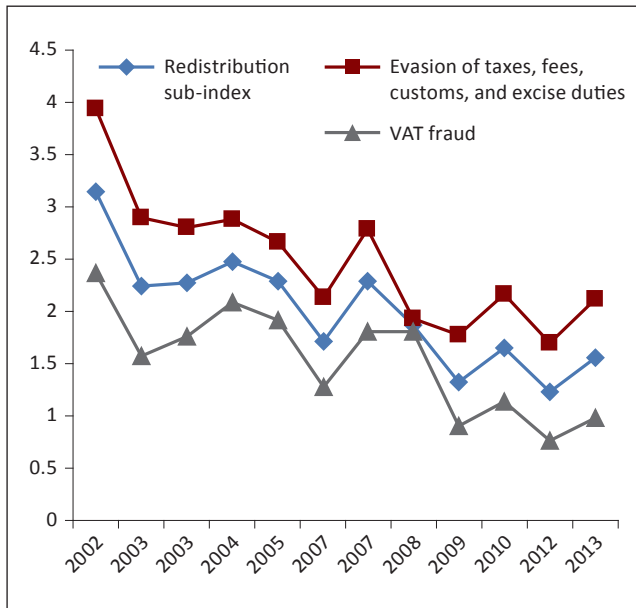
Source: CSD, Hidden Economy Survey on the Population.

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

There has been a notable increase in the sub-index “Redistribution” in 2013 (Figure 7), including a rise in the incidence of cases involving tax evasion, avoidance of customs, fees, and excise duties, as well as VAT fraud. This development confirms the suggestion that **the government change and, particularly, the related administration reshuffling had a direct negative effect on public perceptions for the success rate of tax collection efforts in Bulgaria.** It should be noted that the results show that increased controls in the 2009 – 2012 period and in particular the promising initial results achieved by the National Revenue Agency (NRA) through the creation of the real time link between all fiscal devices in the country and the NRA servers, could not lead to enduring and consistent results in the fight against hidden economy if implemented in isolation. Reversing the slippage in tax collection is critical to preserving fiscal stability. In IMF’s warning words with the new government looking to increase protection of the most vulnerable and promote large scale public investment, revenue collection would be key and “any revenue shortfalls as a result of bigger spending, weaker-than-budgeted economic activity or delays in the reimbursement of EU funds should be accommodated for by adequate government income.”⁶

⁶ IMF Concludes Staff Visit to Bulgaria, Press Release No.13/246, July 3, 2013, available at: <http://www.imf.org/external/np/sec/pr/2013/pr13246.htm>

Figure 7. Dynamics of Sub-index Redistribution 2002 – 2013



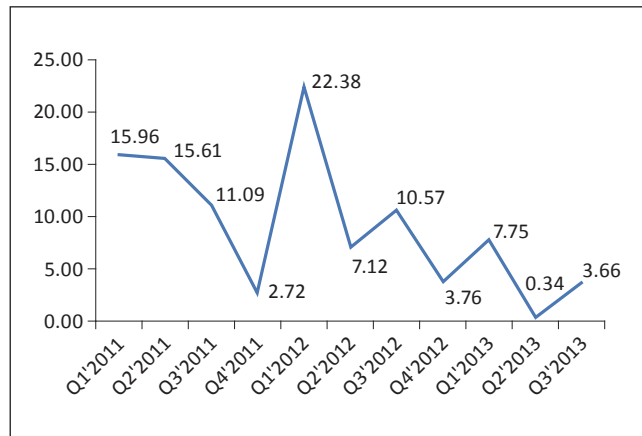
Source: CSD, Hidden Economy Survey on the Business.

A closer look at the tax revenues data reveals a complicated picture and calls for further sustained action on the part of the Bulgarian authorities to reduce the hidden economy’s negative effects. The positive trend of tax revenues growth since 2009 has been subdued as year-on-year tax revenue growth was below 1 % in September 2013, compared to 11.02 % and 7.89 % in September 2011 and September 2012 accordingly. This seems to confirm the finding that **administrative and punitive measures to reduce the hidden economy have only limited time effect** and need to be supplemented by more positive stimulus to produce lasting results⁷ as the gains from early 2012 (when real time link was introduced by the NRA) have cooled off significantly in the following months and particularly in the first three quarters of 2013 (Figure 8 & 9). The decrease in VAT and excise revenue growth could also be indicative of certain control deficiencies as those grew only by 0.34 % in Q2 2013 – the lowest growth rate of collected revenues per quarter for the last 12 quarters (Figure 8). In comparison, in Q1 2012, VAT and excises collection grew by more than one fifth on yearly basis. However, a balanced overview of the collection trends and overall quality

⁷ CSD, The Hidden Economy in Bulgaria and the Global Economic Crisis, Sofia, 2011, available at: <http://www.csd.bg/artShow.php?id=15798>

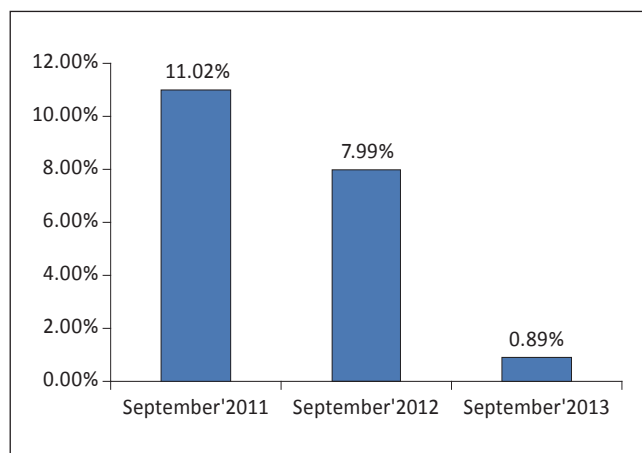
of the work of controlling agencies should be carried out to account for the effects of economic conditions such as registered deflation in the summer of 2013 that inevitably has a depressing effect on the nominal money value of tax revenue.

Figure 8. Growth of VAT and Excises Collected per Quarters (y-o-y growth, %)



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

Figure 9. Tax Revenue Growth September 2011 – September 2013 (y-o-y, %)



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

Hidden Employment

Both indexes of the business and the population show a clear increase in hidden employment. In line with the persistently high rates of unemployment and very tight labour market, the index results for 2013 showed

Table 1. Share of Employed under No Employment Contract under Primary or Secondary Employment 2003 – 2013 (%)

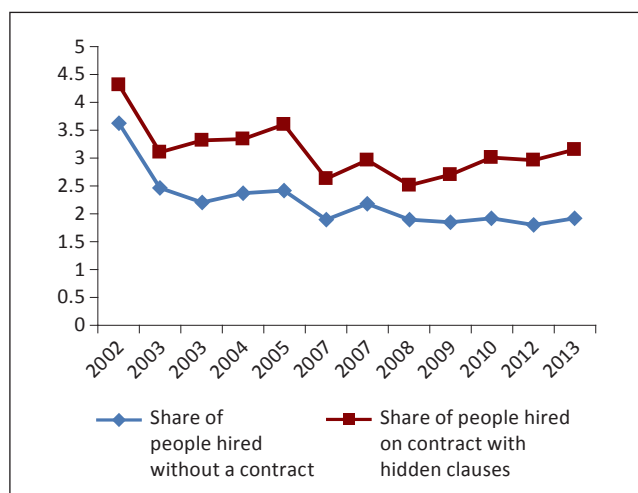
Type	2003	2004	2008	2009	2010	2012	2013
Without labor contract – primary employment	6.0	5.9	5.6	5.9	3.4	3.0	4.0
Without labor contract – secondary employment	77.4	59.1	51.5	51.0	38.1	29.0	32.2

Source: CSD, Hidden Economy Survey on the Population.

that for the first time since 2002, **hidden employment in all of its aspects has increased in Bulgaria** in 2013 (Table 1 & 2). With almost 4 years of anemic growth, businesses have not started re-hiring, and it is quite possible that instead, there has been a large reliance on seasonal or semi-legal forms of employment in order to fulfill temporary demand. This is directly related to the bearish outlook of the Bulgarian economy and business environment as a whole. It requires both tighter government compliance control management and bold measures to incentivize business creation and growth.

The practice of hiring workers with no labor contract edged upwards from 2012 to 2013 but remains low (Figure 10). Instances of employment under a contract with hidden clauses (envelope wages) have continued to increase steadily, although percentage changes are similar in the last few years (Figure 10). In September 2013, **13.8% of the employed reported having received remuneration higher than the one**

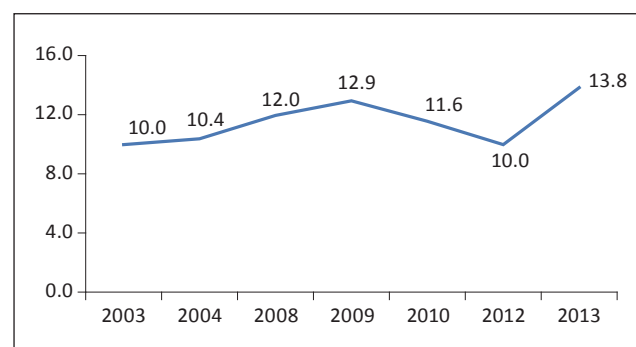
Figure 10. Dynamics of the Indexes “Hired Without Contract” and “Hired Under Contract with Hidden Clauses”



Source: CSD, Hidden Economy Survey on the Businesses.

stated in their contract with the primary employer (Figure 11), which is the highest percentage of hidden employment reported by the employees since the start of the series of the monitoring in 2002. This comes to show that **hidden employment continues to be a pervasive and rising problem for the Bulgarian economy**, indicating the existence of persisting imbalances in the structure of employment incentives in the country.

Figure 11. Incidence of Payment of Remuneration Higher than the Stated in the Contract under Primary Employment in the Past Month 2002 – 2013 (%)



Source: CSD, Hidden Economy Survey on the Population.

Trends in Social Security Contributions

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 incentives structure in the long-term. On the contrary, it exacerbates the problems. In that regard, **a 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.

Based on the results of the surveys and the index, **CSD has made conservative estimates, which showed there have been a total of at least BGN 184.2 mln worth of losses in social and health security payments from underreporting and non-reporting of income for the period between January and September 2013.** If the same trend is assumingly

preserved, that would make a **total loss of BGN 245.6 for the FY 2013 from social and health security payment gap.** In comparison, the amount **lost for 2012 was BGN 184.7 mln.**⁸

In 2013, according to the 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, increased to 12.6 % from 9 % (Table 2). **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 has continued – an increase from 8.4 % in 2010 to 13 % in 2012 and to 15.3 % in 2013** (highest registered since 2002). 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 low social cohesion and compassion in the Bulgarian society. The high level of evasion of social security and healthcare payments, including by better off citizens, show that the opportunities to increase collection through punitive measures are unlikely to produce tangible results. This is particularly

Table 2. Base Amount for Payment of Social Security Contributions under Primary Employment 2003 – 2013 (%)

Type	2003	2004	2008	2009	2010	2012	2013
The minimum social security threshold, although sum of my remuneration is higher	12.1	13.4	13.5	12.9	10.3	9.0	12.6
The minimum social security threshold, which is what I am actually paid	10.3	14.3	9.5	12.6	5.9	7.0	5.2
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	15.3
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	63.8
Other	2.6	0.6	0.3	2.8	1.5	4.0	3.1
Base	348	314	378	395	466	420	505

Source: CSD, Hidden Economy Survey on the Population.

⁸ These amounts have been calculated on the basis of the answers for different kinds of income underreporting and non-reporting by both the employees and the employers as per the survey of Vitosha Research in 2013 and the statistics about active workforce in Bulgaria of NSI. Using an alternative methodology based on alternative assumptions yields that in fact losses have been in the vicinity of BGN 400 mln for 2012 and BGN 500 mln for 2013 accordingly. Such amount could be sufficient for paying nearly 80 % of the entire national monthly budget for pensions while also equaling almost 4 times the amount of BGN 120 million needed for 3 % pension increase by the Swiss pension indexation rule as of July 2014.

true for the healthcare contributions. In order to re-introduce to the system the more than 1 million Bulgarians currently outside of it, there needs to be a combination of incentives and improved service in relation to eyeing re-entry by people able to pay.

On the other hand, the proportion of employed persons that have reported they have been insured on the minimum social security threshold, which corresponds to their actual remuneration, decreased further from 7 % in 2012 to 5.2 % in 2013. This provides additional support for measures aimed at increasing the minimal thresholds as a way of reducing the impact of the crisis on the most vulnerable groups in the country.

Policy Actions on Hidden Economy – Recent Developments in the EU and Bulgaria

EU Level

The European Commission (EC) has set out a three-tier approach aimed at tackling evasion and fraud in the EU – national, EU level and international. According to EC's estimates, there is nearly EUR 1 trillion lost to tax evasion in EU-28 countries and for that and other reasons in the last year and a half, the public debate in Europe has increasingly turned to discussing hidden economy issues and more specifically, a possible crackdown against tax havens and combatting tax evasion in general. Specifically, the Commission devised a VAT strategy on tackling VAT fraud.⁹ Estimates on VAT gap by the European Commission¹⁰ show that VAT gaps have a very wide dispersion across European countries, ranging from the low of

0.2 % of VAT Total Tax Liability (VTTL) recorded for the Netherlands in 2005 to the highest of 49 % of VTTL in Romania in 2009. "For the entire sample, over the period 2000 – 2011 the average VAT Gap is 17 %, and the median 13 %".¹¹ In the year 2011, the estimated total VAT Gap for the EU – 26¹² countries amounted to approximately Euro 193 billion, or about 1.5 % of EU-26 total GDP. The overall gap as percentage of GDP has shown a marked upward trend since the inception of the 2008 – 2009 financial crisis.¹³

In that regard, the EC stepped up "efforts against tax havens, encouraging members to "name and shame" ultra low-tax jurisdictions and crack down on cross-border tax avoidance within the 28-nation bloc". In late 2012, the EC presented a 30-point "action plan" against aggressive tax avoidance to ensure that all businesses and individuals contribute to government coffers and in May 2013, new general guidelines for fight against tax fraud, tax evasion and tax havens were voted in the European Parliament.¹⁴

On national level, many European countries have sought various ways of reducing fiscal deficits without sacrificing economic growth or employment. Overall, **negative enforcement measures that seek to punish the offenders have prevailed in the fight against hidden economy across Europe.** However, there are examples of interesting "carrot" type reforms aimed at encouraging participation in the official economy that have showed commendable results, demonstrating that increasing the penetration rate of electronic payments and reducing tax and administrative burden show reverse correlation with the level of hidden economy in a country. For example, in Germany the "mini-jobs" reform that has simplified the social security and income tax system in order to engage lower wage workers to join the official

⁹ Šemeta, Algirdas, Tackling Tax Fraud and Evasion: Commission Sets out Concrete Measures, 2012, available at: http://ec.europa.eu/commission_2010-2014/semeta/headlines/news/2012/06/20120627_en.htm

¹⁰ EC, CASE, Study to quantify and analyse the VAT Gap in the EU-27 Member States Final Report, Warsaw: July 2013, available at: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf

¹¹ Ibid.

¹² All EU-member states without Cyprus and Croatia.

¹³ See Footnote 10.

¹⁴ European Parliament, REPORT on Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI)), 3 May 2013, available at: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A7-2013-0162+0+DOC+XML+V0//EN>

economy was hailed as particularly successful.¹⁵ In a nutshell, the “mini-jobs” reform means exemption of income tax and social security contributions up to a certain income threshold.¹⁶ Some Southern European countries, such as Portugal have been forerunners in efforts for increasing e-invoice and e-mail usage for fiscal purposes by introducing:

- mandatory invoicing for all activities and certified invoicing programs for companies with revenues greater than EUR 100,000;
- mandatory reporting of merchant POS transactions by banks to tax administration;
- system for cross-checking VAT declarations with credit card transactions from the banks.

Bulgaria: Budgetary Measures

In almost all reports on the preparation and/or the implementation of the national budget, there is a 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 as one of 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 2014. There are three measures envisaged by the government, which follow up on this priority:

- (a) reverse VAT charge for deals involving grain-producers in the country;
- (b) increased fiscal control over high-risk type EU import goods;
- (c) accounting for VAT upon final customer cash realization.

While these measures target rightly the most vulnerable tax and can improve budget revenues, they are unlikely to change the overall business environment, and hence the level of hidden economy in the country. The success of the measures hinges critically on the ability of the government to end political protection over selected companies involved in VAT fraud, in particular at the local level. The government’s expectations for the first measure are for VAT gap to be reduced by BGN 200-300 mln of the estimated by the EC BGN 1.25 bn annual VAT gap.¹⁷ The second proposal calls for increased fiscal control on EU imports for which there is a considerable level of suspicion for large scale tax avoidance schemes while the third measure is quite similar to the first as it is focused to tax crediting small and medium VAT-registered enterprises. If these measures yield the expected results and provided that the projected in the Budget 2014 report ambitious GDP growth of 1.8 % is reached, it can be expected that VAT growth will approximate the predicted by the government 8.5 % increase in 2014. At the backdrop of this focus on VAT, the projected excise income is modest at best, and does not concur with the reported strong government will to tackle problems with smuggling.

Box 2. Efficiency of Regulatory Agencies

When it comes to countering the hidden economy two agencies have been front-stage and have faced increasing scrutiny – the National Revenue Agency (NRA) 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 an increasing number of preventive and educational measures.

¹⁵ AT Kearney, *The Shadow Economy in Europe, 2013*, available at: http://www.visaeurope.com/en/about_us/idoc.ashx?docid=4d53b726-cd71-4ba5-a50b-735d11ca4075&version=-1

¹⁶ Steiner, Viktor and Katharina Wrohlich, *Work Incentives and Labor Supply Effects of the ‘Mini-Jobs Reform’ in Germany*, DIW-Diskussionspapiere, No. 438, 2004, available at: <http://www.econstor.eu/bitstream/10419/18290/1/dp438.pdf>

¹⁷ See Footnote 10.

In 2012, the NRA published a detailed annual report¹⁸, which contains data on control and enforcement activity. The NRA has tried to come up with some more complex efficiency and risk management indicators, a tendency, which should be encouraged and broadened. According to NRA's annual report, the NRA has made 220,578 control checks in 2012, compared to 227,230 checks made in 2011, a decrease of around 3 %. However, there was an increase in investigative checks with almost 3 %. A particularly high growth has been witnessed – 243.8 % growth in social security enforcement related checks as this had been one of the proclaimed NRA's priorities for 2012. The increase in hidden social security in 2013 shown by the hidden economy indexes demonstrates clearly that enforcement measures have not produced sustainable results. The number of revisions made in 2012 was 13,418, almost flat from the previous year (13,232 in 2011). The report revealed that hidden income as a result of regulatory checks and revisions was BGN 3.072 bn compared to BGN 3.097 bn in 2011. It is unclear though how much of these findings are confirmed by courts and enter into force, and how much get collected later on. There was a decline in on-the-spot surprise visits and operational checks of 16 % in 2012. The corresponding decline in ordering fines has gone down from BGN 5.8 mln to BGN 4.7 mln (17 % decrease). Sanctions have also showed a 10 % decrease and accounted for BGN 3.4 mln in 2012. The decrease in on-the-spot checks and sanctions have been brought about from the introduction of strategic planning. There has not been any evaluation of the burden of the inspection activity of NRA on the business nor of the efficiency of the different control measures.

CLI's annual report¹⁹ is less detailed and less customer friendly than NRA's. From the information in the report, it becomes clear that in 2012, CLI has made 56,431 checks, 3,236 more than the checks made in 2011. 258,546 violations have been found, of which 56.7 % have been labor law violations and 43 % – health & safety violations. Among the labor law violations, the biggest chunk are violations related to informal payment schemes (33,367 violations in 2012). From the report, it does not become clear if any and what punitive action has been taken.

From the rest of the regulatory agencies involved partially or entirely in regulatory work directly related to prosecuting hidden economic activities, the Bulgarian Food Safety Agency, Executive Forest Agency, Regional Health Inspectorates do not publish annual reports on their activity, while the National Construction Control Department publishes a report that hardly gives any information about targets and indicators for meeting those targets. Similarly, the Regional Environmental Inspectorates publish monthly data on their control work, which does not allow an evaluation neither of their burden on the business nor on their efficiency.

Confronting the Hidden Economy: Conclusions and Recommendations

In conclusion, the level and the public perception of the size of the hidden economy in Bulgaria has shifted upwards in 2013. CSD's Hidden Economy Index shows that 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 tax evasion sentiments. The bleak economic outlook continues to motivate cautious behaviour not only on the side of businesses but also

on behalf of politicians. Much overdue administrative and structural reforms are lagging behind. A collective of almost BGN 1.45bn annually is lost to VAT evasion and social security contribution gaps only and this is most probably an understatement as it is a product of rough approximations. 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 further motivate the existence of hidden and illegal activities throughout different segments of the Bulgarian economy.

Nevertheless, over the last 10 years, the hidden economy has shrunk and most of the decline has been

¹⁸ NRA, Annual Report, 2012.

¹⁹ CLI, Annual Report, 2012.

brought about by the rise of the official economy, e.g. economic convergence with the EU and 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.

As previously suggested by CSD,²⁰ 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. In

that regard, the envisaged for 2014 VAT tax measures seem to go in the right direction. However, they will have a rather isolated effect if not part of wider positive reforms motivating increasing participation in the official economy. Attention should be turned towards continuing the administrative reform within executive regulatory agencies towards more service orientation. At the same time, increasing levels of electronic payments and wider e-government penetration could serve as the natural remedy against informal economic activities. The ongoing failure of Bulgarian authorities to achieve consistent progress in that regard is unacceptable. Finally, there can be very little success in countering the hidden economy, if Bulgaria continues to have issues with corruption, organized crime and the efficiency of the judiciary.

Table 3. Government Revenue vs. Main Macro Indicators

Indicator (BGN million)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	Q1-Q2 2013*
GDP (Current prices)	60,185	69,295	68,322	70,511	75,265	77,582	35,975
Export Total	35,790	40,342	35,248	40,481	50,061	51,691	25,206
Export Goods	26,427	29,736	22,882	30,435	39,560	40,668	-
Export Services	9,363	10,606	9,576	10,046	10,501	11,023	-
Import Total	47,656	54,557	38,493	41,817	49,552	54,559	26,857
Import Goods	40,624	46,581	31,066	35,878	43,422	47,762	-
Import Services	7,032	7,976	7,427	5,939	6,130	6,797	-
Final Consumption Expenditure	51,532	57,496	54,293	55,709	57,392	61,963	30,428
Gross Fixed Capital Formation	20,519	26,015	20,063	16,138	17,364	18,487	7,198
FDI Total	17,700	13,157	4,766	2,251	3,416	2,539	1,256
EU Structural Funding	22	612	1,879	1,138	1,098	2,391	2,535
Total Government Tax Revenue	13,921	16,125	14,358	13,500	14,467	15,290	7,744
Execution of the Planned Tax Revenue (%)	110 %	96 %	76 %	100 %	101 %	99 %	47 %
Profit tax	1,677	2,060	1,617	1,243	1,356	1,395	960
Income tax	1,809	1,951	2,030	2,013	2,163	2,282	1,215
VAT	6,599	7,486	6,433	6,267	6,612	7,152	3,639
Excises	3,315	4,052	3,845	3,568	3,860	4,048	1,806

Note: * To be confirmed with FY data; official data, available only until Q2 2012.

Source: Ministry of Finance, NSI, BNB, Information System for Management and Observation of EU structural Funds in Bulgaria (www.eufunds.bg)

²⁰ CSD, The Hidden Economy in Bulgaria: 2011 – 2012, Sofia, 2013, available at: <http://www.csd.bg/artShowbg.php?id=16341>