



CENTER FOR
THE STUDY OF
DEMOCRACY

POLICIES TO COUNTER THE EFFECTS OF THE ECONOMIC CRISIS: HIDDEN ECONOMY DYNAMICS 2009

Policy Brief No. 20, December 2009

The hidden economy has been a central topic for discussion in the public space upon each amendment to the economic legislation and particularly before elections or the passing of the national budget. Nevertheless, aside from the Annual Hidden Economy Index released by the Center for the Study of Democracy and a few sporadic analyses by other non-governmental, academic and business organizations, there is a lack of an adequate government system of *ex ante* and *ex post* impact assessment of the proposed measures to fight hidden activities of the wider economy. The adjustments of GDP done by the National Statistical Institute aiming to include hidden economy in the system of national accounts are not made public and do not serve as a basis for decision-making¹.

Thus, public debates on hidden economy become little more than displays of rhetorical skills or actually serve completely different agendas rather than the implementation of measures to curb its negative impact.

MAIN POINTS

- The unstable macroeconomic environment in 2009 has led to unbalanced revenues of the state budget.
- In 2009 the hidden economy index of the business and the population display opposing trends. This is due to the effects of the economic crisis as well as to the measures taken by the government in the second half of 2009. It is indicative of heightened risk of increase in the share of hidden economy in the months ahead.
- The government should undertake a carefully balanced set of measures targeting hidden economy:
 - focusing on improving the rule of law and administrative capacity;
 - reforming the compliance, audit and control system to improve its effectiveness;
 - evaluating the costs and benefits of each action on the economy.

¹ NSI expert estimates provided for the CSD publication *The Hidden Economy in Bulgaria, 2004*, the hidden economy estimates included in the national account in Bulgaria in 2000 amounted to 16 % of GDP. Data from the same experts, reveals that the respective share has decreased to 9 % in 2007/8.

Such an approach to public policy debates could have a reverse effect – constant escalation of control and regulatory measures and ensuing expansion of the hidden economy. This would ultimately lead to public disappointment and shrinking of the scope of possible effective government action in the future.

The current analysis aims to outline a framework for policy assessment in the area of hidden economy by providing: 1.) an overview of the main macroeconomic imbalances related to the presence of hidden economy; 2.) the Hidden Economy Index values for 2002-2009; 3.) a summary of the measures to tackle hidden economy proposed in the past three years and a commentary on the expected effectiveness of the latest package of measures proposed by the Bulgarian Government.

Hidden Economy and Macroeconomic Imbalances

After eleven years of continued growth, in 2009, the Bulgarian economy fell into recession. Economic decline was estimated at 6 % in 2009 and 1 % in 2010². Even before the onset of the crisis there were plenty of indications of unproductive use of human and capital resources pointing to the presence of a sizeable hidden economy. In 2009, the number of people of active age (aged 18 – 64) left outside the official labor market either because they declared they do not seek employment (economically inactive) or because they were discouraged

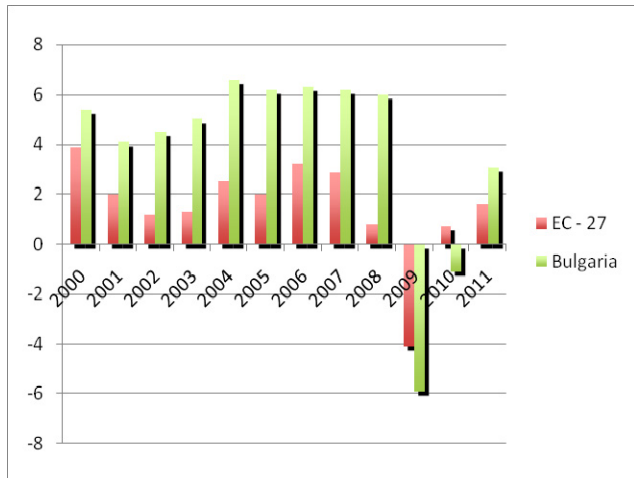
² Autumn Economic Forecast 2009 – 2011: EU Economy on the Road to Gradual Recovery, European Commission, 2009; World Economic Outlook October 2009, International Monetary Fund; Agency for Economic Analyses and Forecasting, Sofia.

exceeded 1.7 million. Providing formal employment to these persons at the average pay rates in the private sector for the first three quarters of 2009 would generate additional labor income worth BGN 11.8 billion³, or 18.6 % of the expected GDP in 2009⁴. In addition, official figures for the first three quarters of 2009 show a substantial difference of roughly 30 % in remuneration levels between the public and private sectors. Assuming that actual pay rates in the private sector are at least equal to those in the public sector, the annual unreported labor income would amount to BGN 3.3 billion or 5.2 % of the estimated GDP for 2009. At the same time, the rate of utilization of manufacturing production capacity lags behind the EU rate by 10-15 percentage points. Bulgaria thus remains the country with the lowest labor productivity per employed person – at 36.5 % of the EU-27 average in 2009, and 11 percentage points behind the next-best ranking country, Romania. The crisis presents an opportunity for Bulgaria to close this gap but this calls for implementation of effective measures to tackle hidden economy.

³ Calculations have been simplified for the purposes of the analysis. In effect, the pay rate in the hidden economy is probably far lower than the one prevailing in the official economy in view of the greater inefficiency of the former. The estimate does not take into account the effects of taxation. However, these considerations do not affect the essential conclusions of the analysis.

⁴ Table: Chief Macroeconomic Indicators. Report under the National Budget Bill, October 2009, p. 15.

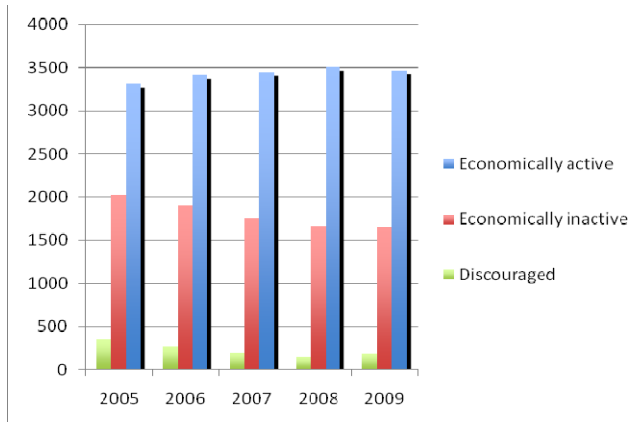
Figure 1: Real GDP Growth (% change on annual basis)



Note: Data for 2009 – 2011 are estimates.

Source: Eurostat.

Figure 2: Workforce Dynamics (in thousands)



Source: National Statistical Institute, Center for the Study of Democracy, 2009.

One of the most distinguishing features of the current global economic crisis is that it is impossible to predict its dynamics and effects over time. In such a complex macroeconomic situation it would be realistic to expect an increase in the share

of the hidden economy due to several concurrent **factors**⁵:

- The pressure on company revenues heightens the motivation to evade due taxes and social security contributions in order to preserve profit margins and competitive standing. The rising rate of unemployment in the past few months indicates that it is relatively easy to layoff staff in Bulgaria, which is a deterring factor against rising hidden employment. Bulgaria comes second only to the Czech Republic on the ease of hiring and firing personnel⁶. At the same time, it was one of the few EU member countries, which displayed continued substantial increase of labor costs during the first half of 2009. Even though such a tendency is considered normal in the mid- and long-term, taking into account the far lower pay levels compared to the EU average, in the short term, in the context of the crisis, this could lead to rising unemployment and pressure to underreport employment and part of the remuneration, which would also lead to loss of social protection. As of the second quarter of 2009, the Labor Cost Index of Bulgaria marked

⁵ For a more detailed discussion of the factors and expectations regarding hidden economy dynamics in 2009, see *Levelling the Playing Field in Bulgaria. How Public and Private Institutions Can Partner for Effective Policies Targeting Grey Economy and Corruption*, Policy Brief 15, Center for the Study of Democracy, May 2008 and *Round Table: The informal economy in Bulgaria: Policy responses in an economic crisis*

(<http://www.csd.bg/artShowbg.php?id=9514>).

⁶ Doing Business 2010, The World Bank.

the highest value in the EU – 113.5, against the EU-27 average of 102.5⁷.

- The shrinking business activity leads to lower state budget revenues which may in turn entail deterioration in the quality of public services, including poorer performance of regulatory compliance, control and audit procedures. The consolidated budget balance deteriorated in 2009 and the trend is likely to worsen by the end of the current year and in 2010⁸. Annual revenues may fall short of budget targets by 20-22 %. As a result of the drastic shrinking of imports, exports, and domestic consumption, indirect tax revenues, which normally account for more than 50 % of budget revenues, have been lagging behind significantly in 2009⁹.

On the other hand, **factors acting in the opposite direction** (towards lowering the share of the hidden economy) are also at play: 1.) in the crisis, unreported activities will shrink at a faster rate than the official rate of decline because of the lower transaction costs of suspending such activities. For instance, it is far easier to lay off an undeclared worker or undocumented supplier or

customer with whom no formal contract has been signed and turnover has not been reported than severing legally binding contractual relations. 2.) the rate of entry of companies into the hidden economy as a result of the crisis will probably be lower than the rate of exit from the market or transition to other forms of hidden economy by the informal economic agents. The actual values of these rates will depend very much on the performance of the regulatory compliance, control and justice administration systems in the country, on the duration and severity of the crisis, as well as on the measures undertaken by the government.

Hidden Economy Index 2009: Components and Dynamics

Since 2002 the Center for the Study of Democracy and Vitosha Research have been calculating and publishing the hidden economy index of the business and the index of unreported economic activity of the population, comprising of the following elements¹⁰:

1. Size of the hidden economy – summarizes the subjective perceptions of business representatives of the scope of hidden economy in the country in general,

⁷ Source: Eurostat. Labor cost index shows the short-term development of the total cost, on an hourly basis, for employers of employing the labor force. The index covers all market economic activities except agriculture, forestry, fisheries, education, health, community, social and personal service activities (2008 = 100).

⁸ International Monetary Fund, Bulgaria – September 2009 Staff Visit, Concluding Statement, Sofia, September 21, 2009.

⁹ Report under the National Budget Bill, October 2009.

¹⁰ The business indexes comprise all four elements while those on the general population include only the hidden turnover and hidden employment. The Hidden Economy Index produced by the Center for the Study of Democracy and Vitosha Research Agency has gained acknowledgement in Bulgaria and Europe as a reliable gauge of the dynamics of the hidden economy in this country. It served as a model in designing the first community survey of undeclared work in the EU in 2007. More details about the structure and methodology are available in *The Informal Economy in the EU Accession Countries*, Center for the Study of Democracy, 2003.

as well as in their respective industries and sectors.

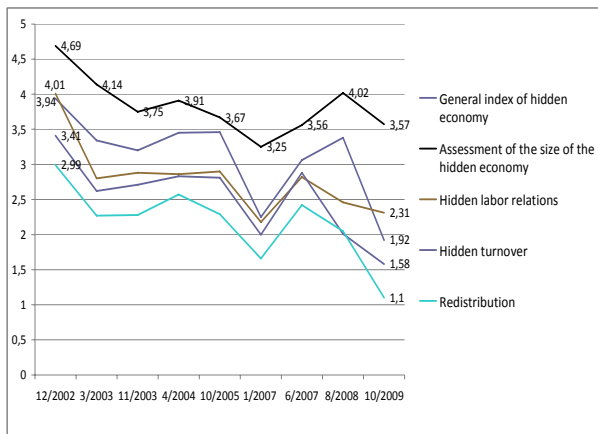
2. Hidden employment – registers the practice of hiring workers without formal employment contracts or under contracts with underreported remuneration (envelope wages).

3. Hidden turnover – summarizes the incidence of various practices of concealing turnover in the respective industry or sector.

4. Hidden redistribution - summarizes the practice of tax, customs and excise duty evasion or non-payment, as well as the existence of VAT fraud schemes.

The comparative analysis of the Hidden Economy Index size and dynamics over time, both in business and population, allows important conclusions to be drawn about the impact of the implemented policies to tackle these practices.

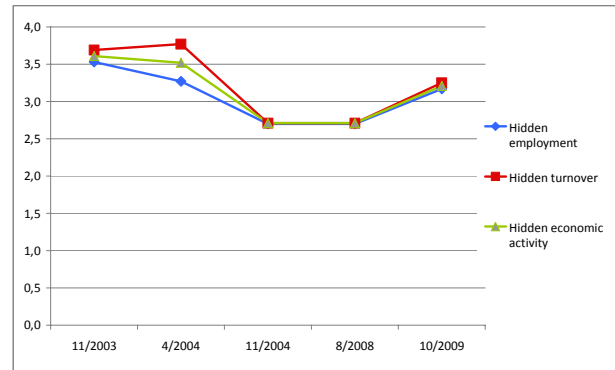
Figure 3: The Hidden Economy Index 2002-2009



Note: The 2008 Index values are based on telephone interviews. All other values are based on data from face-to-face interviews.

Source: Hidden Economy Survey on Business 2009, Vitosha Research, Center for the Study of Democracy.

Figure 4: Index of Unreported Economic Activity of the Population 2003 – 2009.



Source: Hidden Economy Survey on Population 2009, Vitosha Research, Center for the Study of Democracy.

In 2009, the Hidden Economy Index of the business sector and its components and the index of unreported economic activity of the population displayed opposing trends. This seeming contradiction can be explained by the effects of the crisis and the measures undertaken by the government to counter the hidden economy in the second half of 2009. On the one hand, the latter are largely targeted at hidden business turnover. On the other hand, the crisis tends to affect differently over time the population and the business. In the short run it leads to higher incidence of employment and turnover concealment among the population and reduction in the hidden economy in the business sector. The transition from formal to informal economy is far less costly to the population than to businesses. Furthermore, the population indexes are more sensitive to changes in the labor market than to those in product markets and tend to be more victimizational (behavioral) compared to the more perception-based ones in the case of the

business¹¹. The dynamics of the respective sub indexes reveal in greater detail the processes in the Bulgarian economy, including the impact of the measures taken by the government to counter the hidden economy:

1. The perception of the share of hidden economy in the country as a whole is generally more negative than sector-specific assessments

As in previous years, business representatives tend to perceive the scope of the hidden economy in general as larger than in their own specific sector of operation. This reveals a general mistrust in state institutions on the part of the business community and the uncertainty of the business environment in Bulgaria. In 2009 this indicator marked certain improvement, possibly on account of restored political stability in the country after the formation of the new cabinet and of heightened government and media attention to the issue of hidden economy in recent months. For instance, in 2009 there were more than 2,500 news articles referring to informal, grey, or hidden economy. By comparison, their number was about 1,000 in 2008 and less than 500 between 2002 and 2007.¹²

2. A slight increase in hidden employment

The trend is more conspicuous in population indexes and in terms of unreported additional income (envelope wages). Regarding the hiring of workers without labor contracts, there is little change and even a certain deterioration among the

population in the past year. The increase in hidden employment is an expected effect of the global economic crisis in the short run. Yet it is not as straightforward for companies as it is for employees since in a downturn the quickest way of reducing costs is to terminate unreported or informal contracts first and then proceed to cut back on official employment and to hiding part of the official remuneration. At the same time, in order to secure additional income and/or keep their jobs, at times of crisis workers are inclined to accept far from optimal pay and working conditions. In the mid and long run both business and population indexes on hidden employment tend to converge.

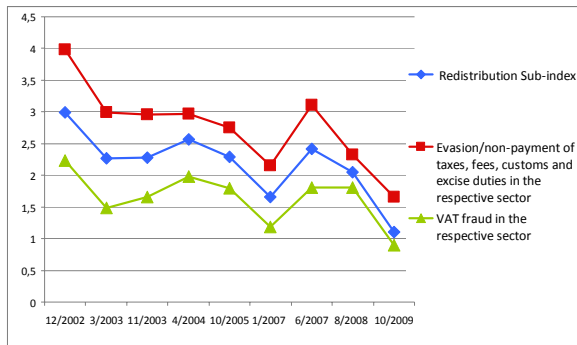
3. Hidden Turnover on the Decline

The drop in hidden turnover in the business sector is the most conspicuous development in 2009, especially regarding the sub indexes related to illegal import and export, as well as VAT fraud. In this respect the effect of the crisis is sustained by the hard-line measures to uncover unreported turnover undertaken by the government in recent months. On the one hand, the crisis brought about a dramatic drop in export and import volumes, which, in the short-term, typically leads to discontinuing of undeclared or informal contracts. On the other hand, the government intensified control to enforce excise-duty and VAT-related compliance, accompanied by a massive media campaign. It should be noted that for the first time since the index was introduced, its value concerning hidden import, excise duties and VAT fraud has halved.

¹¹ Victimization surveys reflect more accurately the real situation and behavior of those surveyed. Perception surveys allow more room for expression of subjective attitudes.

¹² Based on data obtained through Google archive searches on 30.11.2009.

Figure 5: Dynamics of the Redistribution Sub-index and Its Constituent Components



Source: Hidden Economy Survey on Business 2009, Vitosha Research, Center for the Study of Democracy.

Hidden Employment

According to the members of the Bulgarian business community in the past seven years the proportion of employees working under registered employment contracts has more than doubled - from 21.2 % to 46.9 %. This favorable trend has been stable and sustained throughout the period. The initial decisive factor in this respect was the mandatory registration of employment contracts introduced in 2003. Since its introduction, the number of registered employment contracts has approximated the number of employees recorded by the Employment and Unemployment Survey of the National Statistical Institute (NSI). Nevertheless, in mid-2009, nearly one-fourth of the respondents thought that up to 10 % of the employed were working without contracts and almost one in five believed their share exceeded 25 %. The 2009 data registered an additional drop of 8.5 percentage points in business respondents' assessment of the share of those working without contracts. According to the business representatives, by September 2009 the economic crisis in the country had not led to increased incidence of employment without contract. **A more serious problem is the practice of**

concluding employment contracts stating the minimum salary, which then serves as the basis for social security contributions while additional remuneration is offered in cash. The incidence of underreported employment income (envelope wages) is highest in services and in retail. The share of underreported wages in construction comes close to that in services while it is lowest in manufacturing.

Figure 6: Dynamics of the Indexes "Hired Without Contract" and "Hired Under Contract with Hidden Clauses" in the respective sectors over the period 2002-2009 (min=0, max=10)



Source: Hidden Economy Survey on Business 2009, Vitosha Research, Center for the Study of Democracy.

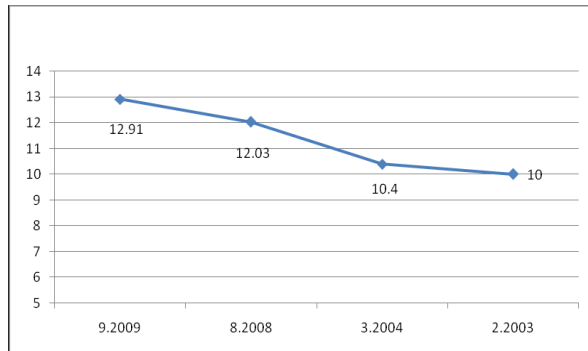
In the past years the share of those working without contract has remained relatively stable (about 6 % of all employed)¹³. In the case of secondary jobs, the share of those without contracts is considerably higher than among those with only primary jobs. Half of the people with secondary jobs did not have an employment contract in 2009, which however is a considerable drop from 2003 when their share exceeded three-fourths (77.4 %). Another aspect of hidden employment that appears to be on the rise is the payment of remuneration different from the one stated

¹³ According to the Hidden Economy Survey on Population by Vitosha Research.

in the employment contract. **At least one in ten employees receives “hidden” remuneration higher than the declared pay rate.** Underreported remuneration is also related to non-payment of social security contributions.

Figure 7: Share of Incidence of Payment of Remuneration Higher than the Stated in the Contract under Primary Employment in the Past Month (%)

(In the past month, have you received remuneration higher than the stated in the contract with your primary employer?)



Source: *Index of the Hidden Economy on Population 2009, Vitosha Research, Center for the Study of Democracy.*

During the period 2003-2009 the share of the employed, which were socially ensured on the basis of pay rates lower than their actual remuneration nearly doubled. The increase was most pronounced in the period of economic downturn of 2008-2009. Respectively, the share of those ensured on the basis of their actual remuneration fell by close to 12 % in six years and again the drop was most substantial in 2009. The economic crisis has led to an increase in hidden employment and undeclared work in particular. The share of undeclared work in Bulgaria (about 25 % for 2007 by estimates of the Center for the Study of Democracy) is among the highest among the countries of

the European Union¹⁴. Comparable levels of unregistered employment are found in Greece (25-40 %), Hungary (25-35 %), Poland (more than 25 %), Romania (20 %), and Slovenia (17-25 %).

Table 1: Base Amount for Payment of Social Security Contributions under Primary Employment (%)

(What is the base amount for social security contributions under your primary employment contract?)

	9/2009	8/2008	3/2004	2/2003
The minimum social security threshold, although the total sum of my remuneration is higher	12,9	13,5	13,4	12,1
The minimum social security threshold, which is what I am actually paid	12,6	9,5	14,3	10,3
The amount stated in my contract even though the total sum of my remuneration is higher	15,5	15,0	8,3	6,7
The amount stated in my contract, which is what I am actually paid	56,2	61,8	63,4	68,3
Other	2,8	0,3	0,6	2,6
Base	395	378	314	348

Source: *Index of the Hidden Economy – Population 2009, Vitosha Research, Center for the Study of Democracy.*

¹⁴ According to data of the European Industrial Relations Observatory.

Measures to Tackle the Hidden Economy

The state of the Bulgarian economy in 2010 will largely depend on the effects of the global economic crisis and the impact of the anti-crisis measures undertaken by the Bulgarian government. One of the main negative effects of the economic decline was the shrinking of budget revenues due to reduced economic activity. The measures announced by the government aim to balance the budget by limiting expenditures and improving revenue collection. In this context, the measures to tackle the hidden economy could play an instrumental role in improving the rate of revenue collection. In October 2009 the Government approved a package of 76 anti-crisis measures with a time span till April 2010. The list of proposed and adopted measures is rather ambitious and only a few have the potential to achieve a tangible impact on the share of the hidden economy and hence, on the income side of the 2010 budget. International good practices lean in favor of a more limited set of measures with more rigorous enforcement. The Bulgarian Government should therefore focus on fewer measures, but it has to ensure closer control over their implementation. This not only calls for an appropriate system of policies but also a respective system to monitor progress and the cost of the implemented measures (in terms of human and financial resources spent by the public and private sectors). The dynamics of the Hidden Economy Index and of the unreported economic activity of the population can serve as basis for a macro-assessment of the measures taken by the government and the private sector to address the adverse effects. This calls for a

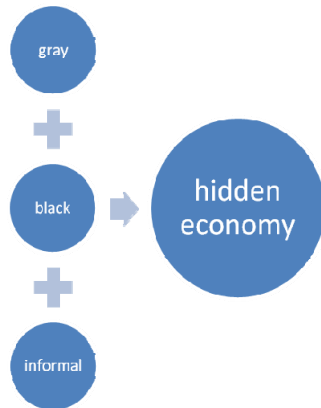
clear grasp of the principles of operation of the hidden economy and an impact assessment of the measures implemented in the past.

The Hidden Economy: Basic Principles of Operation at Time of Crisis

The hidden economy may provisionally be divided into three dimensions: 1) grey economy, consisting of legal activities conducted by legal business entities which however do not report the full scope of their operations to the authorities and/or do not conform to the established legal requirements in their area of activity. The purpose is typically tax evasion, cost reduction or the gain of some other competitive advantage; 2) black economy, consisting of illegal activities (explicitly banned by law) and/or activities conducted by illegal business entities; 3) informal economy, consisting of legal economic activities that are not declared to the authorities on account of their specific nature, such as home produced goods, repairs, etc.¹⁵ The three forms of hidden economy are inextricably linked to the official economy and the implementation of adequate measures to curb their adverse impact inevitably affects the operation of the legal business entities, as well. The respective measures therefore need to be carefully targeted and should be subject to preliminary impact assessment.

¹⁵ *The Hidden Economy in Bulgaria*, Center for the Study of Democracy, Sofia, 2004.

Figure 8: Components of the Hidden Economy



Source: Center for the Study of Democracy.

The studies of the behavior of the hidden economy and how it affects the official one point to the presence of a so-called double business cycle. When the official economy is growing the hidden economy gradually drops to a certain minimum level corresponding to the existing discrepancies between administrative regulation and economic realities and conversely, the share of hidden activity tends to increase in the case of persistent decline in the official economy¹⁶. These observations do not concern the size of the hidden economy in absolute terms as it may grow or shrink regardless of its relative share in the economy.

The reasons for the presence and development of the hidden economy essentially fall into two main groups: 1.) market entry costs (registration fees, bribes, permits and licenses, ensuring utility access, hiring workers, etc.) and 2.) costs of market operation in full compliance with all legal requirements (payment of taxes and social security contributions, conformity to labor

¹⁶ Russo, F., *Double Business Cycle: The Hidden Economy in the US*, Boston University, 2008. Similar conclusions are reached by Giles (1999) and Tanzi (1983).

legislation and the various sector-specific regulations, etc.)¹⁷ The bulk of the hidden economy is due to the barriers to market entry and the smaller part – to market operation costs (taxes and labor legislation).¹⁸ An important presumption for these conclusions to be valid is that control and law-enforcement systems ensure a high level of compliance with legal regulations of the companies in the official economy and present a real threat to businesses operating in the hidden economy. An assumption, which does not hold true in Bulgaria. According to the Bulgarian business, the most important reasons for the existence of hidden economy are: 1.) the presence of corruption; 2.) the lack of sanctions on illegal activity; 3.) the inefficient court system; and 4.) the presence of organized crime. The presence of corruption and organized crime combined with non-penalization and inefficient court system undermine the rules of the game and render the control system ineffective. Getting out of such a situation calls for an innovative approach and high resolve.

Historical Overview of the Measures

In the past three years, 220 measures to tackle the hidden economy have been publicly proposed. These proposals have come both from the government and in the form of expert opinions from business and

¹⁷ For a more thorough analysis of the reasons and results of the presence of hidden economy, see Enste, D. *Shadow Economy and Institutional Change in Transition Countries — in The Informal Economy in the EU Accession Countries*, Center for the Study of Democracy, 2003.

¹⁸ Russo, F., *The Cost of the Legal System and the Hidden Economy*, Boston University, 2008. Similar conclusions are drawn by La Porta and Shleifer (2008), Becker (1978) and DeSoto (1989).

the trade unions. Based on successful practices in the EU, these can be grouped together in four clusters: 1.) administrative, 2.) monitoring and sanctions, 3.) prevention, and 4.) remedial.¹⁹ The measures to monitor and sanction (64) and the preventive ones (127) predominate. Set against the successful practices and policy systems in the EU, the following problems can be identified in Bulgaria as regards the measures to tackle the hidden economy:

1. A long list of proposals and measures without prior assessment

Historically, the approach for designing the programs to tackle the hidden economy has typically been to put together a large number of measures and proposals without conducting a thorough impact assessment. There have been a great many public forums discussing broadly ranging measures which are subsequently put forward by the government. Yet, there has been no critical assessment of these steps: Which of them have proven successful in the past? How much will their implementation cost be? What negative consequences they may have? How will their effectiveness be monitored? What is their expected collective impact? Good practices suggest that it is more worthwhile for a comprehensive program to comprise fewer measures but make sure they are the right ones and provide for rigorous control over their implementation.

¹⁹ Measures to Tackle Undeclared Work in the European Union, European Foundation for the Improvement of Living and Working Conditions, 2008.

2. Economic incentives and prevention are not backed by administrative measures

Bulgarian experience to date and the dynamics of the hidden economy index suggest that the economic measures intended to stimulate business, such as the flat tax, reduced social security and tax rates, have at best limited success unless they are accompanied by tangible improvement of monitoring and effectiveness of the control. On the other hand, in many of the cases the measures to encourage voluntary compliance are accompanied with and rendered pointless by an increased administrative burden, as in the case of the combination of reduced social security rates with higher administratively set minimum social security thresholds. Less attention is devoted to the introduction of administrative regulations that could on one hand alleviate the indirect burden on business resulting from compliance costs with existing legal regulations (red tape reduction, etc.) and on the other hand would set down clear-cut rules for entering the formal economy (mandatory registrations, etc). Bulgaria is among the countries with the lowest general tax rates in the EU yet ranks worst in terms of the time necessary to fulfill tax obligations²⁰.

²⁰ Paying Taxes 2010: the Global Picture, International Finance Corporation, PriceWaterhouseCoopers, 2009. The Report draws on the World Bank Doing Business database to assess the tax-and-security burden in the EU. In terms of the total tax rate Bulgaria has the lowest rate after Luxembourg, Ireland, Cyprus and Denmark. But it has the poorest record in the EU in terms of the time necessary for voluntary fulfillment of tax obligations.

3. Lack of assessment of the local specifics

Good practices suggest that there is no universal solution to uncovering the hidden economy - what has actually worked in some countries has proven ineffective in others. In other words, when developing a sound policy system it is necessary to take into account the national specifics as well - both economic and socio-psychological ones. The measures that have been found productive elsewhere need national adaptation. It should, for instance, be borne in mind that more than 90 % of the Bulgarian companies are micro-enterprises with up to 9 employees for which the chief motivation is survival rather than business growth. Other aspects to take into account when considering measures is the high level of mistrust in the institutions on the part of the public and the business, the poor quality of public services, as well as the limited capacity and low remuneration of public administration personnel.

4. Plenty of measures, no system

The overview of the existing and proposed measures and policies in the past three years reveals the lack of a strategic and consistent approach. The list of proposed measures every year are grouped together thematically but how they interconnect remains unclear. There is no assessment of their collective impact, nor of their mutual interaction. Some may achieve rapid effect while others aim to permanently change behavioral models and could only have an effect over the long run. In this sense, it is necessary to compile a balanced and well thought-out portfolio of measures. What we see instead is a chaotic and ambitious list of measures lacking a cost-benefit analysis and

an assessment of each measure as part of a comprehensive system.

5. Cost-Benefit Analysis

The individual measures have not been subject to cost-benefit analysis. The adoption of most of these measures would entail additional expenditures both for the government and for individual businesses and citizens. Yet, there has been no assessment of the balance between the costs for the implementation of measures and their effectiveness. Such an analysis is indispensable in order to ensure the right allocation of the efforts and resources of the public administration.

For more detailed overview of the existing and proposed measures in the last three years please see Appendix 1: Measures to Tackle the Hidden Economy Proposed in 2008/2009.

The Bulgarian Economy in 2010: Measures to Tackle the Hidden Economy

In the second half of 2009, the Bulgarian Government announced a series of measures aimed to curb the hidden economy. Based on the figures of the hidden economy index for the period 2002-2009 and on the conducted analysis of the effectiveness of counter measures targeting hidden economy proposed in the past, it is possible to draw several conclusions regarding the effect of the latest package of measures put forward by the Government:

- Enhanced control in high-risk areas of VAT and excise duties is already producing results. According to the Hidden Economy Index the share of hidden economy has dropped, particularly with regard to

undeclared import, excise duties, and VAT fraud. Despite the slump in import and the related revenues from customs duties and VAT (decline on an annual basis of 45 % and 43 %, respectively, in the first nine months of 2009), the revenues from excise duties remain largely the same compared to 2008 (with a drop of 5 % only)²¹. In the first half of 2009 alone, the National Revenue Agency recorded a threefold increase in VAT fraud, which is probably due to improved control rather than higher incidence of VAT fraud attempts²². It is particularly important to make progress in this respect since the more companies evade payment or engage in VAT fraud, the further the “grayness” will spread along the chain of added value²³.

- Tighter control will only have short-lived effect in terms of curbing the hidden economy unless steps to enhance its effectiveness and to ensure voluntary compliance on the part of business accompany it. A key factor for the sustainability of the results would be the enforcement of effective sanctions against notorious high-ranking offenders involved in political corruption. In this sense, control authorities need to focus their efforts on major offenders seeking close interaction

with the Ministry of Interior and the Prosecutor General’s Office²⁴. The main priority in the efforts to reduce the size and scope of hidden economy in Bulgaria today should be reinforcing the rule of law. The greatest challenge in this respect is the need to sever unregulated relations between high-ranking law-enforcement officials and the gray business, i.e. eliminating the loops of companies, particularly in excise goods and public-private partnership sectors, such as tobacco and alcohol industries, construction and infrastructure, energy, etc.

- At the same time, it is necessary to seek a permanent change in the perception of the hidden economy in terms of costs and benefits by the citizens and businesses. To this end, it is of key importance to reform the control system and improve the effectiveness of its performance. An important element of such reform should be improving the services provided by the control system and better targeting of its inspections and sanctions. At present most government control institutions act and are perceived by the public and business as repressive bodies rather than service providers. The focus of their activity needs to

²¹ Source of the data, Customs Agency, quoted in Capital Weekly.

²² Source of the data, National Revenue Agency, quoted by bTV.

²³ De Paula, A., J. Scheinkman, The Informal Sector, Working Paper 13486, National Bureau of Economic Research, 2007.

²⁴ For a more detailed discussion and proposed comprehensive measures to counteract corruption and organized crime and the related hidden economy, see *Crime without Punishment: Countering Corruption and Organized Crime in Bulgaria*, Center for the Study of Democracy, 2009 and *Organized Crime in Bulgaria: Markets and Trends*, 2007.

change with more of their investigative and punitive capacity devoted to identifying and punishing major offenders, including through interaction with the court and law-enforcement authorities. Regarding widespread minor violations of the regulations more efforts should be devoted to raise awareness of rights and obligations among citizens and businesses and to promote voluntary compliance. The reform implemented along these lines at the National Revenue Agency demonstrated that successful implementation necessitates the engagement of significant expert resources over a period of 7-10 years. If the power of corruption pressure is to be contained, these reforms need to be combined with restructuring of the respective agencies. The government should introduce greater financial incentives for employees so as to avoid the situation in which the actual compensation of public administration officers is times lower than their minimum personal level of corruption resistance pay²⁵.

- It should be noted that the sanctioning activity of control authorities considerably increases compliance costs of legal and small businesses and may actually be conducive to corruption and

hidden economy. Thus, for instance, in 2008 the Chief Labor Inspection Office conducted more than 34,000 inspections, which means nearly 100 % coverage of the companies paying the bulk of the taxes in this country²⁶. Such mass coverage of business by control agencies is ineffective and can hardly lead to sustainable reduction of hidden economy, yet it is a common practice in the entire control system in this country. On the contrary by improving risk analysis, in 2008 the National Revenue Agency increased the number of established violations from 60,163 (2007) to 88,600 (2008) while conducting 86,000 fewer checks compared to 2007.²⁷ Even in this case the number of checks remains imposing. In this respect control authorities should adopt standard systems of monitoring and assessment of implemented policies and control measures, incl. those aimed at reducing hidden economy. The assessment of the impact of a given measure could be structured around two pillars - implementation process efficiency, i.e. the rational use of resources for the achievement of optimal results, and output effectiveness, i.e. the broadest possible scope and effect of the result achieved in terms of clearly set goals. The main purpose of such a system would be

²⁵ For more detailed discussion and analysis, see *Corruption and Tax Compliance. Policy and Administration Challenges*, Center for the Study of Democracy, 2005.

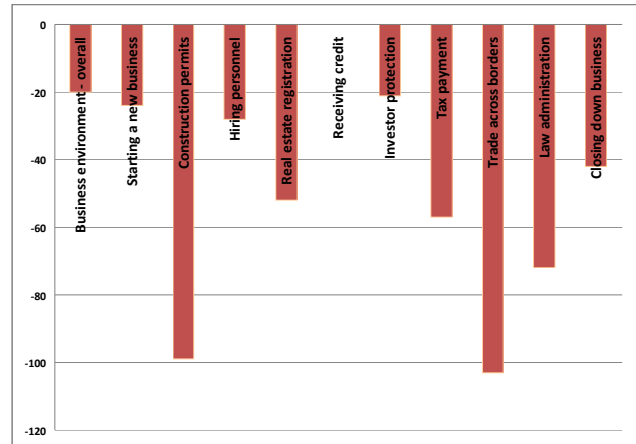
²⁶ According to interviews in the media by the NRA Executive Director, about 6,500 companies account for 90% of the tax revenues.

²⁷ Yearbook of the National Revenue Agency 2007-2008.

to optimize the process and reduce resource expenditure, particularly in control and sanctioning activities.

- The focus of government policy aimed at tackling the hidden economy needs to broaden to take in the entire control system. As it is, most of the attention falls on control authorities immediately concerned with national budget revenue - the National Revenue Agency, Customs Agency, and Chief Labor Inspection Office. It is important for other control agencies to come under the limelight as well since they determine the cost of market entry and operation for businesses - the National Construction Control Directorate, Regional Inspections for Public Health Protection and Control, National Veterinary-Medical Service, Regional Environment and Water Inspection Offices, etc. A first step in that direction could be that all agencies be obliged to post information and data about their activity at least annually on their websites.

Figure 9: Conditions of Doing Business in Bulgaria: Difference in the Country's Position Compared to the Highest Ranking Country of the New EU Member States



Source: World Bank, Center for the Study of Democracy.

- At the same time, it is necessary to conduct a performance assessment of the agencies engaged in government property and expenditure management since they have the capability to significantly alter the competitive structure of the market and their involvement in corrupt practices tends to trigger a surge in gray practices in the private sector. Particular attention should be devoted to the authorities managing public procurement and concessions, such as the Public Financial Inspection Agency, the Public Procurement Agency, the Commission on Protection of Competition, the Chief Inspectorate at the Council of Ministers, etc. Upon inspecting 5 % of the 18,708 registered public procurement contracts awarded in 2008, the Public Financial Inspection Agency found violations in 71 % of the cases which implies either excessive formalization of the control process or the need to

put a total freeze on all public procurement procedures. With such a high rate of non-conformity with the law the most straightforward and market-based mechanism for putting a check on violations – pre-court appeals – appears to be blocked. In 2008, the Commission on the Protection of Competition, which is the body considering appeals against first-instance decisions, received 825 appeals (less than 5 % of all registered public procurement contracts awarded in the country), more than half of which it rejected and only suspended execution in less than 3 % of the cases. In effect, the numbers display a refusal of businesses to contest public procurement decisions. Whereas this hardly constitutes an insurmountable obstacle to large companies that can afford to resort to the court system, small businesses are practically denied access to appeal proceedings. In view of the ever-greater preventive role the Public Procurement Agency is to play in preliminary control over major public procurement contracts and those related to European Funds, it is necessary to try and **facilitate access to, and improve the efficiency of, the appeals mechanism in the case of smaller scale public procurement contracts**. This would provide an improved and more balanced approach to control the realization of the entire public procurement process.

- Last but not least, the government needs to introduce administrative measures in position to help reduce the share of hidden economy while

contributing towards the country's modernization, or the so-called administrative innovations. Besides the policies directly concerned with tackling hidden economy, particularly effective to this end are the policies for the development of human capital, new technologies, and innovations²⁸. One good practical example in this direction could be the introduction of non-cash means of payment using chip cards of cellular phones. It would be necessary to adopt administrative regulations setting a requirement for real time linking of fiscal devices to the tax administration system and for integrating the various non-cash payment devices with the fiscal device.

In order to achieve sustainable results in tackling the various forms of hidden economy, it is indispensable to assess the effectiveness of the adopted policies, of the implementing institutions, and of the individual measures. The proposed measures herein largely involve collection and improved processing of the information on the work of the public administration and could relatively easily be implemented under the Administrative Capacity and Technical Assistance Operative Programs. The first step – providing more information – has already been taken by the Bulgarian government by declassifying and releasing information on the activity of most control agencies. What remains is the easier part.

²⁸ La Porta, R., A. Shleifer, *The Unofficial Economy and Economic Development*, National Bureau of Economic Research, WP 14520, 2008.

Measures to Tackle the Hidden Economy Laid Down in the 2010 Draft Budget

The goals of fiscal policy in 2010 are:

- encouraging business and investment activity by preserving the direct tax rates combined with reduced social security burden on employers in support of economic growth and employment;
- improving the tax and social-security contribution collection rates and reducing the share of the gray economy.

For achieving these goals the Government envisions the following specific measures:

- Increasing certain excise duty rates in line with agreements with the European Commission
- Reducing the general social security burden by 2 percentage points. Increasing the minimum social security threshold from BGN 260 to BGN 420, and BGN 240 for agricultural producers;
- Increasing monthly compensation payments in the event of bankruptcy from BGN 600 to BGN 720 (three minimum monthly salaries);
- Abolishing tax concessions for large-scale investors in certain sectors;
- Increasing the tax rate on gambling revenues;
- Introducing a minimum term of 3 years of possession of housing as a condition for tax exemption upon sale or exchange of the property;
- Mandatory declaration of loans exceeding BGN 5,000 between private individuals;
- Computerization of excise goods monitoring through the specialized Excise Movement and Control System;
- Distance connection between cash register devices and the National Revenue Agency (NRA);
- A series of measures concerning excise duty rates on motor fuels; fiscal storage facility management; ethyl alcohol production in small distillation facilities with up to 500L capacity;
- Strengthening administrative control, introducing stricter penal regulations and increasing the capabilities of customs officers;
- Reducing the initial capital of commercial companies to 2 Leva (implemented);
- Speedier reimbursement of VAT – from BGN 620 million (on July 27, 2009) to BGN 200 million by October 2009;
- Establishing centralized management of concession activity under rigorous control;
- Amending the Law on Public Procurement with a view to eliminating inconsistent and non-transparent procedures, eliminating the distinction of small-scale public procurement, and reinforcing the role and powers of the Public Procurement Agency.

Source: Report under National Budget Bill, October 2009

Appendix 1: Measures to Tackle the Hidden Economy Proposed in 2008/2009

