

# Tackling the Undeclared Economy in Bulgaria

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A baseline report

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## List of abbreviations

BCCI - Bulgarian Chamber of Commerce and Industry  
 BIA - Bulgarian Industrial Association  
 BICA – Bulgarian Industrial Capital Association  
 BSMEPA – Bulgarian Small and Medium Enterprises Promotion Agency  
 CEIBG - Confederation of Employers and Industrialists in Bulgaria  
 CITUB – Confederation of the Independent Trade Unions in Bulgaria  
 CSD – Center for the Study of Democracy  
 CT Podkrepa – Confederation of Labour “Podkrepa”  
 ESC – Economic and Social Council  
 EVS – European Values Study  
 FTR – Formalization Tax Rate  
 Eurofound – European Foundation for the Improvement of Living and Working Conditions  
 GLI – General Labour Inspectorate  
 ILO – International Labour Organisation  
 IMD – Institute for Management Development  
 IME – Institute for Market Economics  
 LARACEAA – Act on Limiting Administrative Regulation and Administrative Control on Economic Activity  
 MIMIC – Multiple Indicators Multiple Causes  
 MLSP – Ministry of Labour and Social Policy  
 MSIT – Minimum Social Insurance Threshold  
 NRA – National Revenue Agency  
 NSSI – National Social security Institute  
 SNA – System of National Accounts  
 SOCTA – Serious and Organised Crime Threat Assessment

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## Executive Summary

This report provides a systematic review of available evidence on the extent and nature of the undeclared economy in Bulgaria, as well as on the institutional actors involved in tackling the phenomenon and their policy approach and measures used.

### Extent of the undeclared economy

Bulgaria is increasingly included in international and European studies of the size and nature of the undeclared economy, allowing cross-national comparisons. Schneider (2013) estimates the undeclared economy in Bulgaria to be 31% of GDP in 2013, which is the highest estimated value in the EU-28. According to the World Bank *Enterprise Survey 2009*, 54% of firms assert that they compete against firms operating in the undeclared economy and for 28% of firms the practices of undeclared sector competitors represent a major constraint. This is high compared with other EU-27 member states.

Recent surveys indicate that although the undeclared economy appears to be shrinking over time, there is an increasing involvement in some types of undeclared work due to the economic crisis. This means that although the overall trend is downwards, not all forms of undeclared work are shrinking.

### Nature and types of undeclared work

Examining sectorial and business variations, there is greater involvement in the undeclared economy amongst small and medium-size enterprises, and those operating in construction, retail, tourism, hotels and restaurants, real estate, garments, food processing and the agricultural sectors as well as some services. Overall, labour-intensive, low technology sectors are more vulnerable to entering the undeclared realm. Producers and distributors of excise goods (alcohol, cigarettes and fuel) are considered at high risk when it comes to tax/excise evasion and under-reported turnover.

Examining the nature of undeclared work, national representative surveys indicate that under-reporting remuneration is more widespread than the lack of formal contracts, and has in fact increased since the beginning of the economic crisis. While primary work without contract is occurring less and less frequently (between 4% and 10% of the employed according to surveys), non-declaration of additional employment is a more serious problem (between 28% and 32% of all dependent employees with a second job). The economic crisis has forced employers to resort to underreporting wages and registering workers on part-time contracts instead. "Envelope wages" are affecting between 14% and 21% of the employed, especially those in the service and retail sectors.

Looking at the supply and demand side of undeclared employment, the Eurobarometer survey shows that in 2007 the majority of undeclared workers were involved in construction, industry and agriculture, while in 2013 the most often provided type of undeclared work was repairs and renovations, followed by "other goods and services". Males aged 40-54 years, the unemployed/temporarily not working, as well as those from small/middle-sized towns and rural areas are more likely to engage in undeclared work. The most frequently purchased product of undeclared work is food. While in the EU27 on average undeclared work is provided to, and purchased from, the immediate social network (friends, family, neighbours, relatives), in Bulgaria the sources and clients of undeclared work are more "anonymous" (other private persons and households, as well as firms and businesses).

Tax evasion and underreported turnover by firms has not been reduced on a sustainable basis despite intensified repressive and control efforts on the part of the Bulgarian authorities. VAT and excise

duties avoidance in the production and sales of fuel and cigarettes is a substantial problem, exceeding 30% of all sales, while both organised crime and legitimate economic actors are involved in these activities. Criminal networks use legitimate business covers and create numerous opportunities for undeclared work (e.g. shuttle traders and low-level street distributors of cigarettes). All this creates an environment prone to corruption and stimulates a culture of informality, undermining business competitiveness.

### **Barriers to formalisation**

When it comes to the barriers to formalising undeclared economic activity, the tax and social security burden is a less serious concern for firms than the overall complexity of tax and regulatory systems, corruption and nepotism, institutional inefficiency and policy instability. According to the World Bank *Doing Business* study, although some improvement in relation to starting a business, paying taxes and trading across borders has been achieved since 2005, no progress is evident in areas such as dealing with permits, getting electricity, resolving insolvency and enforcing contracts. Although the overall tax rate is low, the cost of compliance for companies remains high in terms of time and effort spent on paying taxes and observing regulations. The perceived fairness of the business environment is low and affected by the existence of oligarchic economic structures that enjoy political protection. Strengthening contract enforcement and guaranteeing property rights through an efficient system for law enforcement and administrative control appear to be more pressing issues for policy makers than the popular resolve to reduce taxes (or keep them constant).

Labour market regulations create specific disincentives for low earners to “come into the light”, who bear the main burden of efforts to close social security and pension deficits. The frequent increases of the Minimum Social Insurance Thresholds lead to regressive taxation on workers whose actual pay is below the threshold or stimulate undeclared work instead of reducing it. At the same time, the legitimacy of the social security system is low, and the inadequate quality of public services puts off potential contributors.

### **Institutional actors**

There is no single body in Bulgaria responsible for tackling undeclared work. Although the policy response is focused on labour, in recent years the tax authorities have played an increasingly important role, as improved tax and revenue collection has become a top political priority. The Ministry of Labour and Social Policy (MLSP) has a key role in devising and implementing policies and measures to reduce undeclared work. Tax evasion and violations of the fiscal discipline by both individuals and firms falls within the realm of the Ministry of Finance.

When it comes to enforcement and control, two government agencies have been traditionally at the forefront of efforts to reduce the undeclared economy: the MLSP's General Labour Inspectorate (GLI), monitoring the observance of the labour legislation, and the National Revenue Agency (NRA) at the Ministry of Finance, responsible for state revenue collection (taxes and other receivables). They conduct regular inspections and audits, including joint campaigns for collection of taxes and social security contributions. Cooperation and joint actions have been strengthened in recent years through important legislative amendments and inter-institutional agreements, including with trade unions. Recently the two bodies have improved their ability to detect and penalise undeclared work through risk assessments and monitoring, as well as data sharing. Despite the increased use of e-services and development of consultation and education services by control authorities, a customer-oriented approach and increasing public trust in the state are areas that require further efforts.

Although the membership base of trade unions is declining, they continue to play an important role in the formulation of national labour market reforms and social policy. Together with business organisations, they are actively involved in a wide range of initiatives aimed at raising public awareness in relation to the undeclared economy, and developing targeted measures to tackle it, together with



the government, or on their own. Tripartite dialogue is well institutionalised through social pacts, national councils and formal roundtables. Associations of small and medium enterprises are not representative, and are excluded from formal tripartite dialogue.

### **Policy approach and measures**

The policy response of the authorities to tackling the undeclared economy has been focused on tightened control for both firms and individual taxpayers, while some preventative and curative measures have also been introduced, with mixed results. Overall, the national policy approach towards the undeclared economy is characterised by the following deficiencies: 1) lack of systematic evaluations and cost-benefit analysis of measures; 2) insufficient tailoring of measures to the features of the national economy, as well as fitting those into the existing policy infrastructure; and 3) economic and administrative measures neutralise their respective effects.

*Preventative measures* targeted at businesses include the adoption in 2003 of an act aimed at clarifying and simplifying the rules of administrative regulation and reducing administrative control on the business. Despite its ambitious goals, its application has been limited at best. Administrative procedures continue to be non-transparent and vulnerable to authorities' discretion. Ex-ante impact assessments, in theory mandatory for each new regulation, have not been systematically performed, if at all.

Deterring entry into the undeclared realm has been pursued through measures targeted at both employees and firms, through mandatory registration of work contracts and the introduction of mandatory minimum incomes, on which social security is calculated. While the first measure resulted in a significant reduction in the incidence of work without contract, the second has proved more controversial. The main objective of the Minimum Social Insurance Thresholds was to ensure declaration of wages closer to the actual pay levels in different sectors and occupations, instead of the minimum wage. However, the subsequent increase of the thresholds has put upward pressure on lower wages, and created incentives for micro-businesses to employ wholly unregistered or part time workers.

*Repressive measures* have been increasingly applied by Bulgarian governments in the light of shrinking budget revenues. Detection of tax evasion and underreported turnover was improved through introducing a mandatory real-time link between fiscal devices of economic entities and the servers of the revenue authorities. Additional monitoring has been imposed on the movement of excise goods through the installation of special control devices linked to the Customs Agency, which placed a large administrative burden on excisable traders and enforcement bodies alike. This required a subsequent modification of the measure due to its overall negative economic effect.

Undeclared employment has been targeted through extending the powers of control bodies, increasing penalties, improved risk assessment and data sharing. These measures have been followed by extensive inspection campaigns, conducted separately or jointly by control bodies, leading to temporary compliance at best, but also placing a substantial administrative burden on compliant firms. The sustainability of the effect of such efforts conducted in a "campaign-like" manner is questionable, considering that measures aimed at changing attitudes and fostering voluntary compliance remain limited in scope.

*Curative measures* aimed at supporting undeclared firms and workers to formalise include the introduction of the flat tax on personal incomes, which is now among the lowest in Europe, as well as a food voucher system for private sector employees. The latter is aimed at providing employees with additional non-taxable income, as well as substituting the payment of "envelope wages". Food vouchers are positively evaluated, despite some implementation hurdles.



Several public campaigns aimed at raising awareness and fostering commitment have been conducted by social partners, and recently followed up by a four-year project with a wider scope, launched by trade unions and business associations. This project's more holistic approach is promising in terms of ensuring greater sustainability of efforts to tackle the undeclared economy. It has resulted in establishing a national "Rules for Business" centre, which is expected to become the national focal point for coordination of policy actions, information gathering and consulting services.

## 1. Introduction

Economic activities that are not declared to the authorities for tax, social security or labour law purposes when they should be declared have been widely recognised to have negative effects on society and the functioning of the market economy. In the light of persisting high unemployment and economic recession across Europe, tackling this complex and multifaceted phenomenon has become a political priority in the EU. In Bulgaria, the focus of this report, there has been a similar renewed public interest in tackling undeclared work, especially in the context of weak economic performance and declining public revenues. Indeed, Bulgaria ranks as the European Union member state with the largest undeclared economy, estimated at 31% of GDP in 2013 (Schneider, 2013).

The aim of this report is to provide a baseline assessment of the size and nature of the undeclared economy along with how it is being tackled. To do this, this report takes stock of the diversity of measurement approaches applied at the national and international level to estimate the size of the undeclared economy in Bulgaria, and provides a detailed overview of the specific characteristics and nature of the undeclared economy in the country, along with the context-embedded barriers to formalization, which need to be considered when designing suitable policies to tackle the issue. It also reviews the current institutional framework for combating undeclared work in the country along with the policy approach and measures currently adopted. The outcome will be to highlight how the strong focus of the authorities has been on pursuing administrative control and punitive measures which have had only a temporary and limited deterrence effect on undeclared work. In contrast, the attention given to encouraging voluntary compliance has been limited, and often cancelled out by the overarching deterrence approach, and neither has there been much attention given to the role played by wider economic and social policies in facilitating compliant behaviour.

### Definitions and report structure

There is no official definition of undeclared work in Bulgarian law. The National Statistical Institute (NSI) refers to the phenomenon as the “unobserved economy” (for the purposes of the completeness of national accounts), which also includes criminal activities. The most commonly used term by government institutions (such as the Ministry of Finance) and social partners is “grey economy”, as a broader term to describe all types of economic activity that is hidden from the authorities, while “undeclared work” is also used by the Ministry of Labour and Social Policy and its agencies to highlight the labour aspects of the phenomenon in all its manifestations. National researchers and academics who have developed substantial expertise in this field have established their own variations of the definitions and use different terms, including “hidden economy” and “shadow economy” (CSD, 2011; Stanchev, 2005; Chavdarova, 2002; Loukanova and Bezlov, 2007). Despite these variations in terms used, there are similarities in what is meant by them, in line with the theoretical discussion in the international research community. It should be noted, however, that, although the term “grey economy” is widely used in the public debate and in the research community, it is not always clearly acknowledged if this includes or omits the illegal “black” economy.

Although in many developing countries, enterprise-based and jobs-based definitions have been widely employed (see Williams, 2013), in developed economies it has been activity-based definitions that have been more commonly used to define the scope of the undeclared economy. The most widely used activity-based definition, and the one adopted in this report, defines the undeclared economy as:

“all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002: 139).

This definition has been widely adopted in Europe (see European Commission, 2007b; Williams and Renooy, 2008; Williams and Round, 2008). This excludes illegal (criminal) activities and also unpaid work. Throughout this report, it should be noted, the terms undeclared economy and undeclared work are used interchangeably. When referring to studies that use different terms or capture other aspects of the phenomenon, the specific definition used by the authors is provided wherever feasible.

The present report is organised into seven chapters. **Chapter 2** provides a brief overview of the economic, social and political context in Bulgaria within which undeclared work takes place and outlines the key structural constraints and competitiveness issues of the national economy.

In **Chapter 3**, a review of available estimates of the overall size of the undeclared economy is presented, drawing on evidence from:

- **Cross-national direct surveys** of businesses and households, such as the World Bank *Enterprise Survey*, the Eurobarometer *Survey on Undeclared Work in the EU*, as well as surveys based on indirect measurement methods, such as the MIMIC approach (Schneider, 2013).
- **Indirect measurement methods** applied at national level since the early transition period, using a variety of methods (electricity consumption, monetary, exhaustiveness of national accounts and tax gap estimates). Measurements undertaken by the National Statistical Institute, the Ministry of Finance, the National Revenue Agency, as well as by independent researchers are included.
- **National-level direct surveys**, including longitudinal data series and representative studies covering different business sectors and types of undeclared economic activity. Direct surveys have been conducted annually by the Center for the Study of Democracy (CSD) since 2002 and since 2010 by the Bulgarian Industrial Capital Association (BICA). In addition, an overview of surveys dating back to the mid-1990s is provided.

**Chapter 4** provides a detailed picture of the different forms and manifestations of the undeclared economy in Bulgaria, and the variations across economic sectors and types of businesses. The following broader types of undeclared activities have been reviewed: 1) work without formal contract; 2) under-reported remuneration (“envelope wages”); and 3) tax evasion and under-reported turnover. Special attention is paid to the demand and supply side of undeclared work, where comparison with the EU27 is drawn based on the Eurobarometer Survey. Finally, the intersection between criminal and undeclared activities is discussed due to its particular relevance in the Bulgarian context, exemplified through the case of the undeclared production and sales of excise goods, where the involvement of organised criminal organisations is substantial.

**Chapter 5** outlines the context-embedded barriers to formalisation, including obstacles to doing business in the country, the nature and complexity of tax and regulatory systems, as well as labour market disincentives for low-paid workers. Issues of good governance, institutional efficiency and corruption are discussed, as well as their role as drivers for undeclared work and the low level of public trust in the state’s ability to safeguard rules and provide high-quality public services.

**Chapter 6** describes the institutional infrastructure employed to tackle the undeclared economy in the country. Although the main focus of institutional efforts in Bulgaria is on labour, there are at least three key government bodies that play an important role in detecting, penalising and preventing undeclared work. Their annual reports are reviewed to assess the impact and scope of their efforts aimed at tackling the undeclared economy, as well as the instruments used for cooperation and information exchange. The role of social partners in the form of social pacts, tripartite dialogue and beyond is also emphasized.

**Chapter 7** reviews the policy approach of Bulgarian authorities and social partners towards the undeclared economy and sets this approach in the context of existing policy frameworks for evaluating approaches and measures aimed at bringing undeclared actors out of the shadows. The following main types of policy measures are distinguished: preventative (detering entry), repressive (pursue and punish), as well as measures enabling compliance (curative and fostering commitment). Measures targeted at both the business sector and individual taxpayers are considered. Finally, an analysis of the policy rationale followed so far in Bulgaria is provided, taking into account existing evaluations of policy initiatives and legislation conducted by third parties, highlighting areas for improvement.

## 2. Economic, social and political context

Similar to other post-communist countries in Eastern Europe, Bulgaria underwent a political and economic transition that “was marked by a lack of vision for comprehensive structural reforms and by repeated political hesitations” (Neesham et al, 2011: 93). Newly established institutions failed to fill the vacuum created by the dissolution of old ones, leading to the flourishing of “an informal system of redistribution practices between different social groups” (ibid). Chavdarova (2002: 61) traces the roots of the “formal-informal clash” in Bulgaria back to the prolonged periods of foreign rule in the country’s history, the resulting unstable national self-consciousness and the persistence of personal networks and relationships as a means of finding shelter and “self-confirmation”. It is widely agreed in the literature that the retreat of the state in post-communist transition societies has not been followed by establishment of an adequate institutional and legislation infrastructure, and many aspects of the economic transition remained outside the existing state regulation realm (Nenovsky and Koleva, 2002; Wallace and Latcheva, 2006; Leibfritz, 2011). This means that legislation has been subverted by powerful state and non-state actors interested in “grabbing state recourses” (Wallace and Latcheva 2006: 83), while transition to the market economy has taken place in the undeclared economy. Furthermore, as Schneider and Enste (2000) argue, rising corruption in transition counties is correlated with the informalisation of large sectors of the economy leading to more taxes and more tax evasion, having as an overall effect the demise of the legitimacy of the public realm (Wallace and Latcheva, 2006).

The preparation of the country for EU accession was a key driver for long overdue administrative, judicial and economic reforms. Coupled with several consecutive years of positive economic growth between 2001 and 2007, this drive for reform had a positive effect on the business environment and some research shows that the undeclared economy was decreasing after a growth in the late 1990s (CSD, 2011; Schneider, 2013). However, after accession to the EU in 2007, the positive effect of adopted reforms was reversed by a lack of enforcement and effective implementation, as well as by the economic and financial crisis of 2008-2011, which led to an increasing penetration of the undeclared economy. During the “good years” before 2008, Bulgaria failed to resolve long-standing competitiveness issues and to introduce sustainable improvements in the business environment (CSD 2013b; IMD, 2013). The economic actors’ discontent with the business environment and the economic performance of the country fuel widespread practices such as undeclared employment as socially accepted coping mechanisms. These developments are rooted in traditional shortcomings of the Bulgarian economic environment, such as the prevalence of oligarchic-type economic structures and the emergence of informal social and economic structures (CSD, 2013b).

“The price of entrepreneurship remains high, SME access to EU-funds undermined by inefficient institutional framework and administrative incapacity, while internal consumer demand remains 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.”

Source: *The Bulgarian Economy: Competitiveness 2013* (CSD, 2013b).

Bulgaria became a member of the EU in 2007. With a population of 7.36 million, the World Bank defines it as an upper middle income country with a GNI per capita of USD 6,870 (World Bank *Doing Business Survey*, 2013), the lowest in the EU. The unemployment rate stood at 13% at the end of 2013 and long-term unemployment accounted for 56% of total unemployment. The minimum monthly wage stood at EUR 173.84 in January 2014. According to the *Hidden Economy* annual study of the Center for the Study of Democracy, the country's labour productivity is the lowest in the EU with 41.5% of the EU average (CSD, 2011). In 2013, the country ranked 56<sup>th</sup> out of 59 countries assessed in the World Competitiveness Yearbook (IMD, 2013), having slipped back by almost 20 positions since 2009. The main competitiveness boosting factors are Bulgaria's fiscal stability, the competitive tax regime and the low labour and productivity costs. The main concerns are related to the deep structural problems and inefficiencies of the Bulgarian labour market, corrupt management practices, weak institutional framework and rule of law, and low administrative quality.

### 3. Extent of undeclared work in Bulgaria

#### 3.1. Availability of data on the size of undeclared work

There is no universally accepted method to measure the size of the undeclared economy. Several cross-national data-bases enable the extent and nature of undeclared work in Bulgaria to be compared with the situation in the rest of Europe and beyond, including the Eurobarometer Survey, the World Bank Enterprise Survey and Doing Business surveys. There are also numerous studies that measure undeclared work in Bulgaria using both, direct and indirect measurement methods that employ various proxy indicators and/or seeks statistical traces of undeclared work in data collected for other purposes (e.g., Schneider, 2013; Elgin and Öztunali, 2012) as well as a number of individual country-level surveys (Stanchev, 2005; CSD, 2013; BICA, 2012).

The phenomenon of the undeclared economy has been a focus for research in Bulgaria since the beginning of the transition period, displaying that this phenomenon is not a recent problem. Early studies tended to include the "black economy" (BICA, 2010), while more recent research has sought to adopt a more differentiated approach. A variety of national measurement methods have been applied since the mid-1990s, covering both direct and indirect approaches, which place the share of the undeclared economy at anywhere between 10% and 40% of GDP. In the period 2007-2008, its share was estimated at somewhere between 20% and 35% of GDP, while in some sectors such as construction and real estate less than 50% of the real value of the transactions were reported (CSD, 2011).

One common shortcoming of most available measurements is that they are snapshots at different moments in time and use various methods. The exceptions are Schneider's annual indirect MIMIC estimates, the annual Hidden Economy Index based on surveys of businesses and the population conducted by the Center for the Study of Democracy (CSD) since 2002, as well as the EU-wide Eurobarometer survey carried out in 2007 and 2013. This makes it difficult to identify trends and patterns over time. One should also carefully consider the different components of the undeclared economy that are captured within each separate measurement method, before drawing comparisons between their findings.

There have been efforts in recent years to ensure the continuity of data: CSD has been conducting its Hidden Economy Index survey of the population and the businesses since 2002, while the Bulgarian Industrial Capital Association's national representative survey of the population, employers and businesses has been applied annually since 2010. Policy researchers and academic experts have repeatedly called for the development of a standardized methodology for measuring and analysing the

size of the undeclared economy both on a national and EU level (CSD, 2011; BICA, 2012). Although discussions have taken place about standardising the methodology for estimating the undeclared economy as a share of GDP within the EU (GHK and Fondazione Brodolini, 2009), there are still large differences in the measurements applied by different member states. Furthermore, the estimates of the National Statistical Institute of the size of the undeclared have not been made public on a regular basis.

At the same time, a tailored approach to direct surveys may be more suitable: applying identically worded questionnaires across different countries may lead to understanding problems due to cultural differences (Schneider, 2012). Direct measurement methods have been increasingly applied in Bulgaria through surveys, showing even higher levels of undeclared economy (50%-60%) as perceived by businesses and the population (CSD, 2011). Opinion and perception estimates are likely to be biased by “Bulgarian society’s common distrust with the official state institutions”, reflecting also “subjective perception of the overall quality of the business environment” (CSD, 2011: 34). At the same time, it is also widely acknowledged that when asked about their own involvement in undeclared work, respondents in direct surveys tend to underestimate the size of the phenomenon due to the sensitive nature of the question.

### 3.2. Cross-national studies

In recent years Bulgaria has been included in a number of cross-national studies, based on both direct and indirect measurements of the undeclared economy, which allows international and EU-wide comparisons. According to the World Economic Forum’s *Global Competitiveness Report 2003-2007* (see Djankov et al, 2010), the share of the undeclared economy in lower middle income countries (including Bulgaria) for the period 2005-2007 was **31.25%** of GDP. Meanwhile, Bulgaria is classified as an upper-middle income country. Countries from this group have had slightly lower estimated sizes of the undeclared economy (**27.3%**). The estimate is based on data from the *Executive Opinion Survey*, where executives are asked to give an estimate for the share of the undeclared and unregistered economic activities in their country.

According to the World Bank *Enterprise Survey* of Bulgaria from 2009, 54% of firms report that they compete against firms operating on an undeclared basis and 28.1 % report that the practices of undeclared competitors represent a major constraint on the growth of their business, which is higher than all other EU Member States (Table 1).

**Table 1. Prevalence of the undeclared economy in Bulgaria**

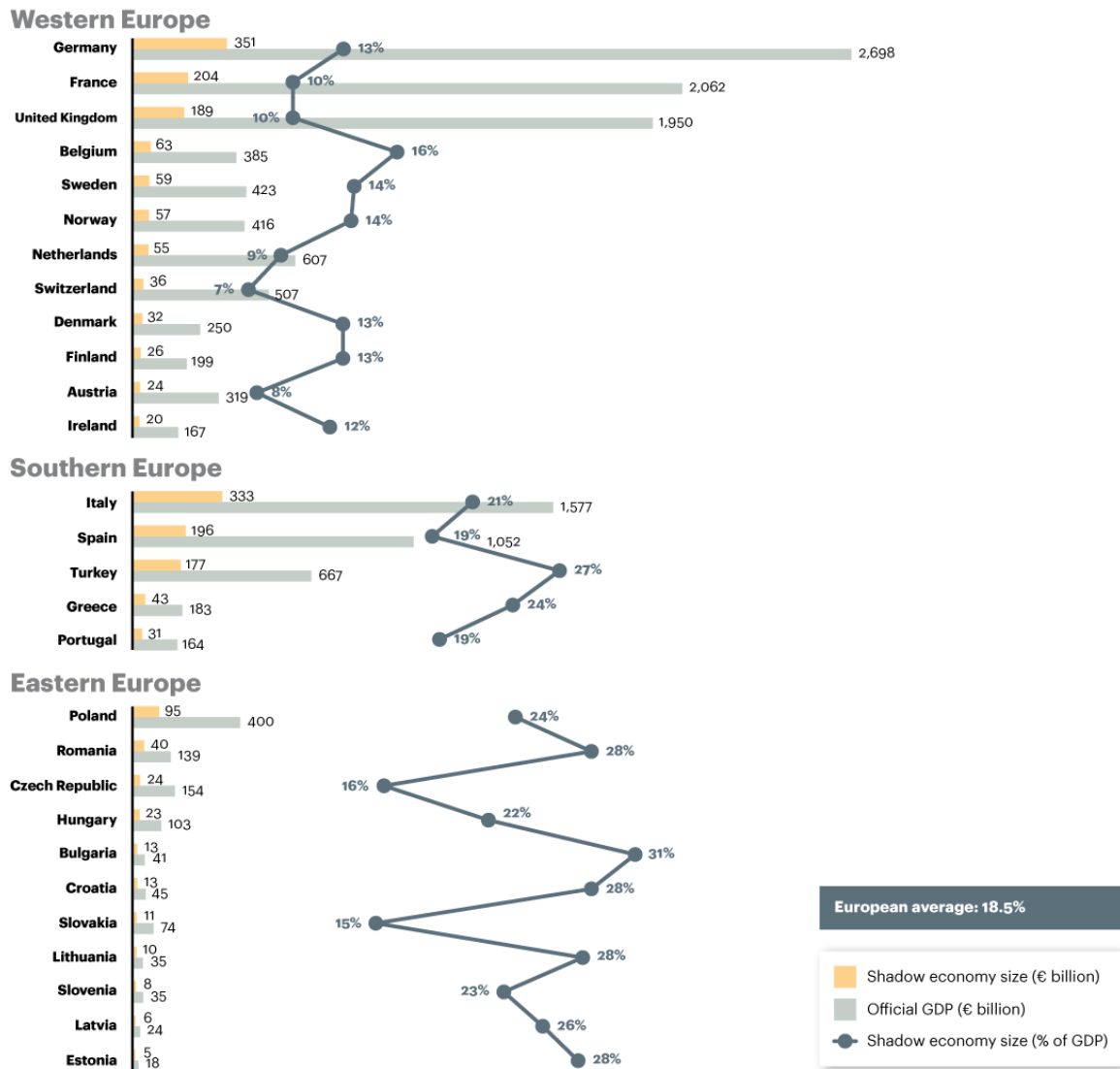
(N=288)	Bulgaria	Eastern Europe and Central Asia	World
% of firms formally registered when started operations in country	<b>98.5</b>	96.7	88
% of firms competing against unregistered or informal firms	<b>54.1</b>	44.3	56.4
% of firms identifying practices of competitors in the informal sector as major constraint	<b>28.1</b>	26.9	30.4

Source: World Bank Enterprise Survey 2009

Some widely cited international measurements that cover Bulgaria conclude that it has the largest share of undeclared economy of GDP within the EU (see Figure 1). Using the Multiple Indicators Multiple Causes (MIMIC) method, Schneider (2013) finds that Bulgaria’s undeclared economy is equivalent to **31%** of GDP (31.9% in 2012 and estimated 31.2% in 2013), compared to an EU average of approx. 19% . According to Schneider, the average size of the undeclared economy in Bulgaria between 1999 and 2007 was 35.3% (Schneider et al, 2010), and has been on the decrease ever since, akin to other EU member states (Table 2).



Figure 1. The share of the shadow economy in relation to GDP across Europe<sup>1</sup> (2013)



Source: Schneider and AT Kearney (2013)

Table 2. Development of the size of the shadow economy in Bulgaria, MIMIC method (2006-2013)

	2006	2007	2008	2009	2010	2011	2012	2013e
<b>Share of the shadow economy as % of GDP</b>	34.0	34.0	34.0	34.0	32.6	32.3	31.9	31.2
<b>EU-28 +</b>	20.9	20.1	19.4	19.9	19.7	19.3	19.0	18.5

Source: Schneider and AT Kearney, 2013. The EU data includes Norway, Switzerland and Turkey.

<sup>1</sup> The data covers EU 28 (excluding Cyprus, Luxembourg and Malta) plus Norway, Switzerland and Turkey.



It should be noted that Schneider defines the “shadow economy” as “all market-based legal production of goods and services that are deliberately concealed from public authorities” to avoid taxes, social security contributions, as well as to avoid compliance with labour standards and administrative obligations (Schneider, 2012). Household services and production, as well as purely criminal (illegal) activities are excluded from the measurement. This definition, therefore, is similar to the definition of the undeclared economy adopted in this report.

Among the EU Member States, the size of the undeclared economy is largest in Bulgaria, as the estimates show, amounting to €12.8 billion, or 31.2% of GDP.

Elgin and Öztunali (2012), who estimated the size of the undeclared economy in 161 countries for the period 1950-2009 based on a two-sector dynamic general equilibrium model, arrive at estimates of between **35.5% in 2000** and **31.9% in 2008**.

In 2007 the first **EU-wide direct survey** on undeclared work was conducted, followed by another round in 2013 on a sample of 1,018 respondents in Bulgaria (European Commission, 2007a and 2014c). According to the EU definition, undeclared work encompasses “all paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States” (European Commission, 2014c). Again, this conforms to the definition of undeclared work adopted in this report in terms of what is included and excluded. The study sheds light on both the demand and the supply side of undeclared work, as well as on the motivations for undertaking undeclared work.

Although only 5% of the respondents in the Eurobarometer surveys in 2007 and 2013 admitted to have undertaken undeclared work, some 39% in 2007 and 33% in 2013 knew people in undeclared employment (Table 3). In 2007, moreover, 14% reported that they received “envelope wages” from their employer (i.e., an undeclared ‘envelope’ wage in addition to their official declared salary from their employer), while in 2013 this dropped to 6% (against a 5% EU average in 2007 and 3% in 2013)<sup>2</sup>. In 2013, 15.4% admitted to have purchased goods and services involving undeclared work, which is a 3% increase from 2007.

**Table 3. Extent of undeclared work in Bulgaria compared to EU27 (2007 to 2013)**

% of respondents	Bulgaria 2007	Bulgaria 2013	EU27 average 2007	EU27 average 2013
Carried out undeclared work	5	<b>5</b>	5	4
Know people involved in undeclared work	39	<b>33</b>	38	32
Received part of their salary in cash (“envelope wages”)	14	<b>6</b>	5	3
Purchased undeclared goods and services	14	<b>16</b>	11	11

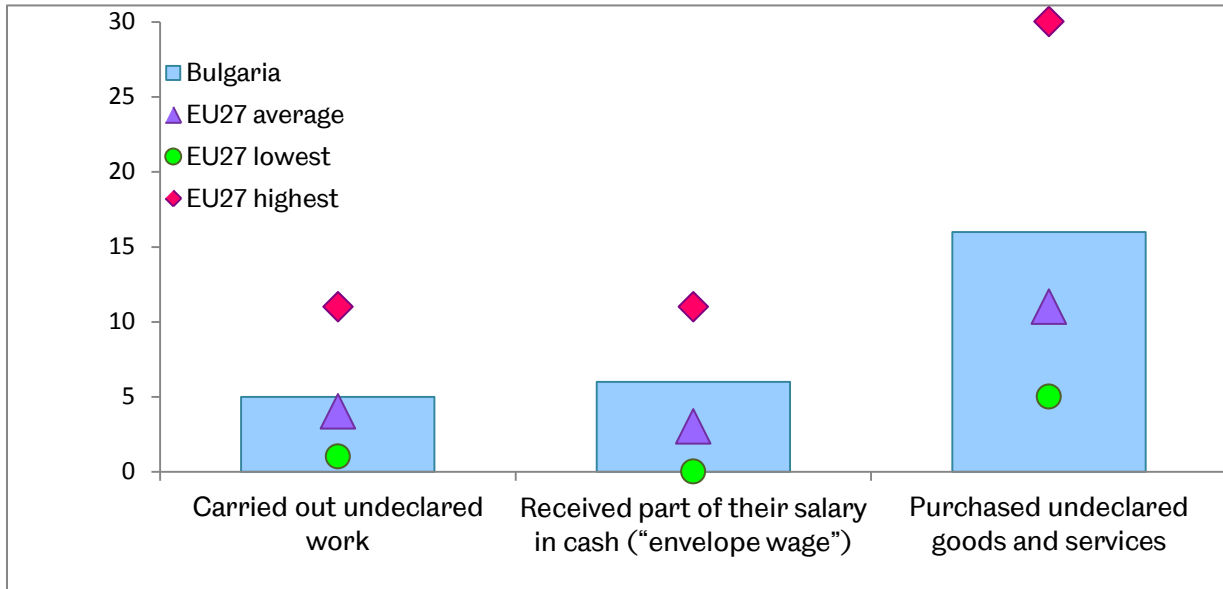
*Source: Special Eurobarometer 402 (Bulgaria: N 2007=1,000; N 2013=1,018)*

These survey results show that the share of people admitting to having carried out undeclared work is not much higher than the EU27 average (Figure 2). However, the share of employees receiving envelope wages and respondents purchasing undeclared products and services is higher than the

<sup>2</sup> It should be noted that the number of dependent employees who received envelope wages is too small (56 in 2007 and 27 in 2013) and the results should be treated with caution.

EU27 average, but below the highest nationally reported values. The survey results are discussed in more detail in the section on the nature of the undeclared economy.

**Figure 2. Extent of undeclared work in Bulgaria and EU 27 (2013)**



Source: Special Eurobarometer 402, 2013 (N=1,018)

It should be noted that while the application of cross-national measurement methods of the size of the undeclared economy based on identically worded questions in different contexts is beneficial for comparisons, it also bears the risk of ignoring national specifics that require a more tailored approach. A review of different national measurements applied in Bulgaria since the early 1990s is presented in the following section. The variations in the results produced indicate the multiple aspects of this complex phenomenon captured through different methodological approaches.

### 3.3. Indirect measurement approaches

Indirect methods for estimating the size of the undeclared economy are based on an analysis of macroeconomic aggregate data. The most commonly applied indirect measurements include the following methods:

- Monetary methods
- Income-expenditure discrepancy methods
- Labour supply-demand discrepancy methods
- Physical input (vs. official product) methods
- Multiple indicators – multiple causes

#### Monetary method

Ahumada et al. (2009) applied a corrected monetary technique to the standard monetary model to measure the size of the shadow economy for the period between 1998 and 2007. This approach is based on the assumption that transactions hidden from official records are made in cash (Ahumada et al, 2009). The research established that when using different specifications of this model and definitions of variables, the average size of the shadow economy in Bulgaria was between 12.2% and 17.5%. These results, however, are lower than existing estimates at that time. The authors acknowledge that these estimates are associated with certain pitfalls of the methodologies used and point out that the results generated should be understood as minimum estimates.

“Average shares of the shadow economy in registered GDP were **12.2 per cent** for a model including a threshold for the variable inducing agents to perform hidden transactions and in which the opportunity cost of holding cash was measured as an interest rate in Euro, **13.6 per cent** for a model including a threshold for the variable inducing agents to perform hidden transactions and in which the opportunity cost of holding cash was measured as an interest rate in Levs, **16.8 per cent** for a model with no threshold for the variable inducing agents to perform hidden transactions and in which the opportunity cost of holding cash was measured as an interest rate in Euro and **17.5 per cent** for a model with no threshold for the variable inducing agents to perform hidden transactions and in which the opportunity cost of holding cash was measured as an interest rate in Levs.”

*Source: Ahumada et al. (2009)*

Earlier estimates by Nenovski and Hristov (2000) from the Bulgarian National Bank, using a modification of the **currency circulation method** concluded that in the two years following the introduction of the currency board in 1997, Bulgaria’s shadow economy was an average of **26.8%** of GDP. This estimate is also considered a minimum, since it includes only the lev-serviced part of the economy, while it was assumed that foreign currencies have at least as high share in servicing the shadow economy as the national (Nenovski and Hristov, 2000).

In 2010, experts from the Institute for Market Economics (Bogdanov and Stanchev, 2010) estimated the minimum size of the shadow economy at **17%**, using the **“contract-intensive money” method** developed by Clague et al (1999). Although the authors argue that this approach is the most reliable quantitative method, they also point to its major shortcoming – it does not take into account “income in kind”, which is estimated at about 25-30% of the households’ income in agricultural areas (Ministry of Finance, 2010).

### Electricity consumption method

Studies attempting to estimate the size of the undeclared economy of Bulgaria during the first years of transition are rare due to the lack of reliable official data. In 2001 a team of economists from the Harvard University, the Agency for Economic Analysis and Forecasting and the Bulgarian Institute for Market Economics attempted to produce an estimate of the phenomenon<sup>3</sup> during the first transition decade. They applied the **physical input approach**, which is based on the assumption that the energy consumption is proportional to the total economic activity in a country (Kyle et al, 2001). Consequently, fluctuations in energy consumption that cannot be accounted for by measures of the total economic activity are due to the undeclared economy. The authors note that this approach is useful to identify changes in the size of the undeclared economy over time, but is not appropriate for estimating its absolute size, since the estimate depends on the base value adopted. The research is based on the assumption that the base value of the size of the undeclared economy in 1989 was 30% of GDP. It found that between 1989 and 1998 the size of the undeclared economy fluctuated between **25% and 37%** of GDP. A decline after the period of hyperinflation in 1996 is observed, which can be explained by the introduction of the currency board in mid-1997, which stabilized the tax revenues to the GDP. When using the assumption that the undeclared economy was 30% of GDP in 1989, its size as a share of GDP reached its highest values in 1990 (32.2%) and 1996 (34.4%), while in 1998 it was estimated at 22%.

<sup>3</sup> The authors acknowledge the difficulty to define the term informal economy or shadow economy and provide a review of varying definitions available at that time. Although the authors do not indicate on which definition their research is based, they highlight Schneider’s and Enste’s (1999: 5) definition as the most detailed, which defines the shadow economy as “unreported income from the production of legal goods and services, either from monetary or barter transactions”. Later in the report, it is said that the electricity consumption method applied is used to capture the size of the “parallel market” of the country. However, this would suggest that illegal activities are also included as part of the total economic activity measured.

The authors further note the shortcoming of this approach, and its “arbitrary nature”, due to the lack of “specific micro-level data allowing definition of an explicit relationship between energy use and economic activity” (Kyle et al, 2001).

In 2011 the Ministry of Finance estimated the share of the shadow economy at **20% of GDP** for the entire period 2000-2009, following a model based on energy consumption (Ministry of Finance, 2011). However, more recent measurements have not been made public, if they exist.

### System of National Accounts

The undeclared economy is one of the components of the so-called Non-observed Economy, which is estimated within the System of National Accounts for exhaustiveness reasons.

#### Definition of the Non-observed Economy in the System of National Accounts

“The Non-observed Economy refers to all productive activities that may not be captured in the basic data sources used for national accounts compilation. The following activities are included: underground, informal (including those undertaken by households for their own final use), illegal, and other activities omitted due to deficiencies in the basic data collection programme. The term ‘non-observed economy’ encompasses all of these activities and the related statistical estimation problems.”

Source: UNEC (2008)

A variety of methods can be used to arrive at an estimate of the non-observed economic activity, such as “the labour input method, commodity flow method, balancing input-output and supply-and-use tables, other reconciliation methods (e.g. comparison of theoretical VAT and actual VAT, theoretical income tax and actual income tax), comparison with norms, use of fiscal data and special surveys” (UNECE, 2008).

The National Statistical Institute (NSI) adds to the size of the GDP of Bulgaria an estimate of the share of the undeclared economy (NSI, 2010), based on Eurostat’s *Tabular Approach to Exhaustiveness of National Accounts* (Eurostat, 2013), which differentiates between seven types of non-observed economic activities. According to this framework the non-exhaustiveness of data comes from the following main factors:

- Unregistered economic activities (deliberately not registered entities)
- Unknown or not covered entities
- Informal sector production
- Deliberately misreporting entities
- Illegal production
- Other (non-response, wages and salaries in kind)

**Table 4. Share of the non-observed economy as % of GDP and GVA (2000-2008)**

Economic sector	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>Agriculture</b>	18.2	18.7	23.0	25.1	22.6	21.9	20.1	20.9	16.6
<b>Industry</b>	16.1	17.6	21.2	20.4	12.4	11.3	10.9	10.3	11
<b>Services</b>	17.8	16.0	13.3	13.9	14.8	15.2	14.2	12.6	12.8
<b>GVA</b>	17.4	16.8	16.6	17.0	15.0	14.7	13.6	12.3	12.5
<b>GDP</b>	15.2	14.7	14.7	14.8	12.7	12.4	11.4	10.4	10.4

Source: National Statistical Institute

According to the NSI, the share of the non-observed economy in 2000 was 15.2% of GDP and decreased to 10.4% in 2008, and was highest in the agricultural sector (Table 4). This estimate is seen by many economic experts as an under-estimate, especially considering the fact that it also includes an estimate of the share of illegal production (CSD, 2011; IME, 2010). In recent years, NSI's data on the hidden economy have not been made public. The figure for 2011 reported by the NSI to the EC was **13.4%** of GDP (European Commission, 2013), which is higher than the most recent publicly reported value in 2008 (10.4%).

Two major problems result from the analysis on the size of the undeclared economy carried out by Bulgarian national authorities – they are not systematically implemented and **do not serve as a starting point for policy decisions**. CSD for example notes that estimates of the NSI should be considered with caution, as they occur at various points in time and use various methodologies (CSD, 2011), making comparisons over time difficult. According to a UNECE study of how non-observed economic activities are estimated in national accounts, this is a common problem in many of the countries surveyed (UNECE, 2008). The study further points to the danger of such estimates being used for political reasons.

### Tax gap estimates

Buehn and Schneider (2012) provided estimates on the size of the undeclared economy using the MIMIC model estimation results as a basis. For Bulgaria the average share of tax evasion for the period 1999-2010 that was due to undeclared work was estimated at **3.9% of GDP**.

Drawing on corruption surveys of the business and tax services in Bulgaria, Pashev (2006b) pointed out that the VAT is by far the most often evaded tax, creating vulnerabilities to payments of bribes to conceal non-compliance and avoid control. A recent EC-commissioned study estimates the VAT gap in Bulgaria at EUR 604 million, equivalent to 15% of the theoretical VAT liability, or **1.6% of GDP** (CASE, 2013) (Table 5).

**Table 5. Bulgaria: VAT theoretical liability and gap in € mill (2000-2011)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total VTTL	1 526	1 769	1 886	2 056	2 330	2 631	3 038	3 631	4 026	3 710	3 684	3 956
Household consumption	1 132	1 296	1 373	1 471	1 660	1 830	2 051	2 405	2 616	2 357	2 415	2 565
Government & NPISH consumption	44	65	63	77	76	75	106	95	116	81	84	87
Intermediate consumption by industries	245	281	305	346	400	450	521	630	713	735	722	816
Gross fixed capital formation	81	104	114	128	152	220	287	383	482	459	417	422
Net adjustments	24	23	30	34	42	56	73	118	100	77	45	65
VAT receipts	1 169	1 310	1 245	1 586	2 011	2 378	2 835	3 190	3 862	3 156	3 299	3 352
VAT Gap	357	458	641	471	319	253	203	441	164	554	385	604
VAT Gap as a share of VTTL	23%	26%	34%	23%	14%	10%	7%	12%	4%	15%	10%	15%
VAT Gap as a share of GDP	2.5%	2.9%	3.8%	2.6%	1.6%	1.1%	0.8%	1.4%	0.5%	1.6%	1.1%	1.6%
Full rate	20%											
Reduced rates									7%		9%	

Note: VAT rates stated at the end of calendar year.

Source: CASE (2013)

The National Revenue Agency estimates the VAT tax gap resulting from organised VAT fraud schemes (such as missing trader fraud and international carousel fraud) at around EUR 360 million for 2010,

based on identification of high-risk economic actors (CSD, 2012) (see Table 6). However, these estimates do not include the gap from unorganised/conventional tax avoidance and evasion, which aim at reducing the tax liability resulting from real transactions. Around 30% of all **organised fraud** schemes occurred in the construction sector, 15% in the service sector (advertising, among others), followed by the production of agricultural goods and food (13%). **Unorganised fraud** is most prevalent in the distribution of fuel and oil products (CSD, 2012).

**Table 6. VAT gap from organised fraud (2005-2010)**

VAT gap	2005	2006	2007	2008	2009	2010
VAT revenues (€ billion)	2.4	2.9	3.3	3.8	3.27	3.3
Organised VAT fraud gap (€ million)	246	244	349	504	413	358
Fraud gap / total VAT revenues	10%	8.2%	10.3%	13%	12.6%	11.1%

Source: Bulgarian Serious and Organised Crime Threat Assessment 2010-2011, based on the National Revenue Agency's tax gap analysis (CSD, 2012).

It should be considered that the lines between organised and unorganised tax fraud are blurred, while the same economic actors may be involved in both types of fraud, even within the same scheme. However, for the purposes of estimating the share of the undeclared economy, it is important to distinguish between siphoning of VAT credit claimed on fictitious transactions and traders, and evading taxes due on real products and services delivered by real economic actors. The latter category, aimed at reducing the tax liability would fall into the definition of the undeclared economy to the authorities. The abuse of tax credit in an organised manner is a type of organised crime rather than tax evasion (Pashev, 2006b).

Therefore, using traditional tax gap estimates to make assumptions regarding the size of the real but undeclared economic activity is difficult, as those usually includes not only tax avoidance and evasion, but also tax fraud that is based on fictitious economic transactions. The National Revenue Agency conducts estimates of the overall tax gap (including VAT), but the data is not public.

### 3.4. Direct measurement approaches

Direct approaches for estimating the size of the undeclared economy collect data on a micro level from separate economic entities (CSD, 2011). The main types include:

- Representative studies of the population and the business
- Studies of time budgeting
- Tax audits

It is widely recognized in the literature that one of the shortcomings of direct surveys is that they tend to produce lower-bound estimates of the undeclared economy, due to the unwillingness of respondents to admit their law-breaching behaviour. Nevertheless, direct measurements have been applied in Bulgaria since the 1990s, illuminating different aspects of this complex phenomenon. National surveys of the population conducted in the 1990s indicate that in 1996, 6.8% of the respondents openly admitted that they worked without any contract and social insurance, while 22% were working on a fake contract (Hristoskov et al., 1996, cited in Chavdarova, 2003). In 2001 the share of people without an employment contract was 6.1% (Chavdarova, 2003, based on data from the National Statistical Institute).



One of the earlier studies of small and medium enterprises and their undeclared work practices was conducted by the Bulgarian Institute for Market Economics (IME) in 2000, together with a team of economists from the Harvard University and the Bulgarian Ministry of Finance's analytical unit (Kyle et al, 2001). The survey covered a sample of 509 Bulgarian companies, the majority of which were private, operating in 10 economic sectors. All of the enterprises were registered in the period 1991-1993. The survey found that the majority of the companies' transactions were conducted in cash (around 70%) and that this undeclared activity was motivated by the following factors:

- high tax and social insurance (77.8%);
- need to prove the origin of money (56%);
- difference between actual and reported salaries (n/a);
- avoidance of customs duties (42.5%);
- licensing requirements (40.8%).

The study further showed that firms were hiding some **34%-35% of income** allocated to labour compensation. Moreover, VAT and social security were most frequently avoided, while "an average of 35.5 % of taxes due were avoided or evaded" (Kyle et al, 2001: 69).

The survey established the following with respect to undeclared work:

- Between 13% and 15% of surveyed firms admitted to employing people without a contract during the 1997-99 period, as well as during their first accounting year.
- Approximately 3% of employed people (ca. 80,000) were not registered in the review period.
- The sectors employing the greatest share of workers without contract were agriculture and trade (mostly on a seasonal and temporary basis), while the smallest share was in the service sector (0.5%).
- 62.5% of the surveyed firms believe that it is a common practice to declare lower salaries than those actually paid (mostly in trade and construction), while another 17.4% know of a small number of such firms.

These results clearly demonstrate the significant extent of undeclared work and businesses' non-compliance, which has to be viewed in the context of incomplete administrative and economic reforms in this earlier transition period, incomplete market liberalisation, weak regulatory and enforcement infrastructure, as well as deep economic imbalances and financial turbulences (especially due to the bank crisis in 1996-1997). This was followed by a period of gradual economic and political stabilisation since the early 2000s.

Data from the Bulgarian Integrated Household Survey shows that by 2000, 25% of all employees in Bulgaria "worked for employers who failed to pay any mandatory social security contributions" or paid reduced contributions on the basis of the national minimum wage (Kolev, 2005: 98-99). In agriculture, the **non-payment of social security contributions** reached 61%, while in trade and construction this phenomenon affected 46% and 42% of the employed respectively (ibid.).

In 2003 the polling agency GFK together with the Institute for Market Economics conducted another survey of a total of 180 firms in three South-east European countries, including Bulgaria (Stanchev, 2005). The sample was relatively small (60 firms per country from industry, services and agriculture) and included firms with 5-500 employees. In Bulgaria, 45% of the firms stated that the most serious competition they face is from such economic actors that do not comply with legislation, while low prices was the second important factor named by 28% of the respondents. Moreover, 42% of the firms considered the increase of the overall tax and social security burden as the most significant barrier to business growth, followed by access to financing (33%) and the burdensome licensing regime (17%).



A national representative survey of the actual income of the population, commissioned by the European Employment Observatory and conducted by Vitosha Research and Industry Watch, covered the period 2005-2007 (Loukanova and Bezlov, 2007; BICA, 2010). The results were juxtaposed with the officially registered labour contracts with the National Statistical Institute (see Table 7). The results show discrepancies in the range of 5-7%, which grew consistently in the reviewed period. However, older survey data shows that in 1999 companies believed the discrepancy between actual and reported salaries was on average 46%, reaching nearly 60% in the construction sector (Kyle et al, 2001).

**Table 7. Actual and reported income (2005-2007)**

Survey conducted	Officially reported net monthly wages (National Statistical Institute)	Actual received total income (cash and in kind) (monthly direct surveys)	Discrepancy
<b>April 2005</b>	318	573	-255
<b>June 2006</b>	345	652	-307
<b>December 2006</b>	363	677	-314
<b>March 2007</b>	384	730	-346

Source: Loukanova and Bezlov (2007), based on data from direct monthly surveys by Vitosha Research and Industry Watch.

Another direct survey of 1,000 randomly selected respondents from the population was conducted in April 2007 by the Bulgarian Industrial Association (BIA). The survey found that the size of the undeclared sector accounted for 35% of the economy and has increased between 2004 and 2007 (Loukanova and Bezlov, 2007; World Bank, 2008a). According to the analysis, if employment in the undeclared economy was added to the GDP, the economic growth for 2006 would increase from 6.5% to 7.8% and income would be 13% higher. The survey results also show that around 18% of employees in the private sector pay social security contributions on their entire salary, while 63% of all employees interviewed pay taxes and contributions on their real income.

Two World Bank discussion papers in 2007 and 2009 assessed through household surveys the extent to which the working population is integrated in the social security system (Peracchi et al, 2007; Perotti and Sanchez Puerta, 2009). The first survey of 200 Bulgarian households, based on the World Bank's Living Standards Measurement Study (LSMS) found that 15.4% of the population were not paying social security contributions, while 4.5% worked without a contract (Peracchi et al, 2007).

The second analysis focused on a sample of 1,310 working individuals aged 15–64, included in the larger Bulgarian Multi-topic Household Survey (BMTHS) commissioned by the World Bank (Perotti and Sanchez Puerta, 2009). It found that 14% of the employed, 58% of the self-employed and 42% of employees in small enterprises were not paying social security contributions on their main job.

### Hidden Economy Index

The Center for the Study of Democracy, together with its independent subsidiary, the sociological agency Vitosha Research EOOD, conduct a series of studies, which have been calculating and disseminating the *Hidden Economy Index*, which has two major components: 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. The information from the two indices 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

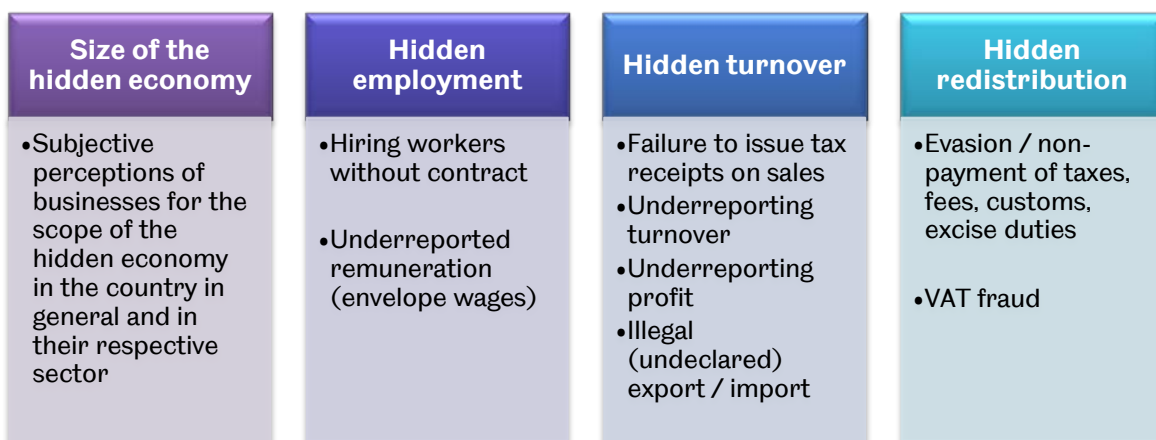
economy (Figure 3). The “hidden economy” is used as a broad term, encompassing the following components (CSD, 2011):

- 1) **Informal economy** (legal, yet unreported): home-made produce and domestic labour, unpaid voluntary work, self-employed and small businesses’ activities with no obligation to declare their activities.
- 2) **Illegal (black) economy** (illegal and unreported): illegal activities and unlawful production of commodities, as well as activities of illegal economic entities.
- 3) **Undeclared (grey) economy** (legal, yet unreported): underreporting the activities of legally operating entities, not registering the entire staff, underreported income, tax evasion and avoidance of social security contributions.

In 2008, the Hidden Economy Index put the size of the hidden economy at between 20% and 35% from GBP. In 2010, on average, businesses assessed the share of the hidden economy in their own sector at 24%, while estimates for the country as a whole stood at 40% (CSD, 2011).

The Center for the Study of Democracy’s annual report on the findings of the Hidden Economy Index for the period 2012 – 2013 shows that the country’s main macroeconomic indicators showed slow economic growth, weak competitiveness, and gloomy labour market conditions. These trends **facilitated the development of hidden economic activities**, which was reflected in the increase of both indices of the hidden economy in 2013 - of the population and of the business. The short-term positive effects of the government’s focus on administrative and control measures in tax compliance were not sustained and tax evasion increased again. The rate of employment under a contract with hidden clauses (“**envelope wages**”) was the highest on record – 13.8% of the employed reported having received remuneration higher than the one stated in their contract. In view of these findings, the measures recommended by CSD to tackle the undeclared economy in Bulgaria include increasing the level of electronic payments, wider e-government penetration and improving legislation aimed at restricting market cartelisation. A key recommendation of the report is to introduce clearer accountability and performance measurement regulations for the government control and compliance agencies.

**Figure 3. Components of the Hidden Economy Index**

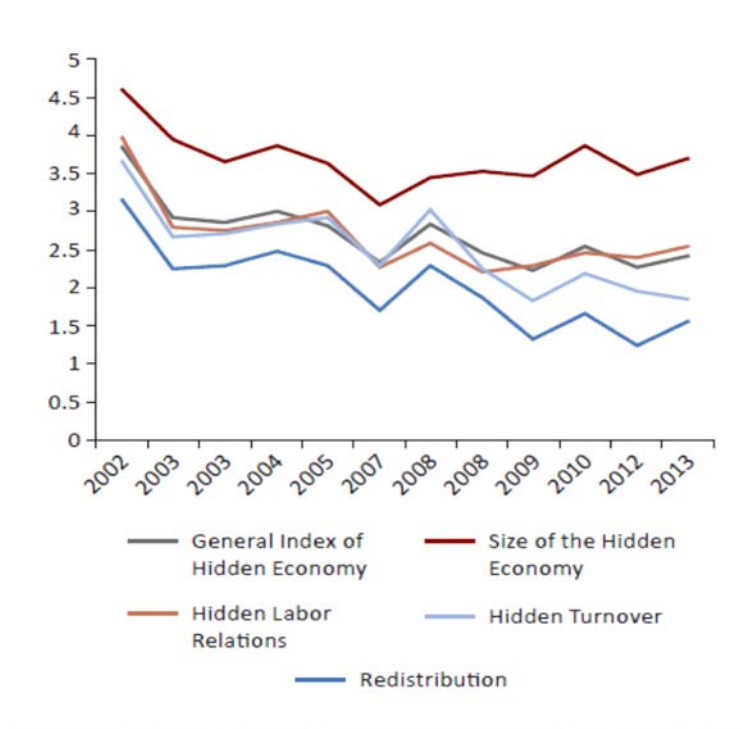


Source: CSD (2011).

In 2013, all indices except the hidden turnover registered an increase (Figure 4). Overall, the businesses’ perceptions of the size of the undeclared economy remain high. Since the monitoring system was introduced in 2002, the index of the overall size of the hidden economy was constantly

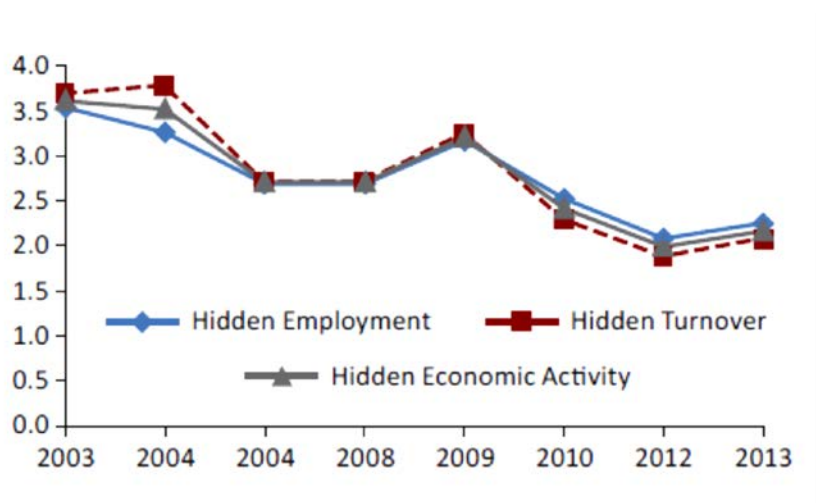
declining up until its all-time lowest value in 2007, which is associated with the country's EU accession process and related reforms, as well as the economic growth in this period. After 2007, the index started to climb again, which is an indication of the harsh economic environment in the context of the global economic downturn, but also of the regulatory environment, stalled institutional reforms after accession and lacklustre implementation of existing regulations such as administrative inefficiency (CSD, 2013).

Figure 4. Dynamics of the Hidden Economy Index (2002-2013)



Source: CSD, Hidden Economy Survey of the Businesses.

Figure 5. Unreported economic activity of the population (2003-2013)



Source: CSD, Hidden Economy Survey of the Population.

## White Economy Index

In 2009, Bulgarian Association of Industrial Capital (BICA) together with the Confederation of the Independent Trade Unions (CITUB) launched the four-year project “Restriction and Prevention of the Informal Economy”<sup>4</sup>, whose main objective is to study the size and manifestations of the undeclared economy and develop policy responses through a mixture of methods. The focus is on direct representative surveys, in-depth interviews and focus groups with businesses and employees. The term “informal economy” used by the project partners encompasses all economic activities performed by legally operating economic actors, who knowingly or unknowingly violate the fiscal discipline, the tax, social and health insurance legislation, including partial or complete non-reporting of actual economic activity (Chengelova, 2012). This refers to activities that are unobserved in the national statistics, have not been taxed by the state authorities and have not been sanctioned, regulated or protected by the state (BICA, 2011c). Despite this broad definition, the analysis does not include illegal activities, or unpaid activities (called the “natural economy”). However, illegal import and export (smuggling) of legal goods is included in the study.

A “**formal economy composite index**” for Bulgaria was introduced in 2011 as part of the project, based on representative direct surveys of the population, employers and employees (BICA, 2011a). The index measures “the formalization rate of the economy and its increase is a sign of the shrinkage of the shadow economy” (Ministry of Finance, 2011). It is composed of a statistical part (VAT, money supply, number of employed people, excise taxes, foreign trade) and a sociological part (surveys of companies and employees).

The index of the “white economy” was calculated at 63.17% for 2010; one year later it increased to 67.4%. (BICA, 2012a). In 2012, the “lightening up” trend slowed down and the index stood at **67.41%**. A more detailed look at the results of BICA’s series of surveys of the population, employers and employees shows that the “grey” share of the economy in 2011 was estimated as follows (BICA, 2012a):

- According to the population: 58%
- According to the employees and workers: 48.6%
- According to the employers: 42.2%

In addition to the index, BICA and CITUB have engaged in a wide range of analytical and monitoring activities, including more detailed study of undeclared practices in 11 pilot sectors, which provide useful insight into the characteristics and motivations for undeclared work in Bulgaria, some of which are discussed further below. This project represents the most comprehensive effort so far undertaken to gain a better understanding of the phenomenon in the country and to develop tailored policy responses in cooperation with all social partners.

### 3.5. Summary

In Bulgaria, both direct and indirect approaches to measure the undeclared economy have been applied since the early 1990s, indicating that the importance of this phenomenon and its prevalence were recognized in the early years of the transition process. While during the 1990s and early 2000s, indirect measurement approaches were more popular among Bulgarian researchers, in recent years a number of direct surveys of the population and businesses have been conducted, allowing for a more differentiated analysis of the different forms and manifestations of the undeclared economy. Much like in the rest of Europe (and the world), there is no universally adopted approach for estimating the size of the undeclared economy in Bulgaria. The lowest estimates of the size of the phenomenon have been produced by the NSI (10%, 2008) within the methodology for estimating the non-observed share of the

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<sup>4</sup> <http://www.ikonomikanasvetlo.bg>

national GDP (non-exhaustiveness of national accounts). Although this methodology has been standardized within the EU, its application on a national level is far from uniform, while in Bulgaria it is not used as an official national estimate.

The review of results from various measurement methods indicates that the undeclared economy, after increasing steeply after 1989 and reaching its pick during the economic and political crisis of 1996, has been on the decline ever since. Recent direct surveys indicate an increase of some types of undeclared economic activity due to the economic crisis, although levels are below the highest registered values. However, it should be also noted that there is a wide discrepancy in estimates depending on the method used, putting the size of the undeclared economy at between 10% and 40% of GDP. In fact, different estimates have resulted from the application of the same method by a different researcher. In recent years Bulgaria is increasingly included in international and European studies of the size and nature of the undeclared economy, allowing cross-national comparisons.

Looking beyond the numbers, it seems to be the nature and country-specific characteristics of the phenomenon in Bulgaria that pose the more pressing questions, as the undeclared economy “*does not shrink in all its parts*” (Chavdarova, 2002: 69). EU-wide data allowing cross-national comparisons also reveals major differences among Member States. The following section assesses the nature and specific manifestations of undeclared work in Bulgaria.

#### 4. Nature of the undeclared economy

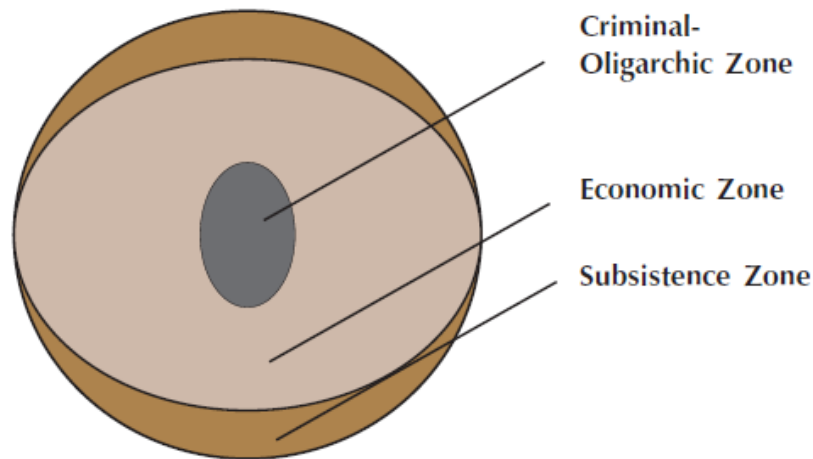
Analyses of the Center for the Study of Democracy for the past 10-15 years have revealed that there are three different dimensions of the Bulgarian economy that is hidden from the authorities (CSD, 2009a; CSD, 2010; CSD, 2011; CSD, 2012).

The **social (subsistence-motivated) dimension** encompasses commodity-exchange activities and is centered on the most economically deprived and socially/geographically isolated communities in the country, including ethnic minority communities. Although this commodity-exchange dominated undeclared realm is shrinking, it remains substantial in villages and small towns. The prevalence of this dimension is rooted in the still weak development of market mechanisms in the economy and low purchasing power of the population. With declining incomes due to the economic crisis many households that have escaped this dimension during the period of economic growth (2001-2008), may have again resorted to informal subsistence activities during the current economic crisis.

The second “**economic**” zone encompasses the largest part of the non-observed economy. It includes “regular” economic actors (firms) that resort to off-the-books practices as a means of coping with the “inconsistencies between economic realities and formal state regulations” (CSD, 2009a). Improvements in the business environment, some institutional reforms and legislation changes in the context of Bulgaria’s EU accession and market liberalization have led to the shrinking of this zone over the past decade, but it remains a significant problem. Labour-intensive, low technology sectors such as construction, retail, textiles, tourism, agriculture and services (e.g. repairs, private education, healthcare, transport, etc.) are particularly affected. Producers of excise duty goods (e.g. alcohol, cigarettes and fuels) are also considered “hotbeds” for such grey economic practices.

#### Figure 6. The three dimensions of the hidden economy in Bulgaria





Source: CSD (2009).

The third dimension is the **criminal-oligarchic zone**, which encompasses oligarchic economic circles, which through politically connected companies and the extensive use of corruption are able gain competitive advantage, access to lucrative public tenders and influence over distribution of public resources. Some of the economic actors in this zone are in parallel involved in the black (illegal) economy (smuggling, drugs, prostitution, etc.).

Although the three dimensions are only a rough depiction of the structure of the undeclared economy widely-defined in Bulgaria, this conceptual division should be kept in mind when discussing potential barriers to formalisation, as each of the zones has its distinctive drivers and mechanisms and requires a tailored policy approach. The rest of this chapter provides an overview of the available evidence on the different types of undeclared economic activities, what motivates their supply and demand, as well the sectoral, business and spatial variations in their prevalence.

In line with the adopted definition, this report focuses broadly on the second dimension of the undeclared economy. However, the intersection between legal yet undeclared activities and organised crime and “black” markets is also discussed. This appears particularly relevant to the Bulgarian case, as organised criminal groups penetrate the formal economic structure to a significant extent. The following forms of undeclared work are emphasised due to their prevalence in the Bulgarian context:

- Work without formal contract
- Underreported remuneration (envelope wages / cash in hand)
- Evasion of social security contributions
- Tax evasion and underreported turnover/profit
- Undeclared production and trade in excise goods

To do this, this section examines the sectors and business types where undeclared practices are more prevalent, a review of the supply and demand side of undeclared work, followed by a more detailed overview of the different types of undeclared economic activities as listed above. It concludes with a discussion of the intersection between criminal and undeclared activities, exemplified through the case of undeclared production and sales of excise goods.

#### 4.1. Sectorial and business variations

Most available data on the sectorial distribution of the undeclared economy comes from direct surveys among businesses and the population. However, direct surveys cover diverse selections of sectors and comparison over time is often difficult.

To evaluate the distribution of the undeclared economy across sectors in Bulgaria in a manner that is comparable cross-nationally, the World Bank *Enterprise Survey 2007* can be analysed. The survey results show that firms in the garments and food sector face the strongest competition from businesses operating on an off-the-books basis, followed by other manufacturing, machinery and equipment (see Table 8). The World Bank *Enterprise Survey 2009* does not provide a sector breakdown for Bulgaria. **Small and medium-size enterprises** are also more likely to face competition from entities operating off-the-books. The Eurobarometer *Survey on Undeclared Work in the EU* (European Commission, 2014c) also confirms that employees from small and medium-size companies are more likely to receive part of their remuneration in cash (“envelope wages”, see further below).

**Table 8. Prevalence of the Undeclared Economy in Bulgaria by Firm Size**

Sector / firm size	Percent of firms competing against unregistered or informal firms	Percent of firms formally registered when they started operations in the country	Percent of firms identifying practices of competitors in the informal sector as a major constraint
<b>By sector (2007)</b>			
Food	70,2	96,6	55,4
Garments	<b>83,1</b>	99,0	<b>59,0</b>
Machinery & Equipment	65,7	<b>58,0</b>	56,6
Electronics	43,9	99,0	20,1
Other Manufacturing	66,4	98,8	38,6
Retail	57,3	100,0	41,4
IT & IT Services	25,3	97,8	25,7
Other Services	59,5	98,2	35,8
<b>By firm size (2009)</b>			
Small (5-19)	60,0	98,8	53,3
Medium (20-99)	61,4	92,5	60,0
Large (100+)	56,9	99,4	36,7

Source: World Bank *Enterprise Survey 2007 and 2009*.

A series of national representative surveys conducted by BICA in 2010 and 2012 asked business representatives, employees, as well as the population to rank the sectors that they believe are mostly affected by undeclared activities. The first four sectors named by all three groups are **construction, tourism, health care** and **diary production**.

The survey also provides valuable data on the occurrence and acceptance of certain types of undeclared work within 11 economic sectors. (BICA, 2011a: 83). The added value of the survey’s results is not least related to the broad definition of the undeclared economy used, which captures several dimensions of the phenomena, both employment- and enterprise-related.



**Table 9. Ranking of 11 pilot sectors with the highest shares of undeclared activities, according to the population, employers and employees**

According to the population	According to the employers	According to employees and workers
1. Construction	1. Construction	1. Tourism
2. Health care	2. Tourism	2. Construction
3. Tourism	3. Health care	3. Health care
4. Dairy production	4. Dairy production	4. Dairy production
5. IT	5. Light industry (printing)	5. Non-banking financial services
6. Non-banking financial services	6. Non-banking financial services	6. Light industry (printing)
7. Machine engineering	7. IT	7. IT
8. Electronics and Electrical Engineering	8. Electronics and Electrical Engineering	8. Perfumery and cosmetics
9. Light industry (printing)	9. Perfumery and cosmetics	9. Electronics and Electrical Engineering
10. Perfumery and cosmetics	10. Machine engineering	10. Machine engineering
11. Postal services	11. Postal services	11. Postal services

Source: BICA (2011a). The survey captured only the 11 pilot sectors listed above.

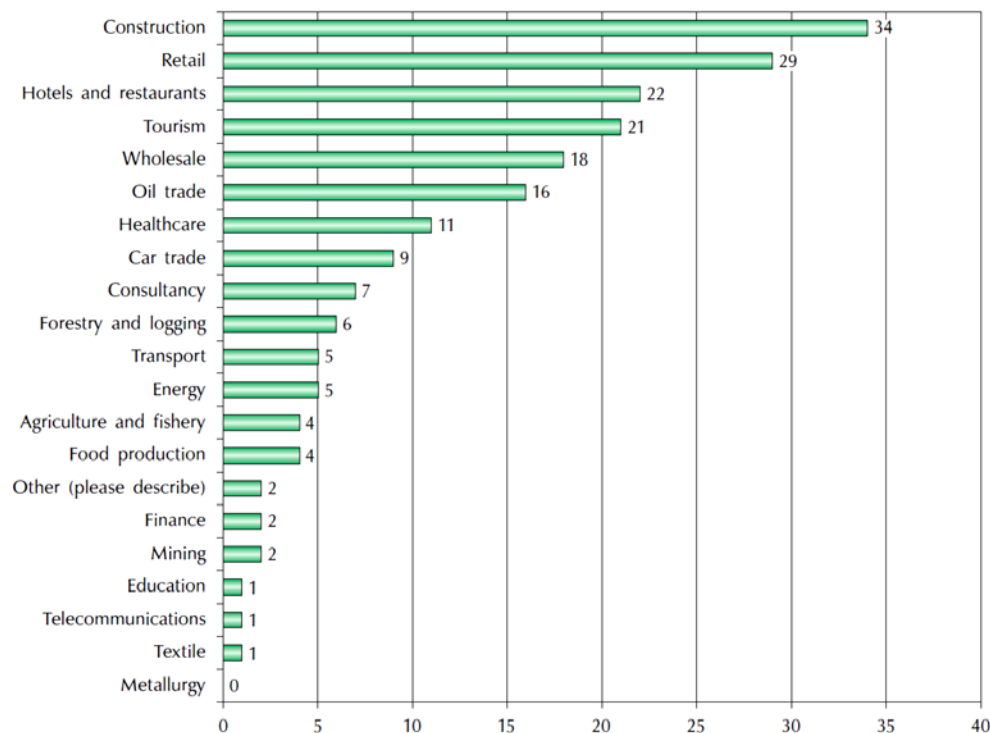
**Table 10. Prevalence of different forms of undeclared work by sector according to the employers (% of employers who believe that undeclared activities occur often and very often in the respective sector)**

Type of UDW	60% and above of the respondents	50%-60% of respondents	40%-50% of respondents
<b>Work without contract</b>	Real estate	Construction	Retail and repairs
<b>Underreported remuneration</b>	Construction Real estate	Transport and communication	Hotels and restaurants Financial and insurance services Agriculture
<b>Social security insurance paid on salary lower than the actual</b>	Construction Hotels and restaurants Real estate	Trade and repairs Administrative activities Transport and telecommunications	
<b>Underreported turnover</b>	Administrative activities and real estate	Hotels and restaurants Finance and insurance Construction Trade and repairs	Agriculture and forestry Manufacturing
<b>Underreported profit</b>	Administrative and supporting activities Real estate	Hotels and restaurants Construction Trade and repairs	Finance and insurance Manufacturing
<b>Cash payments preferred</b>	Administrative activities Real estate	Trade and repairs Hotels and restaurants Construction	Manufacturing Transport and telecommunications

Source: BICA (2011a), Survey of the employers.

The survey shows that the sectors associated by the employers with the greatest prevalence of different forms of undeclared work are construction, hotels and restaurants, retail and repair services, real estate, as well as the administrative and supporting services. Construction, retail and hotels and restaurants are also most affected according to the *Hidden Economy Survey* of the businesses carried out annually by CSD (2011) (Figure 7).

Figure 7. Sectors with the largest shares of hidden economic activity according to businesses (2010)



Source: *Hidden Economy Survey on the Businesses, CSD (2011)*.

An additional source of evidence for sectors most affected by undeclared practices are the annual reports on the inspection activity of the General Labour Inspectorate (2013), which largely list similar sectors as outlined above. According to its most recent report, in 2012 the greatest number of violations related to undeclared work were found in retail trade, hotels and restaurants, food production, construction, wholesale trade, textile production, transport and security firms. It is not surprising that most violations were found in micro and medium-sized firms, given the overall structure of the Bulgarian economy (the average firm size is quite small) and considering that inspection activity is predominantly focused on such businesses. According to the National Revenue Agency responsible for tax collection, tax evasion is occurring mostly in the field of excise goods production and distribution (CSD, 2012).

#### 4.2. Supply and demand of undeclared work

The EC-commissioned Eurobarometer Survey on undeclared work is one of the few, if not the only, data sources that allows a comparison of both the demand and supply side of undeclared work across the EU Member States. It is based on the EU definition of undeclared work: "paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States" (European Commission, 2014c). It was carried out for the first time in 2007 in the 27 member states through 26,659 face-to-face interviews in total, and in 2013 Croatia was added. The survey includes questions of respondents' opinions about, and direct experiences with, undeclared work in the form of carrying out undeclared activities, receiving "cash-in-hand" while in dependent employment, and purchasing undeclared goods and services. The Bulgarian sample in 2013 included 1,018 respondents from different socio-economic groups. This section presents the latest results for Bulgaria, compared to the situation in 2007, as well as to the average in the EU27.

Compared with the 2007 results, the number of those that were involved directly in carrying out undeclared work remained at the same level at 5% (Figure 8). There has been a notable decline in 2013 of the share of employees that received part of their salary in cash – from 14% in 2007 to 6% in 2013. The share of respondents that have paid for undeclared goods and services increased from 14% in 2007 to 16% in 2013.

Figure 8. Change in undeclared work supply and demand in Bulgaria (2007-2013)



Base: all respondents from Bulgaria (N 2007 = 1,000, N 2013 = 1,018). Source: Special Eurobarometer 402, 2013.

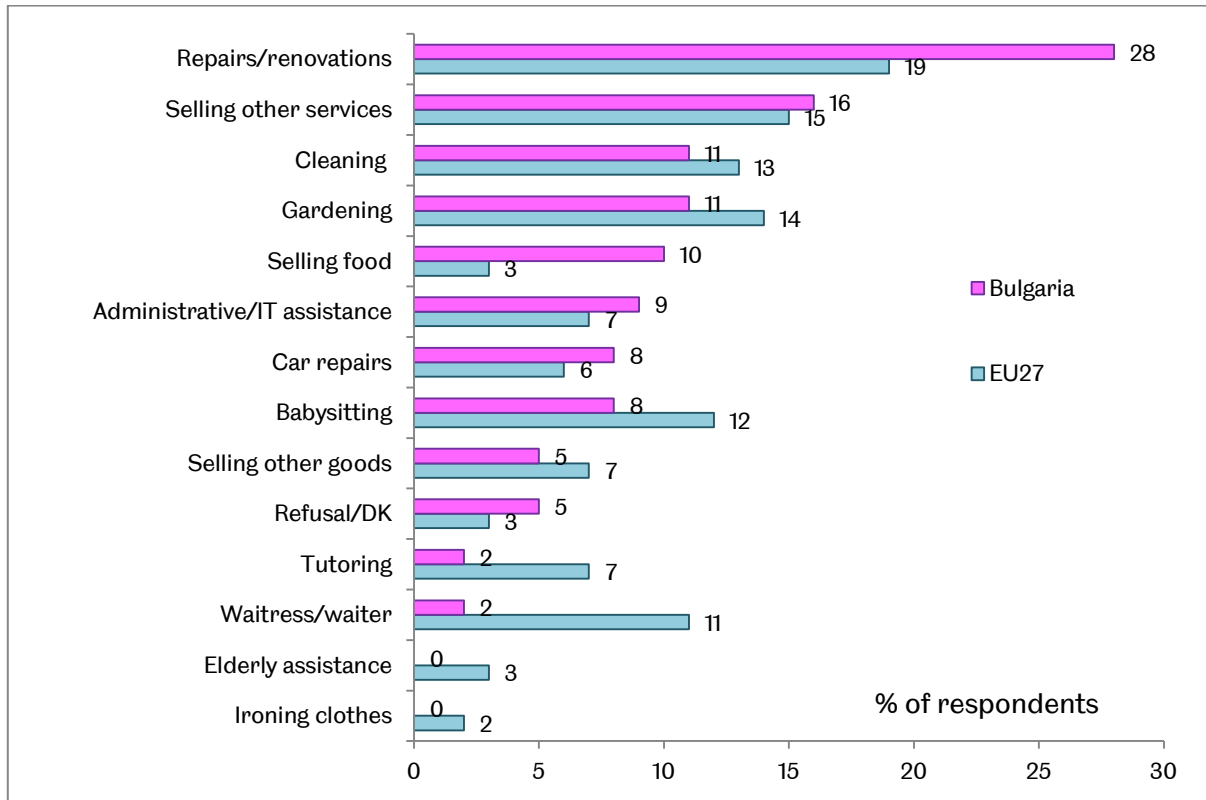
### Supply side

Looking at the supply side, in 2013 the number of respondents that carried out undeclared work over the past 12 months remained at the 2007 level of 5%, or 50 out of 1,018 employees. However, due to the small base size, the results presented in the following and their analysis should be considered with caution.

When it comes to the types of activities provided on an undeclared basis, there has been some change in the methodology, which makes it difficult to compare results with the 2007 survey. In 2007 the survey included questions on the type of sector, in which the undeclared work was carried out, indicating that 27% of respondents worked in **construction**, 15% in **industry** and 13% in **agriculture**. This classification appears much more appropriate to the Bulgarian realities than the approach adopted in 2013. In 2007 no respondents reported providing undeclared personal services. The 2013 questionnaire, however, asks respondents to choose among several categories of undeclared work, most of which can be classified as personal and household services, while there was no option anymore to select sectors.

By far the most common type of undeclared work in 2013 was **repairs and renovations**, which is in line with the average situation in the EU27 (Figure 9). The second most frequently named category is **"selling other goods and services"** (16%), which might be an indication that the provided categories in the questionnaire do not fully capture all types of undeclared goods and services provided by respondents in Bulgaria. Cleaning, gardening and selling food are the next most frequently reported activities.

Figure 9. Types of undeclared activities carried out in Bulgaria (2013)

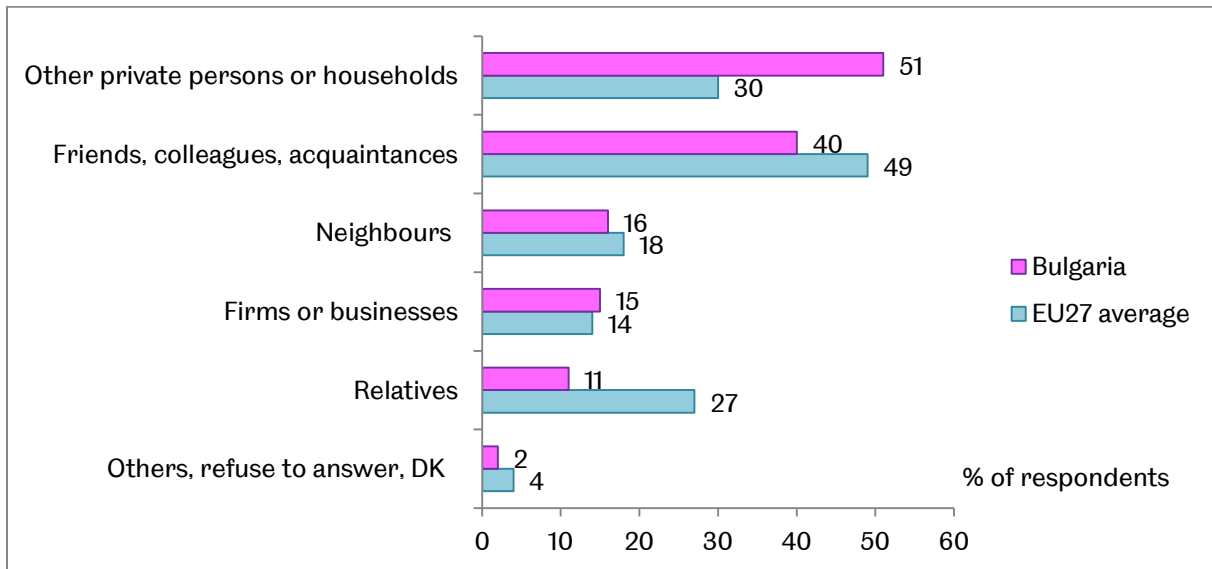


Base: Respondents who have carried out undeclared work in the past 12 months (n BG = 50, n EU27 = 988). Source: Special Eurobarometer 402, 2013.

There has been a change in the “clients” of undeclared work in Bulgaria since 2007. The 2007 survey (European Commission, 2007a) showed that undeclared work was mostly in the form of **waged jobs** and was supplied mainly to companies or businesses (50%). Self-employment for other private persons or households accounted for 28% of all reported undeclared work and 22% of the respondents indicated they are involved in self-employment for friends, family and neighbours. In the EU, however, an average of 55% in 2007 carried out undeclared activities for close social relations, while only 20% worked for businesses.

In 2013, 51% of respondents in Bulgaria stated they have provided undeclared work to other private persons and households, followed by friends and colleagues (40%), while 15% of the respondents worked undeclared for firms and businesses (Figure 10). Overall, this shows that undeclared work provided in Bulgaria has a slightly more **anonymous “face”** compared to the average situation in the EU27, where most respondents provide undeclared activities to their immediate social network through friends, colleagues, acquaintances and relatives.

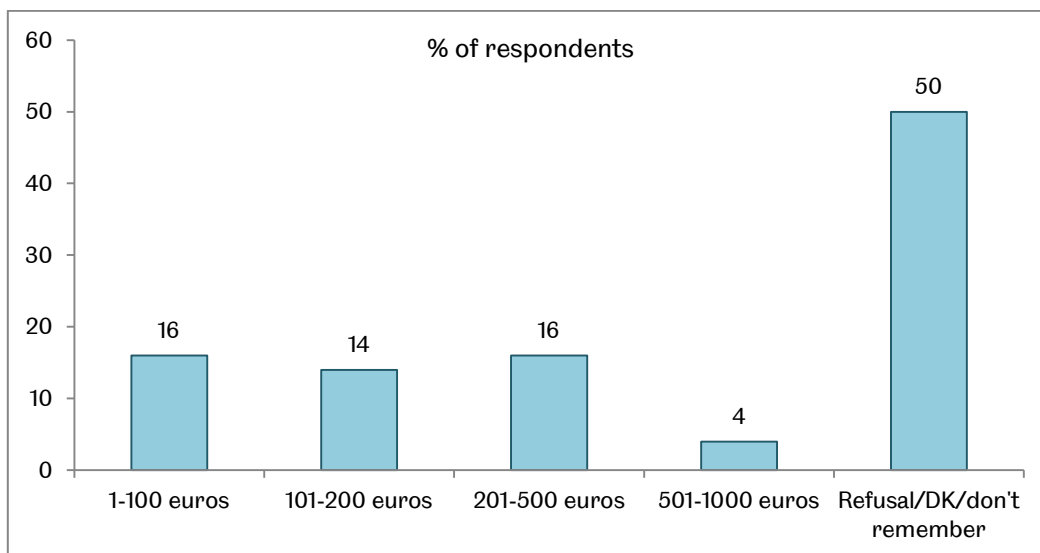
Figure 10. For whom is undeclared work carried out in Bulgaria (2013)



Base: Respondents who have carried out undeclared work in the past 12 months (n BG = 50, n EU27 = 988). Source: Special Eurobarometer 402, 2013.

The mean annual earn from undeclared work is equivalent to €233 (un-weighted), with a median annual income of €150 (both values for Bulgaria are based on un-weighted data). It should be noted that the share of those refusing to name an amount earned was 50% of all respondents that have worked undeclared (see Figure 11).

Figure 11. How much have respondents earned for undeclared activities (2013)



Base: Respondents who have carried out undeclared work in the past 12 months (n BG = 50). Source: Special Eurobarometer 402, 2013.

When it comes to the socio-economic profile of respondents that have been involved in undeclared work in the past 12 months, the survey results demonstrate that male respondents are much more likely to work undeclared than females, as well as those aged 40-54 years (Table 11). Furthermore, the unemployed/those temporarily not working are more likely to engage in undeclared activities, while pensioners are least likely to engage in undeclared work. It is notable that two of the four professionals (lawyers, doctors, etc.) included in the sample (50%) have carried out undeclared work. Respondents

from larger households (3 members and more) and those from small/middle towns and rural areas are also more likely to engage in undeclared work.

**Table 11. Who provided undeclared work in Bulgaria (2013)**

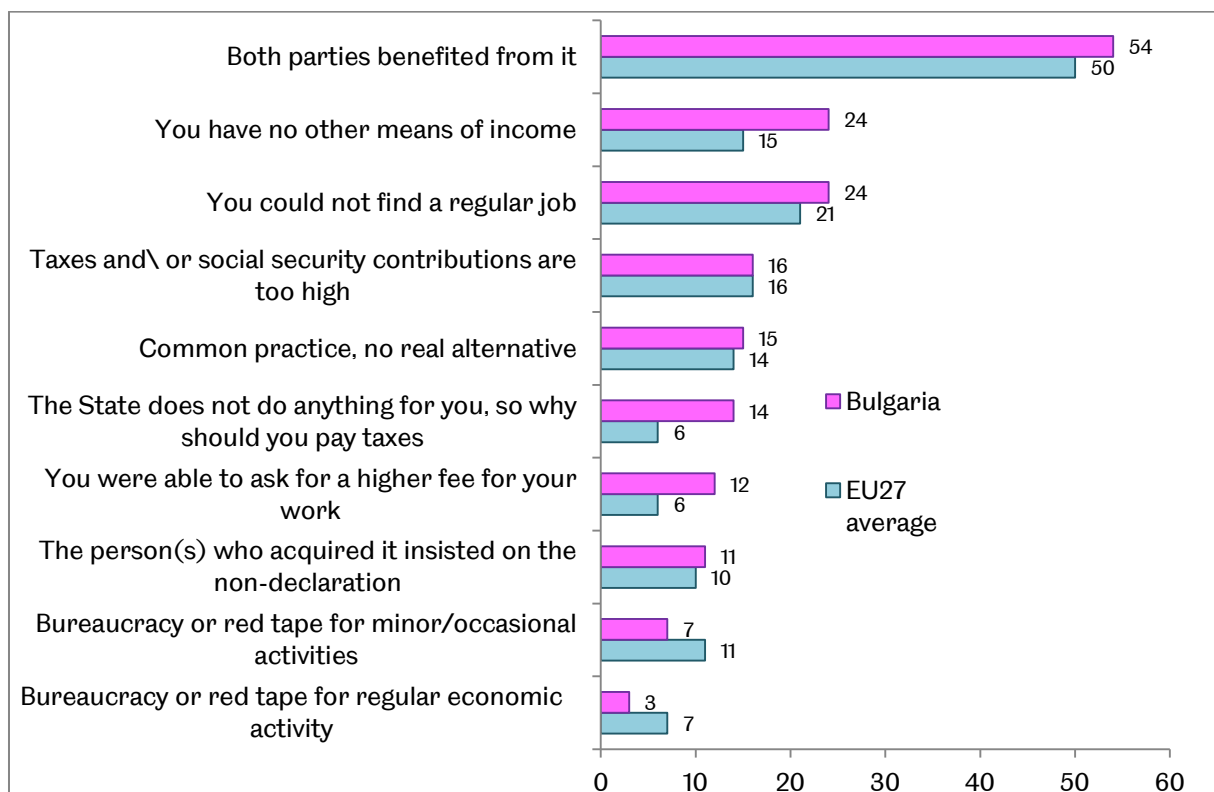
% within		Yes	No	Refusal	DK
<b>Gender</b>	Male	<b>6.8</b>	90.2	2.1	.9
	Female	3.3	95.3	.5	.9
<b>Age</b>	15 - 24 years	3.9	94.1	2.0	
	25 - 39 years	5.4	92.9	.9	.9
	40 - 54 years	<b>8.5</b>	88.7	1.8	1.1
	55 years and older	2.5	95.6	1.0	1.0
<b>Age when finished education</b>	Up to 15	<b>7.7</b>	90.0	1.5	.8
	16-19	5.0	92.7	1.5	.8
	20+	3.9	94.0	.7	1.4
	Still Studying	4.3	95.7		
	No full-time education		100.0		
<b>Occupation</b>	Responsible for ordinary shopping, etc.	5.3	94.7		
	Student	4.3	95.7		
	Unemployed, temporarily not working	<b>13.2</b>	83.3	1.4	2.1
	Retired, unable to work	1.0	97.3	1.0	.7
	Farmer		83.3	16.7	
	Professional (lawyer, etc.)	<b>50.0</b>	50.0		
	Owner of a shop, craftsmen, etc.	4.5	81.8	9.1	4.5
	Business proprietors, etc.		100.0		
	Employed professional (employed doctor, etc.)	6.4	91.5		2.1
	General management, etc.		100.0		
	Middle management, etc.	7.0	90.7	2.3	
	Employed position, at desk	1.1	98.9		
	Employed position, travelling	10.0	86.7	3.3	
	Employed position, service job	3.9	92.1	1.3	2.6
	Supervisor	11.1	88.9		
	Skilled manual worker	5.4	92.4	2.2	
Unskilled manual worker, etc.	3.9	96.1			
<b>Occupation (8 categories)</b>	Self-employed	6.3	85.4	6.3	2.1
	Managers	6.4	91.5	1.1	1.1
	Other white collars	3.3	95.8	.8	
	Manual workers	4.8	93.0	1.3	.9
	House persons	5.3	94.7		
	Unemployed	<b>13.2</b>	83.3	1.4	2.1
	Retired	1.0	97.3	1.0	.7
	Students	4.3	95.7		
<b>Household size</b>	1	2.4	96.0	.8	.8
	2	4.0	93.4	1.7	.9
	3	<b>7.0</b>	90.8	.9	1.3

	4+	5.4	92.7	1.3	.6
<b>Type of community</b>	Rural area or village	5.1	92.0	1.8	1.1
	Small/middle town	<b>7.3</b>	91.1	.8	.8
	Large town	3.6	94.3	1.2	.8
<b>Region</b>	Severozapaden (Northwest)	<b>7.8</b>	92.2		
	Severen tsentralen (North Central)	7.5	91.7		.8
	Severoiztochen (Northeast)	1.5	92.5	3.7	2.2
	Yugoiztochen (Southeast)	5.3	94.0	.7	
	Yugozapaden (Southwest)	4.5	92.3	2.1	1.0
	Yuzhen tsentralen (South Central)	4.0	94.5	.5	1.0
	Sofia [Capital]	3.6	92.2	2.4	1.8

Base: all respondents from Bulgaria (n=1.018). Source: Special Eurobarometer 402, 2013.

When it comes to the reasons for carrying out undeclared work, 54% of respondents named the mutually beneficial character of the activities for both the provider and the client as the main reason, followed by the lack of other sources of income and the lack of regular jobs (24%) (Figure 12). This is largely in line with the reasons reported on average in the EU27. It is notable that participants are to a lesser extent motivated by the bureaucracy and red tape for carrying out minor activities or regular jobs, which points to the economic pressure as an ultimate driver rather than the burden of administrative compliance with labour rules.

Figure 12. Reasons for carrying out undeclared work in Bulgaria



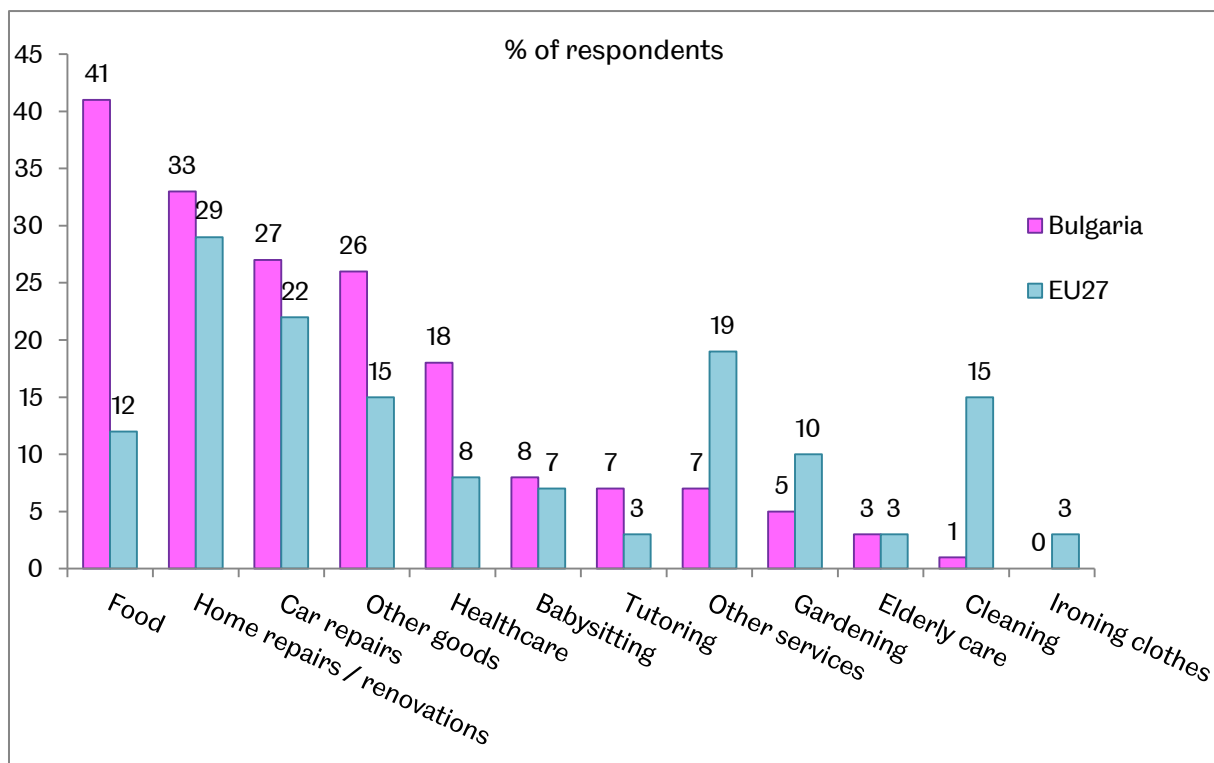
Base: Respondents who have carried out undeclared work in the past 12 months (n BG = 50, n EU27 = 988). Source: Special Eurobarometer 402, 2013.



### Demand side

In 2013 the number of respondents that have acquired goods and services from the undeclared market has increased by 2% compared to 2007 (European Commission, 2014c), which may be an indication of the increased pressure on household incomes as a result of the economic downturn and decreased consumption spending since 2008. In this context it is not surprising that in 2013, the most commonly purchased category of undeclared goods and services in Bulgaria was **food** (41%, EU's highest) (Figure 13). Home cleaning accounts for the smallest proportion of purchased undeclared services (1%). Home and car repairs are also a popular type of undeclared services acquired (33% and 27%), followed by other goods (26%) and health care services (18%). Previous studies have established that the share of domestic help services (cleaning, elderly care, babysitting) in undeclared work in Bulgaria is much smaller compared to two further fields of **household service consumption**: education services (private lessons for the entrance exams for high school and foreign language lessons) and various domestic repair and construction services (Pashev, 2006: 4).

Figure 13. Types of undeclared goods and services purchased (2013)



Base: Respondents who have acquired goods or services from undeclared activities in the last 12 months. (n BG = 158, n EU27 = 2,896). Source: Special Eurobarometer 402, 2013.

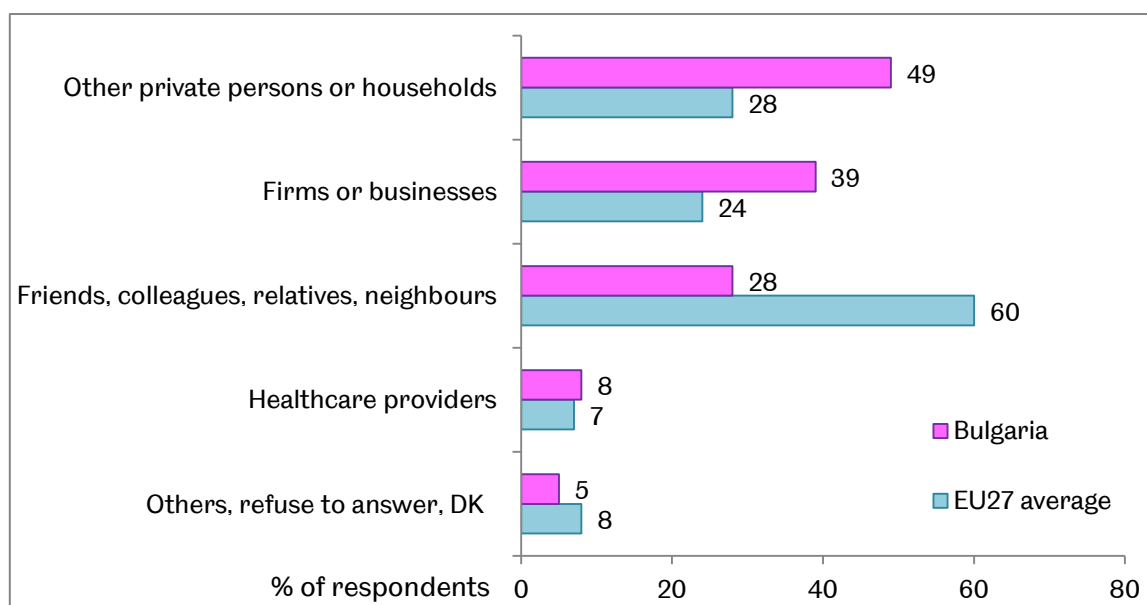
When it comes to the sources from which undeclared goods and services are purchased, Bulgaria differs from the EU average. Products and services from undeclared work in Bulgaria are purchased from registered economic actors - firms or businesses (39% in 2007 and 2013) and through other private persons or households (34% in 2007 and 49% in 2013), and less so through friends and relatives (Table 12; Figure 14). This picture differs significantly from the EU average, where undeclared goods and services are mainly purchased from members of the immediate social network of respondents (friends, relatives and neighbours: 40% in 2007 and 60% in 2013). This is indicative for the “much greater use of anonymous market mechanisms than the EU average”, especially on the demand side (Chavdarova, 2013: 5). The results from the Eurobarometer survey also confirm that there is **high level of social legitimacy** of undeclared work in Bulgaria and that the exchange mechanisms utilised by the undeclared economy are similar to those used by formal economic actors (Chavdarova, 2013).

**Table 12. From whom are undeclared goods/services purchased in Bulgaria (2007-2013)**

% of respondents	BG (2007)	BG (2013)	EU27 (2007)	EU27 (2013)
Friends, colleagues, relatives, neighbours	16	28	<b>40</b>	<b>60</b>
Other private persons or households	34	<b>49</b>	28	28
Firms or businesses	<b>39</b>	39	19	24
Others, refuse to answer, DK	11	5	13	8

Base= those who have acquired goods or services from undeclared activities (N=124 in 2007 and N=158 in 2013). Source: Special Eurobarometer 402, 2013.

**Figure 14. From whom are undeclared goods/services purchased in Bulgaria (2013)**



Source: Special Eurobarometer 402, 2013.

The mean annual spend of Bulgarian respondents on undeclared goods and services was €215<sup>5</sup> over the past 12 months. According to the Eurobarometer survey report (European Commission, 2014c), Bulgaria is one of the countries with a particularly low median annual spend on undeclared goods and services (€118)<sup>6</sup>. However, when compared to the average income level in the country, the amount is much higher in relative terms. In purchasing power standards, wages in Bulgaria amount to around 37% of the EU average.

The socio-economic data gathered through the survey allows for sketching a tentative profile of respondents that have more frequently acquired undeclared goods and services in Bulgaria. Male respondents, as well as those with no full-time education are more likely to spend on such products and services. The self-employed and house persons from households with three and more members, as well as those from rural areas and small-to-medium towns are more regularly than not purchasing undeclared products and services (see Table 13).

<sup>5</sup> Un-weighted value for Bulgaria.

<sup>6</sup> The value is provided based on EU27 weighting of the sample. The un-weighted median annual spend for Bulgaria is €100.

**Table 13. Who purchased undeclared goods / services in Bulgaria (last 12 months)?**

% within		Yes	No	Refusal	DK
<b>Gender</b>	Male	<b>17.3</b>	73.8	3.4	5.5
	Female	14.0	76.5	1.3	8.2
<b>Age</b>	15 - 24 years	12.7	77.5	2.0	7.8
	25 - 39 years	18.3	71.4	2.7	7.6
	40 - 54 years	<b>22.9</b>	69.7	2.1	5.3
	55 years and older	9.6	80.6	2.2	7.6
<b>Age when finished education</b>	Up to 15	10.8	80.0	.8	8.5
	16-19	16.3	73.7	2.5	7.5
	20+	17.0	74.6	3.2	5.3
	Still Studying	7.1	85.7		7.1
	No full-time education	<b>50.0</b>	37.5		12.5
<b>Occupation</b>	Self-employed	<b>35.4</b>	52.1	8.3	4.2
	Managers	17.0	74.5	1.1	7.4
	Other white collars	14.2	77.5	2.5	5.8
	Manual workers	20.6	69.7	3.9	5.7
	House persons	<b>31.6</b>	57.9		10.5
	Unemployed	14.6	79.2	.7	5.6
	Retired	9.8	79.3	1.7	9.2
	Students	7.1	85.7		7.1
<b>Household size</b>	1	8.9	82.3		8.9
	2	13.2	77.4	2.6	6.9
	3	<b>21.8</b>	69.4	2.6	6.1
	4+	16.1	74.4	2.5	7.0
<b>Type of community</b>	Rural area or village	<b>18.1</b>	74.3	2.9	4.7
	Small/middle town	17.7	73.0	2.4	6.9
	Large town	13.0	76.9	1.8	8.3
<b>Region</b>	Severozapaden (Northwest)	19.5	78.1	.8	1.6
	Severen tsentralen (North Central)	<b>23.3</b>	72.5	.8	3.3
	Severoiztochen (Northeast)	14.2	73.1	3.7	9.0
	Yugoiztochen (Southeast)	10.6	82.8	4.0	2.6
	Yugozapaden (Southwest)	10.1	76.9	2.4	10.5
	Yuzhen tsentralen (South Central)	20.6	68.3	1.5	9.5
	Sofia [Capital]	9.0	74.3	3.0	13.8

Base: all respondents from Bulgaria (n=1,018).

Source: Special Eurobarometer 402, 2013.

The main reason for people purchasing undeclared goods or services is the **lower price** (Figure 15). This confirms that the respondents that face greater income constraints (as indicated by the

occupation and type of community of respondents) are more likely to use undeclared market mechanisms for purchasing key goods and services. Purchasing undeclared products as a means of providing a favour to friends/relatives/colleagues or helping someone in need is less prevalent in Bulgaria compared to the EU average. However, reasons related to the failures of the declared economy are more prevalent, namely that one receives a faster service in the undeclared economy, a better quality of service and the goods and services are available.

Figure 15. Main reason for purchasing undeclared goods/services in Bulgaria



Base: Respondents who have acquired goods or services from undeclared activities in the last 12 months. (N BG = 158, N EU27 = 2,896). Source: Special Eurobarometer 402, 2013.

### 4.3. Types of undeclared economic activity

While the Eurobarometer Survey looked at the supply and demand side of undeclared work across the EU28, its focus has been very much on undeclared work conducted by private persons, while the types of goods and services included in the survey relate in the main to household and personal services. To gain a more comprehensive picture of the different types of undeclared activities occurring in Bulgaria and to track their development over time, evidence from a wide range of national studies can be examined, including business surveys. This section provides an overview of the characteristics of the following main categories of undeclared economic activities:

- Work without formal contract
- Underreported remuneration (envelope wages / cash in hand)
- Evasion of social security contributions
- Tax evasion and underreported turnover

In an annual study of hidden employment, CSD (2011) notes that in addition to the above, there are further common manifestations of undeclared work in Bulgaria, such as concealing the actual nature of employment by signing contracts for a different type of activity due to non-compliance with certain standards and norms (environmental and workplace safety, working hours, minimal wages, among others).

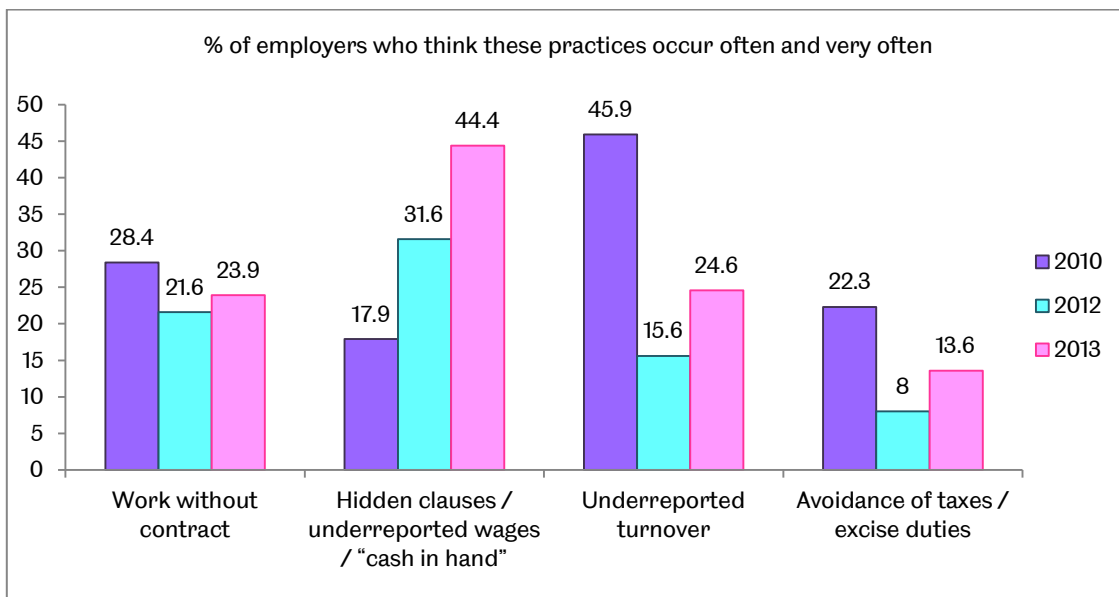
#### Overview

Some of the earlier surveys of enterprises in the late 1990s (Kyle et al, 2001) indicated that **hiring employees without contract** was the most prevalent form of informality in the labour market, while most strongly affected were the sectors traditionally susceptible to undeclared work (trade,

agriculture, construction, including seasonal and temporary work). Several more recent studies show that although regulatory reforms have contributed to the formalisation of work contracts since 2003, the share of employees receiving „envelope wages” has grown in recent years (CSD, 2011, 2013; BICA, 2012a, 2013). According to the nationally representative surveys of businesses, the employees and the population conducted by the Bulgarian Industrial Capital Association (BICA), **evasion of social security contributions and hiding actual remuneration** are the most obvious undeclared practices (BICA 2011b and 2011c). Evidence from direct surveys and monitoring efforts conducted by CSD and BICA suggest that the **non-compliance by employers** presents a greater challenge than the non-reporting by households or the self-employed.

The increase in the **incidence of contracts with hidden clauses** is also confirmed through the most recent monitoring report of BICA in 2013, following surveys conducted in 2010 and 2012 (BICA, 2012b; 2013). Compared to the results from 2010 and 2012, in 2013 there was a considerable increase in the share of employers that think “envelope wage” payments occur often and very often (44.4%) (Figure 16). The perceptions of the occurrence of work without formal contract are in general lower in 2012 and 2013 compared to 2010, which confirms the overall trend evident from other sources (CSD, 2013; NSI, 2013). Underreported turnover and tax/excise duties avoidance were perceived as decreasing from 2010 to 2012, which can be seen as a result of intensified detection and control measures introduced since 2011. However, in 2013 these two indicators increased slightly, which may be a signal for the “fading out” of the effect of tightening administrative controls.

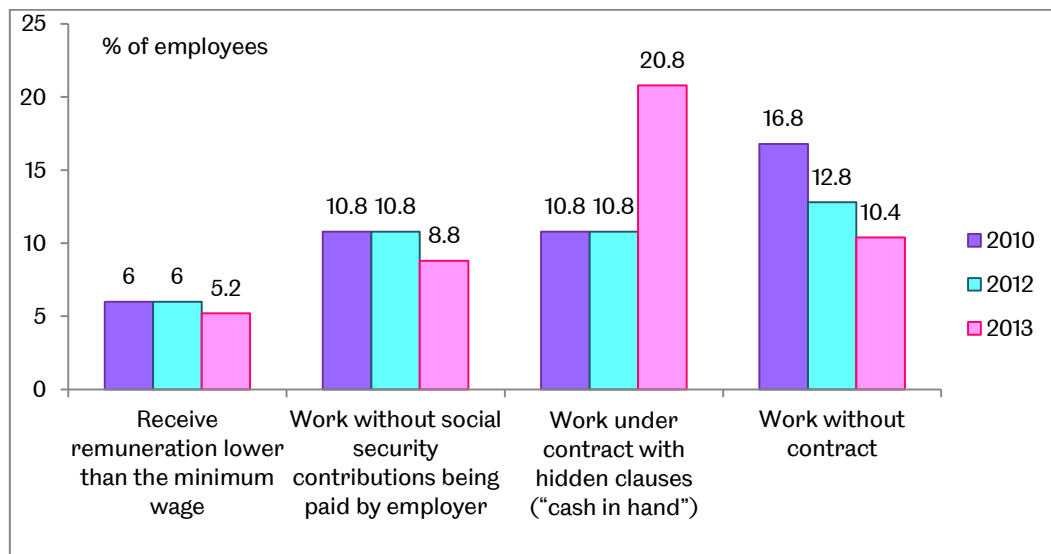
**Figure 16. Businesses’ perceptions of the occurrence of undeclared practices 2010-2013**



Source: BICA (2012b and 2013a), Survey of the employers, N=250 firms.

When it comes to participation in undeclared work, the results of BICA’s annual survey of 250 employees shows that the share of those that admitted to have worked without a contract over the past year decreased from 16.8% in 2010 to 10.4% in 2013 (Figure 17). However, particularly worrying is the trend of increased occurrence of “envelope wages” by 10% from 2012 to 2013, where contracts are signed for a certain amount, but a verbal agreement is made between employee and employer for higher actual payment.

Figure 17. Participation in undeclared work (2010-2013)



Source: BICA (2013a). Survey of the population, N=250 employees

According to representatives of the leading trade union CITUB, after an initial wave of laying off workers without contracts at the beginning of the economic crisis, the past few years have been characterized by employers resorting to under-reporting wages and registering workers on part-time contracts (Daskalova, 2013a). In reality those employees work regular working hours (or overtime), but are insured on the mandatory minimum. According to the Institute for Social and Trade Union Research, in 2012 around 164,000 part-time contracts have been reported by the National Revenue Agency (Daskalova, 2013a).

### Primary work without contract

The difference between the numbers of employees in the private sector detected within the *Survey of Enterprises* and the *Household Labour Force Survey* of the National Statistical Institute provides a picture of the existence of undeclared work for the period 2003-2007 (Table 14). The data shows a sharp decrease in 2004 in the discrepancy between the number of employees according to the Survey of Enterprises and those reported within the Labour Force Survey. However, this is followed by an increase in the following years. This data may be an indication for the decrease of the number of employees without contracts after the adoption of the obligatory registration of work contracts in 2003, but this effect was short-lived, as the difference started increasing two years later.

Table 14. Number of private sector employees: Survey of Enterprises vs. Household Labour Force Survey (2003-2007)

Year	Nr of employees Survey of Enterprises (in thousands)	Nr of employees Household Labour Force Survey (in thousands)	Difference (in thousands)	Difference in %
2003	1418.0	1198.1	219.9	18%
2004	1569.8	1423.4	146.4	10%
2005	1690.9	1497.1	193.8	13%
2006	1841.7	1599.7	242.0	15%
2007	2010.1	1697.2	312.9	18%

Source: World Bank (2008) based on data from the National Statistical Institute.



For the subsequent period (2008-2012), the *Labour Force Survey* conducted by the National Statistical Institute shows that the share of people **working without contract** has been decreasing continuously since 2008, in nominal terms and as % of the employed (NSI, 2013) (Table 15). More than 98% of those without contract work in the private sector. Between 2008 and 2010 the share of those working without contracts in the industry and services was larger than in agriculture, but in the past two years this trend has reversed.

**Table 15. Employees without contract (2008-2012)<sup>7</sup>**

Year	Total employed / thousands	Total employed without contract / thousands (in %)	Employed without contract in agriculture, forestry and fishing	Employed without contract in the industry	Employed without contract in the services
2008	3360.7	70.9 (2.1%)	n/a	n/a	n/a
2009	2847.6	59.2 (2.07%)	14.9	23.3	21
2010	2662.8	51.6 (1.94%)	13.2	19	19.4
2011	2589.2	40.4 (1.56%)	14.6	14.4	11.5
2012	2594.1	37.5 (1.45%)	13.6	12.8	11.1

Source: National Statistical Institute.

Hazans (2011) reviews data from the *European Social Survey* for the period 2004-2009 states that the share of people without a contract for Bulgaria was 9%, while the total share of undeclared employment was 13.2% of the workforce.

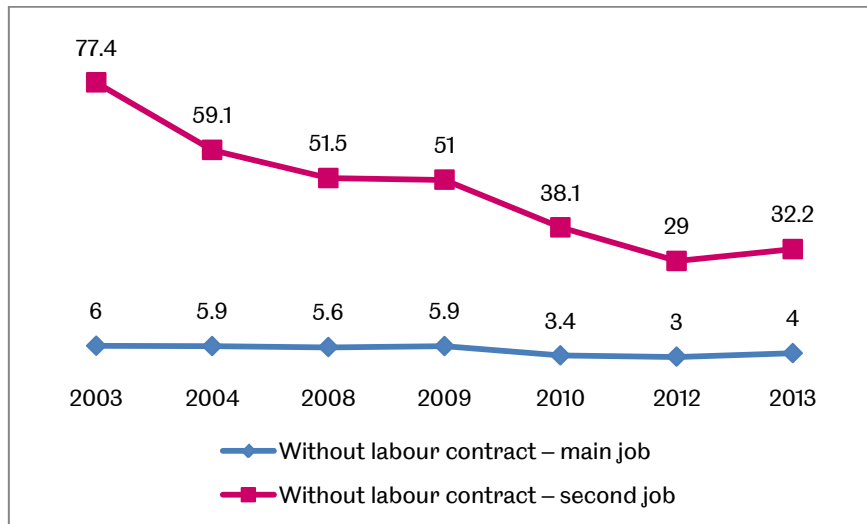
The *Hidden Economy Survey* of the population (CSD, 2013) shows that the proportion of people working without contract was declining since 2003, but increased again in 2013, although remaining at lower levels compared to the period 2003-2009 (Figure 18). A similar declining trend is also registered by the BICA surveys of the employees, where in 2010 10.4% admitted to work without contract compared to 12.8% in 2012 and 16.8% in 2010 (Figure 17). The introduction of obligatory registration of employment contracts led to a gradual approximation of the officially reported contracts and those reported in the *Labour Force Survey* of the National Statistical Institute. However, in the context of the staggering economic and business environment, the increase in 2013 of hidden employment (working without a contract and hidden clauses/envelope wages, see Figure 22) signals “persisting imbalances in the structure of employment incentives” (CSD, 2013), as well as the pressing need for policy interventions that will stimulate business creation and growth.

### Undeclared secondary employment

A particular risk in the context of the economic crisis is the non-declaration of additional jobs carried out by dependent employees, especially when working hours in the primary employment are reduced by employers. The *Hidden Economy Index* shows indeed that the risk of working undeclared is much higher with respect to the second, additional job (CSD, 2013, see Figure 18).

<sup>7</sup> The data excludes discouraged persons.

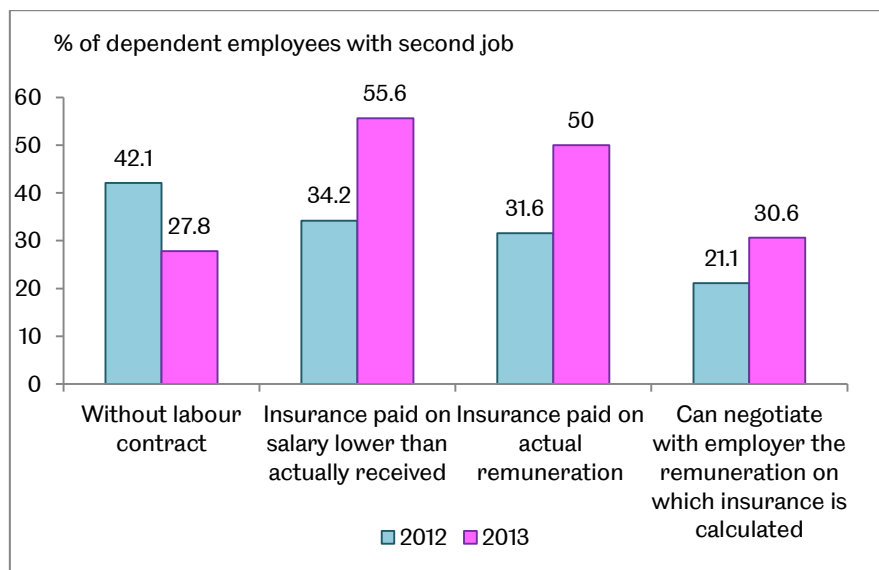
Figure 18. Employees without contract in % (2003-2013)



Source: Hidden Economy Survey of the population, CSD (2013).

The representative surveys of employees conducted by BICA since 2010 have also studied the occurrence of undeclared second jobs. In 2013, the number of dependent employees that had secondary paid jobs stood at 14.4% of all participants, compared to 15.2% in 2012 and 6.3% in 2010 (BICA, 2013a). This is an indicator for the declining incomes due to the economic crisis which has pushed many employees into seeking additional employment. For more than 83% of respondents the reason for engaging in secondary employment is insufficient income from their primary job. The types of jobs performed in secondary employment include retail sellers, agricultural workers, consultants, accountants, medical nurses, electricians, drivers, teachers, construction workers, among others. The share of those that have no contract for their secondary employment decreased from 42% in 2012 to 28% in 2013 (Figure 19). However, those who are insured on a salary lower than that actually paid for their second job increased from 34.2% in 2012 to 55.6% in 2013. At the same time, this trend is balanced out by the increase of the share of those who received the same amount on which social security contributions are calculated - from 32% in 2012 to 50% in 2013.

Figure 19. Informal practices in secondary employment (2012-2013)



Source: BICA (2013a). Survey of the employees.

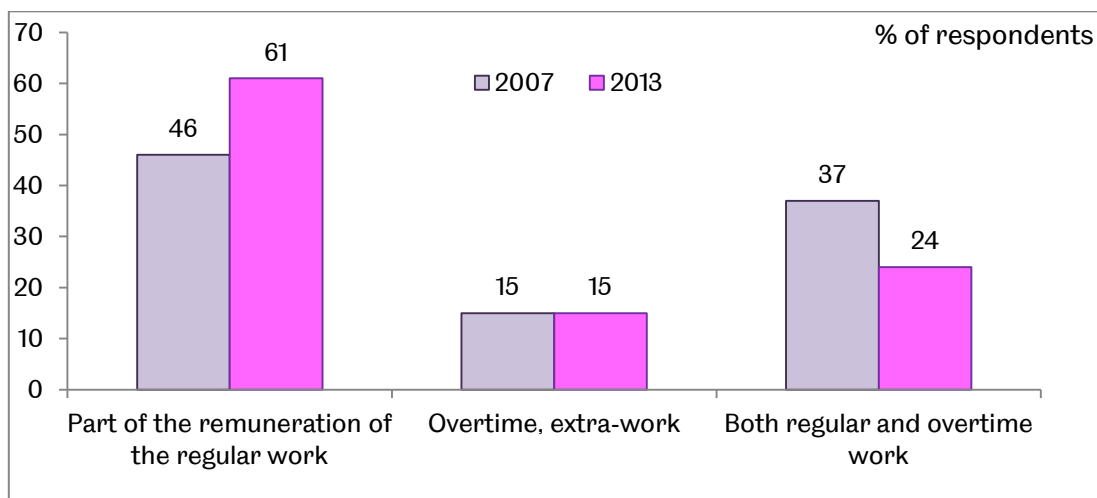
### Envelope wages

Concealment of actual remuneration and paying part of the salaries in cash is a form of undeclared work that is much harder to detect than workers without contract, as in most cases it is based on mutual (verbal) agreement between employer and employee and both parties benefit from not paying social security and taxes. It is often understood as more socially acceptable, as it is the middle ground between working completely undeclared (illegal) and bearing the entire tax burden. The phenomenon of employers declaring work contracts (and paying social security) based on the minimum wage, while paying higher actual remunerations was widespread in the 1990s and early 2000s in all sectors of the economy, until substantial labour reforms were undertaken to deter this practice. In this period, large numbers of dependant employees were not covered by any insurance, while social security insurance funds faced significant shortages.

According to the Eurobarometer surveys conducted in 2007 and 2013, there is a decline by 8% in the occurrence of under-reported wages in Bulgaria. While in 2007, 14% of employees surveyed admitted to have received “envelope wages”, in 2013 their share was only 6% (with 7% refusal rate in 2013). However, the authors of the survey report also note that “due to the small number of dependent employees who have received “envelope wages” the analysis should be considered with care and seen purely as indicative” (European Commission, 2007a).

According to Eurobarometer (European Commission, 2014c), 61% of dependent employees that received “envelope wages” in 2013 were paid for their regular work, which is a notable increase from 2007 (Figure 20). On the other hand, the share of respondents paid “envelope wages” for both regular and overtime work decreased from 37% in 2007 to 24% in 2013. The share of respondents that received envelope wages for overtime and extra work only remained at the 2007 level of 15%. These results may be an indication that ever more employers resort to “survival mode” strategies under the effect of the economic crisis, such as decreasing salaries and working hours, or declaring lower than actual salaries as a means of preserving the business without having to lay off qualified personnel. On average, dependent employees received around 33% of their salary in cash, while the median annual share of the salary paid in this way is 30%.

Figure 20. Type of income paid by employer in cash (2007-2013)



Base: Dependent employees who have received all or part of their salary in cash and not declared it in the last 12 months (N 2007 = 56, N 2013 = 27). Source: Special Eurobarometer 402, 2013.

When looking at the socio-economic profile of dependant employees who received part of their salary undeclared, there seem to be no significant gender differences, while younger respondents (aged 15-24) were much more likely to receive envelope wages than other age groups, as well as respondents without secondary and high education (Table 16). Furthermore, small firms with 5-9 employees are more likely to pay envelope wages to employees. The two occupational categories from which the greatest shares of employees receive envelope wages are supervisors and travelling employees, followed by manual workers. Furthermore, the phenomenon seems to be more prevalent in small/medium towns compared to rural areas or big cities.

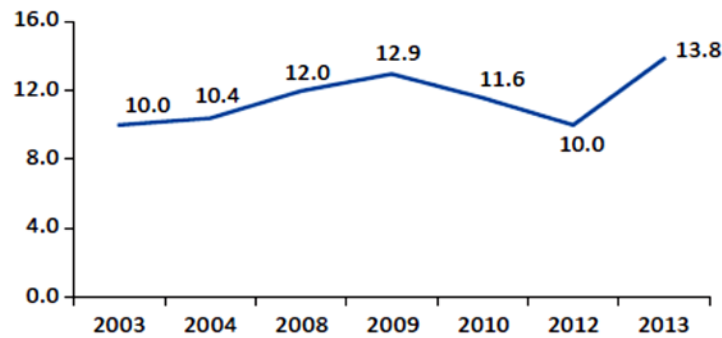
**Table 16. Who received “envelope wages” in Bulgaria (2013)**

% within		Yes	No	Refusal	DK
<b>Gender</b>	Male	6.0	85.4	4.5	4.0
	Female	6.2	90.1	1.2	2.5
<b>Age</b>	15 - 24	<b>25.0</b>	56.3	6.3	12.5
	25 - 39	5.7	85.4	3.2	5.7
	40 - 54	7.0	88.9	2.5	1.5
	55+		98.6	1.4	
<b>Age when finished education</b>	Up to 15	<b>16.7</b>	66.7		16.7
	16-19	7.6	85.6	3.6	3.2
	20+	3.4	92.7	1.7	2.2
	No full-time education		100.0		
<b>Occupation</b>	Employed professional (employed doctor, etc.)	2.1	97.9		
	General management, etc.		100.0		
	Middle management, etc.		97.7	2.3	
	Employed position, at desk	2.2	93.3	1.1	3.3
	Employed position, travelling	<b>13.3</b>	86.7		
	Employed position, service job	6.6	84.2	3.9	5.3
	Supervisor	<b>22.2</b>	77.8		
	Skilled manual worker	8.7	80.4	6.5	4.3
	Unskilled manual worker, etc.	9.8	82.4	2.0	5.9
<b>Number of employees in organisation where employed</b>	1-4	6.9	93.1		
	5-9	<b>14.3</b>	81.0		4.8
	10-19	7.4	92.6		
	20-49	6.7	91.1	1.1	1.1
	50-99	4.9	88.5	3.3	3.3
	100-499	2.9	97.1		
	500 or more	7.7	92.3		
<b>Type of community</b>	Rural area or village	4.3	89.1	4.3	2.2
	Small/middle town	<b>11.3</b>	85.8	.9	1.9
	Large town	4.5	88.5	2.9	4.1

Base: All dependant employees from Bulgaria (N=442). Source: *Special Eurobarometer 402, 2013.*

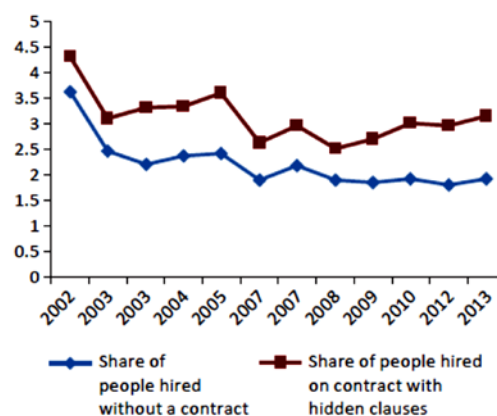
In contrast to the Eurobarometer survey, national longitudinal surveys point to an opposite trend: an increase in the share of employees receiving “envelope wages” over the past two-to-three years. This phenomenon manifests itself in the form of signing (and reporting, which is obligatory) labour contracts for the minimum insurable income amount set by the state for the respective occupational group/sector, while the rest of the actual salary is paid in cash (CSD, 2011). Another option is to declare employees on seasonal or part-time contracts, while in reality they work longer hours / periods. The *Hidden Economy Index* indicates that although the proportion of people working under formal contract has increased in the past decade (from 21.2 % in 2003 to 44 % in 2011), the problem of the so-called “envelope wages” has worsened, especially in the light of the economic crisis (CSD, 2013). In 2013, the share of people receiving remuneration higher than stated in their contract reached **13.8%**, which is the highest share registered since the index was first introduced in 2002 (see Figure 21). According to the Hidden Economy Survey of the businesses, “hiding the actual size of remuneration is most common in the **service and retail-sale sectors**. The share of hidden income from salaries is highest in the construction and services sectors, while lowest in the industrial sector” (CSD, 2011).

**Figure 21. Incidence in % of payment of remuneration higher than the stated in the contract for primary employment (last month) (2003-2013)**



Source: CSD (2013), *Hidden Economy Survey of the Population*.

**Figure 22. Development of the hidden unemployment sub-indexes (2002-2013)**



Source: CSD (2013), *Hidden Economy Survey of the Businesses*.

As mentioned earlier, the national representative surveys of the employees and businesses conducted by BICA and CITUB also indicate an increase in the incidence of work contracts with hidden clauses for higher than the reported remuneration in 2013. Employers are of the opinion that this phenomenon is on the increase since 2010 (Figure 16), while employees also reported higher levels of involvement in such practices (Figure 17). The results for 2013 show that 20.8% of the surveyed employees received

“envelope wages” compared with 10.8% in 2012 and 2010 (BICA, 2013a). As the questionnaire and the survey dataset are not publically available, it is difficult to comment on the methodology of this survey and explain why the reported share of workers receiving envelope wages has increased to such extent in 2013.

### Tax evasion / underreported turnover

As shown in Figure 16, the BICA survey of the employers indicate that from 2010 to 2012 the number of employers that believe underreported turnover and tax evasion occur often or very often has decreased considerably from 2010 to 2012. BICA explains the declining values in relation to **underreported turnover** and **tax avoidance/evasion** with a series of measures implemented by the government to increase fiscal control and revenue collection. The most significant of those is the real-time link between fiscal devices (cash registers) and the National Revenue Agency implemented in 2011, increased auditing and inspection activity of the regulatory authorities, as well as tighter customs regulations. However, in 2013 the share of employees that believe such practices are widespread recorded another increase, indicating the difficulty to achieve a sustainable effect through repressive measures.

CSD’s *Hidden Economy Survey* of businesses includes two sub-indices on **hidden turnover** and **redistribution**, which measure the incidence of the following phenomena in the respective sector:

Figure 23. Hidden turnover and redistribution indexes



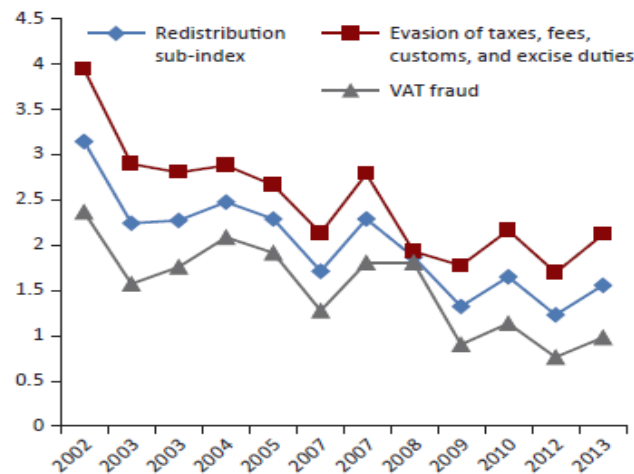
Source: CSD

The latest available data for 2013 shows that the indexes for hidden turnover, VAT fraud and evasion of taxes, customs and excises have increased compared to 2012, but remain at levels lower than in the period 2002-2007 (see Figure 24). For the same period the VAT and excise revenue growth also decreased, following the change of government and the administrative reshuffling in the respective authorities (CSD, 2013c). This indicates that the initial positive effect of the control and punitive measures implemented in 2012 may be short lived if enacted in isolation and neutralised by further political and administrative volatility.

In recent years Bulgarian governments have introduced series of measures aimed at increasing fiscal control and revenue collection. Reducing the undeclared economy is one of the goals of the incumbent government’s adjusted budgetary policy for 2014-2016. Specific measures adopted in late 2013 include: 1) reverse VAT charge for transactions of grain producers, 2) increased fiscal control over the movement of high-risk goods and 3) “cash accounting” of VAT for tax registered SMEs (accounting for VAT upon final customer cash payment) (Ministry of Finance, 2014).



Figure 24. Hidden Economy Index: redistribution, tax evasion and VAT fraud (2002-2013)



Source: CSD (2013). *Hidden Economy survey of the Businesses*.

Improving the collection of VAT has been at the core of the anti-crisis budgetary policies of governments since 2008 aimed at raising additional state revenue, while the focus on high-risk sectors and transactions is a welcomed continuation of earlier efforts. Indeed, in the past several years the National Revenue Agency has improved its risk assessment and detection capability. However, despite the proclaimed resolve to take a more innovative stance towards the undeclared economy, these measures do not signal a major shift in the government's policy approach towards more positive stimulus to make the effect of administrative and control interventions more sustainable. Measures to stimulate the business environment are limited to providing preferential tax treatment (tax reliefs) to companies operating in municipalities with high unemployment, as a means of stimulating investments and increasing employment at the same time. However, political protection over selected companies involved in VAT fraud persists and is undermining the perception of fairness among compliant economic actors.

#### 4.4. Undeclared economy and criminal markets

In some commonly used definitions of the undeclared economy, the difference between criminal and undeclared economic activities is confined to the question of whether the goods and services produced are legal or not, although the production of, or employment relations within, the undeclared economy may also be carried out through illegal means (Williams and Lansky, 2013). While drugs are an illegal product and clearly part of the criminal economy, this differentiation is much more difficult with respect to production of cigarettes and oil products, for example, which are legal products but are produced or distributed in violation of customs and tax regulations. In Bulgaria, offences against the customs and tax regime are defined as crimes in the Penal Code.

In practice the boundaries between criminal markets and the undeclared economy are often blurred, and in many instances the two phenomena cannot be separated from each other (Ponsaers, Shapland and Williams, 2008). Furthermore, previous research has found that criminal groups in Bulgaria participate in the legal economy to a greater extent than their counterparts in Western Europe (CSD, 2012; CSD, 2010; Dzhekova, 2014). Especially in trade, there is a strong link between the undeclared economy and illegal activities, most notably in relation to tobacco products, oil products, alcohol (Renoy et al, 2004). In Bulgaria the intersection between undeclared and criminal activities is of significant importance, due to the "unique nature of organised crime... to the extent that it exercises

considerable influence over the economy which is a platform to influence the political process and state institutions” (European Commission, 2012a).

The process of “hybridization” between the legal and the criminal, and between undeclared and “black” activities, remains under researched, but some authors recognize that it has intensified with the neo-liberal revolution in the 1980s (Palidda, 2013: 29-30). In the case of Bulgaria, this process is particularly relevant to the present discussion. Since the beginning of the transition period, the country’s economic elite has maintained a large part of the economy in a grey zone, closely linked with the markets for illicit goods and services (CSD, 2011). In the 1990s the main sources of illicit enrichment were rigged privatization deals, the breaking of sanctions against Yugoslavia and involvement in grey/black economy enterprises such as protection rackets and the smuggling of excisable commodities, Chinese/Turkish and other consumer goods (Dzhekova, 2014). In the past decade these criminal elites have abandoned much of these traditional criminal sources of income, and have become involved in various VAT fraud, tax avoidance schemes, EU funding and public procurement frauds (Dzhekova, 2014; CSD, 2012). In the field of organized tax and excise fraud, for instance, the **use of the legitimate business structure** is a necessary part of the criminal activity (Dzhekova, 2014). But even in other forms of organized crime (narcotics, prostitution, racketeering), the majority of the criminal groups control some legal business structure – not for the purpose of facilitating crimes, but simply as an investment and a way of laundering their criminal proceeds. As shown in previous studies on the link between organised crime and corruption in Bulgaria, based on anonymous in-depth interviews with prosecutors, tax and law enforcement officials, the hybridization of the legal and illegal economies is far reaching (CSD, 2010). It is facilitated through political and administrative corruption to an extent that powerful (formerly criminal or semi-criminal) economic conglomerates are able to gain competitive advantage through negotiating “**discretionary enforcement**” of laws and regulations at the highest political level. The tax and customs authorities are then reduced to enforcing tools of political orders of “selective control” over certain economic actors.

The second aspect of this interconnectedness of criminal markets and the declared official realm is the informal opportunity structure it creates. The Bulgarian *Serious and Organised Crime Threat Assessment 2010-2011* (CSD, 2012) estimated the annual turnover of six major organised crime markets at €1.8 billion, or 4.8% of the national GDP. However, the report also notes that, within each of these markets where penetration of organised crime is substantial, the criminal core is surrounded by a large group of participants, the so-called **grey periphery**, which are not part of organised criminal structures, but are carrying out a range of associated activities hidden from the authorities.

#### The informal “ecosystem” of organised crime networks

“There are a number of other persons gravitating around this core group of criminals within each illegal market (especially in the smuggling and sale of consumer goods, including cigarettes, illicit alcohol, etc.), **who operate within the grey economy**. They support the functioning of the illegal market by committing a wide range of administrative violations usually not classified as crimes. In practice, however, without this infrastructure at the lowest level – constituted of a large number of socially marginalised individuals – the functioning of criminal markets would be impossible. A case in point is the distribution of illegal cigarettes, where between 5,000 and 7,000 street vendors of small quantities can be sanctioned only by an administrative penalty.

The existence of this wider group of participants, typical for the lowest levels of the criminal markets, often creates the impression that there is no proper organisation. This layer is **the periphery of organised crime**. Some illegal<sup>8</sup> goods and services (cigarettes, sex services, cannabis, oil products) are provided by participants who work for themselves and are not part of organised crime. They take advantage of a criminal ‘ecosystem’ flourishing around the core of powerful criminal organisations but manage to evade control over long periods, or

<sup>8</sup> The authors refer to counterfeit and smuggled cigarettes and alcohol products as “illegal” as this type of production is not declared, and thus breaches the customs and tax regimes in Bulgaria, although the goods themselves are not banned, as is the case with drugs and sex services.

pay a type of criminal rent in exchange for access to lucrative markets or for protection, usually from the competition or from prosecution. Together, these informal and illegal economic activities flow into the grey economy which is equivalent to 25 – 30% of the country's GDP, or between €9.7 – 11.7 billion for 2011."

Source: CSD (2012) *Serious and Organised Crime Threat Assessment 2010-2011*.

### Undeclared production and trade in excise goods

Schneider and Williams (2013: 25) define the undeclared economy as "all market-based production of legal goods and services that are deliberately concealed from public authorities" for avoidance of payment of taxes, social security contributions, as well as compliance with labour market standards and administrative regulations. Considering this definition, in the case of Bulgaria the following undeclared economic activities deserve special attention, as they contribute significantly to the country's value added, although not captured in the national accounts:

- Smuggling of excise goods like cigarettes, alcohol and oil products (undeclared import and export of legally produced goods aimed at avoiding VAT and excise duties), but also smuggling of some "high risk" food commodities (sugar, meat, grain).
- Counterfeit production of cigarettes, alcohol and other goods.

Furthermore, these activities, although characterized by the involvement of organised criminal groups, create numerous opportunities for shadow employment and are also marked by the participation of legitimate (often large) economic players, which creates an environment prone to corruption and stimulate a culture of informality, undermining competitiveness of companies that operate according to the rules.

VAT and excise duties avoidance in the **oil products** market is a substantial problem in Bulgaria, as this is the country's biggest legal market, with revenues from excise duties and VAT as the largest contributor to the state budget (between 47% and 50% of all excise revenues) (CSD, 2012). Therefore, unregistered production and sales in this sector pose a significant risk to the budget stability. The Bulgarian Serious and Organised Crime Threat Assessment (SOCTA) for 2010-2011, conducted by CSD, established, for example, that between 2007 and 2009 the **differences between officially registered sales and the actual consumption of diesel were in the range of 32% to 39%** (CSD, 2012; Table 17). Estimates of the size of the undeclared fuel market rely upon data from the Customs Agency, the National Revenue Agency and data on energy consumption by the National Statistical Institute.

**Table 17. Estimate of the undeclared production of fuel (2007-2009)**

	Consumption	Diesel fuel (thousand litres)	Gasoline (thousand litres)
<b>2007</b>	Actual	2,557,617	627,505
	Declared	1,726,000	597,000
	<b>% of undeclared</b>	<b>32.5%</b>	<b>4.9%</b>
<b>2008</b>	Actual	2,816,161	655,988
	Declared	1,730,000	598,000
	<b>% of undeclared</b>	<b>38.6%</b>	<b>9.7%</b>
<b>2009</b>	Actual	2,485,257	624,619
	Declared	1,697,000	616,000
	<b>% of undeclared</b>	<b>31.7%</b>	<b>1.4%</b>

Source: *Serious and Organised Crime Threat Assessment 2010-2011*, CSD (2012)

The undeclared production and trade in fuel and oil products is characterised by the involvement of both, **legitimate economic actors and criminal networks**. According to the SOCTA, the undeclared

sales of diesel fuel generate between €280 and €430 million per year (26% – 35% of all sales for 2010-2011). The incurred losses to the state budget amount to €300 million in unpaid excise duties and €240 million in unpaid VAT (CSD, 2012).

“VAT evasion and non-payment of excise liabilities in Bulgaria most frequently occur in the **distribution of fuels and oil products**. The main mechanisms include sales without documents, fictitious purchases, sale of derivatives levied with high excise tax rates and sale of petroleum products with low excise duties without documents or with falsified documents, fictitious fuel exports, sale of marked fuel for heating purposes.”

Source: *Serious and Organised Crime Threat Assessment 2010-2011, CSD (2012)*

The **involvement of legitimate companies** in undeclared production and distribution of oil products is substantial. According to the Bulgarian SOCTA, “criminal networks which do not use a legitimate business structure as a front are rather the exception” (CSD, 2012: 47), as this type of activity requires infrastructure that cannot be easily concealed, and which legitimate operators have. Often, individual companies or private individuals may illegally import fuel for their own consumption (ibid).

**Undeclared (illegal) cigarette sales** are the other major underground market of excise goods in Bulgaria, with substantial involvement of organised crime in this activity. It is a matter of debate if this type of activity should be included in estimates of the undeclared or criminal economy. Although tobacco products are not illegal per se, their unregistered production, import and export are considered crimes against the customs regime (Art. 241-242a, Penal Code). Nevertheless, this type of undeclared production is included in this analysis, as it creates **conditions for undeclared employment** of a large number of people that are involved in retail distribution and mid/low-level wholesale (approx. 15,000 people in 2010). Furthermore, the increasing share of cigarettes produced legally by **large Bulgarian manufacturers** that are sold without excise stamps is a particularly worrying trend that presents a serious political risk and generates corruption both in the private and public sector.

According to the SOCTA analysis, around 20% of the unregistered production and trade in tobacco products is not associated with organised crime, but is related to the so-called “shuttle traders” (contraband through Serbia and Macedonia, where excise duties are lower, smuggling of duty-free cigarettes at the Turkish border, small-scale smuggling from Greece).

In 2010 the total revenues from the sale of undeclared (illicit) tobacco products reached **€250 million**, or 16 – 18% of total consumption: the legal (formal) market amounted to €1.24 billion (CSD, 2012). The size of the illegal market, in terms of cigarettes reached between **30% and 40%** of all cigarettes sold (CSD, 2012).

The undeclared sales of tobacco products (both legally produced and counterfeit) since 2008 have been growing rapidly due to the increase in cigarette prices, coupled with declining incomes and the overall effects of the economic crises. Between 2008 and 2010, the prices for mid-range cigarettes in Bulgaria increased by up to 70%, as a result of the alignment of Bulgaria’s minimal excise tax levels with those of the EU after the country’s accession to the union. This type of undeclared economy requires immediate policy attention in the light of the next wave of excise increases expected to be finalised by 2018 (Ganev, 2013), in order to contain a similar hike in undeclared sales.

## 5. Barriers to formalization

A successful policy approach to undeclared work not only would remove the barriers to formalisation, but also provide incentives for businesses and individuals to opt for formalisation (World Bank,

2008b). The nature of those barriers links directly to the discussion of the causes and drivers of undeclared work.

The burden of tax and social security contribution is identified in the literature as a key driver that influences and motivates undeclared work, followed by the quality of state institutions and the tax morale (Schneider and Williams, 2013), as shown in Table 18.

**Table 18. Main causes of the increase of the undeclared economy**

Variable	Influence on the shadow economy (in %)*	
	(a)	(b)
Tax and social security contribution burdens	35–38	45–52
Quality of state institutions	10–12	12–17
Labour market regulation	7–9	7–9
Transfer payments	5–7	7–9
Public sector services	5–7	7–9
Tax morale	22–25	–
Influence of all factors	84–98	78–96

(a) Average values of 12 studies

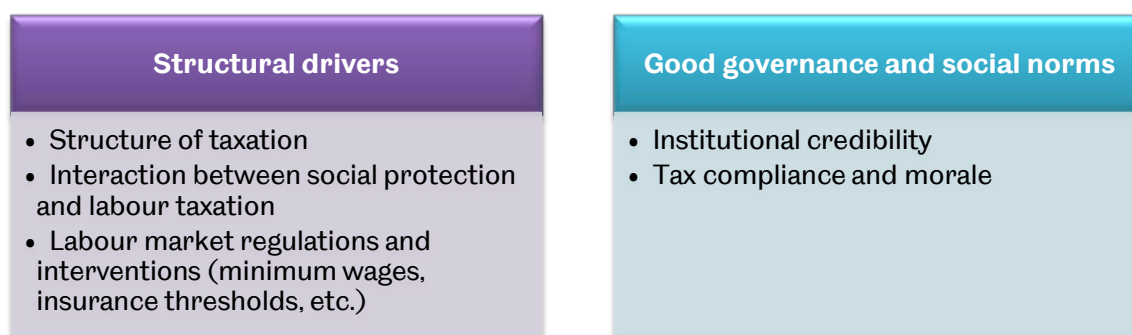
(b) Average values of empirical results of 22 studies

\*This is the normalised or standardised influence of the variable average over 12 studies (column a) and 22 studies (column b)

Source: Schneider (2009) in Schneider and Williams (2013)

According to a study on the incentives to formalize undeclared labour in the new EU Member States (Packard, Koettl and Montenegro, 2013), there are two broad sets of incentives for the undeclared economy (Figure 25). The first encompasses structural drivers (taxation structure, incentives created by social protection, effect of labour regulations such as the minimum wage) and the second is related to social norms and the relationship of trust between state institutions and individuals/firms (including tax morale, institutional credibility and efficiency, good governance).

**Figure 25. Drivers of undeclared work**



Source: based on Packard, Koettl and Montenegro (2013).

A series of World Bank commissioned studies of the undeclared economy in Central and Eastern Europe have focused in particular on the effect of taxation and labour regulations as incentives for undeclared work, especially the high burden of labour and indirect taxation (Leibfritz, 2011; Hazans, 2011; Koettl and Weber, 2012; Packard, Koettl and Montenegro, 2013).



The European Commission (2012b) in its opinion on the country's convergence programme for 2012-2015 highlights the remaining challenges for improving the administrative capacity of the public sector, especially the tax administration, where tax efficiency is low, tax evasion is prevalent, while the administrative costs for tax collection, as well as the business cost of compliance remain high. At the same time, there have been several delays with the implementation of e-government reforms.

According to recent surveys of businesses, employees and the population conducted by the business association BICA in 2010 (a survey of 500 firms from 11 pilot economic sectors, as well as a national representative survey of 1,000 employees), the majority of respondents believe that the undeclared economy is the "lifeline" for firms' survival (BICA, 2011a; 2012b). This applies particularly to small, family-owned businesses. The common perception is that if they fully comply with the tax regime, they would suffer substantial losses and would eventually go bankrupt. The central theme emerging from the analysis of employers' attitudes is that the undeclared economy is a multifaceted phenomenon that fulfils a social and economic function, namely to compensate for the existing **loopholes and inadequacies in the existing tax and social security legislation**, as well as for the **uneven treatment of different economic actors** by the state (BICA, 2011a). The latter phenomenon often finds its manifestation in the maintenance of double standards and preference of certain actors over others, while the harshness of sanctions is also perceived as selectively applied. Consequently, the undeclared economy is perceived as a "necessary evil". This corresponds closely with the analysis of CSD, which identifies the existence of **oligarchic economic structures and political protection** over certain economic actors as major weaknesses of the country's economy, which impair competitiveness and fairness (CSD, 2011, 2013).

BICA' annual surveys and in-depth interviews with business representatives from 11 economic sectors identified the following key drivers for involvement in the undeclared economy (BICA, 2012a):

- **Unfavourable economic and business environment:** legislative loopholes, frequent legislative changes, weak/ineffective administrative framework leading to distrust in institutions, as well as general insecurity and bleak business prospects.
- **Excessive regulatory regimes, red tape,** including "fabricated" regulations, mistreatment of the business by the state, weak/ineffective administrative framework.
- **Bad quality of the state administration:** corruption, unlawful enrichment, embezzlement
- Tax and social security burden
- **Lack of financial resources** for businesses: access to financing, lack of liquidity, expensive technologies, weak purchasing power of population.
- National **culture and mentality.**

According to a study on the specifics of the informal opportunity structure available to migrants in the EU Member States, in Bulgaria "the underground economy is a character of the labour market structure itself, as the phenomenon occurs, both potentially and actually in all sectors and branches in the private sector" (Rezaei and Goli, 2008).

From a labour perspective, the 2013 Eurobarometer Survey on undeclared work in the EU (European Commission, 2014c) shows that in Bulgaria, as well as in the EU, the two main reasons for undeclared work are lack of regular jobs and the low salaries in the formal market. The third most frequently named reason in Bulgaria is the lack of control by authorities, while the tax and social security burden is a less serious concern (Table 19).



Table 19. Main reasons for doing undeclared work (2007 and 2013)

First and second most important reasons for doing undeclared work (% of all participants)	BG % (2007)	BG % (2013)	EU27 % (2007)	EU27 % (2013)
Salaries in regular business too low	22	16	26	20
High taxes / social security contributions	7	7	17	
Lack of control by authorities	23	16	12	12
Lack of regular jobs	9	22	10	15

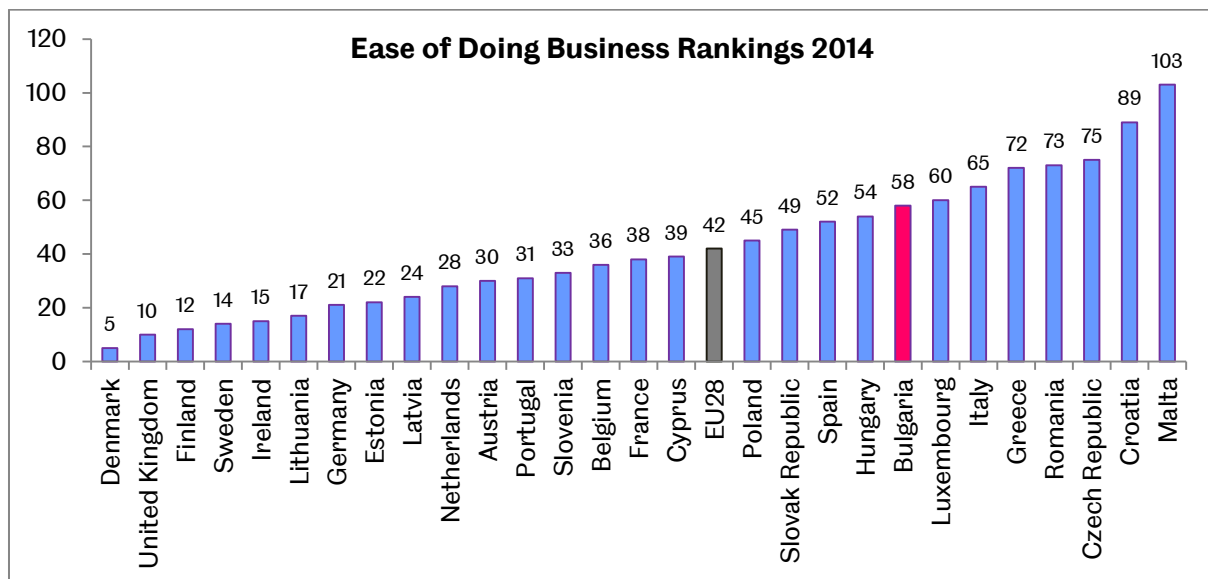
Source: Eurobarometer Surveys 2007 (n=1,000) and 2013 (n=1,018)

The reported barriers emerging from direct surveys with businesses and employees include a mix of administrative, structural, economic and socio-cultural factors which is illustrative of the difficulty of devising a suitable policy approach that accounts for all these factors.

### 5.1. Business environment barriers

To assess the barriers to operating in the declared economy from a firm perspective, the annual World Bank *Doing Business* surveys can be analysed. These provide data on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business when complying with relevant regulations. It measures and tracks changes in regulations affecting 10 areas in the life cycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Examining quantitative estimates of the ease of doing business in each of these ten areas and comparing the findings with 189 other countries, the finding is that overall, Bulgaria was ranked 58<sup>th</sup> out of 189 in 2013 in terms of the ease of doing business (the EU-27 overall as a composite was ranked 40<sup>th</sup>) and 57<sup>th</sup> in 2014. The implication is that it is more difficult to open and run a small business in Bulgaria than in the EU-28 as a composite, although Bulgaria does perform better on some aspects relative to other EU countries (see Figure 26).

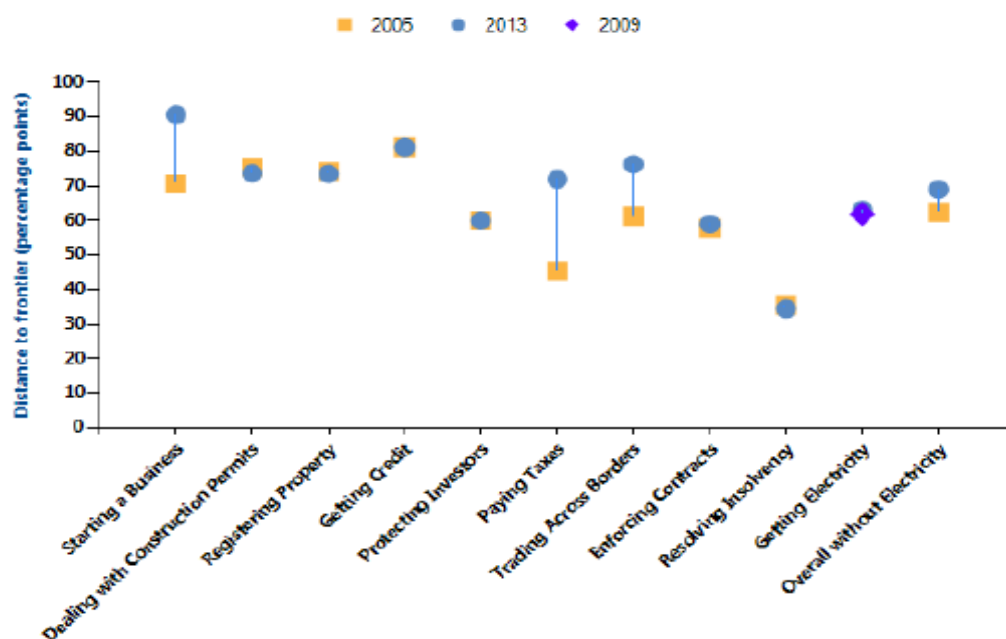
Figure 26. How Bulgaria ranks in EU28 on doing business topics



Source: World Bank Doing Business 2014

Compared with the situation in 2005, Bulgaria has achieved the greatest progress in making easier the process of starting a business, paying taxes and trading across borders (see Figure 27, where the value of 100 represents the best performer and the distance of the Bulgarian economy from it). The country ranks 65<sup>th</sup> in terms of **starting a business** against an EU composite ranking of 70 while the best performer in Southeast Europe is ranked 7<sup>th</sup> (Macedonia). The process of registering a firm requires 4 procedures, 18 days and 1% of income per capita. Bulgaria has introduced a number of measures to make it easier to start a business in the country, including reducing the registration procedures, reducing the minimum capital requirement from USD 3,250 to USD 1,300, enhancing the efficiency of the company registry, and introducing a centralised electronic database for commercial registration. There has been no notable progress in all other areas.

Figure 27. How far has Bulgaria come in the areas measured by *Doing Business*

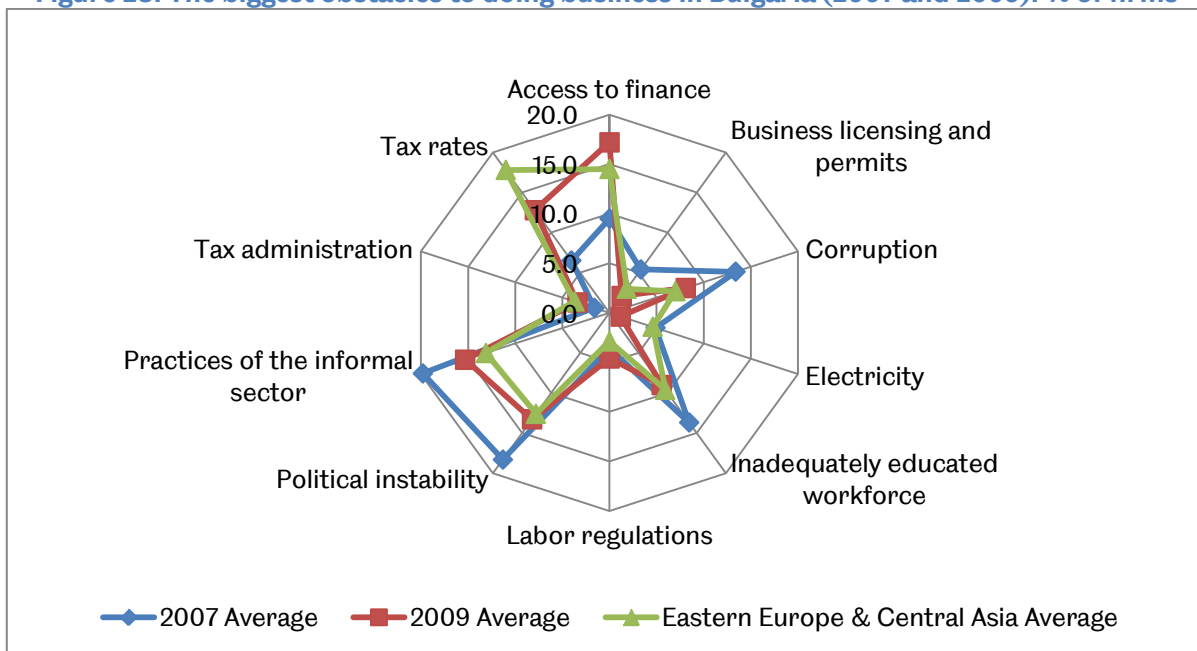


Source: World Bank *Doing Business* 2014 (the placement on the scale from 0 to 100 indicates the distance from the best performer (100)).

In terms of obtaining construction permits, the country is ranked 118<sup>th</sup> and it in fact made the process more complicated in 2009 by increasing the fees, time and procedures required, which accounts for the drop in the country's ranking from 2007. Getting electricity is another troublesome area where the country ranks 135<sup>th</sup>, with no reforms implemented in this field in recent years. Furthermore, the pressure on businesses to pay bribes to obtain construction and operation permits and licenses in 2009 was higher than the average for the upper-middle income countries (World Bank, 2009a).

The World Bank *Enterprise Survey* 2007 showed that the practices of the undeclared sector, along with political instability were the two biggest constraints to businesses operating in Bulgaria (see Figure 28). Two years later, this situation has somewhat improved, but the firms surveyed continue to see the practices of the undeclared economy as the second major constraint to doing business, preceded only by concerns about access to financing, as a result of the impact of the global economic crisis. Tax rates are also experienced as more burdensome in 2009 compared with 2007.

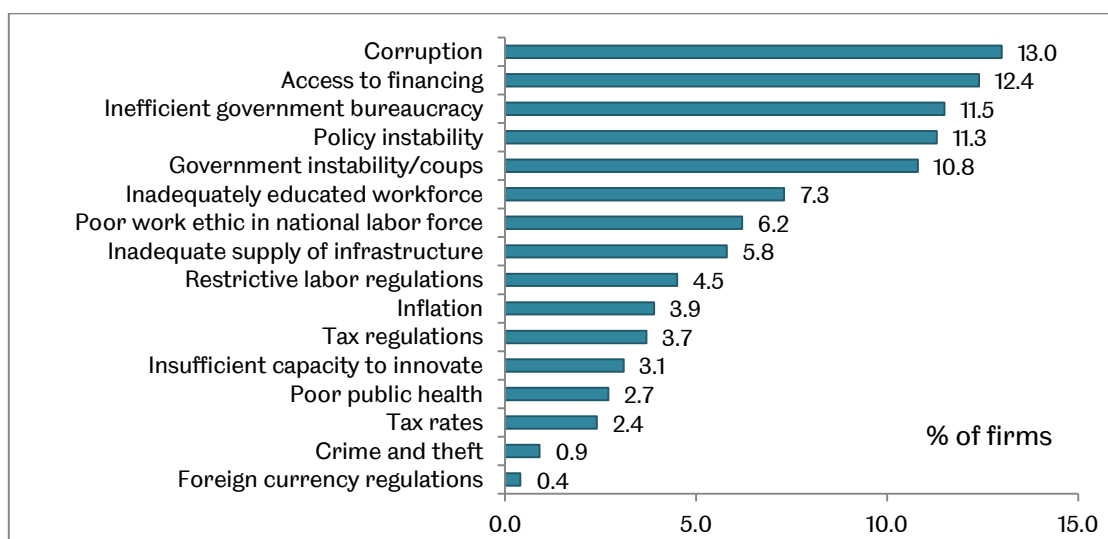
Figure 28. The biggest obstacles to doing business in Bulgaria (2007 and 2009): % of firms



Source: World Bank Enterprise Survey 2007 and 2009 (N=288)

The World Economic Forum in its *Global Competitiveness Report* provides more recent data on the most problematic factors for doing business in Bulgaria, within an *Executive Opinion Survey* conducted in 2012 on a sample of 120 Bulgarian companies (Figure 29). Most respondents find that corruption, access to financing, followed by inefficient bureaucracy and policy instability are the most burdensome aspects affecting the business environment in Bulgaria. It is remarkable that the majority of these factors are related to institutional efficiency and volatility of the political landscape, putting in question the neoliberal advocacy for retreat of the state from its regulatory function in the market (Williams, 2013). Especially in the case of Bulgaria (and other post-communist countries), the undeclared economy has flourished during the early transition period when a regulatory and institutional vacuum existed in most areas of public life, while enforcement of normative rules was particularly weak.

Figure 29. The most problematic factors to doing business in Bulgaria (2012)

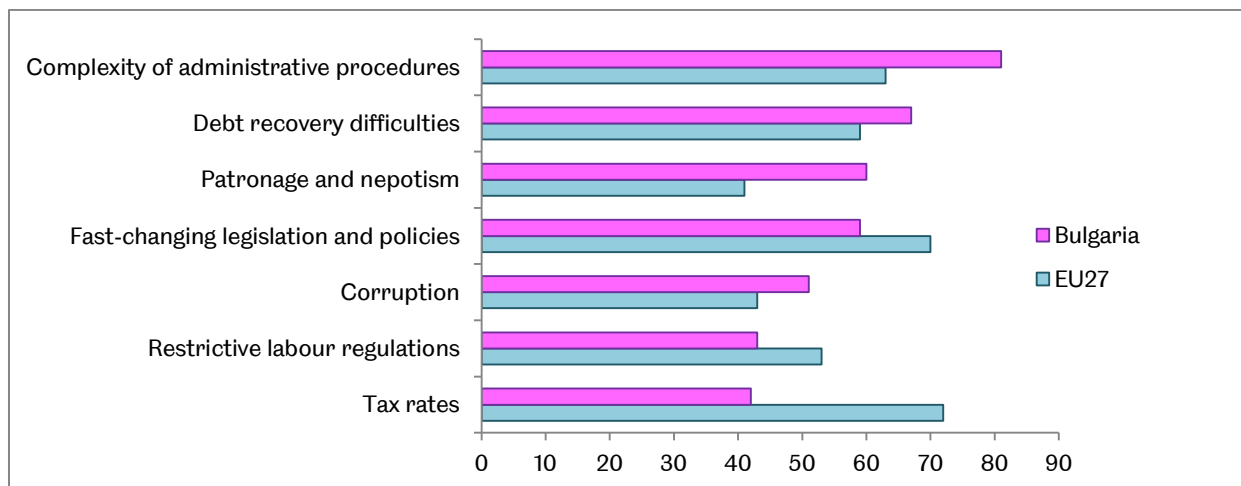


Source: World Economic Forum, Executive Opinion Survey 2012-2013: key indicators for Bulgaria (N=120).

Given these answers, it is not surprising that the lowest ranks given by business executives are related to the first pillar of the index - **institutions** – Bulgaria overall ranks 107 out of 148 countries in this indicator. Enterprises gave the lowest scores to indicators such as public trust in politicians (2.4 out of 7), favouritism in decisions of government officials (2.5 out of 7), judicial independence (2.6) and diversion of public funds (2.7) (WEF, 2013). In the sub-indicator “organised crime” Bulgaria ranks particularly bad (130th out of 148 countries).

A third source of businesses’ assessments of the obstacles to the business environment is the Eurobarometer survey on *Businesses’ Attitudes Towards Corruption in the EU* (European Commission, 2014a). It was conducted in 2013 with a sample of 301 Bulgarian companies from diverse sectors<sup>9</sup>. While tax rates are the biggest problem for companies in the EU27 on average, in Bulgaria they are less of a concern than the complexity of administrative procedures, debt recovery, and patronage and nepotism (Figure 30).

Figure 30. Problems encountered when doing business: Bulgaria vs. EU27 (2013)



Source: Flash Eurobarometer 374 (European Commission, 2014a)  
 Base: N (BG) = 301; N (EU27) = 7,541

It is notable that all three rankings of the top obstacles to businesses reveal a similar picture. The most constraining factors are not so much tax rates and labour regulations but factors related to the qualities of the institutional and political system in the country.

In this context, market entry barriers and costs of operating on the market are important disincentives for formalisation, but their removal or ease would bring improvement to the business environment only if subsequent contract enforcement and property rights are guaranteed by the state. This requires efficiently operating systems for law enforcement and administrative control that protect formally operating firms and increase the cost for non-compliant actors. However, this does not hold true for Bulgaria (CSD, 2011). Direct longitudinal surveys of businesses at national level have repeatedly pointed to corruption, lack of sanctions for illegal activity, inefficient judiciary and the penetration of organized crime into the economy as the key reasons for the existence of undeclared economic activities and a culture of non-compliance (Goev, 2009; CSD, 2011).

<sup>9</sup> Energy, mining, oil and gas, chemicals; healthcare and pharmaceutical; engineering and electronics; construction and building; telecommunications and Information technologies; financial services, banking and investment.

## 5.2. Tax and regulatory systems

Some international studies have shown that there is a correlation between the efficiency of the tax system and the undeclared economy (e.g., Packard et al, 2012). According to Johnson et al (1997) countries with complex and expensive taxation and regulatory schemes “wind up in an economically unproductive equilibrium with a large informal sector” (cited in Stanchev, 2005).

A national survey of small and medium enterprises in the late 1990s revealed that 77.8% of Bulgarian companies reported the main burden to business expansion to be the high tax and social security burden (Kyle et al, 2001). However, more recent studies (see above the Eurobarometer Survey 2013, Doing Business Survey 2014) indicate that the tax burden may have a less decisive effect in Bulgaria than factors such as the overall cost of compliance, the effectiveness of the public administration, corruption and general trust in and legitimacy of institutions. Furthermore, recent research on the relationship between the prevalence of under-reported wages and tax and social security rates on labour, found no significant correlation to confirm that either illicit envelope wage practices or wholly undeclared work are due to high taxes, or greater levels of state intervention in the labour market (Williams, 2012, 2013a,b,c). In fact, deregulation is seen as counterproductive for formalisation in countries with weak law enforcement systems (Kus, 2010; Williams, 2013d).

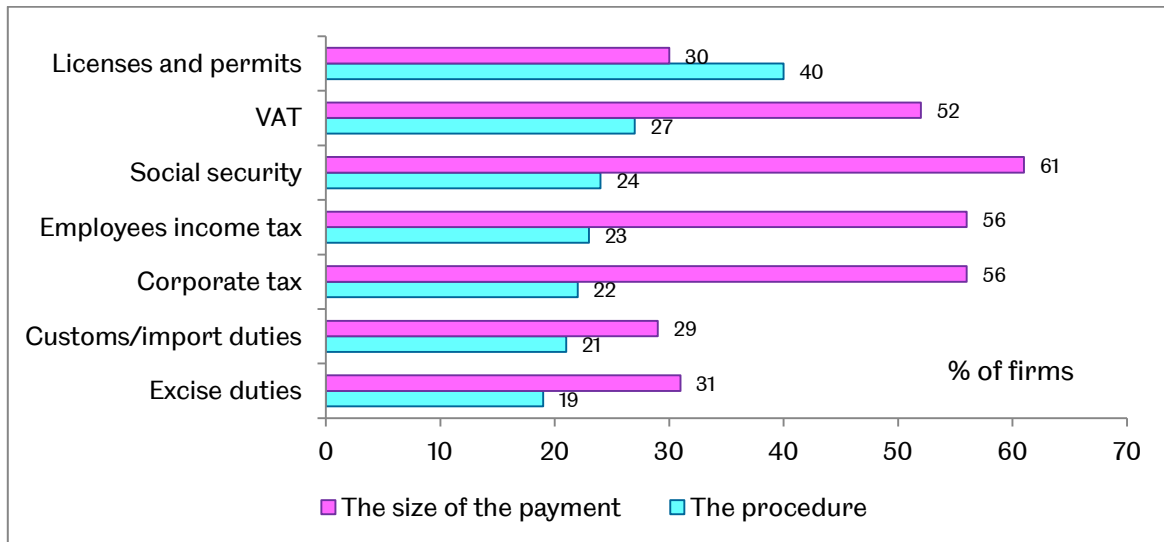
Madzharova (2011: 33) argues that low corporate income tax rates can have side effects on other tax bases: such as exacerbation of payroll tax evasion, “if the contribution burden on employers is significant and payroll tax evasion is prevalent”. Given these findings, the question of how taxes affect informality appears to be much more complex, and includes factors such as not only the size of tax payments, but also the structure (mix) of taxation, the governance of the tax system (Williams, 2012), as well as the nature of the labour market regulations and the structure of welfare systems (Packard, Koettl and Montenegro, 2012).

The World Bank’s *Doing Business* survey allows for international comparison in relation to the ease of paying taxes. In 2013 Bulgaria ranked 81<sup>st</sup> out of 189 countries while the EU-27 as a composite is ranked 63<sup>rd</sup> in terms of paying taxes (including labour, income and corporate tax). On average, companies make 13 tax payments per year, spend 454 hours per year filing, preparing and paying taxes. The total tax rate in 2013 stood at 27.7% of profit, compared to only 8.2% in Macedonia.

According to the *Paying Taxes 2014* report of PricewaterhouseCoopers (based on the *Doing Business Survey*), between 2004 and 2010 the total tax rate in Bulgaria fell by 17.5%, as a result of gradual reductions, which is the largest registered decrease in the EU (PWC, 2013). For the period 2004-2012, across the EU-EFTA region, “the greatest single reduction for any economy and any type of tax was a **reduction of 15.6% in labour taxes** in Bulgaria due to a series of reductions in employer’s social security contributions” (PWC, 2013: 97). Despite the reductions, in 2012 **the share of labour taxes was still 73% of the overall tax rate** in Bulgaria. In 2008 Bulgaria introduced the flat tax on personal income (10%), replacing the progressive tax system.

A survey of 500 businesses from 11 economic sectors carried out by BICA in 2011 (2011a) showed that obtaining licenses and permits was the most problematic area for companies in terms of procedure (40%), followed by the VAT payment procedure (27%). The size of the payment is most problematic when it comes to social security payments (61.3%) (see Figure 31).

Figure 31. Which payments of businesses to the state budget are most burdensome?



Source: BICA (2011a), survey of businesses (N=250).

Reducing taxes, or keeping them at the same level, has been part of the populist agenda of several governments in the past years, based upon the promise that despite the severe austerity programs implemented in many EU Member States, Bulgaria will not place an additional burden on consumers or businesses through higher taxes. Instead, the preferred approach was focused on increasing control over revenue collection. However, such popular, but superficial measures like reducing certain tax rates while increasing revenue collection, have proved to be inefficient in the long run for bringing companies into the declared realm, as the overall system complexity and the service provision of public institutions has not improved (CSD, 2011). For instance, it is not very helpful for a new business to pay lower taxes, if it cannot obtain the necessary permits to start operations in the first place. Furthermore, while the introduction of the 10% flat tax on corporate profits and personal income had some positive effect on tax compliance, its effect appears to have been short-lived, while other more burdensome taxes (such as VAT and labour taxation) continue to be evaded in a widespread manner.

The frequent changes in the tax and social security legislation often lack justification of their appropriateness and necessity (CSD, 2011; IME, 2010). New procedures and regulations are introduced in a non-consistent manner, without sufficient explanation and preliminary training of both the businesses and the tax administration (CSD, 2011). This creates mistrust between the business sector and the institutions responsible for implementing the tax policy (CSD, 2011), as well as a sense of unpredictability for the businesses, which might affect negatively their compliance behaviour and coping strategies.

The analysis of CSD's *Hidden Economy Monitoring System* suggests that the lack of impact and needs assessments of proposed and existing tax reforms and the absence of a holistic policy and regulatory approach towards the business environment have in the past led to the adoption of policies and normative rules which in fact have cancelled out or contradicted previous measures or have increased the administrative burden of compliance. In their good intentions, authorities often add to the complexity and inefficiency of already existing sets of normative rules. One example is the reduction of social security contribution rates and the increase in the minimal social insurance threshold in 2010 (CSD, 2011). A dedicated law for restricting administrative control over economic activity<sup>10</sup> was

<sup>10</sup> Act Restricting Administrative Regulation and Administrative Control over Economic Activity, promulgated in State Gazette No. 55/17.06.2003.



adopted in 2003, setting out the requirement for mandatory ex-ante assessments of new regulatory regimes. However, this requirement has not been fulfilled to a satisfactory degree, while other important objectives of the law have not been achieved. A further discussion of regulatory reforms adopted in Bulgaria aimed at simplifying compliance with administrative regulations is provided in the section on the policy approach and measures to tackle the undeclared economy.

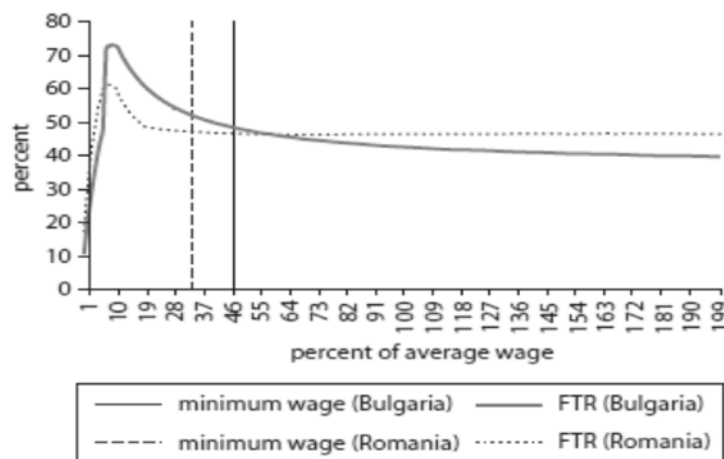
### 5.3. Labour market barriers

Working without a contract and underreporting salaries are practices that reflect the general lack of social solidarity in Bulgarian society and the lack of confidence in state institutions and in the social security and pension systems. In the long run this phenomenon reflects negatively on employees' pensions, and can destabilize the social security system through severe imbalances in the light of reduced budget revenues during economic crises. A case in point is the hasty attempt of the government to correct such imbalances in 2010 through transfer of payments from private to public social security funds (CSD, 2011). According to the 2008 European Values Study (EVS, 2011), only 16% of the population have trust in the social security system, while 77% have not much trust or none at all.

There are particularly strong disincentives for low-paid workers to “come out of the shadow”, stemming from long-persisting labour imbalances and the structure of labour incentives. The current structure of social security places the largest burden on low earners, which is a strong incentive for hiding income or working completely off-the-books. At the same time, the poor (and worsening) quality of essential public services such as health and pensions undermines strongly citizens' willingness to pay into the system. The pay-as-you-go logic of the social security system does not link benefits to contributions, which only adds to the problem (Stanchev, 2005). As Neesham (2011) notes, this leads to a vicious circle of deteriorating public services and decreasing numbers of contributors.

With respect to labour taxation, Koettl and Weber (2012) argue that the specific construction of labour taxation and social benefits regimes in the new EU Member States provide strong disincentives to formalization among low-paid workers. They introduce the *Formalization Tax Rate* (FTR) as a new measurement of the “disincentives stemming not only from labour taxation, but also from benefit withdrawal due to formalization” (Koettl and Weber, 2012: p. 3). As such, the FTR measures “the share of undeclared income that an informal worker has to give up to formalize” (Packard et al, 2012). According to this analysis, a single person with no children in Bulgaria, who earns less than the minimum wage in the undeclared sector, would have to give up between 50% and 70% of his income if s/he decides to go formal (see Figure 32).

Figure 32. Formalization tax rate and minimum wage in Bulgaria and Romania



Source: Koettl and Weber (2012), based on the OECD Tax and Benefit model (2011)

\*FTR rate for single person with no children.

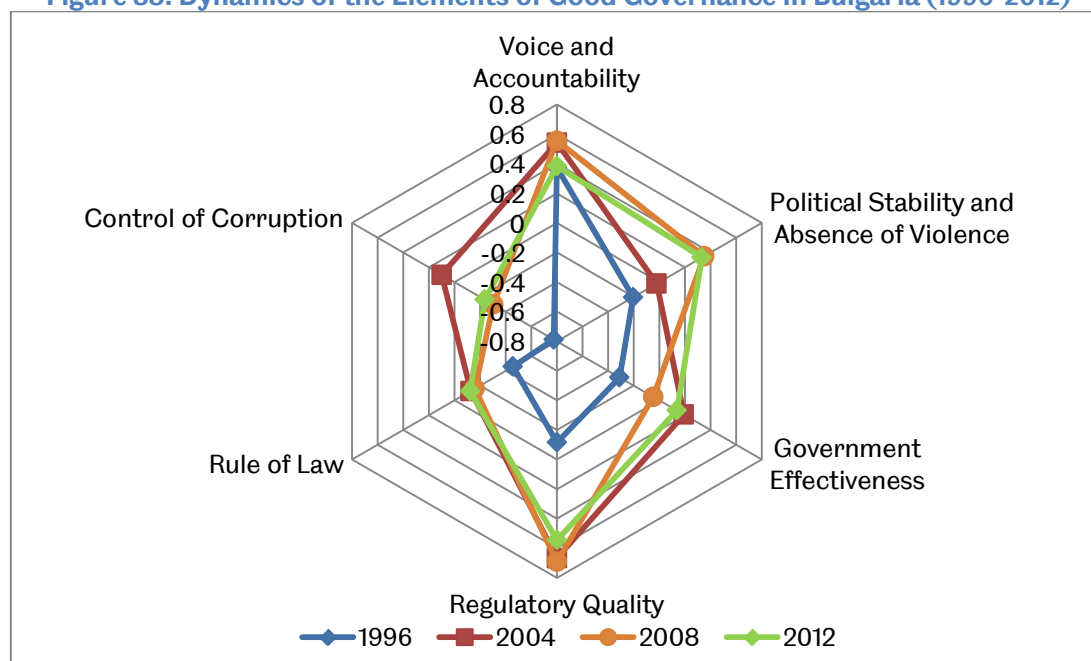
In 2003 the obligatory Minimum Social Insurance Thresholds (MSIT) were introduced in Bulgaria for nine types of professional group from all sectors and branches. These are negotiated each year via tripartite dialogue. Should negotiations fail, the MSIT are set by the government. Although they were introduced as a tool to stimulate social insurance to be paid on real salaries and reduce undeclared work, several critics argue that the steep increase of the MSIT has had the opposite effect for some categories of workers (low earners), whose actual pay is below the obligatory threshold. The effect of the MSIT on undeclared work is discussed further below in the section on policy measures.

#### 5.4. Government efficiency, corruption and public trust

Research has established that there is a relationship between corruption, trust in public institutions and the incidence of undeclared work in transition countries (Wallace and Latcheva, 2006). Corruption is emphasised by several studies as a major barrier to democratisation of institutions in transition countries and a driver that facilitates the functioning of the undeclared economy (Renooy et al, 2004).

The World Bank's *Worldwide Governance Indicators* can be assessed to trace the progress of Bulgaria since 1996 in six major governance areas, such as control of corruption, rule of law, political stability and government effectiveness. The indicators signal that the most significant progress has been achieved from 1996 up to 2004, but since then the country has in fact backtracked in the field of control of corruption (Figure 33). From 2008 to 2012 government effectiveness increased slightly, but all other indicators stagnated. This picture is confirmed by the assessment of the European Commission within the progress reports under the *Cooperation and Verification Mechanism* for Bulgaria and Romania (European Commission, 2012a), where the lack of tangible progress on a number of corruption and rule of law issues has been severely criticized.

Figure 33. Dynamics of the Elements of Good Governance in Bulgaria (1996-2012)



Source: World Bank, *Worldwide Governance Indicators 1996-2012*<sup>11</sup> (higher scores indicate better governance).

<sup>11</sup> The WGI are composite governance indicators based on 31 underlying data sources (surveys of households and firms, commercial business information providers, NGOs, public sector organisations). These data sources are

Several national surveys of businesses and employees conducted in recent years confirm that undeclared work enjoys high levels of social legitimacy in Bulgaria (BICA, 2011a, 2011b, 2012a; CSD 2011, 2013; Chavdarova, 2013). This is rooted in the deep mistrust of the population in the institutions as a particular form of the country's socialist legacy, which has become the prevailing social norm rather than an exception. Chavdarova (2013: 7) describes to the point the mutually reinforcing character of social mistrust in institutions and institutional ineffectiveness:

“In the case of Bulgaria, confidence in the proper functioning of the three legislative powers is practically absent from society. This situation puts registered and informally operating businesses on an equal footing; it does not matter whether or not their owners have signed written business contracts given that they do not believe that the legislative power would defend them in case of need. This specific cultural embeddedness of informal entrepreneurial action creates the impression that the latter entails no risk of being caught and punished.”

## 5.5. Conclusion

The evidence presented in this section from several national and cross-national surveys since the early 2000s demonstrates the complex nature of the barriers to formalisation of the undeclared economy, which requires a holistic and integrated approach that considers the interplay between tax systems, institutional efficiency, fiscal and economic measures, and overall good governance and high quality of state services, among other factors. At the same time, a tailored approach is needed that should take into account the various dimensions of undeclared economic activity, and the underlying motivations of the actors involved in each of those realms. Government policies are often constrained in their effect by structural characteristics of the national economy and the role of the business cycle (CSD, 2011). Administrative and legislative measures aimed at reducing, preventing or eradicating the undeclared economy should be therefore accompanied by, or implemented within the context of, wider macroeconomic and fiscal measures.

The next section reviews the policy approach of Bulgarian authorities to tackling undeclared work and sets it in the context of existing policy frameworks for evaluating measures aimed at bringing such economic actors out of the shadows.

## 6. Institutional framework for fighting undeclared work

This section provides an overview of the main institutional actors involved in detecting, limiting and preventing undeclared work, as well as the role of social partners. There is no single body in Bulgaria responsible for tackling undeclared economic activity. Instead, several ministries are involved in this policy area through specialised agencies, with cooperation and joint actions taking place with respect to certain control and detection tasks.

A 2010 study of 31 European countries (Dekker et al, 2010) reveals that only eight countries (26%) have either a single agency responsible for the fight against undeclared work or central coordinating committee responsible for ensuring coordinated action by the multifarious departments involved in tackling undeclared work. Furthermore, the study found that there are three main pillars where the authorities' efforts are focused: labour, social security and taxes (Table 20). Bulgaria belongs to the group of countries where the main focus in tackling undeclared work is on labour. As such, the Ministry of Labour and Social Policy has a key role in devising and implementing policies and measures to reduce undeclared employment relations, but it is not the single responsible institution, as there are

also authorities active in the two other pillars. The National Revenue Agency and the Customs Administration have a central role in the collection of taxes and excise duties.

**Table 20. Undeclared work policies in Europe: focus on three pillars**

Focus on Labour	Focus on Social Security	Focus on Taxes
Bulgaria	Belgium	Austria
Cyprus	France	Denmark
Czech Republic	Switzerland	Estonia
Greece	Liechtenstein	Germany
Hungary		Finland
Italy		Ireland
Iceland		Netherlands
Latvia		Norway
Lithuania		Sweden
Malta		United Kingdom
Luxembourg		
Poland		
Portugal		
Romania		
Slovakia		
Slovenia		
Spain		

Source: Dekker et al (2010).

## 6.1. State institutions

The **Ministry of Labour and Social Policy** (MLSP), develops drafts of legislation, proposes programmes and measures to tackle undeclared work. As such, the MLSP implements state policy through its specialized units, namely the Employment Agency, General Labour Inspectorate, Social Assistance Agency and their regional structures, and the Agency for Foreign Aid. It regulates the activity of labour market institutions at national and regional level. It also participates in the development of the main parameters of social security and payments related to it.

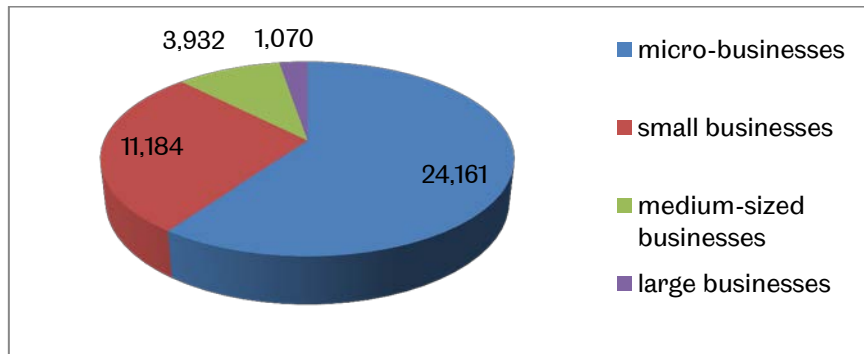
The **General Labour Inspectorate** (GLI) is an executive agency within the MLSP with 28 regional directorates. It is the main body exercising control over the observance of labour laws under the Labour Code, including the area of undeclared work. It has access to the electronic register of employment contracts managed by the National Revenue Agency. In 2009, the GLI signed a cooperation agreement with the two largest representative trade unions for joint control and information activities and campaigns in response to the new challenges of the global financial crisis and the growth of the grey economy. The website of the GLI allows for anonymous complaints to be made regarding violations of labour regulations. A public catalogue of complaints addressed at the GLI through a specialised complaints website<sup>12</sup> is indicative for the wide range of violations reported by employees concerning incorrect or lacking payments of social security contributions by employers, no compensation for overtime work, no payments for annual or sickness leave, incorrect or lacking work contracts, among others.

According to the annual report of GLI, in 2012 the inspectorate conducted 56,431 inspections, 30,695 of which were planned inspections and the rest followed tips and complaints by citizens. Around 4,000 of these inspections have been carried out jointly with other control bodies. A total of 40,347 firms were inspected in 2012, of which 60% were micro-businesses (1-9 employees), 28% small businesses (10-49

<sup>12</sup> <http://www.oplakvania.com/list/drzhavni-institutsii/drzhavni-agentsii-i-sluzhbi/izplnitelna-agentsiya-glavna-inspektsiya-po-truda.html>

employees), 10% medium-sized businesses (50-249 employees) and only 3% were large companies with more than 500 employees (Figure 34). These proportions roughly reflect the structure of the Bulgarian economy when it comes to firm size. This means that every large enterprise in the country (above 250 employees) was inspected at least once, and that almost all medium firms have been visited by GLI.

Figure 34. Businesses inspected by GLI in 2012 by firm size



Source: General Labour Inspectorate, Annual Report 2012.

As a result of the inspections, 146,683 violations of the labour legislation were identified, or 56.7% of all violations found (GLI, 2013). Violations related to undeclared payment schemes which accounted for the biggest share of all labour code-related violations (33,367 violations in 2012). The majority of the violations were detected in small and medium-sized businesses, especially those inspected for the first time. The sectors with the largest number of violations found related to undeclared work are retail trade, hotels and restaurants, food production, construction, wholesale trade, textile production, transport and security firms. The main reasons for the breaches of normative and legal requirements are the lack of financial resources, as well as lack of qualified human resources staff. The GLI notes that employees were increasingly willing to work under unfavourable conditions due to the stagnation of the labour market.

The amount of inspections, coupled with the number of violations found, is a strong indicator of the prevalence of undeclared work in Bulgaria. Furthermore, the large number of inspections puts in question the sustainability and effectiveness of this form of control activity, as the fines remains too low to offset non-compliant behaviour in the long term. Furthermore, the large number of visits demonstrates the significant administrative burden on compliant companies (CSD, 2013).

The second key body responsible for tackling the undeclared economy is the **National Revenue Agency** (NRA). The tax administration in Bulgaria was significantly reorganised between 2000 and 2006 within a World Bank-assisted Revenue Administration Reform Project launched in 2003 (World Bank, 2009b). The NRA was established in its current form in 2006 as a specialised body within the Ministry of Finance. It incorporated the collection and servicing of state taxes (income tax, VAT, corporate tax, patent tax) and the mandatory social security contributions. Also since 2006, excises are collected and administered by the Customs Agency within the Ministry of Finance. In 2010 the State Receivables Collection Agency was abolished and its functions were merged within the NRA, which now collects all public and private state receivables following the change, and represents the state in bankruptcy proceedings.<sup>13</sup> The NRA further provides information to tax payers, insured persons and insurers on their obligations and rights. Since 2007 NRA collects and administers all information

<sup>13</sup> <http://www.nap.bg/en/page?id=541>

related to the registration of labour contracts and the minimum social security thresholds, together with the National Social Security Institute.

The NRA carries out two main types of tax control activities: control inspections and audits. Audits cover a past tax period and are aimed at uncovering tax liabilities. Inspections can be conducted by all territorial units of the NRA and their objective is to detect regulatory violations. In 2012, NRA conducted more than 220,000 control inspections and 12,418 audits. The undeclared income revealed as a result of inspections and audits amounted to BGN 3 billion (€1.5 billion) in 2012, a slight decrease from the previous year (Table 21).

**Table 21. National Revenue Agency: inspections and controls 2011-2012**

Performance indicator	2011	2012
Control inspections	227,230	220,578 (-3%)
Inspections related to social security enforcement	2,474	8,505 (+243.8%)
Audits	13,232	13,418 (+1.4%)
Hidden income revealed	BGN 3.097bn	BGN 3.072bn (-0.8%)

Source: National Revenue Agency, Annual Report 2012.

Since 2012, so-called operational inspections and on-the-spot visits have been conducted by a specialised unit at the NRA. These inspections are based on information on potential tax violations. Based on the incoming information, a selection procedure is applied when identifying companies to be visited. Since 2011, operational inspections have been intensified in order to ensure compliance with the new requirement for connecting firms' fiscal devices with the NRA. However, in 2012 the number of inspections then decreased by 16% (Table 22).

**Table 22. Results from operational checks carried out by NRA in 2012**

Performance indicators	Unit	2011	2012	Change in %
Operational checks conducted	number	38,462	32,235	-16%
Administrative offences acts issued, incl.:	number	14,329	7,887	-45%
- observance of Ordinance N-18 (remote connection of fiscal devices with NRA servers)	number	8,540	4,819	-44%
- observance of social insurance legislation	number	4,908	2,454	-50%
- observance of other legislation	number	881	614	-30%
Sanctions/fines imposed	BGN	5,758,316	4,764,670	-17%
Penal orders entered into force	number	6,581	5,694	-13%
Fines entered into force	BGN	3,783,457	3,397,417	-10%
Paid penal orders entered into force	BGN	1,255,689	1,069,706	-15%
Checks within the summer inspection campaign at holiday resorts	number	1,657	1,154	-30%
Administrative offences acts issued within the summer campaign	number	927	385	-58%

Source: National Revenue Agency, Annual Report 2012.



Although the majority of violations are related to non-compliance with the requirement for a real-time link of fiscal devices, their number has decreased significantly since 2011 as more and more companies have installed and connected their fiscal registers with the NRA system. Social insurance violations detected have also declined in 2012 compared with 2011. Overall, the amount of total sanctions imposed in 2012 by the NRA was BGN 3.4 million (€ 1.7), but only a little over BGN 1 million (€0.5 million) in sanctions had been paid by the time the NRA annual report was published.

According to the NRA (2013), the improvement in some performance indicators is due to the introduction of more efficient monitoring and risk assessment procedures, which allows for more targeted inspections.

The **National Social Security Institute (NSSI)**, established in 1995, is a specialised body within the MLSP, responsible for the application of the Social Security Code, and administrating the public insurance system. It guarantees citizen's rights to pensions and benefits. The NSSI collects the obligatory social, pension and health insurance contributions and all information related to the Minimum Social Insurance Thresholds and the registration of employment contracts. The NSSI has a central unit in Sofia and 28 territorial departments across the country. It manages an e-register of insured persons and provides a number of information services to citizens and firms.

The cooperation between GLI, NRA and NSSI is regulated through an agreement for joint prevention and control activities of the observance of the tax, social security and labour legislation.<sup>14</sup> Traditionally, the NRA and the GLI have been at the forefront of the fight against undeclared work, through conducting regular inspections and audits. In recent years the two bodies have improved their ability to detect and penalise undeclared economic activity through risk assessments and monitoring, as well as data sharing. They now publish detailed annual reports which have led to improved accountability following public pressure. They have also started to develop prevention and education measures, and have become more customer-oriented through increased use of e-services. The NRA is in fact the national leader in terms of provision of e-services, followed by the NSSI. However, customer service provision is an area that requires further improvement (CSD, 2013).

It should be noted that there are a number of other agencies and state bodies with regulatory and control functions, which have an impact on regulating the business environment and different sectors of the economy, such as the National Constructions Control Department, the Executive Forest Agency, the Regional Health Inspectorates, Regional Inspectorates on the Environment and Waters, among others.

## 6.2. Role of social partners

Social partners have played a significant role in Bulgaria's policy and institutional reforms. Social pacts and tripartite "round table" dialogue between the executive branch of government, representative organisations of employers and trade unions were established in the early 1990s through the **National Council for Tripartite Cooperation (NCTC)** and have led to the adoption of numerous social policy and labour market reforms, although these have been also significantly constrained by economic and political factors (Deacon and Stubbs, 2007). Important labour regulations are negotiated annually via tripartite dialogue, including the statutory minimum wage, Minimum Social Insurance Thresholds, pension reform and retirement age, among others.

In 2011, around 33% of the workforce was covered by collective bargaining agreements (Tomev, Daskalova and Mihaylova, 2013). There are two main trade unions that meet the representation

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<sup>14</sup> Agreement No. 85 of 29 September 2010. Available at: <http://www.gli.government.bg/page.php?c=26> (last accessed 10 April 2014).

criteria: Confederation of Independent Trade Unions in Bulgaria (CITUB) with 328,000 members and Confederation of Labour “Podkrepa” (CT Podkrepa) with 91,738 members. The infrastructure of employers organizations is somewhat fragmented, with multiple memberships possible due to unclear membership rules (Tomev, Daskalova and Mihaylova, 2013). The major business associations and employers organizations that meet representativeness criteria are the Bulgarian Industrial Capital Association (BICA), Bulgarian Industrial Association (BIA), Bulgarian Chamber of Commerce and Industry (BCCI), Confederation of Employers and Industrialists in Bulgaria (CEIBG). Organisations representing SMEs do not meet representativeness criteria and are not included in tripartite social dialogue.

In 2001 the **Economic and Social Council** (ESC) was established, based on the model of the European Economic and Social Council. It is independent from the executive and legislative powers and responsible for social and civil dialogue between its members (employers, trade unions and other civil society organisations), as well as for consultations and mediation between the structures of civil society and the public authorities.

In 2006 the social partners signed a **Pact for Economic and Social Cooperation** for the period 2007-2009.<sup>15</sup> This strategic document sets out the main priorities and objectives for the development of the economic and social sector, including some that are relevant for tackling the undeclared economy (Loukanova and Bezlov, 2007). It includes a wide range of recommendations agreed upon by all parties.

In recent years, the employers’ organisations and the national trade unions have joined forces against undeclared work. There is a strong and broad consensus amongst the social partners that tackling the undeclared economy should be a priority for policy action. Trade unions are concerned with the instability of the social security system caused by undeclared work and underreported salaries. Business associations highlight the negative effect of the undeclared economy on legitimate enterprises. In 2007, two of the largest employer organisations, together with seven media outlets and support from trade unions, launched a broad public awareness campaign called “Come Into the Light”. Between 2009 and 2013 BICA and CITUB implemented a large-scale project on “Restriction and Prevention of the Informal Economy”, which led to the establishment of a national centre to streamline the efforts to tackle the problem, as well as for consultations of citizens and businesses. The project generated a considerable amount of secondary and primary data, including from a series of representative surveys, interviews and focus groups with businesses and employees. The project is the most comprehensive attempt so far at developing sustainable mechanisms for counter-action at national level. Within the project, a public council for the restriction and prevention of the undeclared economy was created in 2009, comprising representatives of the government control institutions, ministries, social partners and other stakeholders (Daskalova, 2013c). Its main objective is improved coordination and cooperation at national level in tackling the undeclared economy (Daskalova, 2013c).

In 2010, social partners signed a national agreement on *Regulations for Home Based Work in Bulgaria*, implementing the *ILO Convention No 177*. A draft bill was proposed for amendments to the Labour Code and Social Security Code, Law on Safety and Health at Work, to include a normative regulation of the home-based work, the rights and obligations of home workers and their employees. According to the trade union CITUB<sup>16</sup>, in 2011 there were between 300,000 and 500,000 home-based workers, the majority of which is in the undeclared sector.

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<sup>15</sup> Пакт за икономическо и социално развитие на Република България до 2009 г.

<sup>16</sup> <http://www.knsb-bg.org>

## 7. Policy approach and measures to tackle undeclared work

### 7.1. Typology of policy approaches

It has been widely recognized, at EU- as well as at national level, that the fight against undeclared work requires a holistic policy approach that pursues not only eradication and **repression** (through penalties, increased cost of informality and increased risk of being caught), but also one that provides **incentives for formalisation**. The European Commission has repeatedly called on Member States to adopt policy responses that aim at transforming undeclared work into regular work, including through simplification of the business environment, improving law enforcement and more effective sanctions, as well as providing incentives in the tax and social benefit system (European Commission, 2003, 2007b).

According to Williams and Renooy (2008), such measures are generally three types: **preventive** (detering entry into the undeclared economy before it occurs), **curative** (facilitating the transfer of those already operating undeclared into the formal realm), and **commitment** measures (aimed at changing attitudes towards tax compliance and playing by the rules). Although in recent years Member States have started to develop such enabling and preventative measures, the focus seems to be still very much on repression and control, as these approaches are assessed by national institutions as most effective. A study of the policy approaches to tackle undeclared work in 31 European countries (Dekkar et al, 2010) revealed that the majority of stakeholders consulted cited measures to improve detection as the most effective category, followed by preventative measures. Policies aimed at fostering commitment are assessed as the least effective (Table 23).

**Table 23. Stakeholder opinion of the importance of different types of policy measures**

% of relevant stakeholders from 31 European countries citing:	Most effective	Effective	Least effective
Measures to improve detection	<b>64</b>	19	17
Preventative measures	24	<b>57</b>	19
Curative measures	18	38	44
Fostering commitment	12	27	<b>61</b>

Source: Dekker et al (2010).

### 7.2. Overview of the policy approach in Bulgaria

Bulgaria, much like other countries from CEE and EU candidate countries, has developed targeted policies to tackle undeclared work. However, unlike countries such as Estonia, Poland and the Czech Republic, where such reforms started early on in the transition period and were facilitated through some positive economic development, Bulgaria started to shape its policy response to the undeclared economy since 2000 (Renooy et al, 2004), where some positive results were achieved in the years preceding EU membership, facilitated by the overall reform drive during this period, owing mainly to external pressure. However, a fading of this reform drive after full membership of the EU in 2007, coupled with the effect of 2008 economic crisis, contributed to the slowing down and even reversal of much of the progress achieved previously. In this context it also became apparent that the enacted reforms have not been deep-reaching enough or lack practical enforcement and implementation. It could also be argued that efforts to align Bulgarian legislation with the EU *acquis communautaire* in preparation for full membership has contributed to the emergence of a more complex and often confusing regulatory environment due to the requirement to introduce a large number of new rules, which has often been conducted as a box-ticking exercise, without sufficiently overhauling existing ones.

Nevertheless, the EU accession process has increased Bulgarian policy makers' sensitivity towards specific issues such as corruption, organised crime, the rule of law and the undeclared economy,

which in many of these areas resulted in the set-up of specialised bodies or targeted interventions to tackle these problems and respond to external pressure to fulfil membership requirements. On the one hand, this has fostered some specialisation, but on the other the fitting-in of such specialised tools within the overall system and institutional infrastructure has not been fully achieved. The policies to tackle the undeclared economy can be seen as an example of these developments.

Since the early 2000s there have been two major waves of policy reforms in Bulgaria which led to the adoption of specific measures to tackle undeclared work. The first was in 2002-2003, when a number of labour-related regulations were adopted, along with some improvements in the business environment. The second started from 2008 onwards as a response to the global economic crisis and aimed at improving tax and social security revenue collection as a means of addressing increasing budgetary shortages and labour market imbalances. What these two reform waves had in common is their focus on increased control and enforcement, which had an initial positive effect on the formalisation of shadow economic activities, but this effect was not retained in the long run. The past two years have been characterised by a continued focus of the government on improved tax collection (VAT mainly) and tackling undeclared imports and exports of excise goods.

### 7.3. Types of measures

The policy approaches framework provided by Williams and Renooy (2009), displayed in Table 24, can be used to analyse the existing infrastructure of measures implemented by the Bulgarian authorities to restrict and prevent undeclared work. It should be noted that in practice many of the policies launched include elements from several of the categories. For example, public awareness campaigns have often been accompanied by increased control activity and inspections. This strategy is a step in the right direction towards a more coordinated and comprehensive response to undeclared work. The list of measures provided in Table 24 and discussed below is not exhaustive, but it is a good starting point to illustrating the key features of the national policy approach in the fight against the undeclared economy.

**Table 24. Types of approaches and measures implemented in Bulgaria**

Approach	Method	Measures implemented in Bulgaria
<b>Deterrence (pursue and punish)</b>	Improving detection	<ul style="list-style-type: none"> <li>• Mandatory real-time link between fiscal devices and the NRA servers (2011)</li> <li>• <i>Ordinance No. 3</i> on the remote measurement and monitoring of excise goods: Excise Movement and Control System (2010)</li> <li>• Increased number of (joint) inspections and unannounced checks (NRA, GLI)</li> <li>• Targeted annual campaigns for collection of social and health insurance contributions (GLI, NRA, NSSI)</li> <li>• Data matching and sharing (NSSI, NRA)</li> <li>• Risk assessment and monitoring of “high risk” legal entities for VAT fraud (NRA)</li> <li>• Restriction of cash payments above BGN 15.000 (2011)</li> </ul>
	Increasing penalties Increasing perception of risk	<ul style="list-style-type: none"> <li>• Increased penalties for violations of the labour legislation</li> <li>• Public campaigns on inspection activity</li> <li>• “Come into the light” campaign – whistleblowing hotline advertised, inspections based on anonymous complaints (2007)</li> <li>• “Work legally” campaign (MLSP) – highlighted sanctions, monitoring of specific companies (2008)</li> </ul>

		<ul style="list-style-type: none"> <li>• “Naming and shaming” employers owing social security contributions to the state budget (public list of debtors) (NSSI)</li> </ul>
<b>Enabling formalisation/compliance</b>	Prevention (deter entry)	<ul style="list-style-type: none"> <li>• Act on Limiting Administrative Regulation and Administrative Control on Economic Activity (2003)</li> <li>• Mandatory registration of work contracts (2003)</li> <li>• Mandatory minimum social insurance thresholds (MSIT) for most sectors and occupations (2003)</li> <li>• Reducing the initial required capital of commercial companies to 2 BGN (2010)</li> </ul>
	Curative/stimulating (encouraging movement out of shadow economy)	<ul style="list-style-type: none"> <li>• Introduction of flat tax on personal incomes and corporate profits (2008)</li> <li>• Reducing social security contributions</li> <li>• Tax exemptions for firms operating in areas with high unemployment</li> <li>• National Center Rules for Business – advising and informing firms (2010)</li> <li>• Food vouchers (additional non-taxable income for employees) (2003)</li> </ul>
	Fostering commitment	<ul style="list-style-type: none"> <li>• Education, online training and public awareness campaigns within the “Work Legally”, “Come Into the Light” and “Rules for Business” initiatives</li> </ul>

Source: Policy framework adapted from Williams and Renooy (2009).

In 2009, CSD carried out a review and evaluation of proposed measures to combat undeclared work between 2005 and 2009. In the review period, 222 measures have been proposed by the government, the business sector and trade unions (CSD, 2011; CSD, 2009b). The majority of these were focused on deterrence (64 measures related to monitoring, data exchange, tax collection, more efficient inspections, stricter sanctions), as well as prevention (127 measures including new employment categories, stimuli for business and employees, stricter requirements, increased powers, publicity of campaigns). There have been only 9 remedial measures proposed, such as amnesties, stimuli for clients, business support and voluntary compliance. The following provides an overview of the more significant measures implemented since the early 2000s and a brief assessment of their impact on undeclared work.

### Prevention (deter entry)

In early 2000s, a number of important measures were introduced in Bulgaria, aimed at easing the administrative burden on the business environment and simplifying compliance, as well as labour market regulations aimed at preventing undeclared work, including mandatory registration of work contracts and mandatory social security thresholds.

### Act on Limiting Administrative Regulation and Administrative Control on Economic Activity

In 2003 an important piece of legislation was adopted in Bulgaria, aimed at setting clear rules for the administrative bodies with respect to the regulation and control they exercise on the economy. The act’s overall objective was “to facilitate and to encourage the pursuit of economic activity, by means of restricting to socially justified limits the administrative regulation and administrative control exercised over the said activity by the state bodies and by the bodies of local self-government.”<sup>17</sup> The initial draft

<sup>17</sup> Act Restricting Administrative Regulation and Administrative Control over Economic Activity, promulgated in State Gazette No. 55/17.06.2003.



of the *Act on Limiting Administrative Regulation and Administrative Control on Economic Activity* (LARACEAA) was prepared by a number of business associations and think tanks (Bulgarian Small and Medium Enterprises Promotion Agency (BSMEPA), the Institute for Market Economics (IME), the Bulgarian Chamber of Commerce and Industry (BCCI), the Bulgarian Industrial Association (BIA)), as well as lawyers and experts from the Commission on Economic Policy to the National Assembly and the Ministry of Economy. The Act was amended and supplemented over 20 times since the initial draft. Media reports refer to the Act as a piece of legislation that is crucial and yet “virtually unknown” and not sufficiently used (Boncheva, 2009).

The Act defined two **types of regulatory regimes**: licensing and registration, as well as separate deals or single actions that refer to individual deals (World Bank, 2010: 13). It also provided that all regulatory regimes and requirements for permits, certifications and notifications of separate deals and actions must be **authorized by law**. It set out the **guiding principles** of legislation and administrative procedure, including the principles of economic freedom, proportionality and legitimate expectations. Furthermore, the need for **justification of the necessity of all types of regulations** was introduced, limiting the discretionary power of policy makers. Another important requirement was introduced – that of an **ex-ante impact assessment** for each piece of regulation, accompanied by the obligation to make it public and inform in advance all stakeholders affected by the regulation. The Act introduced the principle of **“silent approval”** on the part of administrative bodies when issuing permits and certificates. Furthermore, an administrative body may not require from applicants a **proof of circumstance**, if that proof has already been certified before another body and entered into a register. The aim is to avoid the practice of double submission of identical documents to several bodies. The Act furthermore set out the **obligations** of the administration in exercising its powers, as well as the **main rules for executing control** on business activities. It also provided a list of economic activities covered by a licensing regime (World Bank, 2010).

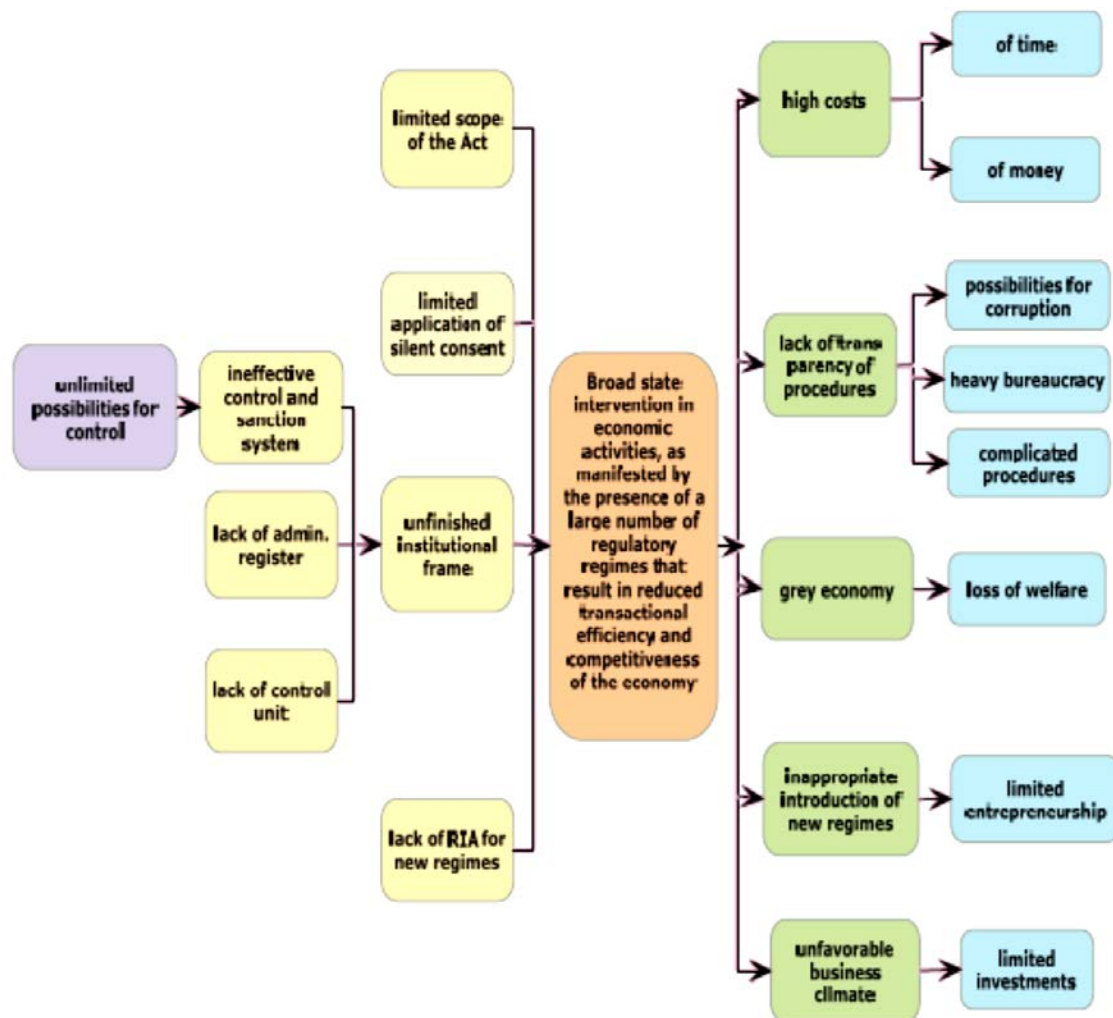
In an ex-post evaluation conducted in 2010, the World Bank concluded that the Act’s overall goal has been only partially achieved, while a number of important objectives have not been achieved at all (World Bank, 2010). The main deficiencies of the Act and its implementation, as identified in the evaluation, include (see also Figure 35):

- **Limited scope**: the two categories of regulations defined within the Act do not cover all types of regulation of business; the majority are covered by other specific laws or the Administrative Procedure Code.
- Insufficient application of the principle of **“silent consent”** as special laws avoid its application.
- **Ex-ante impact assessments** of proposed regulatory regimes, required under the Act have not been performed.
- **Undeveloped institutional framework** for enforcement of the Act. No sanctioning and control system is in place, no single authority with primary responsibility for implementation, no central Administrative Register of regulatory regimes.

The World Bank concludes that these deficiencies in the implementation of the Act create opportunities for corruption, as there is no transparency of the logic of administrative procedures (licenses and permits are not processed in the order they are received, and companies are not given any information on the progress of the procedure or as to why licenses are not granted). The assessment further highlights the problems created by non-compliance with the law of local authorities in particular.



Figure 35. Regulatory regimes and administrative control: problems and effects



Source: Ex-post impact assessment of the Act on Limiting Administrative Regulation and Administrative Control on Economic Activity (World Bank, 2010).

The Bulgarian Economic and Social Council (ESC) also gave a negative assessment of the implementation and impact of the LARACEAA, in line with the conclusions emerging from the World Bank's ex-post evaluation (Economic and Social Council, 2009). The ESC noted that the central and local administrations **largely fail to observe** most provisions of the Act. In an assessment of the regulatory regimes in Bulgaria, the business association BIA (2006) highlighted the numerous violations of the Act that remain completely unsanctioned, and highlighted how various other existing regulations are contradicting the provisions of the LARACEAA.

Since 2004, consecutive Bulgarian governments have adopted a number of strategic national programs in line with the EU *Better Regulation* agenda (World Bank, 2010). However, the implementation of measures aimed at improving the quality and efficiency of the state administration remain ambiguous, despite some improvements of the business environment. Particularly telling is the failure to implement a comprehensive e-government reform, despite the drafting of detailed plans, strategies and laws dating back to 1998, as well as the establishment of dedicated administrative structures (and recently – ministries) to fulfil the task.

### **Mandatory registration of labour contracts and minimum insurance thresholds**

During the transition period of the 1990s up until the early 2000s, the phenomenon of undeclared work has become particularly widespread, mainly in the form of work without labour contract, as well as evasion of tax and social security contributions by declaring lower (often equivalent to the minimum wage) than the actual remuneration of employees. This resulted in insufficient insurance coverage of employees, while the social insurance and pension funds faced deficits. It was estimated that in the late 1990s one third of all labour remuneration was undeclared (Kyle et al, 2001), while official data from NSSI suggest that 1.2 million out of the 1.9 million registered employees in 2002 were insured on the basis of the minimum wage (Neykov, 2003).

In 2003 a number of important regulations of the labour market entered into force that had a restricting effect on these widespread forms of undeclared work. An amendment of the Labour Code in 2002 introduced the mandatory registration of individual employment contracts with the National Social Security Institute (NSSI). The contract had to be registered before the first day of work (and not within a certain period after employment has commenced), thus preventing employers claiming that undeclared workers had only started work that day when inspected, and making sanctioning easier to implement. As a result, during the first year after the measure was introduced, the number of registered employment contracts increased by 300,000, while 60,000 new employers were “detected” (Tomev, 2009a).

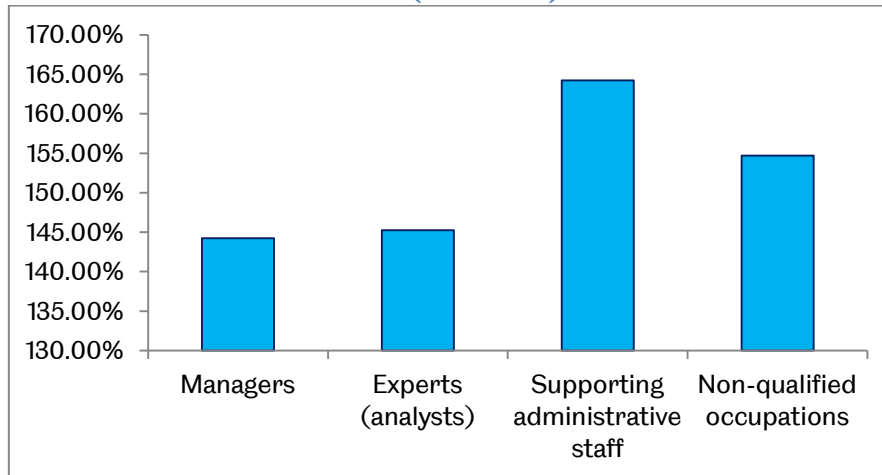
The second measure adopted in 2003 through changes in the Mandatory Social Security Code was the introduction of **Minimum Social Insurance Thresholds** (MSIT) for nine occupational groups across 48 sectors. The thresholds are negotiated via tripartite dialogue on an annual basis. In case negotiations fail, the government sets the thresholds. The MSIT was a countermeasure to the widespread practice of insuring employees at the level of the statutory minimum monthly wage instead of the actual wage (Pashev, 2005), thus effectively increasing “the lowest amount on which social security contributions have to be paid” and prompting employers to declare wages closer to the actual pay levels in the respective sector and occupational category (Tonin, 2011: 23). The declared income on which social security contributions are calculated cannot be lower than the obligatory minimum threshold agreed for the respective sector and profession. In case employers report lower income, the authorities can launch targeted inspections. As a result of the mandatory contract registration and the MSIT, the revenue of social security insurance funds increased by BGN 120 million (€60 million) in the first half of 2003 compared to 2002 (Neykov, 2003). According to NSSI data, “the average income on which social insurance contributions are calculated was 11% higher in the first quarter of 2003 than in the same period in 2002” (cited in Neykov, 2003).

However, the measure has not sufficiently deterred the practice of hiring workers on part-time contracts or registering employees in a different occupational category with lower MSIT (Tomev, 2009a). In other cases, employers comply with the MSIT, but deduct the incurred higher expenses for social security contributions from workers’ salaries (Tomev, 2009a). Targeted inspection campaigns by the authorities in recent years have focused on checking part-time contracts in particular.

The introduction of this type of de-facto presumptive tax has been criticized by some experts as an indication of the state’s inability to monitor and collect taxes on real incomes (Pashev, 2005). While the initial effect of the MSIT measured in additional state revenue was substantial, experts have warned that the subsequent trend of their frequent increase coupled with the raising of the minimum wage has provided “incentives to the micro-business to employ unregistered or part time labor” (Pashev, 2005: 11) due to large wage differences between small and large firms. Especially in the light of the economic crisis MSIT put an “upward pressure” on wages (Maiväli and Stierle, 2013). This implies “repressive taxation” (higher effective tax rates for low-paid jobs, whose actual salary is below the

threshold, while high-paid employees pay lower taxes) (Pashev, 2006). As such, it is argued that the increases in MSIT (from 2008 to 2012 a cumulative increase of 50%-60%) has pushed low earners into either wholly undeclared work or unemployment (Ganev, 2012; Slavova, 2011; IME, 2009).

**Figure 36. Minimum insurable income for major occupational categories - cumulative change in % (2004-2012)**



Source: Institute for Market Economics (2012).

Impact evaluations of the MSIT have been conducted periodically by the Institute for Market Economics (IME), concluding that although the measure was introduced to counter the undeclared economy, its effect was exactly the opposite and the thresholds have prompted its increase (Slavova, 2011). The increase of the thresholds in 2009 by 26.6% was also negatively assessed by IME, as it reportedly incurred a net loss of BGN 545 million (€278 million) to businesses, citizens and the public budget for 2009 (IME, 2009).

The European Commission in its opinion on the country's convergence programme for 2012-2015 pointed out the significant impact of the crisis on low-skilled workers and called for "a review of the system setting minimum thresholds for social security contributions", in order to "balance the need to reduce undeclared work and to ensure that low-skilled workers are not priced out" (European Commission, 2012b).

As Tonin (2011: 24) points out, the difficulty with the MSIT is to set them at the appropriate level: "a too low MSIT compared to effective wages fails to capture most of underreporting. A too high one, on the other side, endangers competitiveness and employment." Social partners' involvement is key to determining the thresholds as they are better informed of the actual situation in different sectors, but also because the measure would have a greater legitimacy amongst employers and employees. However, Pashev (2005) notes that in Bulgaria "micro businesses" are left out from the decision making process as they are not represented in national associations, while at the same time those businesses are most vulnerable as they often employ unqualified (low-paid) workers.

Furthermore, Pashev (2005) argues that the measure targets underreporting at the lowest wage levels, while evasion on the part of high-income earners is not addressed sufficiently. This is also reflected in the enforcement and control activity of the authorities, which targets predominantly small tax payers, while penalties imposed are not proportionate to the financial liability. As such, the measure has been seen by some employers as an attempt of the administration to close the social security and pension deficits by collecting payroll tax from those that pay minimum wages, while large tax violators remain unaffected (Pashev, 2006).

### Restricting cash transactions

Another prevention measure was implemented in 2011 through the adoption of the *Cash Payments Restriction Act*, aimed at limiting cash transactions for payments larger than BGN 15,000 (€7,500).<sup>18</sup> Payments and contracts above this ceiling are to be executed either via a transfer or a deposit in a payment account. The objective of the measure is to improve transparency of cash flows, increase national revenue, and reduce the undeclared economy through preventing tax evasion and lower social insurance and pension contribution payments. Nevertheless, the practice of cash payments of remunerations remains widespread among Bulgarian employers, although bank services in the country are well developed. Proposals for the introduction of electronic payment of all wages and salaries have been so far rejected (CSD, 2011; Ministry of Finance, 2010).

### Deterrence measures (pursue and punish)

In the period 2008-2012 the key control and enforcement authorities intensified their detection and penalizing efforts in response to declining state revenues. There have been several measures implemented that ensured better monitoring, risk assessment and targeting of tax and social security violators, increased powers of control agencies, joint inspections and harsher penalties. However, as the Hidden Economy Monitoring System of CSD shows (2013), despite some initial positive results in restricting undeclared work and tax evasion, the effect of these measures has “cooled off” with time and revenue growth has not been sustained as economic stagnation continued.

### Real-time link between fiscal devices and NRA servers

In order to prevent and deter the widespread underreporting/concealing of turnover and ensure better tax compliance in the context of decreasing state revenues in the crisis period, the Bulgarian government in 2011 amended the *Ordinance No18/2006 on the Registration and Reporting of Sales on Commercial Premises through Fiscal Devices*. The amendment introduced a statutory requirement of all trade entities to connect remotely their fiscal devices to the servers of the NRA in real time. The measure was proposed by the Bulgarian Industrial Association (Daskalova, 2013b). The remote connection had to be completed in the following stages: gas stations (by 1 January 2011), pharmacies (by 31 August 2011), VAT-registered grain traders (by 30 November 2011), and all others (by 31 March 2012). This has placed an additional burden on trade entities for purchasing new fiscal devices and paying annual fees to communication providers. Nevertheless, the measure has put all economic actors on an equal footing and allowed for much better monitoring and risks assessment resulting in more targeted inspections. The NRA was able to detect 2,000 companies concealing turnover, mainly small shops, catering and entertainment companies and construction firms (Daskalova, 2013b). VAT revenues increased for the second half of 2012 compared to the same period in 2011, although this growth was not sustained in the same period of 2013 (CSD, 2013).

The fine for failing to implement a connection of fiscal devices with the NRA was BGN 10,000 (€5,000). Furthermore, failure to fulfil the requirements resulted in temporary closure of businesses, as evident in the case of 400 gas stations whose operations were suspended (it is unclear if these have restored their activities), while 40 new stations previously operating in the shadow were “formalised”. A cost-benefit assessment or an evaluation of the overall economic impact of the measure (as a result of business closures) has not been carried out in a timely manner.

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<sup>18</sup> *Закон за ограничаване на плащанията в брой*, Обн. ДВ. бр.16 от 22 Февруари 2011 г. [*Cash Payments Restriction Act*, promulgated in The State Gazette, No. 16 of 22 February 2011]  
[http://www.tmlawoffice.bg/assets/files/news/Limits\\_Payments.pdf](http://www.tmlawoffice.bg/assets/files/news/Limits_Payments.pdf)

### Excise goods movement and control system

In addition to the above measure, amendments to *Ordinance No. 3* on the measurement of flows of excise goods entered into force on 19 February 2010, requiring the installation of additional monitoring devices by traders of excisable commodities (alcohol, fuels, tobacco) to prevent the movement of unreported excise goods (Ministry of Finance, 2010).

The measure was negatively received by economic actors and (unsuccessfully) contested in court. Following continuous criticism from oil companies, the most vocal of which is the country's largest oil refinery, almost three years after the measure was implemented, the Ministry of Finance in December 2013 proposed an amendment to *Ordinance 3*, recognizing the huge administrative and financial burden placed on excise goods operators (for purchasing and installing the control devices and the necessary software) and the overall negative economic effect of the measure (Ministry of Finance, December 21, 2013). In its justification of the proposed amendment of the regulation, the Ministry of Finance further pointed out that the measure did not achieve its intended objectives and the expected revenues from excise duties have not been collected. It was further acknowledged that the customs authorities did not have the necessary human resources and administrative capacity to oversee the installation and maintenance of all devices, as well as to process all the data collected through those. According to the deputy minister of finance, "the Ordinance consists of a number of vague and overlapping provisions, which leads to legal uncertainty", while analysis of the impact "has shown the lack of an overall concept of the control exercised" (Ministry of Finance, January 23, 2014).

It is noteworthy that the biggest oil refinery in the country failed to comply with the set deadline for installing the measuring devices and entered into a legal dispute with the authorities, after the government started a procedure for revoking its license, which was however stopped in court. The measure coincided with the increase of excise duties in 2010, as mandated by EU harmonization legislation, which, coupled with the declining domestic consumption as a result of the economic crisis, led to rise of illegal sales and smuggling of cigarettes and fuel. Concerns have emerged that evasion of tax and excise duties has continued, as fuel was now stored in illegal (non-registered) excise warehouses outside the control of the customs authorities.

Further measures for control over excise goods include:

- An amendment of the *Excise Taxes and Warehouses Act* of 1 January 2006 entered into force in early 2011.<sup>19</sup> It requires that vehicles shipping marked fuels need to have installed a GPS tracking devices.
- In July 2012, the Customs Agency and the NRA started a joint project on establishing an information system for control of fuel products and data exchange between the two agencies (NRA, 2013).
- In January 2014, a new *Ordinance on the Fiscal Control of Goods of High Fiscal Risk* entered into force, introducing clearer rules and procedures for fiscal inspection of vehicles shipping goods of high risk through the Bulgarian borders (Ministry of Finance, January 23, 2014).

It is evident from all these administrative and legislative changes aimed at process optimization, that improving efficiency of control and ensuring better collection of budget revenues has been one of the core priorities of governments since the beginning of the crisis.

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<sup>19</sup> Promulgated in *The State Gazette*, No. 19 of 8 March, 2011



### Increased penalties and enhanced (joint) controls

The *Pact for Social and Economic Development* signed by the social partners in 2006 declared the fight against the undeclared economy as a policy priority and set out a number of measures aimed at ensuring strict compliance with the normative requirements for firms and employees. Furthermore, amendments of the *Labour Code* enacted in 2006 and 2008 **extended the powers** of control authorities and introduced **harsher penalties** and fines for employers breaching the tax and labour legislation (Loukanova and Bezlov, 2007; Daskalova, 2013a). Employers that hire workers without an employment contract are liable to a penalty of BGN 15,000 (€7,500) per worker, compared to the previous amount of BGN 1,000 (€500). Moreover, labour inspectors have the right to temporarily freeze the activity of the offending companies. The GLI and its territorial departments have the right, on their own initiative or following a complaint made by workers, trade unions or members of the public, to inspect the companies at any time of the day or night. In 2011 there was an attempt to change the law so that employees working without a contract, not only employers, can be held liable and fined, but this measure was later contested in court and abolished. In 2010, a new *Law of Labour Inspection* was adopted, strengthening the role of trade unions and allowing for tripartite participation in labour inspections.

The MLSP in 2006 launched the “**Work Legally**” campaign, which combined a public information campaign and intensified inspections and control activities (monitoring of specific companies). The information campaign aimed at raising awareness about the negative effects of undeclared work, as well as of the sanction for offenders. In parallel, the GLI conducted a broad inspection campaign in the summer months of 2006, with a large part of the inspections (partially conducted during the night) originating from tip-offs. The GLI carried out 5,100 checks of 4,800 companies (Daskalova, 2013a). In 2008, in another large-scale inspection campaign, it detected 183,871 violations within 34,558 checks, mainly in the construction, tourism and real estate sectors (CSD, 2011).

The period 2011-2012 was marked by further large-scale control and inspection campaigns carried out jointly by NRA, GLI and NSSI (NRA, 2013). Each campaign targeted different vulnerable areas and risks, as follows:

- 2011: NRA conducted an inspection campaign targeting firms insuring their employees on the basis of **part-time contracts**. NRA conducted 4,917 checks, inspected 57,000 work contracts and issued 720 penal orders for breaches of the social insurance legislation. As a result, 8,400 employees previously in part-time employment have been ensured on the basis of full-time employment contracts. This campaign was repeated again in 2012, when 4,800 part-time employees were registered and insured on full-time contracts following the checks. A third round of checks was conducted in early 2013 on employers that have repeatedly failed to comply despite previous control activities related to this risk.
- 2011: Inspections of employers with due social security contributions that have not officially declared any employees. The checks led to the payment of additional social security contributions due in the amount of BGN 10.4 million (€5.3 million). Furthermore, in 2011 and 2012 several checks were conducted of companies that have registered employees but failed to pay any social security contributions.
- 2012: An inspection campaign targeting **underreported remuneration**, resulting in 314 checks and 242 orders for administrative offences.
- 2012: NRA conducted 7 campaigns for stimulating **voluntary payment** of overdue taxes, social security contributions and other outstanding payments to the state budget, by making telephone calls to debtors to remind them of their obligations. A total of 11,500 individuals and firms out of 20,000 selected debtors were called by employees of NRA's information centre.



The overall value of the due payments was BGN 20.3 million (10.4 million), but there is no information what share of that amount was collected following the calls.

- April 2012: On-the-spot visits (operational checks) were conducted of 80,701 trade entities to ensure compliance with the requirement for **installation of fiscal devices** connected remotely to NRA servers.
- July-August 2012: a summer campaign was conducted targeting 1,154 selected high-risk trade entities in the **Black Sea holiday resorts**, aimed at tackling tax and social security evasion and underreporting of turnover.

### **Effectiveness of repressive and control measures**

The policy approach in targeting the undeclared economy in Bulgaria has focused mainly on intensifying control in a “campaign-like manner”, in response to macroeconomic and budgetary imbalances (CSD, 2009a). Inspection waves are planned and organised in advance and then conducted within a few weeks or months. This approach has often led to temporary compliance at best, but in the worst case scenario it has also placed an increased administrative burden on formally operating businesses, creating incentives for bribes. The extensive focus of inspections on micro and small-to-medium sized businesses, coupled with the non-balanced nature of penalties contributes to the overall high regulatory burden for smaller firms. Fines imposed tend to be regressive, especially on SMEs, while large tax violators are often sanctioned with too low penalties or are less harshly inspected. “Reverse prioritisation” of smaller and easier to handle tax abuse investigations is a well-known phenomenon in the behaviour of Bulgarian enforcement authorities.

Moreover, mechanisms for internal anti-corruption checks need to be in place to prevent such practices. Fighting tax evasion means also fighting corruption in the tax administration. A large-scale study on the links between organised crime and corruption (CSD, 2010) paid particular attention to the way economic actors (criminal networks that have (partially) legalised their businesses, as well as large formal economic conglomerates) “negotiate” with the political class what can be also called “discretionary enforcement” of regulations, facilitated by corruption.

Furthermore, it is questionable if the effect of inspections and on-the-spot visits is sustainable – after fines have been paid, companies can fall back into their previous behaviour, until the next inspection. Without any measures to stimulate and promote change in attitudes towards voluntary compliance, increased controls and checks in a “firefighting”-like manner do not have the capacity to deter and prevent “bad” behaviour in the long term. Furthermore, control authorities will continue to be seen by taxpayers and citizens as penalizing bodies mainly, until a more positive relationship is established through the development of a customer- and service-oriented approach and fair treatment on the part of control bodies, in order to restore trust of citizens in public institutions.

### **Curative measures**

#### **Flat income tax**

In January 2008 amendments to the taxation law entered into force, introducing a flat tax of 10% on personal incomes and corporate profits. The aim of the measure was to stimulate growth of people’s incomes, to simplify the tax system and increase compliance. At the same time, the non-taxable minimum income was abolished. Bulgaria’s flat tax rate is among the lowest in Europe and the world. According to a parliamentary hearing held in December 2008 the introduction of the flat tax has not resulted in the expected increase of social security and income revenues. In late 2013 the socialist-led governing coalition discussed plans to abolish the flat tax and replace it with progressive income taxation, but no concrete steps in this direction have been undertaken yet.

## Food vouchers

Since 2003, a food voucher scheme is in operation in Bulgaria, and is widely supported by businesses and trade unions. The scheme aimed at providing additional non-taxable income to long-term employees in private companies, thus increasing household purchasing power. The second intended effect is to substitute/reduce undeclared “cash” wage payments by employers, especially to those insured on the basis of the minimum social insurance threshold. The costs of the employer for food vouchers are treated as a social expense and are exempt from all taxes. The vouchers’ value can be up to BGN 60 (€30) per month per employee, and are not included in employees’ taxable income. Employers are not allowed under the current legislation to decrease employees’ gross wages by the means of vouchers (KC2 and Industry Watch, 2010). The overall quota for the issuance of food vouchers is defined annually by the Ministry of Finance in the state budget. Food vouchers can be purchased by employers from operators licensed by the Ministry of Finance – there are 14 of them authorised for 2014. The vouchers can be used in exchange for food products/meals in a number of restaurants, supermarkets and food chains that have a contract with the licensed voucher issuers.

The quota principle for the vouchers has been frequently criticised by trade unions and employers: bigger companies can afford to buy all the vouchers they need for their employees at the beginning of the year, thus exhausting the quota before the year-end, which leaves other companies without coverage. For example, the 2013 annual quota of BGN 120 million (€60million) was exhausted by July, and employees called for the removal of the quota principle. In 2013, the scheme was used by 4,000-5,000 employers (predominantly larger companies) and covered 350,000 employees, or around 15-16% of all employed and around 19% of all private sector employees. In 2014 trade unions and voucher operators negotiated with the government a considerably higher annual quota equivalent to BGN 240 million (€120 million), divided in 120 equal individual quotas, to be provided to voucher issuers upon request. This amount is expected to cover the majority of eligible employees.

In 2010 the consultancy companies Industry Watch and KC2 Ltd (2010) conducted an impact assessment of the food voucher system. The assessment notes that, given the extent of undeclared work in the country, no additional tax benefit is derived from the scheme by employers or employees, as the food vouchers are used to substitute the undeclared wage payments, thus leading to a reduction in undeclared work in the form of envelope wages. However, it has a positive impact on the economy and increases VAT revenues: “all other conditions being equal, in 2010, roughly BGN 12 million [€6 million] more will buy food (generating BGN 2.4 million [€1.2 million] additional VAT income for the national budget)” (KC2 and Industry Watch, 2010). The assessment furthermore estimated that “every additional lev, not paid to the national budget, as a result of the food voucher system expansion, generates between BGN 1.9 [€ 0.97] and BGN 12.09 [€6] incremental net income for the employed persons” (ibid.).

## Fostering commitment

In 2007, two of the largest representative employer organisations in Bulgaria (BIA and BICA), with the support of eight national media outlets launched the “**Come Into the Light**” initiative, aimed at stimulating a wide public debate on the undeclared economy. A special website was created, which provides an opportunity for suggesting best practices and mechanisms to tackle undeclared work, a discussion forum, an electronic form for submission of anonymous signals about violations, as well as a number of publications, news and information related to the topic. The initiative was supported by state institutions and all representative state unions. A survey among businesses and employees on the prevalence of undeclared work was conducted in 2007, and the results were publically discussed at a roundtable attended by a wide range of stakeholders in June 2007.

In the first months of the initiative, a large number of complaints were received through the website, related to breaches of the labour legislation and undeclared work practices (over 200 complaints in the first month after the project launch, see Tomev, 2009c). The involvement of major media outlets through publishing articles on the problem, as well as information and interviews related to the project, has contributed to increased public awareness and to bringing the topic of undeclared work on the public agenda.

The initiative provided a useful platform for broad public debate on the undeclared economy. Given the strong engagement of the main social partners with diverse initiatives related to the undeclared economy, taking place at different points in time, a better coordination and synergies between stakeholders and efforts could optimise the impact of these somewhat fragmented activities. For example, the second year of the project “Come Into the Light” coincided with the launch of the “Work Legally” campaign by the MLSP. Although both initiatives have contributed to increasing public awareness and dialogue, in addition to generating a large number of tip-offs from citizens, their campaign-like character does not guarantee sustainability of impact.

These two public campaigns “Come Into the Light” (2007) and “Work Legally” (2008) were followed up in 2009 by a large-scale project launched by the employers’ association BICA and the leading trade union CITUB. The project “Restriction and Prevention of Informal Economy” (2009-2014) is worth BGN 8.9 million (€4.5 million) and is co-founded by the European Social Fund. This adopted a more holistic approach towards tackling the undeclared economy by the project partners, combining a range of activities:

- Establishment of a National Center “Rules for Business” for coordination of the national activities aimed at restricting and preventing the informal economy
- Establishment of a whistleblowing hotline for reporting undeclared practices
- Drafting of analytical reports based on primary and secondary data collection on the size, nature and manifestations of the undeclared economy, as well as best practices to tackle it.
- Brainstorming sessions and focus groups for generating suggestions for mechanisms to tackle the undeclared economy
- National representative sociological surveys of businesses, employees and the general population (attitudes, opinions, participation in undeclared economic activities).
- Development of a Composite Index for the diagnosis and prevention of the undeclared economy
- Intra-company and branch audits through qualitative in-depth interviews
- Distance learning course platform
- Information and public awareness campaigns, round tables, public discussions and press conferences
- Media campaigns (TV clips, internet banners, billboards, metro clips, broadcasts)
- Monitoring of media reporting on the issues of the undeclared economy

The underlining objective of the project is to promote an attitude of zero tolerance towards the undeclared economy among stakeholders, businesses and citizens. The project outline clearly declares the ambition to establish a sustainable mechanism for coordination and information gathering that will aid the formulation of more effective policy responses and strategic vision. These efforts are centralised within the **National Centre “Rules for Business”**, established in 2010, which is expected to become a national focal point for coordination of policy actions, information gathering and consulting services for businesses and citizens. The Centre is expected to continue functioning after the project is finalised to ensure sustainability of the actions undertaken so far. It has a regional structure of nine centres across the country staffed with trained consultants. It offers dedicated open

days for free consultations of representatives of different economic branches. By August 2013 the Centre provided more than 17,000 consultations to citizens and businesses on issues related to the undeclared economy; the largest share of consultations was provided to firms from the electrical engineering sector. An additional 2,000 consultations have been conducted following signals received through the dedicated hotline. The Centre noted that as a result of the project's overall activities, there has been an increase in the number of signals received as the project progresses, and citizens as well as firms have developed higher awareness and sensibility towards the problems and risks of the undeclared economy (BICA, 2013b).

Each project activity includes **evaluation indicators** for monitoring their implementation. There are 16 indicators overall, the majority of which are of a quantitative nature (number of respondents surveyed, number of sectorial audits, number of in-depth interviews, number of public consultations, signals received via the hotline, number of public campaigns and round tables organised, number of people trained through distance learning, number of relevant media publications).

The Centre also publishes detailed evaluation and progress reports on all activities undertaken within the project, which also include qualitative assessment of results and recommendations for improvement of the services provided by the Centre (BICA, 2013b). One shortcoming of the project's written outputs is the length of the analytical and monitoring reports published (each report is between 150 and 650 pages long, the average length is around 200-300 pages), and the lack of synthesised overview of the main findings and conclusions that can be quickly reviewed and comprehended by the reader. This makes the reports inaccessible to the general public, as well as to stakeholders. The large amount of quality information and analyses published could be made more reader- and user-friendly through publishing short policy briefs or adding to each report a résumé of the main findings and recommendations.

As the project's partners are representative organisations close to employers and employees, but also to the main national authorities involved in tackling undeclared work, the project can benefit from a high level of legitimacy, already well-established communication channels between the stakeholders and target groups, as well as good understanding of the problems of businesses and employees. Ensuring the sustainability of this so far highly promising initiative will be a key for achieving long-lasting results and change in attitudes.

#### 7.4. Evaluation of existing policy measures

The Bulgarian government have so far focused on the adoption and strengthening of control and administrative measures to counter undeclared work. This emphasis on punitive and corrective measures has produced some results in the area of tax evasion and registration of labour contracts (CSD, 2013). As Schneider (2013) notes, however, measures against the undeclared economy are in general perceived as unpopular, *"and their success depends heavily on controls, sanctions and penalties for enforcement"*. It is also remarkable that despite the strong involvement of business associations in initiatives aimed at tackling undeclared work, there have been virtually no examples of self-regulation mechanisms initiated by businesses in the form of codes of conduct, commitments to good governance and compliance, peer monitoring and sanctioning (CSD, 2011).

The control authorities invest a tremendous amount of resources and time in inspection activity, which does not necessarily translate into sustainable revenue growth. Furthermore, the effect of such measures tends to be limited in time, as efforts to stimulate voluntary compliance and change attitudes are still limited in scope. However, when implementing incentives for businesses to operate in the declared realm, one should also consider the potential effect of reinforcing a behaviour of

seeking privileges instead of achieving the intended level playing field, as it has been the case of tax exemptions for businesses in areas with high unemployment and stimulating business incubators and concentrated “economic zones” (Renooy et al., 2004).

Moreover, despite the large number of policies implemented by the state authorities to counter and reduce the undeclared economy, there is no evidence of a systematic evaluation of the effect of measures implemented or planned. As in the case of the ordinance on excise goods measurement and control, its impact was evaluated only in response to strong negative feedback and complaints both from businesses and the customs agency responsible for implementing the measure on the ground. It is evident that the “campaign-like”, ad-hoc reaction of the authorities to immediate economic crises and the perceived need for quick intervention leads to hasty policy decisions that have a questionable effect and need to be abandoned or significantly modified afterwards, increasing administrative and financial costs for all actors involved. This additional burden has often neutralized the positive primary effect of both detection and stimulating compliance measures. Another example in this respect is the continuous increase of minimal social security thresholds in recent years, resulting in an additional regulatory burden for businesses, which “cancels out” the positive effect of reduced social security contributions (CSD, 2011). The Center for the Study of Democracy (2011) summarises the key issues with existing measures aimed at tackling the undeclared economy in Bulgaria as follows:

- Lack of systematic evaluations and cost-benefit analyses of measures
- Dissonance between economic and administrative control measures
- Measures not tailored to the specific characteristics of national economy
- No integrated approach: many measures, no system

One of the few attempts to assess the perceptions of businesses and employees of the effectiveness of policy measures to tackle the undeclared economy was undertaken in 2012 by BICA in partnership with CITUB (BICA, 2012b). The evaluation includes a survey of 250 companies from 11 economic sectors and 250 employees, conducted within the project ““Restriction and Prevention of Informal Economy”. It is based on their opinions and assessments of the effectiveness of the government’s overall policy approach, as well as of nine specific policy measures implemented since 2010.

The majority of respondents (40% of employers and little over 30% of employees) are of the opinion that an integrated and comprehensive policy approach is not evident, while the efforts so far have been isolated in nature (Table 25). More than 25% of both groups of respondents think that the resolve of the authorities to tackle the problem is not genuine, and that tackling the undeclared economy is not a political priority for policymakers.

**Table 25. Attitudes towards the government’s efforts to tackle the undeclared economy**

	Employers	Employees
There are isolated efforts, but a comprehensive policy approach is lacking	39.6%	31.7%
Tackling the grey economy was never on the political agenda	27.4%	25.5%
There are measures that rather silently support the grey economy	14.2%	12.1%

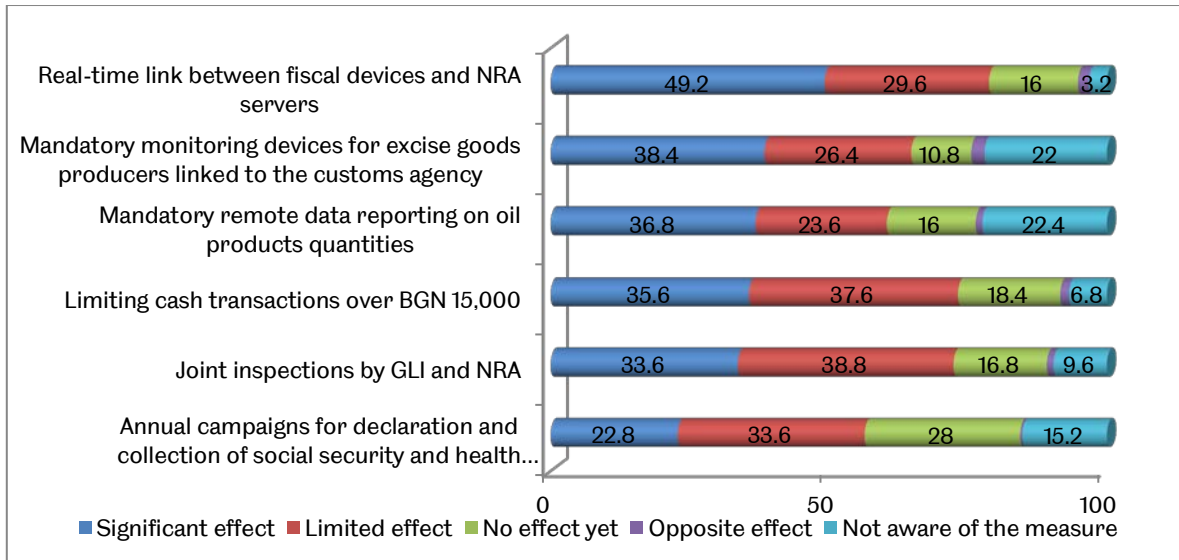
*Source: BICA (2011a). Surveys of employers and employees.*

The survey is highly informative of the perceptions of different economic actors of how well certain measures have worked. With respect to their evaluation of specific measures, employers and employees alike regard the real-time link of fiscal devices with NRA servers as the most effective policy intervention (Figure 37 and Figure 38). The least popular measure and the least effective according to



the employers are the joint inspection campaigns conducted by the NRA and GLI, which signals respondents' discontent with the high regulatory burden that the inspections placed on them.

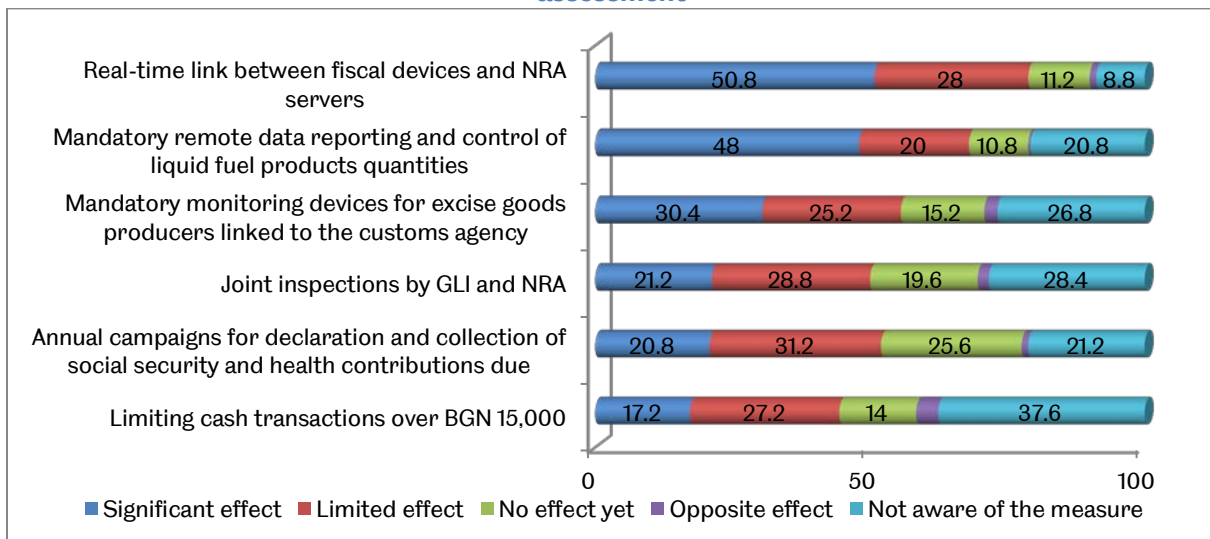
**Figure 37. Effect of policy measures to tackle the undeclared economy – employers' assessment**



Source: BICA (2012b) Survey of the employers (N=250).

Amongst the employees surveyed, the least popular policy intervention are the annual campaigns of the control authorities for detection and collection of social security contributions, followed by the joint inspections of GLI and NRA.

**Figure 38. Effect of policy measures to tackle the undeclared economy – employees' assessment**



Source: BICA (2012b) Survey of the employees (N=250).

However, the fact that between 21% and 28% of the surveyed employees were unaware of the existence of these measures indicates the need for broader information campaigns by the authorities. In contrast, the requirement for a real-time link of fiscal devices with NRA was to a much greater degree discussed in the public domain, not least because of the problems attached to its implementation, reported in the media. The measure that is least known among employees is the



restriction of cash transactions over BGN 50,000, as it mainly affects businesses. Overall, employers and employees alike assess positively the introduction of measures for stricter monitoring of sales and movement of excise goods. These measures have contributed to putting all economic actors on equal footing and preventing underreporting of economic activity.

While this type of assessment of measures is a step in the right direction, gaining a more in-depth understanding of the actual impact of policy measures on all economic actors involved, as well as on the business environment as a whole, would require a more in-depth and systematic assessment. Such an effort would include specific evaluation indicators and would consult a wider range of stakeholders. It would be based not only on stakeholder opinions (subjective indicators), but also on socio-economic (objective) indicators.

It should be noted that CSD, as well as BICA have been monitoring proposed and adopted policy measures on a regular basis, including suggestions made by social partners and civil society organisations (see CSD, 2011, 2013a and 2013c; BICA, 2010, 2012a, 2012b, 2013a). While such efforts contribute to a much more detailed understanding of the particular policy environment in Bulgaria, going a step further would require carrying out a systematic evaluation of the effectiveness of these measures through a common framework, as well juxtaposing its results against an assessment of the institutional setup, the broader policy and normative infrastructure in place, as well as the particular risks of undeclared economic practices both at individual and firm level.

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