



Republic of Bulgaria
ECONOMIC
AND SOCIAL COUNCIL

OPINION

on

INFORMAL ECONOMY AND MEASURES FOR ITS RESTRICTION

(on its own initiative)

Sofia, 30 November 2006

The 2006 Action Plan of the Economic and Social Council envisages the preparation of an Opinion at the Council's initiative on the subject: "Informal Economy and Measures for its Restriction." The President of the Economic and Social Council assigned the preparation of the draft Opinion to the Standing Committee for Economic Policy.

Mr. Vladimir Boyadzhiev – was appointed Rapporteur.

The Committee drafted and put forward for approval in plenary session the draft Opinion.

The Economic and Social Council endorsed the Opinion at a plenary session on 30 November 2006.

I. INTRODUCTION

Informal economy has many names, different aspects and meanings, yet it always points to existing or future problems in society. Informal economy is also known under various terms often used as synonyms for different areas depending on the analytical tasks of researchers.¹ Informal economy exists everywhere – not only in transition countries and developing countries, but also in EU and OECD member-states. Informal economy does not recognize national borders and in the opinion of a number of researchers it could grow into a cover up for criminal activity since it is assumed that informal sector in the new EU member states (Bulgaria and Romania included) is connected even to a larger extent to that of EU 15 as compared to official national economy. Informal economy is one of the most dangerous “reefs” in the development of business and social prosperity of democratic societies.

The Economic and Social Council is of the opinion that the problems related to informal economy are important for society and have grave consequences for the political, social and economic development of the country. The economic activity based on non-acceptance of official rules, the emergence of new forms of business and social ties related thereto, on the one hand, and the too tight regulation and administration of business accompanied by lack of adequate public control, on the other, is a serious challenge for Bulgaria at the threshold of the European Union. Furthermore, in view of the emerging trend of criminalization in some cases, the informal economy could act as a factor which could strongly undermine the opportunities which this country will receive during the first years of its EU membership.

The Economic and Social Council has established that there is urgent need of political and social actions which are to aid the government and society to understand better the nature of informal economy and, in the long run, to result in a policy targeted at the systematic liquidation of prerequisites for informal sector, which does not abide by the rules and regulations of law. To this end, it is necessary to overcome the reluctance in part of the administration to reinforce the legislation and counteract to the influence of this sector in economy, as well as undertake effective measures for its improvement and practical application, which will contribute much to the economic and social development of the country and, in the short term, will speed up the approximation of the country to average European standards. In this connection, the Economic and Social Council is of the opinion that the effective counteraction to informal economy includes proactive measures for its legalization as consistent policy and as a reflection of national economic and social interests.

The problems arising as a result of informal economy are said to be among the most important ones for the economic transition and transformation of society in Bulgaria. The scope of informal economy is a factor which has a direct influence on the legal sector operating in abidance of the rules and regulations of the law. This is why the assessment of the scope and scale of informal economy, the reasons for its existence and expansion,

¹ The terms used are: underground economy, illegal work, informal sector, illegal sector, free economy, alternative economy, black economy, hidden economy, unofficial economy, parallel economy, shadow economy, unobserved economy, and unregistered economy.

the establishment of the factors influencing its development are all of great importance to planning concrete measures for its reduction.

By developing this position at its initiative the Economic and Social Council has set itself the goal to focus once again the attention of society, institutions and politicians in Bulgaria to the reasons, consequences and problems generated as a result of existing informal economy and its influence on public life, particularly on the eve of this country's accession to the European Union.

A number of state institutions, researchers from academic circles, non-governmental organisations, economists, politicians, even foreign diplomatic representatives have many times called for consistent, adequate and targeted measures and actions to limit the sector of informal economy particularly in its part directly related to illegal criminal business and the main macro "regulators" it uses – political corruption and money laundering.

The Economic and Social Council in its capacity as an institution of organised civil society states its firm conviction that it is high time counteraction against informal economy expansion became a priority of state and civil society not just in the form of an abstract slogan, but through concrete and efficient measures within the frameworks of integrated policy for the creation of favourable conditions for its legalization and, at the same, for ousting criminal business from the economy to the field of "black economy," where it would come within the provisions of the law. To this end, special attention should be paid to the efficient use and restriction of potential misappropriation of resources coming in from EU funds, as well as to the creation of prerequisites disallowing any opportunity to use those funds to finance informal economy.

II. INFORMAL ECONOMY²

In early 1990s, the liberalization of economies in the countries of Central and Eastern Europe, the process of property transformation and the development of market economies contributed much to the considerable expansion of the informal sector. Its growth thrived additionally on the poor institutional capacity of both the state and economic subjects of those economies. At present within the context of the need for real convergence both in economic and social plan within the frames of the European Union, the study of factors and manifestations of informal economy has become current issue in view of the great potential for economic growth in this sector. Going out "in daylight" of part of the informal economy would increase fiscal revenues and would cut down the social price of economic reforms that have not yet come to an end in transition economies and more specifically in Bulgaria. Informal economy is not only a complex social and economic phenomenon comprising the entire system of public and economic structures and relations. It is above all a process in which the public, private and criminal property are used for the purpose of obtaining income,

² This Opinion without claiming to be scientifically precise and exhaustive with regards definition uses the term "informal economy" as a collective term for all activities creating added value to national economy, yet partially or in full remain not accounted for in the assessment of gross domestic product and, at the same time, generate income, which remains outside the regulation and control of society. This definition helps encompass a broader scope of economic activity – from economic activities for personal needs and undeclared labour to illegal and criminal activity.

“hidden” for the authorities of state government and control, based on which it is often defined as “hidden” economy. The informal economy is closely related to and intertwined with legal economy, the official sector of social reproduction. The “hidden” sector uses the “services” of state and society for its activities, material factors and resource, human resources and manpower, without entering into official relations with the state as an economic subject, in as much as not attempting to “regulate” corruption practices, “marketisation” of its connections with the formal sector.

It is a fact that informal sector existed even during the command-administrative system of economic management. In the course of market relations growth, however, it enjoyed galloping development and its current proportions and manifestations are essentially different from those before the start of transition. In practice, the scale and trends in the development of informal (hidden) economy depend to a large extent on the condition and state of official (legal) economy. This has predetermined also the differences in terms of scope and structure of hidden economy between the countries of well-developed market economy, with a faster and successful transition to it, and delayed social and economic reforms. The first group of countries is characterised by a narrowed scope of hidden economy, conditioned by the precision of legislative, control and judicial systems. The problems of those countries are related mainly to illegal (criminal) shadow economy. The second group includes states where official economies go along with a considerably large share of the “hidden” economy. Even graver are the issues related to the scope and negative effects of informal economy in the countries, Bulgaria included, where reforms have been only faked years on end following the start of transition. This has created favourable conditions for the expansion of the informal sector.

The relative share of informal economy on a world scale, according to various assessments, accounts for approximately 10-12% of GDP. In the countries of the so-called “third world” it exceeds 30-40% on average, while in transition economies it fluctuates to approximately 25-30% on average. Analyses show that when the share of “hidden” sector exceeds the critical levels of 40-50% of GDP, its influence on economic life becomes so strong that the clash between formal and informal activities turns from secondary to a primary social and economic clash. To this end, the problems of informal economy are determined as some of the most important for economic transition, while for Bulgaria – the high levels of its share give rise to serious issues related to the European integration and improvement of the functions of legislative, control and judicial systems, as well as justified fears for its role as a “reverse thrust” for processes of integration into common market and the cohesion of public structures.

This Opinion does not aim to describe the discussion related to terminology used by various authors and institutions, or to reflect different assumptions related to the applicability and efficiency of methods used for the assessment of the informal economy phenomenon. Yet due to their importance for the analysis of all perspectives of the informal economy phenomenon, we wish to highlight the major approaches and criteria used as a basis for terminology definition. The two dominant approaches in identifying informal economy are the neo-classical approach, which defines it as an optimum reaction to economic agents of high taxation and excess state regulation, and the interventionist approach, which focuses

on the existence of “hidden economy” as a voidance of market. In this connection, while the first approach considers informal economy as “unreported activity,” the second aims to define concrete behavioral features of the phenomenon. In short, four types of criteria are dominant in the definition of “hidden economy” – fiscal criterion, which highlights economic activities unreported in compliance with tax and social security regulations to competent authorities and institutions; economic (market) criterion, which focuses on the difference of paid and non-paid services; legal criterion, which identifies the economic activities in conflict with the law (drug business, trade in stolen cars and items, etc.); and statistical criterion, which differentiates economic activity from the perspective of accountability (scope) and official statistics. If we try to summarise different approaches and criteria for informal economy definition within the meaning implied in this Opinion, it could be deemed as an aggregate of activities carried out either for need to compensate the lack of sufficient revenues in official (legal) economy, or for high levels of profit and revenues generated through lowered or unreported profit and loss in legalised economic activity, or directly through illegal activity. This collective working definition allows the consideration of the phenomenon in the broadest possible scope encompassing all from unpaid work³ as part of home production, assistance for neighbours and public organisations, etc., up to hidden revenues from legal economy and unreported production from registered economic subjects for the purpose of tax evasion, manufacture of unregistered production units, as well as incomes from theft at the workplace and all types of entrepreneurship comprising the manufacture of products and provision of services whose production, sale and distribution are usually prohibited by the law.

In the 1990s, the National Statistical Institute issued regular assessments of the scale of “hidden economy” at a macroeconomic level. As early as the start of economic reform Bulgaria ranked at one of the top places among transition countries by the scale of hidden economy. Some comparative data published by foreign researchers show that in the 1999-2000 period the scope of informal economy as a GDP share stood at 36.9% as compared to 38% as an average level for transition countries and 16.8% - for OECD countries.

Table 1

Share of the hidden economy in GDP according to the assessment of NSI
Department of National Accounts and Balance Sheets

Years	% of goods production included in GDP	% of production not included in GDP
1993	18	above 10
1996	28	above 15
1997	34	above 18
1998	38	above 15
2000	40	above 15
2002	38	above 15
2003	35	above 10
2004	30	above 10

³ It is perhaps appropriate to recall the campaign launched by the International Labour Organization for elimination of child labour.

According to a World Bank Economic Memorandum for Bulgaria hidden economy is estimated to stand at approximately 32% of GDP in 2004. Perhaps the most consistent series of research dedicated to the trends of development in informal sector in Bulgaria are the monitoring surveys of the scale and dynamics of hidden economy in Bulgaria conducted on a regular basis by "Vitoshka Research" sociological agency since 2002. These comprise two groups of indexes: indexes of unreported economic activity and indexes of natural economy and home production. These surveys show a considerable change in the total size and dynamics of informal sector in Bulgaria for the period November 2002 – November 2004.

None of the used hidden economy assessment methods is universally preferred and contains a number of conditions, hypotheses and restrictions. A report entitled "Shadow Economy in Bulgaria" was published in 2001, as a result of the joint work with University of Harvard, the Agency for Economic Analyses and Forecasting and the Institute for Market Economics. The report analyses in detail hidden economy in three different aspects – with regards cash in circulation, by the energy consumption method and from a micro economic perspective through the poll method. The results as a whole confirm the statement that in late 1990s the share of informal economy in Bulgaria, although diminishing, still remains high. The main conclusion which is also reiterated in this Opinion of the Economic and Social Council is that many of the informal activities have big growth potential and should there be conditions for their transition to official sector, this would not only influence positively competitiveness growth in Bulgarian economy, but would reduce the social burden of reforms.

III. INFORMAL ECONOMY – A CHALLENGE AHEAD OF ECONOMIC AND SOCIAL POLICY

One of the most frequently used measurements of informal, "hidden" economy is the share of unobserved GDP in the value of the measurement declared by official sources. Since in its nature GDP is an income generated by the agents in a given economy, it could be split in two major groups – *unobserved income from entrepreneurship* and *unobserved (unreported) income from labour*. This distinction allows focusing attention on issues related to informal economy by taking into consideration the interests of the state as an institution of public authority having inherent functions with regards allocation of revenues, as well as the interests of its citizens including the two large groups of economic agents – the business and employed labour.

The major asset of the Economic and Social Council is that in its nature it is not influenced by ideologies that often find way into discussions over adequate economic policy. A great variety of opinions could be discovered in ideological polemics - from underestimation of the "informal (shadow) economy" phenomenon to imaginary overstatement of its scale and influence. Exit points in almost all discussions are various assessments of the shadow economy scope, which is often deemed decisive for the plausibility and reliability of analyses. Unfortunately, due to this position, research efforts focus on issues such as: which is the best method for assessing the size of shadow economy, or what part of labour force falls within shadow economy, or how this is going to change in time.

Yet for the Economic and Social Council the analysis of reasons and consequences for informal, “shadow” economy is far more important. The reasons, consequences and issues related to the big share of informal economy are relatively broadly discussed in Bulgaria particularly in the context of fight against organised crime and corruption, including with the help of established institutions in the non-governmental sector, e.g. Centre for the Study of Democracy. The focus of these discussion is targeted not only at measures for fight against corruption, but also at the opportunities for the improvement of state fiscal policy due to well-known financial difficulties in reimbursement of public spending in Bulgaria. At the same time, more serious criticisms come out in public space, to a large extent under the pressure of European institutions and member-states, related to legislative decisions, ineffective judiciary and public finance utilisation. Despite all measures taken to implement European requirements, the non-efficiency of the actions and measures targeted at the restriction of informal economy, in the long turn, results in discontent and growing disappointment with the economic and social policy.

In almost all studies, tax and social-security burdens are stated as some of the most important factors defining the status of informal economy. The bigger the margin between final labour cost in official economy and revenues after taxation (net labour income), the bigger the incentive to avoid this margin and work within shadow economy particularly so in the presence of a complex, vague and contradictory social-security system like that in Bulgaria. To a great extent, this margin is dependent on the social security system and the aggregate tax burden and, to this end, these turn out to be key factors for the existence and expansion of informal economy.

In this connection, there is much reason in the following questions: why do people choose to work in the shadow economy? What other factors (apart from incentive and incomes) could bring in expansion of informal activities? Is it possible that other theories could help in the future to determine the relevant factors? What is it that influences individual decisions to work in the shadow economy (where the influence of tax and social-security burden is taken into consideration)?

A number of studies show that entrepreneurs pass on to shadow economy not so much as to evade taxes, but rather to get rid of bureaucracy and corruption. It is no secret that fees collected by some regulatory regimes exceed several times the costs of the respective administrative service and in practice account for a new tax unregulated by a law and hence contradictory to the Constitution.

The increasing pressure of regulations (often measured by the number of laws and regulations like, for example, the licence regimes) is yet another important factor leading to shrinking freedom of choice for individuals occupied in the official economy. It is a matter not only of labour market regulations, but of trade barriers, the start and the end of an economic activity (registrations, permits and other regulatory frameworks).

In specialised analyses, representatives of business organizations state the conclusion that the “power” of regulations is the major factor accounting for tax burden for companies and citizens and not the total scope of regulations. It is namely the regulatory “power” which forces the companies to pass on to informal economy. According to this study, each regulation has a considerable influence on the share of informal economy and the nature

of this connection is unambiguous: most regulations lead to an expansion of the shadow sector in the economy. This shows that all demands addressed to the government focus reasonably on a lower number of regulations or at least on their improved application instead of the constant increase in their number. At the same time, however, governmental representatives indicate that they constantly receive different propositions related to the regulations as part of the constant dialogue with the business. Most of them are in favour of an intervention by the state in certain fields aiming to reinforce the application of legal provisions or to introduce new ones where such lack. In a many aspects, this contradicts to the openly declared ambition to decrease licensing, permit and registration regimes in the country. Yet to a great extent this reflects the wish of the business to bring out to the fore a larger part of the economy of the country so that competition could be loyal and open. The adherence to policy of more regulations and laws aiming to fight shadow economy according to some researchers leads to the expansion of red tape power and employment in the public sector.

According to a number of researchers, the introduction of taxes in economy has a positive effect on it on condition that the state provides adequate welfare in return for the taxes paid by the citizens, which in turn means that there should be positive incentives and stimuli for transition to official economy. Some of the most successful economies worldwide – those of the Scandinavian states, characterised by a great extent of competitiveness and at the same time well-developed social parameters, are an indicative example for an influence on informal economy.

It is assumed that in welfare economy the state plays the role of a “well-meaning” dictator striving to maximise the aggregate welfare. For this reason big tax obligations, low marginal tax rates or even a version of personal flat rate determined by a political vote of the citizens for a certain economic policy, are suggested as measures for prevention of deformations in the allocation and optimisation of tax system. These issues are covered in detail in public finances. Compulsory appropriation on the behalf of the state, its negligence and that of other institutions has been subject to criticisms. The optimistic assumption that the state does not strive to maximise its personal benefits, but those of society and in this way acts opposite to the established principles in economics is not admissible for supporters of modern public finances. The presumption of management aiming to maximise welfare in modern public finances is replaced by an egoistic assumption whose purpose is to maximise budget in order to obtain more power over public funds and thus acquire additional power.

It is believed that the expansion of informal economy leads to a decrease in state revenues which in turn leads to lower quality and lower quantity of provided public goods and services. In the long run, this could result in an increase of taxes in the official sector and deterioration of quality of provided public wealth (e.g., worse infrastructure) and of powers of the administration, so as a consequence to all this new stimuli would appear for transition to shadow economy. Some studies show that a smaller share of the shadow sector is observed in countries with higher tax collectibility. This is due to a large extent to comparatively lower tax rates, smaller number of laws and regulations and fewer cases of corruption which would otherwise push entrepreneurs away.

Countries in transition such as Bulgaria have more regulations which in turn leads to more corruption, higher effective taxes on the activities of official economy and consequently

– higher relative share of the shadow sector. It would be an extreme conclusion to say that wealthier OECD states, as well as some states in Eastern Europe have found a “good balance” of relatively low tax and regulatory burden, considerable collectibility of budget revenues, good application of laws, control over corruption, as well as a considerably small share of unofficial economy.

It could be accepted that Bulgaria is facing the challenge of considerable reform in tax and social-security system, not only in compliance with the requirements of EU, but also for the purpose of averting a possible collapse of the “social state” due to a spiral of high taxes and a number of regulations leading to the expansion of informal, shadow sector. The latter has caused additional problems to public finances thus giving rise to new increase in taxes, new stimuli for their evasion and transition to shadow sector, etc. In this way shadow economy could be discussed as a challenge ahead of the “social state.” While this cumulative process is still going on, the institutions and rules may lose control over society as it has already happened in the latest history of transition in Bulgaria.

There are a number of important reasons in Bulgaria, as a country in transition, apart from the abovementioned ones for the existence and resistance of the informal sector of economy. Such are the lack of expertise and trust in official institutions (legislative, administrative, judicial); inefficient and corrupted administration and consequently inadequate application of laws and regulations. Serious problems arise from high costs and great administrative burden for entrepreneurs along with comparatively high yet often unexpectedly changing taxes in a combination with inadequate provision of public wealth and infrastructure on the behalf of the state, leading to a poorer abidance of official rules and laws. Consequently, rights over property are often left unsecured by official institutions and people look for other opportunities to do this, while the development of informal and illegal structures leads to the emergence of negative side-effects (e.g., more free scope of action for organised crime). Among these effects we should also highlight the fact that often “hiding into the shadow” is of crucial importance for surviving or starting a business, while the possibility to disclose illegal activity or tax evasion is relatively small, thus an analysis of the costs-benefit ratio any person would fast enough come to the conclusion that illegal labour is far more attractive than legal which is also confirmed by the fact that illegal employment is widespread.

Economic agents – entrepreneurs and the subjects they have created for the sake of operation, as well as employees, have the opportunity to change location in order to evade unwanted economic conditions, a certain tax or social-security system. Households for their part also have the opportunity to migrate. Yet another opportunity for everyone is the transition to the shadow sector of economy. Here options include either tax evasion through financial transactions, or a fictitious change of location. People in turn are able to decide to work illegally or in the informal criminal sector, or at their household. The fact that these options exist means that the democratic state has been restricted to a certain extent, because it is unable to neglect the preferences of its citizens. This internal pressure for correction in economic path of development has been further increased by pressure coming from outside – expanding globalisation. Mobility, hence number of alternatives, increase in number. The limit of loyalty/ tolerance is reached when financial burden grows too heavy. The political and social stability, as well as public consent have been threatened by the

rising shadow economy. This might lead to the accumulation of setbacks for democracy. Shadow economy is a signal that there is a significant rift in the system of regulations.

The main factors for the expansion of informal economy are related to tax and social-security system. The complexity of company legislation and low efficiency of the judiciary are also important for the development of hidden economy. There are also typical factors for Bulgaria, such as for example the development of private sector which in the 1990s focused on the sector of services and existed under the form of small and medium-size enterprises characterised by non-bank financing and frequent changes of property. The poor use of non-cash payment resources, as well as the specific geographic situation of the country, which is favourable for the illegal trafficking in goods and humans, is also important.

Operating within the shadow sector, companies partially or fully evade paying taxes and social securities. They are also able to account for additional savings by not abiding to legal requirements of safe and healthy labour conditions, requirements related to environmental protection and, last, but not least, they have no sanctions for violations of intellectual property rights.

The influence of labour market regulations on shadow economy has been explained and theoretically substantiated in a number of studies, all of which draw the conclusion that – regulations lead to a considerable increase of labour costs in official economy. Yet the fact that they could be transferred on to employees creates an additional prerequisite for transition to shadow economy where they could be evaded. To a large extent, such behaviour is an after-effect of the discussion of informal economy summarised in two quite opposite statements: on the one hand, it has been blamed for a number of economic problems, while on the other hand – it is viewed as a legitimate free space in an economic system with too high taxes and complex regulations.

We need to admit that society is facing a dilemma which should be solved with the help of concrete and consistent policies, common will and efficient measures. On the one hand, the opportunities for hiding revenues, tax evasion and the shadow of political “umbrella” on the behalf of the well-off breeds massive resentment among society, and on the other hand, those working illegally have been subjected to far less criticisms in public mind. EU states clearly declare the position that those employed in the informal sector have an antisocial behaviour because they are a source of increasing unemployment and social injustice, a position which breeds significant intolerance of social security fraud, illegal labour and massive tax evasion, which, among other things, is one of the main reasons for fears from Bulgarian workers on the labour markets of old member-states. In Bulgaria this type of employment and income is viewed as a means of survival and a response to labour market compensating poverty and limited incomes from employment in official economy.

The GDP generated in informal economy is in fact an unreported income generated by the economic agents and calculated mainly from: employment without a labour contract and payment (receipt) of labour remunerations exceeding the officially declared ones. Data of NSI can be used to draw conclusions about the share of informal sector in economy from the point of view of employment.

Based on the assumptions drawn by Bulgarian trade unions and supported also by employer organisations certain positive steps have been made to reduce the share of informal

economy in the field of employment – the registration of labour contracts and agreement over minimum social security thresholds. Data in Table 2 show that after their introduction in 2003, the tentative number of those employed in grey economy has been shrinking, yet the relative share is still too high. Some studies⁴ in recent years however show that this measure has had a short-lived effect. According to data of these studies and research for less than a year – from March to November 2004 – the share of employees for whom the real size of social security is not paid in, had gone up from 1/3 to 1/5. Only 6 out of 10 employees were insured on their real salaries, experts claim. The share of employees who were had no social or health securities at all is too high – three out of every 10. These facts give rise to real fears that the tendency for bringing a big part of grey employment out to the fore of will persist.

A more exhaustive analysis of the index calculated by Coalition 2000 and Vitoshka Research however shows an increase of the share of those employed without a labour contract in 2003 and 2004, as well as an increase of the margin between the wages declared for tax purposes and actually paid. At the same time however, the amount of hidden company turnovers is shrinking. The abovementioned report draws some very important conclusions regarding income concealment on labour market: (1) employers tend to declare smaller than actual wages more often than employing without a contract; (2) most frequently wages are concealed in the sector of services and construction; (3) the expansion of the enterprise results in a decrease of unreported labour costs.

Apart from the employed without a labour contract who do not have contribution to social security system and an opportunity for insured incomes upon retirement age, in Bulgaria there are also labour contracts with hidden clauses, aiming to ignore the minimum social security threshold there are registered labour contracts for a half working day, while hired workers work on a full working day thus uncontrolled overtime is put in. A more precise look on the all-out structure of registered labour contracts and minimum social security thresholds in the personal register of the NSSI reiterate the fact.

The exact number of persons employed without labour contracts is hard to establish because very frequently the inspections of Chief Labour Inspectorate show that advantage is taken of child labour, labour put in by people simultaneously registered as unemployed at the labour office and women on maternity leave. From the perspective of fields, branches and economic activities, the analysis shows that the highest relative share of those working without labour contracts goes to construction (29,7%) and services (26,7%), while in industry it is 16,7%, according to data of 2004.

⁴ A report by Coalition 2000 and Vitoshka Research on hidden economy in the period November 2002 – November 2004.

Table 2**Assessment of the employed in grey economy sector**

Indicators	2000	2001	2002	2003	2004	2005
I. Employed – total	2,980,108	2,968,069	2,978,562	3,166,499	3,236,387	3,233,988
II. Number of socially secured persons	2,303,726	2,311,091	2,170,061	2,393,927	2,491,829	2,501,302
1. Labour and official legal relations	2,119,014	2,117,688	2,007,636	2,216,078	2,300,550	2,303,328
2. Socially secured on their account	184,712	193,403	162,425	177,849	191,279	197,974
III. Margin: I- II – tentative number in grey economy	676,382	656,978	808,501	772,572	744,558	732,686
% of the employed	22	19,19	26,8	24,29	22,83	22,6

The concealment of income from wages and salaries, hence the loss of revenues in tax and social security systems is one of the typical features of grey economy. The options for this are: for those working without a labour contract – full concealment of incomes and no contributions to tax and social security system; partial concealment of incomes based on untrue clauses in labour contracts and a typically Bulgarian phenomenon – social security on the level of minimum social security thresholds and incomes lower than the thresholds or those legally established for the minimum wage in the country. The assessment of unreported income according to poll data shows that approximately 35% of those working on a labour contract receive higher from the reported income and it accounts for between 40-50% more than official salaries for the country – BGN 310 in 2005.

It should be stressed that the opportunity for entrepreneurs to pay “under the table” additional remunerations practically means that they have already started to generate income in the field of informal economy, mostly from unregistered turnovers, since it would be irrational to expect that this size of payment has as its source the legal profit of enterprising risk. This is evidence that the phenomenon of “informal economy” is able to reproduce and induce on an interrelated base – each of its manifestations naturally gives rise as a consequence to another one. In this sense, informal economy has a destructive impact on the social-security system.

Attention has already been paid to the negative role of grey economy on the social security system by way of shrinking its incomes, on the one hand, and, on the other - through illegal draining of security funds by way of hiring without a labour contract of persons registered on the labour market and receiving unemployment benefits. A significant problem is also

the draining of sources under supplementary programmes related to the active measures for employment. It is also an important problem that 50% of those self-employed do not pay general income tax security while the percent of the unregistered employed in agriculture amounts tentatively to 75% in 2002 up to 55% in 2005. The main challenge for the sharp drop in this relative share is the need to include farmers and their lands in registers allowing them to receive European specialised funds for agriculture. What is more, the “Pensions” funds is faced with problems because part of these people lacking the necessary years of service will receive social pensions or minimum pensions for which they have had no contribution in the social security income.

The Economic and Social Council has the opportunity to consider and put to the fore the problems of labour in informal economy in the light of national economic and social interest. In this sense, the issues of labour, trade unions and workers social rights raised within the frameworks of the issues of informal economy are nationally responsible and important for the state. The violation of these rights breathes “life” into informal economy. This in turn is a prerequisite for everyone – the state, trade unions, employer and non-governmental organizations, media – to focus their attention and commit to a greater extent to the subject of observation of labour trade union and social rights of workers and employees.

Breaches in labour legislation and violations of adopted EU standards in the field of industrial relations have an extremely negative influence not only on labour market but also on the business environment by implicating labour resource as a factor of unfair competition. Such violations service and “feed” informal economy. What else if not “grey economy” and unfair competition is the use of labour without paying the worked out remuneration or the outstanding millions of Bulgarian leva to the social security system in the country?

The parallel existence of the two sectors in the economy – the legal and the informal, has a negative effect on the overall social and economic development. In the first place, from the point of view of no profitability of technological and technical renewal in the hidden sector, the scientific and technical progress lags behind and as a whole efficiency of labour drops down. Secondly, investments as a whole are cut back due to the restriction of their sources (only the resources interior to the hidden sector are then invested) and the lack of guarantees for the investors outside the system. Thirdly, the negative effect of the parallel coexistence of a legal sector and hidden economy is related to the expansion of tax burden on economic subjects working in the “white” side of economy. The costs for services provided by the state are in this sense allocated among a dwindling number of tax-payers. This situation “urges” to a transition to the shadow side of business mostly those who are hesitating in their choice of direction (in the “white” or in the shadow side of economy) due to the fact that the price of “legalization” is too high. The result could be even a collapse in the legal sector - only the biggest players remain in the “white” business simply because they cannot go into hidden economy. In the fourth place, the existence of hidden economy renders all measures related to the pursuit of a consistent macroeconomic policy inefficient. In this case, it is built on the basis of inadequate indicators and macroeconomic indicators. This holds particular importance for monetary and loan policy because hidden economy generates turnovers which are not under the control of the Central Bank.

The expansion of the share of informal economy at the expense of the official economy could be viewed as a response of separate individuals (citizens, entrepreneurs, hired workers) who feel overburdened by the state and seek ways out of the situation. If the increasing share of informal economy has been provoked by the increase in taxes, the social security burden and the lack of commitment on the behalf of the state, then a “slip” in the direction of informal sector and particularly to “underground” economy could result in undermining the foundations of tax and social security system. The outcome could be a vicious circle of a subsequent increase in tax rates, additional expansion of shadow economy, gradual weakening of economic and social pillars of public order. Furthermore, the influence of shadow economy on the official should also be taken heed of, since the capital and labour in the sector of informal economy could lead to deformations in resource allocation, while production factors would not be used in this case in the most efficient way. The expansion of shadow economy share could possibly attract workers (foreign and local) from the official labour market and thus compete with legal companies.

The analysis of expanding shadow economy effects is quite difficult to make and empirical evidence could hardly be provided. Most studies focus on the influence of resource allocation and loss of state budget revenues. What is important in this case is the impact on official institutions, norms and rules. Shadow economy could be viewed as an indication of a serious deficit of trust to the existing social order and rules governing the official economy.

Naturally, it is also believed that informal sector could be viewed as optimum in the sense that it responds to the needs of economic environment for urban services and small-size production. From this perspective, it is believed that the informal sector gives the economy dynamics and enterprising spirit and brings in tighter competition, higher efficiency and more restricted state activity. It is claimed that informal sector might also contribute to “the establishment of markets, expansion of financial resources, stimuli for entrepreneurship.” According to some researchers, the willing choice between formal and informal sector could lead to a higher potential of economic growth and consequently to a positive correlation between the expansion of informal economy and economic growth. The Economic and Social Council finds the above statements unacceptable and is of the opinion that the effect of informal, shadow economy expansion on economic growth is extremely negative.

No matter the effect, however, no matter the empirical evidence used to defend such a statement, including by calculating the benefits of increased consumer demand based on spending of income obtained from shadow economy activities and related thereto indirect tax transitions, society should not be deluded - in fact, word is here of money laundering and legalisation of income acquired in an illegal way within the frameworks of shadow economy.

The Economic and Social Council is of the opinion that actions targeted at a considerable shrinking of informal sector might lead to a tangible rise in business competitiveness, tax incomes, hence bigger quantity and higher quality of public goods and services, which in the long run would act as incentive to economic growth. In this sense, the political will for consistent, concrete measures in the field of legislation, economic regulation and administrative capacity could help reveal the potential for growth generated by the expansion of official economy at the expense of the unofficial.

The opposite however also holds true. The expansion of the shadow sector has a negative influence on growth by way of limiting opportunities for the use of public services by citizens and by way of inefficient use of the existing public welfare and services or their non-utilization as a whole. Furthermore, the flourishing shadow economy could cause serious difficulties to politicians since the official indicators, such as unemployment, labour force, GDP, income and consumption have been distorted. Policy based on unrealistic indicators is very likely to be ineffective, rather poor. This is why the reciprocal effect between shadow and official economy should be taken heed of while planning economic measures particularly ones related to fiscal policy. If “illegal activity” is a fact in an economy, then tax collectibility could reach the negative slope of Laffer curve where higher tax rates lead to lower tax revenues in all other conditions equal.

The legal and economic analysis of “hidden” economy allows identifying the most sensible economic areas which once falling within the grey sector lead to negative consequences for the economy as a whole. In the first place, this is the sphere of cash circulation where sector criminalisation and going grey are particularly dangerous for society and the entire economic system. A number of experts are of the opinion that to some extent it is a matter of transition to a control over the sphere of cash circulation by certain criminal structures. A segment of the insurance business, banking, currency trade, etc. are an example to this end. In the long run this could undermine financial stabilisation and narrow down the opportunities for conducting economic reforms.

Property relations are yet another sensitive sphere. Going grey and criminalisation in this case pertain mainly to property in trade and public catering, immovable urban property, energy and raw materials complex, logging and woodworking, building materials production, construction, agriculture, land estate, state property operation incomes, etc. In practice, on the one hand, property turns out to be the economic base used by the participants in the hidden economy to built their grey schemes, on the other – it is used to legalise financial resources utilized in the shadow business.

Thirdly, foreign economic sphere is a particularly sensitive sector with regards hidden economy. It is used not only for fast accumulation of capitals, but also for the legalization of a considerable part of criminal incomes. Import and export operations often give rise to antidumping and other measures against legal exporters. Yet a number of studies on hidden economy state that it is the market of consumer goods and services that is most crucial for the formation of favourable conditions for informal business. All consequences of the formation and development of grey-black economy are reflected here, including concealment of incomes, social security, tax obligations, contraband of goods, etc.

In the long run, informal “grey” economy turns into a major source of funds used by economic circles to put pressure on state officials and institutions. The lack of adequate counteraction leads to a number of negative consequences:

1. Further intensification of the social and economic problems related to the period of transition by way of draining resources from the public sector;
2. Marginalization of many able-bodied individuals and their lasting alienation from the labour market;

3. Undermining of the principles of competition and free private initiative;
4. Increase in market risk for investors and their lasting alienation from Bulgarian market;
5. Participation in international corruption and criminal networks through which the country “integrates” into regional criminal infrastructure established under the influence of the events in the Western Balkans;
6. Establishment of a negative image of the country before foreign partners – both in business and politics, which further deepens Bulgaria’s isolation from developed Western democracies and impedes Bulgaria’s integration into EU and NATO;
7. Seizure or illegal leverage on the government thus threatening stability of democratic institutions;
8. Reproduction of financial resources for further expansion of criminal activities, including provision of a fresh inflow of dirty money to maintain corruption lobbies at all levels of state institutions;
9. The inflow of dirty money in politics through direct funding of political parties and their election campaigns has a particularly negative effect. This gives rise to backdoor networks of financial dependence which on the one hand restrict the independence of political sphere and on the other – create prerequisites for strengthening the power of organised crime.

Economic crime carried out by mafia circles and structures and the politicians and civil servants related thereto have not yet been seriously analysed in terms of both the phenomenon and the measures necessary for its restriction despite the fact that from the very start of transition period have been within the sight of civil society and state institutions.

The analysis of causes and effect of informal economy on the allocation of resources, incomes and policy for official economy stabilisation as a whole underlines the formulation of propositions to economic and social policy for restriction of the informal economic sector as an economic and social challenge.

IV. RESTRICTION OF INFORMAL ECONOMY – ACTIONS AND MEASURES TARGETED AT REVEALING POTENTIAL ECONOMIC GROWTH AND SOCIAL JUSTICE

The transition from informal economic activity, from the shadow sector, to official economy is not possible without proactive intervention by the state. In a long-term perspective, society will not accept the violation of laws and rules – they are the founding pillars of state. The trend for transition to shadow economy should be apprehended by politicians as a warning signal.

Traditionally the measures proposed for restriction of informal economy presuppose stricter control and harsher penalties. Unfortunately, such propositions often go as far as just cure the symptoms. Fighting the symptoms leads rather to actions causing a deeper “plunge” in the informal sector and results in additional “shadowing” of economy rather than contribute to any significant reduction of its expansion in economic life.

The Economic and Social Council is of the opinion that, in the first place, informal economy establishes unfair competition and thus acts as a major hindrance to business developing under the conditions of Bulgaria’s European membership. In this connection, the main efforts of state authorities, competent institutions and legislators is to stop unregulated imports (contraband) of goods, particularly in some sectors of processing industry, such as manufacture of leather, shoe, textile and articles of textile.

The contraband of goods in the country creates conditions for unfair competition and finances shadow economy. Bulgarian and foreign importer companies create a strong system of relations with distributors and retail traders to carry out contraband imports. They use the weaknesses in existing customs, financial and penal legislation and it could be said that they cope quite successfully. Attempts have been made to penetrate tax and customs services by bribing civil servants in order to secure in this way contraband channels.

The Economic and Social Council also lays an emphasis on the fact that there are serious problems in legislations and procurement practices which could be observed both in the requirements stated in the calls of proposal as well as in the compliance of formalised criteria, which allow the participation of persons related to the assignors, and the bid of unrealistically low tender prices, which lead to unfair competition and opportunities for corruption practices. Some public facts and non-transparent yet current cases of social importance of inefficient public-private partnership mostly in concession agreements have also given rise to reasonable fears that informal economy is expanding to gain new territories.

At the same time the Economic and Social Council wishes to focus the attention of state authorities and institutions, representatives of legislative, executive and judicial powers, that according to ILO the level of informal economy in a country is indicative of the efficiency of its government. The high level of development, the increase in the share of hidden shadow economy is considered a function of unrealised or poorly implemented governmental policies and plans. This is why, in its capacity as speaker of the interests of organised civil society, the Economic and Social Council takes as its irrevocable task to formulate and

propose to the government some possible measures aiming to legalise informal economy and surmount related corruption and crime rate.

The Economic and Social Council takes special interest in enhancing the participation of citizens in the government of public systems considered a cherished priority of the state, such as public finances and tax system. To this end, the trend observed in the process of Bulgaria's EU accession talks to pass on crucial decisions to Brussels and justify European pressure does not build up tax-payers' sense of control over state spending. A pro-active participation in decision-making process by way of referenda and civil initiatives might help restrain the sense of infringement of citizen's personal freedom. At the same time, moral and loyalty have been growing up, which helps a successful struggle with shadow economy. The enhanced participation of people leads to taking up responsibilities on their part as a personal contribution and interest to state affairs. The right to participation could lead to a mitigation of the problem of state power concentration since the efforts of the state would be deemed to meet the expectations which in turn would lead to reinforcement of tax moral. One of the major reasons for the relatively low share of shadow economy in Switzerland, as compared to the rest of OECD countries, is the presence of a great many elements of a direct democracy. In a long-term perspective, this would lead to strengthening public capital and the sense of adherence to a certain community which in turn would lead to the survival of societies and future provision of public wealth.

The Economic and Social Council suggests that the policy of decrease of financial stimuli for carrying out activities in shadow economy should be the main approach in restricting informal economy. This could be achieved through:

- ✓ **Adoption of a Programme for fight against informal economy with an interdepartmental coordinating authority;**
- ✓ **Coordination of measures and optimisation of information among authorities for the purpose of fight against unfair competition, including parallel imports and exports at lower prices;**
- ✓ **Transparency of public finances, tax system and spending policy of the state;**
- ✓ **Decrease in the size of taxes particularly direct taxes to levels equal to tax evasion costs;**
- ✓ **Tax system simplification, including VAT registration of all economic subjects (companies);**
- ✓ **Abrogation or mitigation of some regulatory regimes, as well as reconsideration of the size of fees collected thereto;**
- ✓ **Reforms in the social security system, including reforms opening up opportunities and incentives for pressure on the behalf of the insured persons with regards failure to pay social securities;**

- ✓ **Continuous financial decentralisation;**
- ✓ **Enhanced administrative efficiency and fight against corruption;**
- ✓ **Application of harsh legal penalties for intentional non-payment of wages and salaries;**
- ✓ **Public control over the work of the administration;**
- ✓ **Strengthening administrative capacity and introduction of an integrated information system;**
- ✓ **Concentration on improvements and reforms of institutions and systems for raising awareness and communication with regards the need of reform;**
- ✓ **Introduction of instruments of direct democracy in the solution of significant national and local problems including tax system modelling.**

The Economic and Social Council hails the efforts of social partners for the organisation of events, discussions and campaigns related to the legalisation of informal economy particularly in view of its manifestations in the field of labour and industrial relations. At the same time, ESC calls on trade union and employer organisations in Bulgaria to join hands in the spirit of autonomous social dialogue among responsible representatives of the main economic agents, to contribute to the improvement of national labour and social security legislation and the adoption of European and international labour and social security standards as one of the main instruments for efficient restriction of informal economy.

The Economic and Social Council is hopeful that all interested parties – state authorities, the upright and law-abiding Bulgarian business, trade unions, public and non-governmental organisations and last but not least the media – will join efforts in this direction and support the implementation of these measures, the restriction of informal economy is a national and state task which will assist Bulgaria's efforts in catching up with EU state, it will open up opportunities for a bigger economic growth and social cohesion in Bulgarian society as part of the common European space.