

GREY ECONOMY AND CORRUPTION IN BULGARIA: EMPIRICAL EVIDENCE

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1. Introduction

The analysis of dimensions, spread, and consequences of grey economy phenomenon in Bulgaria is still under intensive public policy debate even after the official EU integration of the country since January 2007. Many aspects of this debate consider the interrelation between corruption, the extent of transactions underreporting, and the prospects of economic development within EU common economic space. Even though private sector already dominates most of Bulgarian industrial sectors in the recent years, the assertion that state bureaucracy still has a significant influence on the economic activity is commonly shared by policy analysts.

A commonly shared view characterizes the early transition (first half of XX-th century 90s) by minor progress in privatization process and considerable drop in Bulgarian manufacturing output. This was typically explained by a variety of obstructions in transforming social and political mechanisms related to the complex of inherited bureaucratic barriers during the market transition. Additionally, some deficiencies in economic policy, collapsing infrastructures, and the loss of human capital due to emigration have created substantial hindrances to the process of economic resurrection in the early transition. These circumstances created favorable environment for the spread of grey economy and corruption practices interlinking the success of business operations with the administratively provided shelters.

A typical theoretical approach in the literature is to model the underreporting behavior in a cost-benefits analysis framework where the motivation reflects the impact of various institutional and cultural factors (Tanzi, 1998). Economic theory also identifies the rise in tax and social security burdens as one of the most important causes of the increase of the shadow economies worldwide. This effect is explained by a switch of labor supply to the hidden economy (considered as an untaxed sector) driven by the enlarging difference between the total labor cost and after-tax earnings in the official economy (Schneider & Enste, 2000). Studies of hidden economies for the period of early transition have found some evidence for the assertion that the success of market reforms is related to lower levels of the shadow economy (Eilat & Zinnes, 2002).

It is acknowledged that corruption restrains economic growth and the overall efficiency in an economy as well as creating distortions in competition. Katsios (2006) notes that excessive regulations obstruct the redistributive and stabilization function of the government and create favorable conditions for a spread of bribery practices. However, the interrelation between corruption and shadow economy needs to be analyzed as a complex economic phenomenon where both substitutive and complementary effects are possible (Schneider & Enste, 2000).

Since July 1997 Bulgarian monetary system has adopted a currency board arrangement which provided adequate conditions for macroeconomic stabilization and steady (albeit with annual rates of only 4-6%) economic growth in the years of EU accession. The official income level in Bulgaria however is the lowest among the new EU member countries with GDP per capita in PPP about 37% of the EU25 average for 2007 (NSI, 2008). Additionally, the excessive concentration of administrative control over public resources provided favorable conditions for rent-seeking behavior during the transition where

interpersonal principles and norms play important role (Chavdarova, 2001). In the same time, the legislative framework of business activities and taxation has undergone prolonged period of adjustment which often resulted in a chronic dependence on regularly changing bureaucratic discretion (Kelchev, 2006).

2. Survey of attitudes of business representatives

The paper suggests hereafter some empirical evidence on selected issues regarding the grey economy and its interrelation with corruption practices anticipated as barriers to private businesses development in Bulgaria during the EU accession period. The analysis utilizes data from a sample questionnaire survey conducted in the summer of 2007 by “Vitosha Research” Agency among owners, managers or experts of 386 business organizations. The survey design used the business register as a sample frame to draw a nationally representative sample of firms. Almost 89% of them were small and medium sized enterprises and about 90% controlled or entirely owned by private entities. During the survey respondents expressed their opinion about the spread of grey economy and corruption in the country as well as about various aspects of underreporting practices in their branch. This allows for an evaluation of the potential impact of these phenomena on the prospects for private businesses development in the common European economic space.

2.1. Assessment of the grey economy spread

Business persons were asked to evaluate (up to their experience, knowledge, and understanding of the problem) the extent of “shadow operations” in their branch as compared to the country as a whole.

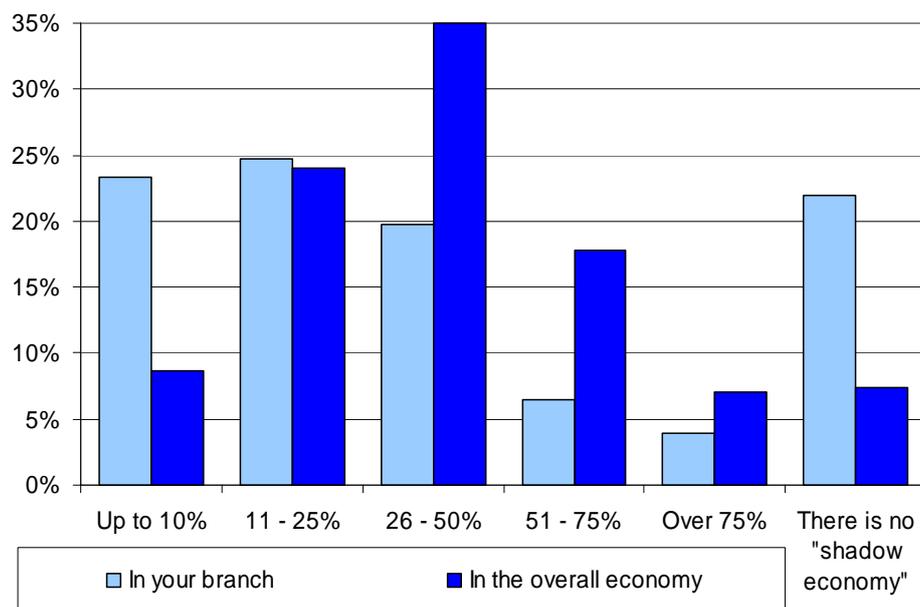


Figure 1. Distribution of responses to the question “What is your opinion on the extent of grey economy (1) in your branch (2) in the country?”
/response rates: (1) 72% and (2) 63%/

It is interesting to note that the perceived extent of the grey economy in all sectors is significantly higher than the same extent in the own branch (fig.1). The average share for the overall economy is estimated at 38% compared to 26% for the branch, where the modal answers are “11%-25%” for the own branch and “26%-50%” for the country as a whole. Similar results are obtained by other questionnaire surveys which provides some evidence that

business people typically perceive the scale of this phenomenon as larger “in the other” than “in the own” branch of activity.

In addition to the overall assessment, the respondents were asked to evaluate several important shadow economy dimensions. One of them is the hidden employment which is found when the employees work without official labor contract with the employer. More frequently, however, employees do have such a contract but often accompanied by “hidden clauses” agreements, mainly in respect of the actual versus officially reported remuneration (e.g. reporting the minimum wage).

- The average share of employees working without formal contract in the branch is assessed by respondents at 21% (or each fifth) which provides evidence for an underestimation of the actual employment in the country.

- The average share of the employed with “hidden clauses” is assessed at 29%; thus, for about half of the employees in these (mainly private) businesses the remuneration is partially or entirely underreported resulting in a substantial loss in revenues from labor income taxes.

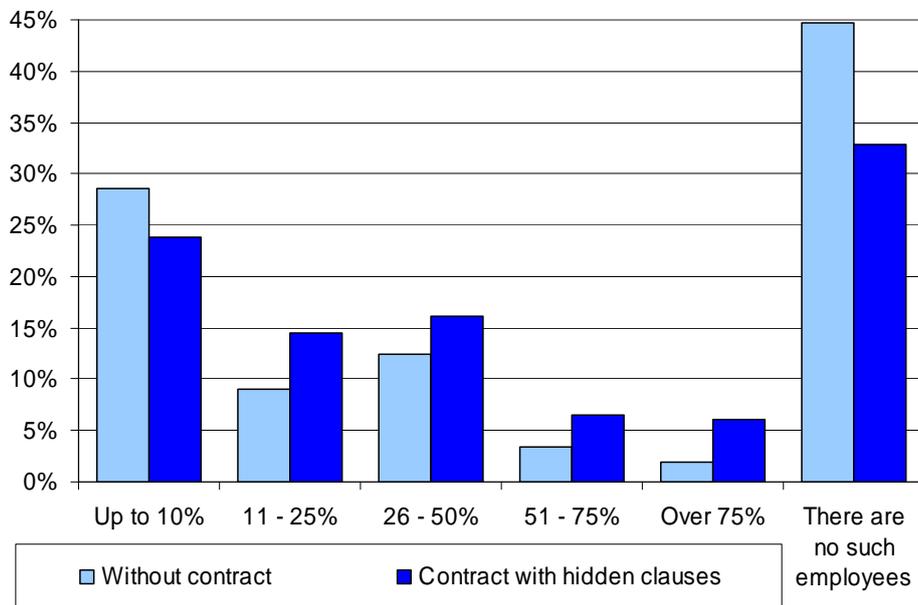


Figure 2. Distribution of responses to the question “What share of the employees in your branch work (1) without an official labor contract (2) with a contract but under hidden remuneration clause?”

/response rates: (1) 69% and (2) 64%/

- The share of payroll funds paid out from a “black account” (not reported and evading the payment of social insurance and personal income tax) is assessed at 30% on average by the respondents.

- Finally, the overall extent of grey economy is approximated by the share of unreported turnover – it is estimated at 26% which is found quite close to the current macroeconomic estimates of non-observed economy share in Bulgarian GDP.

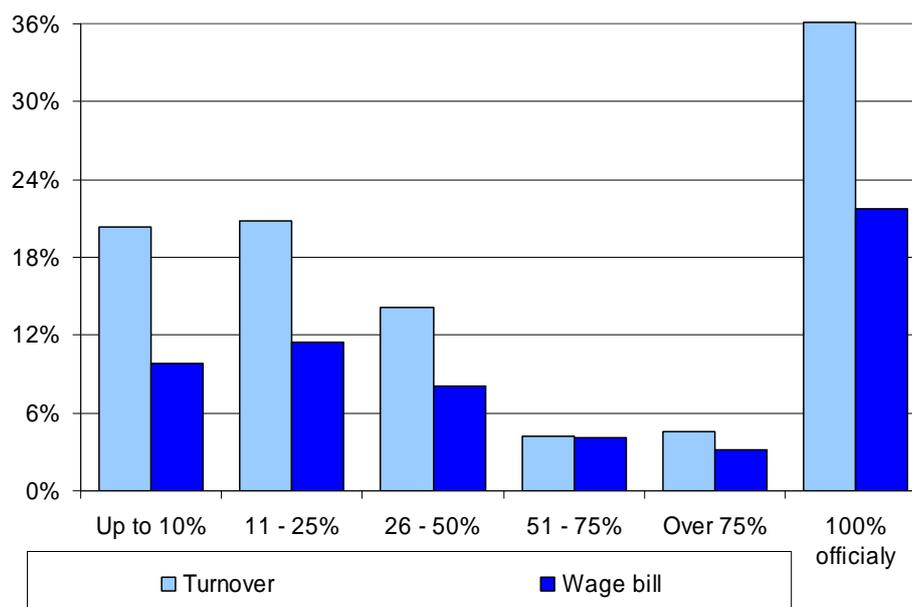


Figure 3. Distribution of responses to the questions “What share of the turnover of the companies in your branch is not reported?” and “What share of the remuneration expenditures are paid unofficially?”
/response rates: (1) 62% and (2) 58%/

Table 1. Reasons for evading taxes by the companies

| Respondents identify up to 3 main reasons: | % of responses | % of cases |
|--|----------------|------------|
| Tax rates and duties are too high | 23.0 | 41.7 |
| Administering of tax regulations /compliance/ is too complicated | 7.8 | 14.2 |
| The work of state bureaucracy does not worth the payment of so high taxes | 12.0 | 21.8 |
| Tax compliance leads to a loss in competitiveness of the complying firm | 13.0 | 23.6 |
| Firms are going to bankrupt if pay all due taxes | 14.7 | 26.7 |
| It is more profitable to pay "unofficialy" in order to avoid penalties, sanctions, fines | 7.6 | 13.7 |
| Because of the illegal nature of the activities | 3.6 | 6.5 |
| Other | 2.0 | 3.6 |
| Companies in my branch do not evade taxes | 9.4 | 17.1 |
| Not replied | 7.0 | 12.7 |
| Total | 100.0 | – |

The tax evasion is typically assumed as a major motive for shifting the activities “in the shadow”. The main reason for this, as identified by respondents (over 40%), is the tax burden level. However, other incentives play also a significant role, of which the most important are related to the costs of evasion. It is believed that if all the due taxes have to be paid, assuming that the other agents succeed to avoid it, the firm will lose its competitive position in the branch. In the same time, each seventh respondent finds that it is preferable to use bribery as a more efficient way to avoid (otherwise quite higher) tax payments.

There is no doubt that private businesses accumulate an amount of unreported income which provides them with a position to cover necessary unofficial payments related to evasion of taxes and social insurance. Except income-related taxes, a substantial source of non-recorded funds is the evasion of the turnover tax – respondents assess the share of successfully evaded VAT between 16% and 35% on average. However, a large fraction of respondents (74%) declare that their company is not using such funds for bribery, and half of the others do not respond to the question.

2.2. Opinions about corruption practices

A range of alternative operational indicators are adopted in the survey instrument to capture various aspects of bribery as perceived by business representatives. When limited to indicate up to 3 most corrupted systems, respondents emphasize mainly on the customs (46%), judiciary system (36%), health care system (26%), parliamentary members (21%), police and law enforcement (20%), and high-level government officials (19%). The opinions about the extent of corruption involvement of the lower-level officers in public administration are however equally split between “most of them” and “few of them” (about 36% each); similar results are found about the extreme answers “almost all of them” (7%) and “almost none of them” (6%).

In the same time, the majority of respondents state that they have never been asked, directly or indirectly, to pay unofficially to public administration officers (fig.4). Only 18% of responded business representatives had cases of direct request, but quite a higher share (30%) of them were indirectly shown that they are expected to “stimulate” in some way the public servant. The most important factors identified by respondents regarding the spread of corruption amongst public sector employees are the low level of remuneration in the budgetary sector (54%), the desire of rapid enrichment of the persons in power (43%), the deficiencies in legal framework (39%), the inefficient control (29%), etc.

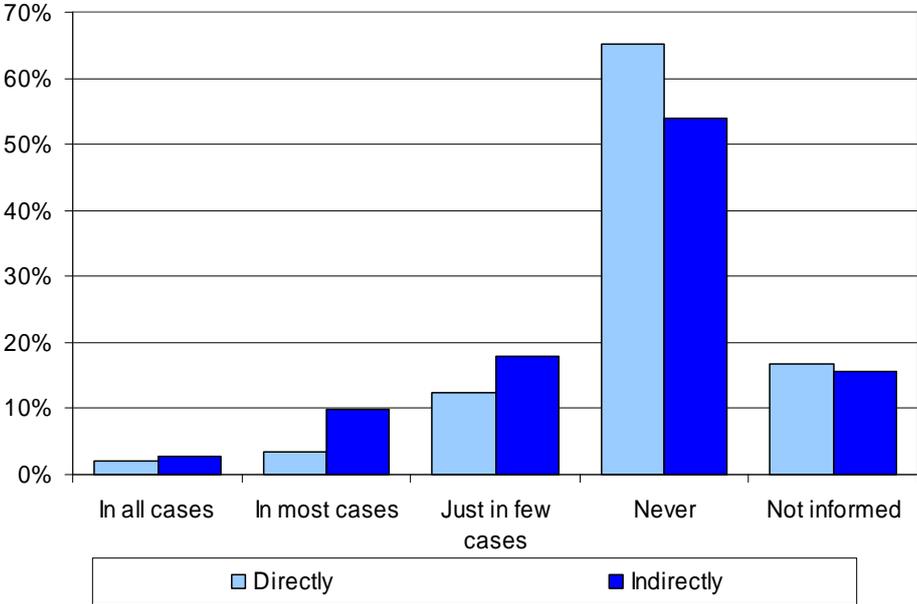


Figure 4. Distribution of responses to the questions “When contacting public sector officers, how often you were (1) asked directly (2) indirectly expected to give money, present, favor?” /response rates: both 74%/

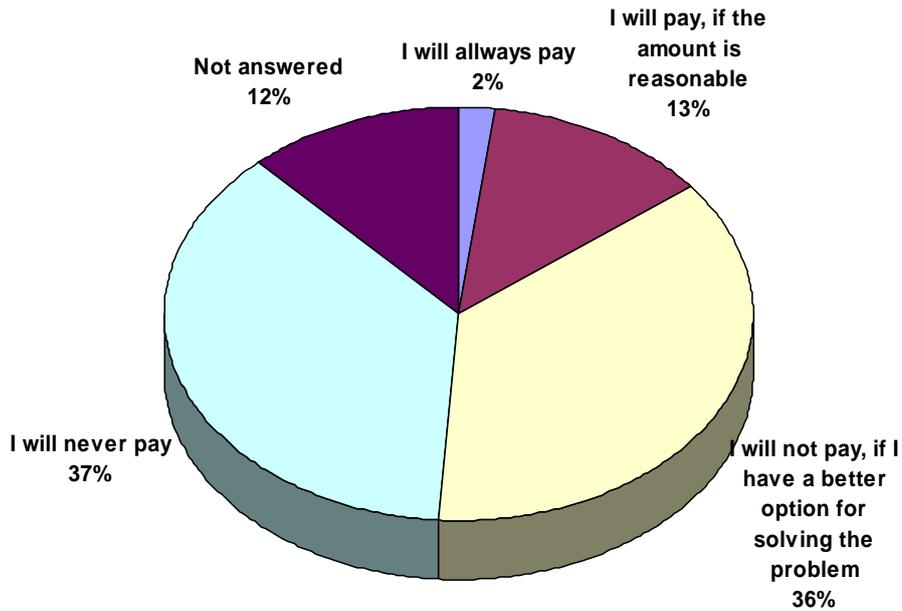


Figure 5. Distribution of responses to the question “If you are asked money by a public employee to solve your problem, what would you do?”

Although some progress has been made in the years of EU accession, there is not yet developed an efficient mechanism for combating corruption within the state administration. The predominant share of respondents imply that even the businesses do not make serious efforts to resist to bribery practices, and the situation with the state officials’ efforts is even worse (fig.6). This opinion is widely shared in the business community having in mind that about 3/4 of respondents indicate that high-level government officials make no or very little effort to strive against corruption.

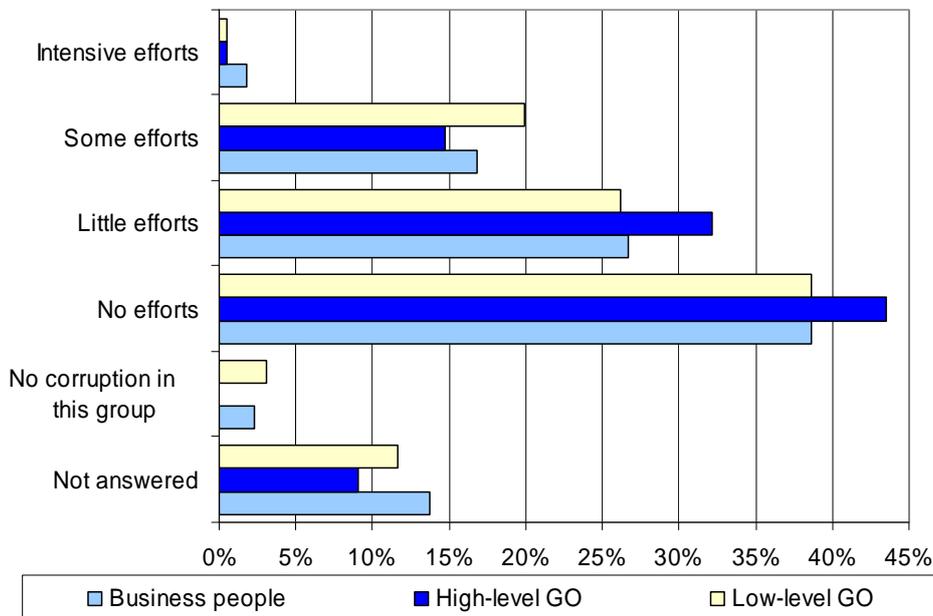


Figure 6. Distribution of responses to the questions “How do you find the efforts of each of the following groups in combating corruption? (business people, high-level and low-level government officials)”

A substantial majority of respondents (over 70%) also declare that they personally have not faced directly any corruption pressure. About 20% however explicitly state that they have not undertaken anything, and just few percent have issued a signal to the police, prosecution, or higher-level administration officer. This result leads us to suspect that “mass” corruption phenomenon is in some extent amplified in the public opinion realm. Anyway, the survey certainly provides worrisome evidence for a low level of anti-corruption attitudes among business people who still follow a “less-resistance” behavioral strategy.

2.3. “Grey economy – corruption” interaction

It is commonly agreed by economic policy analysts that shadow business activities and corruption practices are interlinked phenomena. A lower level of corruption in the public sector should restrict the grey economy spread, and vice versa – with restrained “shadow operations” (providing “black account” funds for bribery purposes) corruption would be substantially hindered. In an attempt to test a hypothesis for such an interaction we check for an association between the assessment of (a) the spread of corruption practices among public sector official and the grey economy spread (b1) in the country and (b2) in the branch.

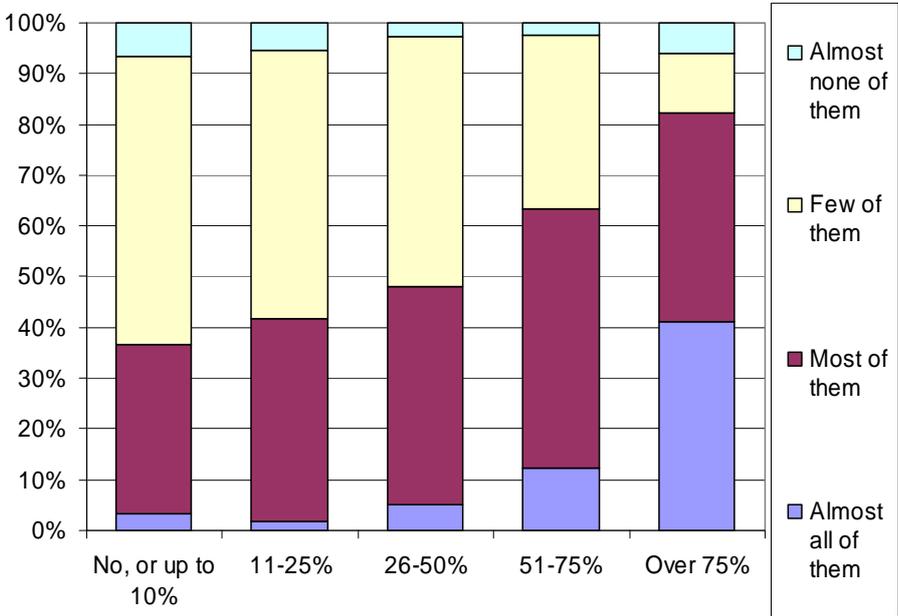


Figure 7. Distribution of responses to the question “How would you assess the involvement of public sector officials in corruption?”, conditional on the assessment of the grey economy share in the country

Both hypotheses show a statistically significant interaction between the opinion of respondents regarding the spread of grey economy and corruption (a-b1 at 0.05 and a-b2 at 0.01 level of significance). There is no doubt that these socio-economic phenomena are interrelated and further investigation of this association can provide important empirical evidence about its specific aspects.

3. Final remarks

The spread of grey economy, tax evasion, and corruption is still a problem in Bulgaria as a new EU member state with not only domestic but also international implications. Serious obstacles still exist in the country in respect of infrastructures renewal (e.g. in transport, water, and waste management); bureaucracy and ineffective law enforcement; unfavorable demographic trends and emigration of professionals; inflexible labor market; various environmental problems. Achievement of better results in combating corruption is unlikely without sustained efforts in the finalization of structural and institutional reforms. Moreover, in the framework of the adopted EU legislation and transparency requirements, the enforcement of anti-corruption measures becomes much more important for the current Bulgarian public policy. This necessitates additional comprehensive investigation of the options for implementation of potentially effective tools that will be able to restrain, as much as possible, the extent of grey economy operations and induce a higher degree of societal intolerance to corruption, fraudulent behavior, and tax evasion.

4. References

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