

GREY ECONOMY AND PERSPECTIVES OF BULGARIAN BUSINESSES DEVELOPMENT IN THE EU ACCESSION PERIOD

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The paper suggests some empirical evidence on selected issues related to the influence of business environment factors and corruption practices anticipated as barriers to the successful finalization of the transformation of Bulgarian economy and its integration in the common European economic space. The analysis utilizes sample data from a questionnaire survey among 345 representatives of business organizations having ownership, managerial, or expert positions within the firm. During the survey, respondents expressed their opinions about the spread of grey economy as well as about various aspects of transactions underreporting practices in their branch, providing a ground for the evaluation of the impact of these phenomena on the perceived potential for private businesses development. Evidence from business people attitudes is provided in support of the opinion that restraining the corruption and bureaucratic barriers, provision of the higher public decision-making transparency, as well as improving law enforcement and judiciary system effectiveness are important conditions for domestic entrepreneurship stimulation and overall stable economic growth within the European economy.

Keywords: grey economy, business survey, Bulgaria

Introduction

The transition to market economy in Bulgaria experienced several periods characterized by features specific of the respective socio-economic conditions, both domestic and international. During the early transition (typically referring to the first half of 1990s) it was commonly agreed that grey economy had substantially proliferated in the country during the processes of social,

political and market reforms. The spread of this phenomenon was related to the inherited relative technological backwardness and insignificant success in privatization along with residual bureaucratic barriers, faulty political mechanisms, intensifying corruption practices, an incoherent economic and monetary policy, collapsing infrastructures, etc., which decreased the country's potential for a rapid economic resurrection.

The faulty mode of doing economic reforms in Bulgaria during the early transition is a common understanding and the country faced major challenges in making “a double effort”: to finalize the socio-economic transformations and to prepare for the integration in the European Union (Rangelova, 2002). Since July 1997, the Bulgarian monetary system has adopted a currency board arrangement which provided adequate conditions for macroeconomic stabilization and a 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 still the lowest among the new EU member countries with GDP per capita in PPP about 37% of the EU-27 average for the last year (2006) before the full EU membership (NSI, 2008). Additionally, an excessive concentration of administrative control over public resources provided favourable conditions for rent-seeking behaviour during the transition where interpersonal principles and norms play important roles (Chavdarova, 2001). At the same time, the legislative framework of business activities and taxation has undergone a prolonged period of adjustment, which often resulted in a chronic dependence on bureaucratic discretion (Kelchev, 2006).

The analysis of dimensions, spread, and consequences of the 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 among corruption, the extent of transactions underreporting, and the prospects for economic development within the EU common eco-

nomic space. Even though the private sector already dominates most of Bulgarian industrial sectors in the current decade, the assertion that state bureaucracy still has a significant influence on the economic activity is commonly shared by policy analysts. Thus, a complex of socio-economic circumstances created a favourable environment for the spread of grey economy and corruption practices interlinking the SMEs survival with the success of their “shadow” operations.

The definition of grey (or shadow) economy is considered as a controversial topic which is still debatable albeit substantial literature focuses on various dimensions of the concept (for a comprehensive literature survey, see Schneider & Enste, 2000; Schneider & Enste, 2002). Hereafter, we conform to a commonly accepted understanding of the “grey” economy as economic activities generating unreported income from the production of legal (in nature) products, including the barter operations; it should incorporate all transactions that, generally, would be taxable if reported to the state. More precisely, here we follow a more narrow definition stating that the grey economy is associated to “all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons: (1) to avoid payment of income, value added or other taxes, (2) to avoid payment of social security contributions, (3) to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc., and (4) to avoid complying with certain administrative procedures, such as completing statis-

tical questionnaires or other administrative forms” (Schneider, 2006:5).

A typical theoretical approach in the literature is to model the underreporting behaviour 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 labour supply to the hidden economy (considered as an untaxed sector) driven by the enlarging difference between the total labour 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). Moreover, it is acknowledged that excessive regulations obstruct the redistributive and stabilization function of the government and create favourable conditions for a spread of bribery practices (Katsios, 2006). However, the interrelation between corruption and shadow economy needs to be analysed as a complex phenomenon where both substitutive and complementary effects are possible (Schneider & Enste, 2000).

The paper suggests hereafter some empirical evidence on selected issues regarding the grey economy and its spread related to the issues of private businesses development in Bulgaria during the EU accession period. The analysis utilizes data from a sample questionnaire survey conducted at the end of 2007 among owners, managers

or experts of 345 business organizations¹. During the survey, respondents expressed their opinion about the spread of grey economy and corruption as well as about various aspects of underreporting practices in their branch and in the country. This allows for evaluation of the potential impact of these phenomena on the current development of Bulgarian businesses already operating within the European economic space.

Assessment of grey economy spread by business persons

Questionnaire survey and respondents' profile

The survey design was developed to provide, as much as possible within the budget limitation, a countrywide arbitrary selection of respondents through a random selection of interviewers among the UNWE students' community. This approach provides an independent selection of units of observation approximating fairly well the necessary random sample of firms. The survey conditions guaranteed the anonymity of respondents providing a relatively higher response rate on the main questions capturing the extent of grey economy spread in the business operations within the respective economic sector. Opinions of respondents were required on several main groups of issues in respect of:

business environment conditions and their relations with grey economy spread;

¹ The survey was conducted within the work on Research Project NID.21.03-5/2006 of UNWE Research Program, 2006-2008, by a team of the Center of Statistical Studies at the University of National and World Economy (UNWE), Sofia.

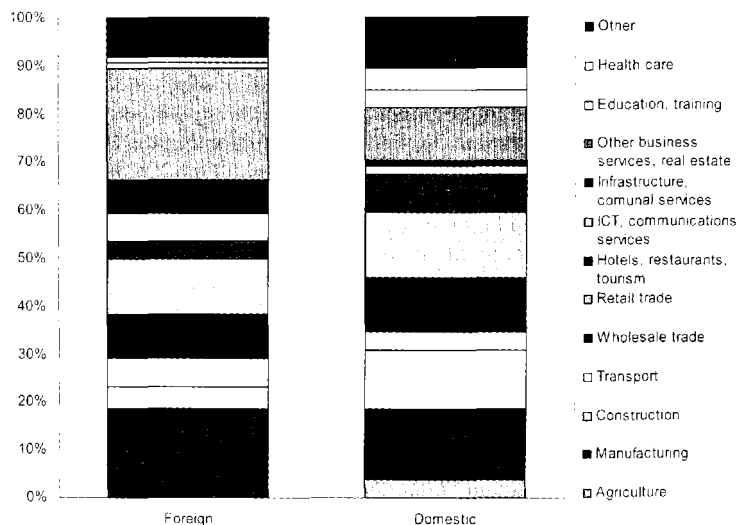


Figure 1. Structure of the sample by foreign participation and economic branches

- the main forms of realization of shadow operations, along with the assessment of the degree of grey economy spread in the branch and in the economy as a whole;
- the identification of the main negative consequences of grey economy on business performance and the key public policy approaches to its combating.

The questionnaire consisted of four sections covering (a) the passport characteristics of the firms; (b) the perceptions of respondents about the features of the business environment; (c) the opinions and assessment of the extent of the grey economy spread in the branch and in the country; (d) the opinions on the effects of grey economy on the business environment and possible means for its restriction.

About half of the firms have activities allocated in the capital city (Sofia) and one third in a district-center city; the shares of the main forms of ownerships are: 22% for sole proprietorship firms, about 50% for limited liability companies (split equally between single-owner and partnership types of companies), and another 22% for joint-stock companies. About each fourth respondent represents a firm with the predominant foreign participation, but the sectoral structures of the two sub-groups differ (Figure1); the main sectors of the domestic companies are manufacturing (15%), retail trade (14%), construction (12%), and wholesale trade (11%), whereas among the foreign-controlled companies the leading sectors are business services (incl. finance and real estate, 23%), manufacturing (19%),

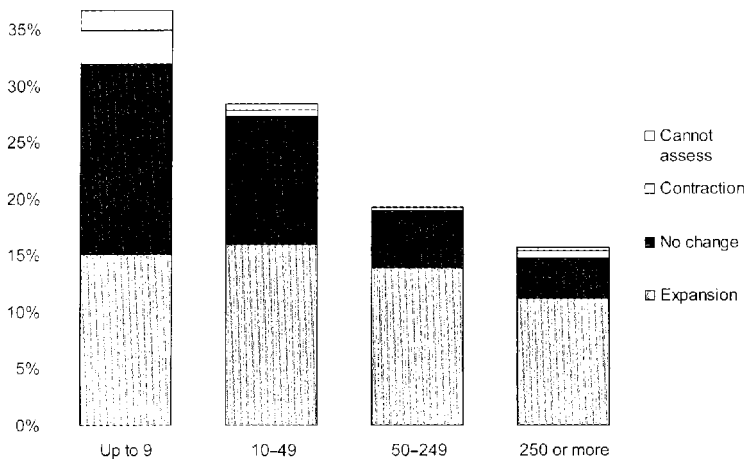


Figure 2. Structure of the sample by enterprise size (number of personnel) and short-term expectations about their business

and trade (retail 12%, wholesale 9%). These distributions of the sample deviate to some extent from the population structure by the type of enterprise and economic sector, and hence additional post-stratification is necessary. Hereafter in the paper, we present the original (non-weighted) results for various distributions and estimates of mean levels and proportions.

About each seventh firm is large (according to Bulgarian classification, with at least 250 employees), so the majority of the respondents represent business organizations of small and medium size (37% micro-firms with up to 9 employees). More than half of the respondents have positive expectations about the near future of their firm's business, although the share of optimists decreases from 72% among large companies to 40% among micro-firms representatives (Figure 2). Almost one third

of the interviewees are owners (entirely or as major partners), 30% have managerial positions, and one fourth occupies expert positions in the firms'. Additionally, about half of respondents assess the scale of their firm's operations as around the mean level, whereas almost 38% characterize their company as being "over the average" in the respective branch. This provides a satisfactory ground for the treatment of the interviewees' opinions and estimates as having a solid ground in their experience, knowledge and understanding of the business problems, acquired in their active business practice.

Assessment of the grey economy spread

Business persons were asked to assess the extent of "shadow operations" (associated to the share of unrecorded turnover) in their

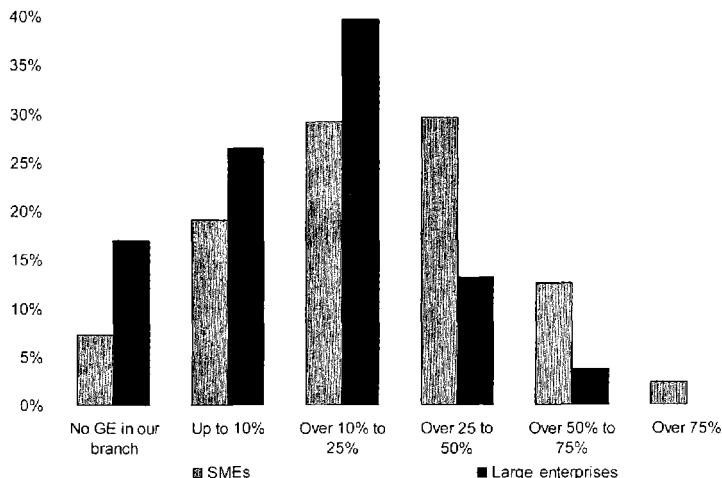


Figure 3. Responses to the question "What is your opinion on the extent of grey economy in your branch?"

branch as well as the *perceived aggregate share of hidden transactions in the overall economy*, i.e. all sectors as a whole.

The average share for the overall economy is estimated at 40.9% compared to 25.3% for the branch, where the modal answers are "over 10% to 25%" for their own branch and "over 25% to 50%" for the country as a whole. It is interesting to note that the assessment of grey economy spread in a branch diverges significantly (at 0.01 level) between the representatives of SMEs and large companies (Figure 3) Assuming the knowledge about the typical "practices of peers" (and implicitly of their own practice), small firms tend to evaluate the extent of shadow operations in the respective branch quite higher (27.1% on average) than people from large firms (15.6%). Some weighting of these judgments is generally possible (on the basis

of appropriate sectoral data), which would provide a higher estimation accuracy of these parameters. Similar results are obtained by other questionnaire surveys (e.g. CSD, 2007) which provide some evidence that business people typically perceive the scale of the grey economy phenomenon as "larger in the other than in our own" branch of activity.

Another important dimension of the shadow operations is *hidden employment*. The respondents were asked to evaluate two shares: (1) the share of the employees working without official labour contract with the employer; (2) the share of employees having a formal contract but accompanied by "hidden clauses" agreements. The latter was quite extensively used by private entrepreneurs in the early transition, and even after 15 years of reforms such practices are still in use, mainly in respect of

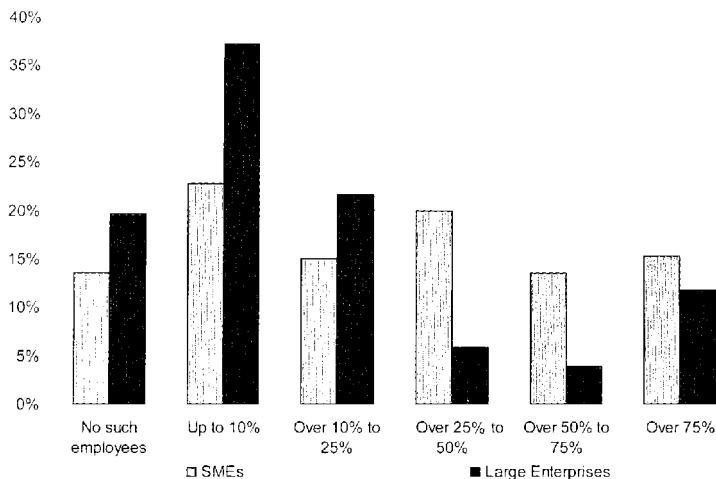


Figure 4. Responses to the question “What share of the employees in your branch work with a contract but under a “hidden remuneration” clause?”

the actual versus officially reported remuneration (typically, reporting the minimum wage as a basis for payroll and income taxes; also, reporting half-workday employment instead of the actual).

The average share of the employed with a “hidden clause” is assessed at 31%; a significant difference is found yet again between SMEs (33.1%) and large companies (20.6%) (Figure 4). There is no doubt that the labour remuneration of a substantial share of employed is partially underreported, which results in an underestimation of the actual level of the compensation of employees (as the main GDP component) and, moreover, in a considerable aggregate loss in revenues from social security contributions and personal income taxes. Albeit with quite lower parameters, the spread of entirely hidden employment (i.e. workers without any formal labour contract) additionally

exacerbates the situation: the overall average share of this employment is estimated at 10%, with 5.7% for large and 10.6% for small and medium-sized companies.

It is, however, important to note that during the years of EU accession, characterized by accelerated efforts for accomplishment of negotiated improvement in public policies, legislative framework and law enforcement, the extent of grey economy had been somewhat restricted. Indicative of this are the answers of business persons to the question “How would you evaluate the share of hidden transactions now as compared to 5 years ago?”. Almost 45% of respondents find it as “reduced” in their own branch, and 40% regarding the country as a whole. The share of those considering the grey economy spread as “expanded” is quite lower (22% for their own sector and 32% for the overall econo-

my), but along with those finding it as not changed (31% for their own branch and 26% for the country) the majority of respondents are not so optimistic.

Main determinants and consequences of grey economy spread

Business persons were asked to identify up to three main factors facilitating the spread of hidden transactions in the country. The initial expectation was oriented towards the tax burden level and the ineffectiveness of tax administration. However, respondents undoubtedly focus on two major problems that provide a favourable environment for the grey economy (Table 1): *corruption practices* identified by almost 60% of the interviewed and the *lack of fast and effective law enforcement* (42%).

It can be argued that some of the suggested factors are interrelated and respondents identify those that most clearly reflect the everyday problems of their business practice. It can be concluded that the major

reason for systematic shadow transactions is the ineffective rule of law and the possibilities to “get away” through appropriate bribery. 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. In this respect, a substantial source of unrecorded funds is the evasion of the turnover tax indicated by respondents when assessing the regularity of occasions of several shadow operations within their branch (Table 2).

The opinions about some important business environment factors evaluate several circumstances accompanying shadow transactions. Table 3 contains the distribution of answers on a set of items, *but only of those respondents* that have found the statement “The majority of firms in Bulgaria are substantially involved in grey economy operation” as “absolutely valid” (46%, or 159 interviewees). Vast majorities of these respondents find that private

Table 1. Main reasons for the grey economy spread

	% of responses	% of cases
Corruption	19.3	58.9
Non-penalization of illegal activities and crimes	13.6	41.6
Ineffective judiciary system	9.7	29.6
High tax burdens	9.6	29.3
Operation of “administration-business” mafia	9.6	29.3
Endeavour to rapid enrichment	8.9	27.3
Deficiencies in the legislation	8.3	25.2
Ineffective tax auditing and control	8.0	24.3
Complicated and sluggish administrative procedures	6.4	19.6
Specifics of Bulgarian entrepreneurial culture	4.3	13.2
Inefficient border control	2.2	6.7
Total	100.0	–

Note: 341 valid cases, 1041 responses.

Table 2. Responses to the question “How often each of the following activities is practiced in your branch?”

	Very often	Relatively often	Relatively rarely	Very rarely	Not practiced
Downsizing the officially recorded profit in respect of the actual	23.8	25.6	20.9	13.5	16.2
Recording a lower official amount of transactions than the actual	18.0	22.8	20.4	20.1	18.6
Payments of large amounts in cash	10.7	15.7	18.7	23.7	31.2
Recording lower customs / excise / other duties on products	8.3	20.8	19.0	22.3	29.5
Manipulating turnover records to “download” VAT credit	5.2	10.3	14.3	20.7	49.5
Illegal import and / or export	3.0	7.5	13.9	21.4	54.2

Table 3. Responses to the question “Do you consider as valid each of the following statements?”

	Absolutely valid	Somewhat valid	Somewhat invalid	Absolutely invalid
Current conditions for private business development are favourable	5.7	37.1	44.0	13.2
Economic policy of the government stimulates private business development	1.3	23.9	48.4	26.4
Next year the business conditions will improve	7.5	32.7	37.1	22.6
Legislative framework of private business operation is good	1.9	28.3	54.7	15.1
Private business in Bulgaria is facing a variety of administrative obstructions	54.1	31.2	11.5	3.2
State administration in Bulgaria acts as independent of private economic interests	8.2	6.9	22.6	62.3
Police in Bulgaria effectively protects the private business security	1.9	8.8	38.4	50.9
Current tax system is good and stimulates private business development	3.8	13.8	45.9	36.5
Interests rates are too high	52.2	33.8	12.1	1.9

businesses in Bulgaria are facing various bureaucratic obstacles; the business legislation and the tax system are still not favourable enough; Bulgarian state officials are not independent enough of particular business groups’ interests; the police protection of businesses is still not effective enough. Although about three fourths of these interviewees do not find the economic policy as stimulating private business development, there is a somewhat

higher optimism since 60% of respondents believe that business conditions in the country will improve in the next year 2008.

Business people were asked to identify the *main negative consequences* for their organizations that are highly likely to emerge as a result of grey economy operations. While limited to indicate up to three most important items, respondents emphasize mainly the following:

establishment of systematic practices of unfair competition (66% of all respondents, 26% of all indicated items); takeover of the respective market by a narrow range of companies, development of monopolies / oligopolies (39%, 15%); loss of clients, drop in the volume of sales (33%, 13%); loss of profits due to the necessity of paying bribes (30%, 12%); obstructions in providing qualified personnel (26%, 10%); illegal imports of analogous commodities and their distribution at dumping prices on the domestic market (20%, 8%), etc.

All the barriers to private business development are identified at the end of the first year of the EU membership of the country. It is essential for the public policy and civil society to intensify their efforts for improving the conditions of domestic business environment. In the opinion of the business persons interviewed, the most important aspect of these efforts is *combating corruption* (65% of respondents; choice of up to 5 items out of 15 suggested). A set of almost equally chosen courses of action are: improvement of judiciary system effectiveness (48%), introduction of governmental measures stimulating private businesses (44%), enforcement of tax auditing practices (43%), and legislative introduction of more severe penalties (40%). Not much less frequently are identified the reduction of VAT tax rate and

compulsory social security rates, but more importantly, efforts in improving administrative procedures are required to restrain any non-transparent interrelations between business interests and governmental decision-making.

Final remarks

The spread of shadow economy operations and corruption practices with not only domestic but also international implications is still a problem in Bulgaria as a new EU member state. Serious obstacles still exist in the country in respect of infrastructure renewal (e.g. in transport, water, and waste management); bureaucracy and ineffective law enforcement; unfavourable demographic trends and emigration of professionals; inflexible labour 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 an additional comprehensive investigation of the options for implementation of potentially effective tools that will be able to restrain the extent of grey economy, to induce a higher degree of societal intolerance to fraudulent behaviour, and to provide effective stimuli for private businesses development.

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ŠEŠĖLINĖ EKONOMIKA IR BULGARIJOS VERSLO VYSTYMOŠI PERSPEKTYVOS INTEGRACIJOS Į ES LAIKOTARPIU

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S a n t r a u k a

Pereinamoju (Tranzicijos) laikotarpiu Bulgarija šalia pozityvių permainų patyrė ir negatyvių. Viena iš jų yra pilkosios ar kitaip – šešėlinės ekonomikos suvešėjimas. Nenuosekli, prieštaringa ekonominė politika, ydingi politiniai mechanizmai, biurokratinės kliūtys, neefektyvūs teisiniai režimai buvo svarbiausi pilkosios ekonomikos paplitimo veiksniai.

Straipsnyje pilkosios ekonomikos tyrimas pradedamas koncepcinio aparato analize ir vėliau tęsiama nagrinėjant didelės grupės šalies verslininkų apkla-

sos rezultatus. Apklauso tikslas buvo iširti pilkosios ekonomikos atsiradimo veiksnius, pasireiškimo formas, paplitimo laipsnį, taip pat pilkosios ekonomikos reiškinį padarinius verslui.

Pabaigoje daroma išvada, kad, norint sumažinti pilkosios ekonomikos paplitimą ir jos neigiamą įtaką ūkiui, būtinos nuoseklios pastangos vykdant institucinę ir struktūrinę reformas, įgyvendinant ES teisės normas, didinant sprendimų priėmimo procedūrų skaidrumą.