

# The Underground Economy in Romania

Nițu Maria

*The Bucharest University of Economic Studies*

[Nitumaria2@gmail.com](mailto:Nitumaria2@gmail.com)

## Abstract

*The article aims to present conceptually the underground economy, the appearance and the main characteristics of this phenomenon, especially within Romania. The underground economy is a difficult concept to set in terms of a strict definition. The main purpose is to maximize incomes indifferent to the means and methods used that contravene norms with social and legislative character. Thus, it can be said that the emergence of the underground economy coincided with the very emergence of the state which imposed norms, laws, rules related to its activity and taxpayers. In Romania, in the last years there has been a decrease in the size of the underground economy from 48.9% in 2006 to 38.4% in 2016. The phenomenon of the underground economy is present worldwide and can reach remarkable dimensions. The Government of Romania must take effective policy measures to counter this phenomenon and make it less attractive to work in the area of the underground economy.*

**Key words:** Romania, underground economy, corruption, tax, government

**J.E.L. classification:** E6, H2, K4

## 1. Introduction

The underground economy is a difficult concept to set in terms of a strict definition. Its obvious goal is to maximize revenue regardless of the methods and means to be used. It is an ensemble of organized economic activities that are carried out in violation of social and economic norms, the purpose of which is to generate revenues that escape state control. If we go from this definition, we could say that the emergence of the underground economy coincided with the very emergence of the state that imposed rules, laws, rules related to its activity and taxpayers.

The oldest forms of underground economy that we might recall were: poaching, the use of clandestine distilleries, illegal trade in precious stones and special fabrics and border traffic with consumer goods missing from the market organized in the socialist system.

After the revolution by liberalizing the frontiers and the movement of people, new and dangerous forms of big business emerged: arms trafficking, drugs, tobacco, alcohol, live meat traffic, the amounts of these activities multiplying exponentially and representing a fierce temptation for those who have subscribed to the underground economy.

## 2. Theoretical background: The emergence of the underground economy concept. Factors and Effects

The first international concerns related to this concept were reported in the 1970s, when there was a lack of consolidated legislation in the field, legislation supplemented by appropriate legal rules to combat unfair competition and corruption.

The first economist to report the phenomenon was named P. Gutman and published in 1977 in the Financial Analyst Journal an article titled The Subterranean Economy, pointing out that there are economic activities that are not statistically recorded, and those who can no longer be neglected. Shortly, specialized literature attributed other meanings to this type of economy: *underground, black, irregular, closed, unofficial, parallel, informal, clandestine, dual, cash* - these terms being taken from the translation of several international laws.

The factors that led to the amplification of this phenomenon are:

- Reporting by officials in official statistics of errors that could not be explained;
- Recording mistakes in government policy due to erroneous perception of economic reality;
- Obtaining conclusions that were not realistic when investigating the economy of households that distorted reality;
- Reporting of increasing and frequent dysfunctions in the system of taxes and duties.

Subsequent forms of underground economy included numerous tax fraud practices, clandestine work, drug production and trafficking, corruption, unregistered domestic activities, unregistered activities in the national accounting system, etc.

We consider that the main possible causes of the underground economy, at least valid for Romania and for many other countries, would be:

- Tax pressure exerted by the State through direct and indirect taxes: There are many economists who have highlighted the statistical relationship of the above-mentioned comparison, especially direct taxes, being the main cause, as taxpayers pay attention to the exaggerated size that the state sets as a levy, thus putting a *desertion* front of payment, and this is amplified by the multitude of complementary indirect taxes (especially consumer taxes).

- The intensity of regulation is another factor that binds the freedom of individuals who are employed in the official economy (a fact that has been reported in the field of black labor market in the case of border trade traffic and the restrictions on the labor market for foreigners). These restrictions have the effect of substantially increasing labor costs in the official economy and reducing them for black work. In this case, governments would have the solution to improve labor and trade laws not increase their number.

- The public service sphere is a factor that increases the dimensions of the underground economy, as budget revenues are low and therefore the revenues of the public servants are affected (their salaries), all having the effect of decreasing the quality and quantity of goods in the medium and long term; public services, officials become corruptible, trying to counteract state neglect of their public functions.

The decision to choose the area of the underground economy will always be based on a "cost-benefit analysis, in which black labor and tax evasion will be much more attractive compared to normal earnings"(ICEG EC, 2006).

The main harmful effect of the underground economy is how it will affect the fiscal health of the state in which it is present. There are economists who say that if governments were able to control the forms of the underground economy, many public sector tax issues could be limited. Another effect is that the underground economy will absorb an important part of the redundant workforce in the public sector (which will go over it in an outward-looking way). The attempt is made to gradually transform the underground economy into an official economy that establishes its own links and regulations.

### 3. The underground economy in Romania

If we were to undertake an analysis of the underground economy, the first reference should be to the parallel between it and the level of taxation, then we should address the issue of corruption and illegal work.

It is noted that the few percentages that represent the increase in taxation in the European states have generated a real infusion of tax evasion. Increasing the level of taxes should in all cases impose an increase or decrease in prices that affect everyone, but mostly the final consumers. Under these circumstances, the underground economy will register overcompensation by providing cheap, low-quality products by tax evasion, as clandestine manufacturers will practice prices that compete unfairly against prices in the real economy, while more and more businesses will be attracted by the underground economy taxpayers that the state additionally imposes on them, and the possibility of undeclared work whereby some individuals will obtain profits from the non-declaration and non-taxation of salaries that they offer to those who work illegally.

Experts in the field have calculated "the impact of tax increases on the underground economy, showing that the increase in the marginal rate of income tax by one percent, the growth recorded by the underground economy will be 1.4%."(Tanzi, 1983) The same economists claim that if the

amount of undeclared earnings increases by 0.05%, for each percentage increasing the amount of tax revenue will question the revenue increase by reducing the tax evasion, which would be sufficient to cover the losses caused by the decrease taxes.

If we are to offer practical data on the increase of the level of taxation and its influences on the underground economy, we can show that in 2006 Romania was at the middle of the ranking of some of the EU countries: in Romania "the total number of taxes was 89 (4 for economic agents, 60 for taxes on labor income, 25 for other taxes and fees) compared to the extremes of this analysis, for example Latvia having 8 taxes (one for the income of economic agents, 2 for taxes on labor income, 5 other taxes) and Latvia being the minimum tax analysis threshold, while Slovakia ranked first with a total of 344 taxpayers (of which 80 on the income of economic agents, 120 on labor income, 144 other taxes and taxes)"(PriceWaterhouseCoopers and World Bank, 2007).

If we analyze the tax rates in the Central and Eastern European countries at the same time, we can show that in Romania in 2006, the total tax rate was 48.9% (in which the tax rate of the agents' income the economic tax rate was 9.3%, the labor tax rate was 38.6%, while the official rate of tax on economic agents' income was 16%), from which it was clear that the value of the labor tax was extremely high leading both businesses and people working illegal. However, in 2016 Romania experienced a decrease in the total tax rate from 48.9% in 2006 to 38.4%, being below the EU average (40.3%). The official results indicate that "a rise in the underground economy with a percentage of GDP leads to a decline in the GDP of the same state by 1.22%, which leads to a destruction of the economy of that state"(Miritoiu and Popescu, 2009).

Also, the underground economy is complementary to corruption due to the fact that taxpayers can plunder with tax inspectors so that they no longer report the debtor's debts in exchange for certain bribe amounts, which in fact express the institutional quality of civil servants and the ANAF(National Financial Management Agency) itself. In high-income countries, the official sector is governed by law and coercion. In low-income countries, there may be other mechanisms to take over, so that economic agents end up corrupting civil servants in all areas. Corruption appears to "pay for activities that protect the underground economy so that" entrepreneurs "in the underground economy make sure they are no longer" detected "by the authorities" (Miritoiu and Popescu, 2009). Thus, we can assert that the underground economy and corruption are mutually reinforcing, so that in low-income economies the activities of the underground economy and corruption are complementary, while in high-income economies, the underground economy and corruption can be substituted (civil servants have wages that are large enough to stop committing illegalities and doing their duty).

In order to show the impression and size of the underground economy due to corruption, Transparency International has launched a Public Corruption Perception Index (CPI) in 180 states, using a comparative scale from 0-10 where 0 indicates the most high level of perceived corruption and 10 is attributed to its minimal level. Romania is considered a country with a high level according to this index being assimilated to a group of states such as Costa Rica, Cuba, Italy, Macedonia, Croatia.

The link between illegal work and the underground economy involves all remunerated activities that are not declared to public authorities. There are authors who report tax fraud through illegal work beyond criminal activities in the sense that there are no direct links and delimitations between fraud and employment. International estimates in the EU indicate different dimensions and characteristics of the illegal work in EU states with a share of up to 20% of GDP, in the form of tax evasion and labor taxes. We can exemplify states that have a low level of work at black ex: Austria 1.5% of GDP, Belgium 3-4% of GDP, Finland 4.2%, but at the opposite end we also find states with a high level of black work: Latvia 18%, Lithuania 19% Italy 16-17%, Romania 16-21%, Bulgaria 35% (source: National Reports).

In order to determine the impact of the underground economy in Romania as well as at international level, the following methods can be applied:

A) Electricity-based methods, in which the difference between the official GDP growth rate and the increase in total electricity consumption rate is attributable to the growth of the underground economy

B) The labor force method starts from the mathematical assumption that the official labor force participation rate is constant, its modifications being due to activities in the underground sphere

C) Methods based on the quantification of data in the national accounts system compares the results from the national accounting in the GNP estimation and has two approaches to the expenditure method and the revenue method (sums the expenditures with the incomes are the difference, the annual fluctuations representing the underground economy)

D) The monetary method explores the ratio between the currency in circulation and the value of the sight deposits aiming at increasing the liquidity and circulation rate of the currency by comparing whether they are the same in the underground economy and the official economy.

#### 4. Conclusion

The phenomenon of the underground economy is present worldwide and can reach remarkable dimensions. Experts in the field have estimated the size of the underground economy, especially in the new EU member states, as follows: "39.4 % in Latvia, 38.2 % in Estonia, 36.5 % in Bulgaria these states being at the top of the EU ranking in this area". (Schneider and Burger, 2005)

In Romania, the share of the informal economy in GDP is about 30% and is a worrying issue. At the same time, in the last years there has been a decrease in the size of the underground economy from 48.9% in 2006 to 38.4% in 2016.

Also, in Romania, the estimates are different so that the Court of Accounts has advanced a value of 30 billion euros (24% of GDP) while the National Institute of Statistics evaluates 20 billion euros, but there are also the international institutions that have made a calculation of about 40 million annually (30% GDP) with growth potential.

We can conclude this analysis of the underground economy by saying that the dimensions of the underground economy may differ a lot depending on the calculation solutions adopted by each institution.

The conclusions of all analyzes show that governments have not shown a high interest in reducing the value of the underground economy for several reasons:

- About 40-50% of the underground activities are complementary to official activity, which implies adding value that implicitly helps to increase official GDP;
- Losses that occur through full non-payment of taxes and fees are estimated to be moderate in the sense that more than two-thirds of the "black" earnings will later be spent in the official economy.

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