

The Underground Economy in Romania

Veronica Popovici
Norina Popovici
Camelia Mihai

"Ovidius" University of Constanta, Faculty of Economic Sciences, Romania

verovnp@yahoo.com

norinapopovici@yahoo.com

cami.moraru@yahoo.com

Abstract

In recent decades, the underground economy has become an obstacle to economic development, all the more so neither its size nor its evolution are known exactly. The activities associated with the phenomenon of the underground economy are concrete realities, met throughout the world. For a state to be able to efficiently allocate resources, it is essential to have information about the magnitude of the underground economy, the activities involved in this process and their frequency, the people involved. However, it is very difficult to analyze and measure the underground economic activities, the labor force or the goods involved, since the people involved in this type of activities do not want to be identified. The purpose of this paper is to quantify the size of the Romanian underground economy and to identify the main factors that contribute to its growth.

Key words: tax evasion, corruption, underground economy

J.E.L. classification: E26, H26, O17

1. Introduction

The phenomenon of the underground economy is present in all countries of the world, having different dimensions and proportions in the GDP of a country. In the specialty literature this concept is found under different names such as hidden, dangerous, illegal, unofficial, gray, unmeasured, shadow, occult, hidden, secondary, counter-economy, parallel, informal or invisible economy (Braşoveanu, 2010, p.70).

The estimation of the underground economy plays an important role in the literature, as well as the debate regarding the definition of its concept and the appropriate estimation methods. The economists could not rely on a consolidate definition and methodology in order to measure the underground economy, as this is not directly visible, noticeable (it is hidden). Therefore, trying to measure a hidden phenomenon raises a number of issues.

Although the underground economy has been defined and interpreted as having more meanings, it is important to remember only the common essence of the debate: it encompasses all undeclared economic activities with both, social negative effects (regarding the social equity) and economic effects (reduction of GDP).

2. Theoretical background

The most complex definition of the underground economy is considered to be that of Pierre Pestieau, according to which it consist of "all economic activities which are carried outside the criminal, social or fiscal laws or which escape the inventory of national accounts" (Rădulescu, 2007, p. 90)

Schneider has defined activities in the underground economy as all economic activities that contribute to value added and should be included in national revenues, but are not currently registered by national measuring agencies (Schneider, 1986, p. 654). Smith defines the concept as a market based on the production of goods and services, whether legal or illegal, but which is omitted from official estimates of gross domestic product. (Smith, 1994, p. 18).

Tanzi and Schuknecht explained the underground economy as all the economic activities hidden from public authorities with the purpose of avoiding taxation. It should be mentioned that the definition of the underground economy offered by Tanzi and Schuknecht is a little restricted, it assumes that tax evasion is the only motivation for the existence of the underground economy (Tanzi, Schuknecht, 1997, p.166).

Mirus and Smith differentiate informality by the fact that activities are legal or illegal and require monetary or non-monetary barter transactions (Mirus, Smith, 1997, p. 4). Pozo divided the informal economy into three groups: irregular economy, "pure" tax evasion, and illegal activities (Pozo, 1996, p.75)

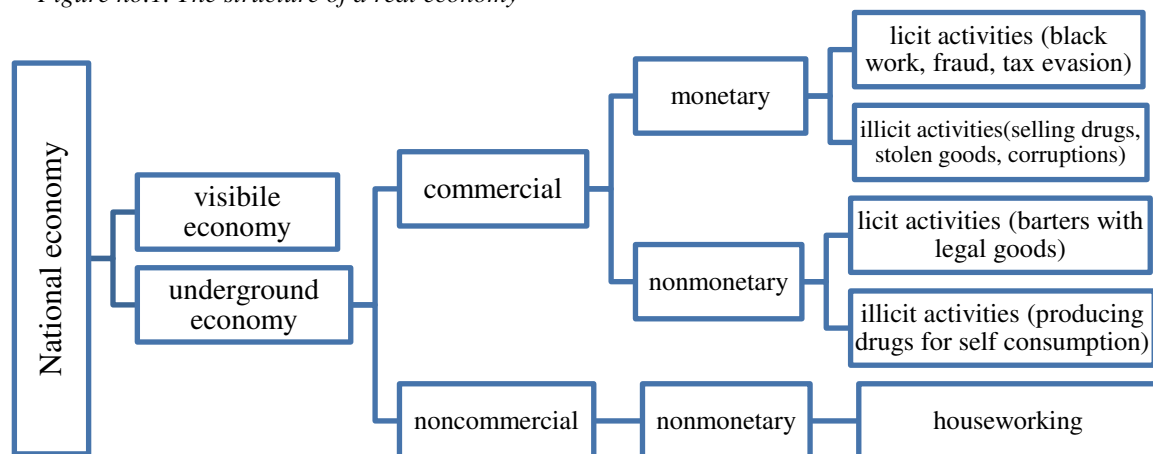
The activities in the underground economy can be classified into legal hidden economic activities, illegal economic activities and non-market economic activities.

Hidden legal economic activities (underground production) refer to production activities considered legal, but purposely masked from public authorities, with the purpose to escape from paying tax (VAT or income tax) or social security contributions; economic activities that are opposite to the existing tax laws, deliberately or because of inefficiencies on the part of the institutions. Such activities include companies that overestimate their expenditures, legitimate incomes obtained and washed abroad, undisclosed or unreported returns.

The illegal component embrace all economic activities that are forbidden by law, such as the production and distribution of controlled substances (marijuana, cocaine, heroin), the production and sale of restricted weapons, the sale of stolen goods and smuggling of goods, prostitution and workforce provided by minor children (UNECE, 2008).

Underground or non-market economy activities include home production, service exchange or babysitting.

Figure no.1. The structure of a real economy



Source: adaptation after Pestieau (1989)

Among the causes of the emergence of the underground economy are the pressure of the regulations imposed by a state, the fiscal pressure imposed by the taxation and the fiscal morality or the attitude of the citizens towards a state (McGee, 2005, p.38).

The size of the underground economy has serious economic and political consequences for a nation. Schneider and Enste have indicated that the increase of the underground economy can start a harmful cycle. Such a consequence may be the decline of tax revenues, if there is a development in untaxed transactions in the underground economy. When contribution in the underground economy enlarge, tax revenue losses complete the government financial tension to accomplish the needs of the community. With low incomes, there is a tendency for governments to cut spending or raise taxes to insure the necessary social services. This may drive more individuals into the

underground economy or may determine current underground participants to work longer (Schneider, Enste, 2002, p.10).

3. The dimension of the underground economy in Romania

In order to analyze the underground economy in Romania is requested a parallel between this and the level of taxation, tackling the problem of corruption and illegal work.

An impact on the informal economy dimension in Romania was caused by the economic crisis, which led to its growth, as in all European states. Thus, the hidden economy in Romania increased from 27.03% in 2007 to 28.23% of GDP in 2009. After this year, the percentage of these activities registered a constant downward trend, reaching a minimum value in 2014, when the percentage was 22.73% of GDP.

In 2010, parallel economy in our country reached a level of 26.76% of GDP, being surpassed only by Bulgaria. At that time, the average for EU states was 20% of GDP, which means that Romania had almost 7 percentage points more, an interval that would have allowed our country to obtain appreciable amounts in the national public budget, under the conditions of an increased fiscal discipline (Braşoveanu, 2010, p.70).

Table no.1. The size of underground economy in Romania, 2007-2018, % of GDP

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|------|------|
| % | 27,03 | 25,44 | 28,23 | 26,76 | 25,41 | 25,14 | 23,97 | 22,73 | 22,40 | 26,3 | 28,1 |

Source: Medina, Schneider, 2018

In 2015, most of the total underground economy, ie 22.1%, was brought by the „unobserved economy”, which included fraud to pay VAT, work in black, the informal sector (individual unregistered enterprises). The rest, 0.3%, was brought about by illegal activities such as smuggling of alcohol and tobacco, prostitution and drug trafficking. Thus, Romania ranked 4th among the 31 European countries analyzed by the IMF in a report, the highest share being held by Bulgaria at that time, with 29.6% of GDP. In 2016, the activities associated with the underground economy represented over 200 billion lei from the GDP of our country, which means a 26.3% of GDP.

A high level of the unofficial economy has as main negative consequences the decrease and the reduction of the growth rate of the official economy. For a country like Romania, the percentage held by this underground economy is worrying, and the negative effects of the high percentages are visible in the level of GDP and in the level of tax revenues.

Worldwide, the average size of the hidden economy is 31.9% of GDP. According to a report by International Monetary Fund, out of 158 countries analyzed, those with the highest share of the gray economy are Zimbabwe (60.6% of GDP) and Bolivia (62.3% of GDP) and the lowest rates are found in Austria (8.9% of GDP), Switzerland (7.2% of GDP) (Medina, Schneider, 2018, p.18).

4. The causes of the underground economy in Romania

There are numerous reasons attributed to the cause of an underground economic situation in different countries. The size of the underground economic activities is mainly motivated by the *non-payment of taxes and fees* in general, and the fiscal burden on the work, in particular (social insurance contributions). In our country, the fiscal burden (the difference between the total costs incurred by the employer and the net salary of the employee) was in 2018 36,7%, a percentage that places Romania on 7th place in the European Union and on the 1st place in Central and Eastern Europe (being the highest percentage), given that the European average was 32,5%. To this burden is added the bureaucracy of payment of taxes and fees, the bureaucratic effort being a very big one.

Other factors contributing to the high level of the informal economy are:

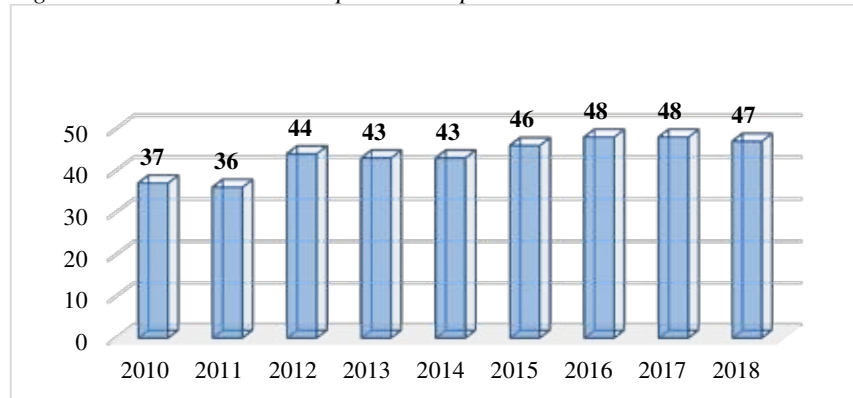
Government effectiveness (quality of public services and social services): poor quality of public services, especially education and health, motivates tax evasion. People pay their taxes and fees, even they are very high, but when they encounter a medical problem they have to pay or not receive adequate medical services, the motivation to voluntarily comply with the tax burden decreases significantly. The quality of public services is also evidenced by the number of deaths

from road accidents, as a result of inadequate infrastructure. Thus, the number of deaths from road accidents in Romania is the largest in the European Union, compared to the population. If the average at EU level is 49 deaths per 1 million inhabitants, unfortunately, in our country at the end of 2017, 98 deaths were reported for one million inhabitants. Also the first place is occupied by Romania regarding the possibility of avoiding deaths in persons under the age of 79, the average in our country being 48%, well above the European average of 33,1%. The apathy for paying taxes arises because of the inability of institutions and governments to provide social services. People simply do not want to honor their fiscal obligation very much, because they believe that the government does nothing for them. Various studies have highlighted the lower capacity of institutions to collect income from economic activities, which is an indication of weak economic institutions, which contributes to the size of the underground economy.

State control over corruption - the high level of corruption further determines the orientation of legal or potentially legal economic activities towards the underground segment. For example, when entrepreneurs need a license to open a business in the official economy and are forced to buy it from a corrupt official, the level of corruption and bureaucracy can push legitimate businesses underground, thus increasing the size of the underground economy. Thus, going underground is considered as a substitute for bribe-taking, although companies sometimes bribe officials to avoid official taxes.

Corruption encourage the underground economy through a number of mechanisms, as follows: (1) corruption decreases the official economy, declines the tax base and thereby reduces income collection; (2) corruption may redirect some of the public financial resources to areas other than those initially provided, which may lead to inefficacious use in non-priority divisions; (3) corruption instigates to increase the values for public or private works, decrease of investments, decrease of productivity due to the mutuality between the works carried out and the bribe received; it benefits the companies present in the informal economy through lower expenditures as a result of small reporting and non-payment of legal fees (Braşoveanu, 2010, p.74).

Figure no 2. Romania's Corruption Perceptions Index



Source: www.transparency.org/country/ROU

Transparency International calculates an indicator for each state, called the Corruption Perceptions Index (CPI), an index that ranks countries and territories according to how corrupt the public sector is perceived to be. The score of a country or territory indicates the perceived level of corruption in the public sector on a scale from 0 (extremely corrupt) to 100 (very clean). Romania obtained 47 out of 100 points in the Corruption Perceptions Index in year 2018, Transparency International ranking our country on 61st place out of 180 countries in the world analyzed.

The perception of fairness and justice, in the fiscal system, affects the incidence, as well as the size of the underground economies. All working adults in a population have to pay taxes, but when people perceive their neighbors as people who do not fully pay their taxes, there is an incentive for them to evade paying the tax.

Black work, which consists of all the activities carried out in an undeclared or partially declared form by an employee for an employer, is still a significant problem in Romania, especially as at present the employers are sanctioned only with fines. In 2013 Romania was ranked on 2nd place

among EU countries with the highest percentage of undeclared employees, ie 26,2% of the gross value added. The negative consequence of black work is that employees do not have access to social protection or benefits arising from employment contract and unpaid envelope payments are currently met at a high level. In 2017 almost 1,4 million Romanians worked in black, most of them in the field of industry (550.000 people), trade (350.000 people), construction (350.000), transport and communications (163.000 people).

Increasing the intensity of regulations (often measured by the number of laws and regulations, such as license requirements) is another important factor, which reduces freedom (at choice) for people involved in the official economy. These regulations may include market regulation, trade barriers and labor restrictions, especially for foreign workers and students.

5. Measures to reduce the underground economy in Romania

In order to reduce the level of informal economy, the same factors that determine it first, namely the quality of public services, the level of labor taxes, the efficiency of using public money, must be analyzed, but the digitalization of Romanian institutions must be emphasized, which has a significant good influence. This measure has contributed a lot in countries such as Poland and Bulgaria, significantly reducing citizens' desire for tax evasion.

Other measures recommended by the European Commission in order to reduce underground economy include simplifying administrative matters so that the cost of the taxpayer decreases, including here the time allocated for the payment of taxes, the strengthening of control and law enforcement activities, adopting specific measures depending on the sector of activity, especially in the fields of agriculture, restaurants and hotels, services.

A number of measures that can be adopted especially in Romania are the restructuring of the National Tax Administration Agency, the reduction of bureaucracy, the intensification of the fight against corruption, the support of non-cash payments, zero tolerance towards tax evasion, ensuring a total transparency regarding budgetary expenditures; the total rethinking of the system of social contributions based on the principle of fair treatment of taxpayers, regardless of their form of income.

6. Conclusions

In a broad way, the underground economy covers very different activities: illegal (traffic, corruption), activities that are not included in the national accounting (internal work, voluntary service or mutual aid in the neighborhood) or are not declared to the social administrations and tax (tax fraud, clandestine work). The forms and size of the underground economy may vary conform to the economic system, the legislation and other local features.

Since underground economic activities are a reality of life all over the world, most societies seek to manage all the activities through different actions such as sanction, criminal prosecution, economic growth or education. Collecting information on who is attracted in underground activities, the incidence with which these activities are carried out and their scale, are critical to make effective decisions regarding the allocation of resources of a country. Unfortunately, it is very complicated to obtain precise information about these underground activities on the goods and labor market, because all the people involved in these activities want to remain unidentified. Therefore, estimating shadow economy activities can be seen a scientific passion.

Understanding the underground economy has important political involvements. First of all, it is necessary to build an environment in which the economic activity can be effortlessly formalized. Secondly, at a comprehensive level, the underground economy ensure a supplementary argument for the necessity to educate people about the goal of taxation, so as to meliorate fiscal morality and, hence, compliance with tax payments. Thirdly, it is important to ensure that the tax system itself is not a scale and it is not constructed in such a way as to encourage a hidden economic activity.

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