

## The underground economy in Romania

Adriana Veronica LITRA<sup>1</sup>

**Abstract:** *The paper aims at covering issues related to the underground economy, activities that compound this phenomenon, its magnitude in Romania and reported to the European average. Underground economy in Romania consists of undeclared work (2/3 from the total) and unreported income; it decreased from 33.6% of GDP in 2003 to 28% in 2014, but remained over EU-28 average with about 10 p.p. Among EU-28 countries, only Bulgaria exceeds the size of the underground economy of Romania. The underground economy is a challenge for the leadership of the state which must act simultaneously to stop illegal activities, and to discourage non-declaration of the legal activities. Corruption favours maintaining the underground economy, delays economic development, obstructs democratic processes and affects justice and the law state.*

**Key-words:** *underground economy, corruption, informal activities*

### 1. Introduction

Underground economy, a phenomenon present in any economy, but in different proportions, appears in the literature under various names: black market / shadow / parallel / hidden / informal / gray / unofficial / cash / invisible economy. The underground economy involves economic transactions not measured by government statistics or ignoring government regulations and laws.

Underground economy can be seen as a complementary size of the formal economy. The expansion of hidden economy has resulted in diminishing official economic development, the negative effects being felt in terms of GDP size and tax receipts.

One of the most comprehensive definitions was given by Pierre Pestieau, according to which underground economy represents "all economic activities taking place outside criminal, fiscal or social laws or escape national accounts inventory". (Braşoveanu, 2010)

---

<sup>1</sup> Transilvania University of Braşov, [adriana.litra@unitbv.ro](mailto:adriana.litra@unitbv.ro)

## 2. Underground economy – concept, components, factors of influence

The non-observed economy (NOE) (as in *Non-Observed Economy in national accounts, Survey of Country Practices*, United Nations Economic Commission for Europe, 2008:2) refers to all productive activities that may not be captured in the basic data sources used for national accounts compilation. The following activities are included: underground, informal (including those undertaken by households for their own final use), illegal, and other activities omitted due to deficiencies in the basic data collection programme. The term ‘non-observed economy’ encompasses all of these activities and the related statistical estimation problems.

***Underground production:*** production activities that are legal but deliberately concealed from public authorities in order to avoid paying tax (e.g. VAT or income tax) or social security contributions; meeting statutory standards; or complying with official procedures and regulations such as the completion of administrative forms or statistical questionnaires. As well as “underground”, which is the term most commonly employed, some countries also employ the terms “concealed activities”, “hidden economy” or “black economy” to denote this type of activity.

***Informal activities:*** legal production activities which are characterized by a low level of organization, with little or no division between labour and capital as a factor of production. The informal sector typically functions on a system of unofficial relationships and does not rely on official agreements. It is broadly characterised as consisting of units engaged in small-scale production of goods and services with the primary objective of generating employment and incomes for persons concerned. The definition of the informal sector corresponds with that of household unincorporated enterprises.

***Illegal activities:*** productive activities which are forbidden by law or which become illegal when carried out by unauthorised persons. The following types of illegal activities are considered in the inventory: production/import/sale of drugs; prostitution; sale of stolen goods and smuggling of goods (UNECE, 2008).

The concept of Informal Employment in Romania refers to: wage workers without registered labour contract; low-paid work; envelope payments; black market activities; non registered firms; enterprises that pay no corporate taxes; unpaid family workers; household production; small firms (fewer than 5 employees); low-productive work combined with non-declared work; wage workers with formal job; subsistence agriculture; vulnerable and poor individuals and households; false self-employment (Parlevliet and Xenogiani, 2008).

### 3. Extent of the underground economy in Romania

National Institute of Statistics made approximations of the underground economy size, in order to reveal a GDP that reflects more accurately the potential capacity to produce of the economy, even if it is not totally declared.

The non-observed economy estimates included in national accounts are calculated for:

- formal sector, by estimating underground labour and the evasion on value added tax;
- informal sector, by estimating the undeclared output of family associations and self-employed persons.

In a press conference of the National Council of Small and Medium Enterprises in Romania, it was appreciated that the underground economy in Romania is made at a rate of about 2/3 from undeclared work, and the rest of 1/3 from not reporting income by enterprises (CNIPMMR, 2014).

The size of the shadow economy strongly correlates to economic cycles. Economic downturns are accompanied by rising unemployment, diminishing of disposable incomes, uncertainties related to future, which increase the tendency to drift into "shadow activities" – partial unreported employment, underreported sales, underreported incomes.

Development of underground economy is fuelled by several factors:

- The level of taxation practiced: there is a strong correlation between perceived tax rate and extent of the underground economy.

- Ease of detection and system of penalties applied: the less chance of being caught, the higher degree of elusion. The smaller the penalties for such doings, the stronger individuals take the risk of committing.

- Rupture produced between citizens and government, distrust in public institutions, belief that the amounts collected by the state budget are not redirected in citizens or society/economy benefit, unconsciousness of the costs caused by the underground economy on citizens.

- The proportion of payments made with cash: the underground economy is more developed in countries with high proportion of cash payments, since the cash payments cannot be traced. The use of electronic payment systems provides transparency to the transactions.

Professor Schneider's research has found that increasing electronic payments by an average of 10% annually for at least four consecutive years can shrink the size of the shadow economy by up to 5%. (UNECE, 2008: 252-259)

The average EU-28 of the percentage of GDP held by informal economy decreased from 22.6% in 2003 to 18.6% in 2014, with a relapse during 2008-2009 when, over the background of the economic crisis, it increased from 19.6% in 2008 to 20.1% in 2009.

In Romania, the percentage owned by the underground economy in GDP had also a downward trend during the period 2003-2014, from 33.6% in 2003 to 28.1% in 2014 (according to Schneider), with a slight increase in 2010.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
RO	33.6	32.5	32.2	31.4	30.2	29.4	29.4	29.8	29.6	29.1	28.4	28.1
EU-28	22.6	22.3	21.8	21.1	20.3	19.6	20.1	19.9	19.6	19.3	18.8	18.6

Source: Schneider, F., Raczkowski, K., Mroz, B., 2015

Table 1. Size of the shadow economy, Romania and EU-28 over 2003-2014 (% of GDP)

Analysing the evolution of the underground economy in Romania between 2008-2014, compared to the evolution of the average of EU-28 states, even though the percentage owned in GDP declines in both cases, it was maintained a constant gap between Romania and the EU average of approx. 10 percentage points, demonstrating a systemic problem of the Romanian economy.

	2008	2009	2010	2011	2012	2013	2014
GDP (billions of euros)	139.7	117.5	121.9	131.3	131.7	139,4	150,0
Share of shadow economy % of GDP	29.4%	29.4%	29.8%	29.6%	29.1%	28.4%	28.1%
Shadow economy (billions of euros)	41,1	34,5	36,3	38,9	38,3	39,6	42,1

Source: ATKearney, Schneider, F., 2013.

Table 2. The shadow economy, Romania, 2008-2014

Romania held in 2014 the second place among the countries of EU-28 in terms of the percentage of gray economy in GDP, after Bulgaria with 31% of GDP, being followed by Croatia with 28% of GDP, Estonia and Lithuania with 27.1% of GDP, Cyprus 25.7% of GDP, Latvia with 24.7% of GDP, 24% of GDP Malta, Poland and Slovenia with 23.5%, Greece 23.3% of GDP. The lowest share of gray economy in GDP was estimated to be in 2014 in Austria (7.8%), Luxembourg (8.1%), Netherlands (9.2%), United Kingdom (9.6%), France (10.8%).

#### 4. The fight against the underground economy

The underground economy is a challenge for the leadership of a state which must act simultaneously to stop illegal activities, and to discourage non-declaration of the legal activities. In addition, the government should consider boosting economic

development by lowering the tax burden, creating jobs, implementing macroeconomic policies to stimulate economic growth.

All the measures that can be taken to reduce tax evasion can be divided into two approaches which differ in vision, but largely complementary: extension of administrative constraints and / or boosting voluntary compliance.

a) Extension of administrative constraints mainly refers to measures to roughen controls and penalties. But this category of measures generates a series of perverse effects, negatively affecting also the "bona fide" economic agents, proving an inhibiting character on overall economic development

b) Pushing voluntary compliance aims at acting on the causes that generate these "disobedience" behaviours. Thus, the second category of measures intends to provide incentives for economic actors to behave "correctly", thus taking into account not only purely economic aspects, but also those related to collective and individual psychology.

One of the issues with particular impact in the fight against tax evasion is to ensure tax receipts issuing at every commercial transaction, thereby allowing proper collection of VAT. In this respect there are two major measures that have demonstrated efficient in several countries:

- partial VAT refund to the consumer;
- organizing a lottery of tax receipts. (CNIPMMR, 2014)

Also in Romania, the Government (by Ordinance Govt. No. 10/2015) regulated the organization of Lottery tax receipts, as a measure to combat tax evasion by motivating, involving and empowering citizens in the taxation of merchants incomes from selling goods and services directly to population, encouraging people to request the tax receipts for taxing the incomes of economic agents.

Romanian Ministry of Public Finance, Romanian Lottery and NAFA (National Agency for Fiscal Administration) organized in 2015 nine lottery draws of Fiscal Receipts Lottery.

Total amount of tax receipts lottery prizes was 4,938,897 lei, which sum was divided between 17,985 winners.

The biggest prize was of 250,000 lei. The prizes were taxed at 16%. Lottery tax receipts began in April 2015 and by the end of September 9 draws were held, six monthly and occasional three.

Ministry of Public Finance, Romanian Lottery and NAFA announced the continuation of tax receipts lottery also in 2016. (MPF, Ro)

## **5. Corruption**

The simplest definition is "corruption is the misuse of public power (by elected politician or appointed civil servant) for private gain.

A more complex definition for the concept "corruption" was developed by prof. dr. Petrus van Duyne: "Corruption is an improbity or decay in the decision-making process in which a decision-maker consents to deviate or demands deviation from the criterion which should rule his or her decision-making, in exchange for a reward or for the promise or expectation of a reward, while these motives influencing his or her decision-making cannot be part of the justification of the decision". (www.corruptie.org)

Corruption delays economic development obstructs democratic processes and affects justice and the law.

Corruption favours the underground economy through several mechanisms:

- Corruption reduces the official economy, lowers the tax base and thus decreases revenue collection.

- Corruption can divert a part of public financial resources to other fields than those stipulated, leading to an inefficient use in non-priority areas of those funds;

- Corruption cause increases of costs for public or private works, declines in investment, low productivity as a result of the interdependence between the accomplished works and received bribes; favours companies present in the informal economy through lower costs due to underreporting and not paying legal taxes (Braşoveanu, 2010).

Transparency International calculates an indicator for each state called Corruption Perceptions Index (CPI), a global aggregate index that captures the perceptions of business people and country experts regarding the level of corruption in the public sector. The scores the countries are awarded reflect the degree of corruption perceived: 100 points means not at all corrupt, 0 points – extremely corrupt.

CPI 2015 places Romania on 58<sup>th</sup> rank among states in the world (out of 167 countries analyzed) with a score of 46 points, compared to a European average of 65 points. (Transparency International Romania)

At the top of the ranking, with the best scores, are Denmark (rank 1 with 91 points), Finland (ranked 2 - 90 points), Sweden (ranked 3 - 89 points); Romania sharing 58<sup>th</sup> place together with Greece, while the last places in the ranking are occupied by Afghanistan (rank 166 - 11 points), North Korea and Somalia (rank 167 - 8 points).

## **6. Conclusions**

Underground economy is a complex phenomenon, different studies reveals different sizes of its extent, depending on the specific definition and the methods of measurement.

Informal employment in Romania takes diverse forms, starting with subsistence activities, to deliberate actions to hide earnings in order to avoid to pay

taxes: wage-employees not declaring or under-declaring their incomes, employers not registering their labour force, workers without labour contracts, tax evasion, false self-employment, etc. Informal employment also includes illegal activities because of the specificity of the product (forbidden for sale, distribution, possession), or because the activities are effectuated by unauthorized agents.

Underground economy, maintained and perpetuated by high levels of corruption, leads to a high degree of tax evasion, thus adversely affecting the level of taxation, compromising the economic growth, leading to the increase of budget deficit and consequently to enlarging public debt of Romania.

## 7. References

- Braşoveanu, I.V., 2010. Economia subterană și corupția: probleme majore ale economiei românești. *Economie teoretică și aplicată*, vol. XVII (2010), No. 11(552), pp. 68-80.
- Consiliul National al Intreprinderilor Private Mici si Mijlocii din Romania, 2014. *"Loteria bonurilor fiscale" propusa de CNIPMMR se va aplica in Portugalia*. [pdf] Available at: <[http://www.immromania.ro/stiri\\_fisiere/loteria-bonurilor-fiscale-propusa-de-cnipmmr-se-va-aplica-in-portugalia-7683.pdf](http://www.immromania.ro/stiri_fisiere/loteria-bonurilor-fiscale-propusa-de-cnipmmr-se-va-aplica-in-portugalia-7683.pdf)> [Accessed 24 March 2016].
- Kearney, A.T. and Schneider, F., 2013. *The Shadow Economy in Europe*, 2013. [pdf]. [online] Available at: <<https://www.atkearney.com/documents/10192/1743816/The+Shadow+Economy+in+Europe+2013.pdf>> [Accessed 23 March 2016].
- Mara, E.R., 2011. *The underground economy in Romania*. [pdf] Available at: <[https://mpira.ub.uni-muenchen.de/36440/1/MPRA\\_paper\\_36440.pdf](https://mpira.ub.uni-muenchen.de/36440/1/MPRA_paper_36440.pdf)> [Accessed 24 March 2016].
- Ministry of Public Finance, Romania., 2016. *Detalii*. [online] Available at: <<http://www.mfinante.ro/acasa.html?method=detalii&id=120737>> [Accessed 24 March 2016].
- Parlevliet, J. and Xenogiani, T., 2008. *Report on Informal Employment in Romania*. [pdf] Available at: <<http://www.oecd.org/dev/poverty/41012694.pdf>> [Accessed 24 March 2016].
- Schneider, F., Raczkowski, K. and Mroz, B., 2015. Shadow Economy and tax evasion in the EU. *Journal of Money Laundering Control*, Vol. 18 (1), pp. 34-51. [pdf] Available at: <<http://www.econ.jku.at/members/Schneider/files/publications/2015/JournalofMoneyLaunderingControl.pdf>> [Accessed 24 March 2016].
- Transparency International Romania. *Perception Corruption Index*. [online] Available at: <[http://www.transparency.org.ro/politici\\_si\\_studii/indici/ipc/2015/index.html](http://www.transparency.org.ro/politici_si_studii/indici/ipc/2015/index.html)> [Accessed 24 March 2016].

- United Nations Economic Commission for Europe, 2008. *Non-Observed Economy in National Accounts. Survey of Country Practices*. [pdf] Available at: <<http://www.unece.org/fileadmin/DAM/stats/publications/NOE2008.pdf>> [Accessed 23 March 2016].
- Wempe, J., van Hulten, M., Slingerland, W., Popovych, O, 2016. *What is corruption*. [online] Available at: <<http://www.corruptie.org/en/corruption/what-is-corruption/>> [Accessed 24 March 2016].