

# THE UNDERGROUND ECONOMY IN ROMANIA

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## **Abstract:**

*The actual economic crisis has a major impact on the underground economy because of tax burden increase especially. This study realizes an analysis of the major implications of the economic crises on the size and the consequences of the underground activities. Also we try to reveal the correlation between the underground economy and the official one. The conclusion of this study is that the shadow activities have grown since the financial crisis began.*

**Key words:** *underground economy, tax burden, taxation system*

**JEL classification:** *O17, O52, H2*

## **Introduction**

The underground economy in Romania is very high comparative with other EU countries. The economic crisis has brought a growing of shadow economy in a context where there were increases of taxes, in particular VAT and excise duties.

Underground economy has grown alarmingly in the developed countries over the past two years, with starting the economic crisis, according to calculations made by international economists. Black hiring and evasion of tax or payroll taxes are becoming more common, even in developed countries.

By definition, the unofficial economy constitutes activities that are not recorded in the government statistics. As such, the extent of the unofficial economy in a given country is hard to measure precisely.

The shadow economy is often considered as a debilitating force that saps the official economy by attracting factors of production away from the official economy and creating competition for official firms (Choi et al, 2002).

The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons (Schneider, 2005):

- (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 labor market standards, such as minimum wages; maximum working hours, safety standards, etc., and
- (4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

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The period of transition from centralized to market economy caused changes of commercial and productive activities, in the informal legal sphere. Moreover, informal economy exists before 1989, mainly driven by households' former party activity and security, which take place outside the state accounting (Buziernescu, 2007).

Underground economy in Romania has continued to increase after 1990, notably due to:

- Inconsistent tax legislation as this many gaps;
- Increase opportunities for corruption through decentralization;
- Parallel economy inherited from the old regime;
- Generalized attitude of acceptance of corruption among the population;
- The emergence of small businesses, generating significant underground economy (tax evasion and undeclared work);
- Tax evasion late appearing no law. 87/1994;
- Lack of true experts in the field of taxation;
- Ever-rising tax burden and the inability of taxpayers to bear.

Regarding the last aspect mentioned the need to attract state revenues prompted governments to tighten tax. In these circumstances, to circumvent tax a law that is being targeted by many companies in Romania tend not necessarily to emulate their fabulous profits, but to ensure their very survival. Thus, there is a parallel part of the economy develops the instinct of conservation and economic environment. In times of crisis, economy becomes a way of adapting to difficult situations. In essence, when a system crashes, components and seek a new formula and spontaneously redistribute resources and control institutions fail to keep up with even less time to anticipate. With the crisis deepening the partnership between the state and taxpayer disappears, being replaced with the abuse of state tax evasion and the use of economic agents.

According to the National Institute of Statistics estimates, withholding full VAT and income tax evasion is the most important part of economy in our country. In the study conducted following INS reported inaccuracies in the Romanian economy:

- ❖ undeclared work;
- ❖ VAT evasion;
- ❖ income tax evasion;
- ❖ informal sector.

A higher level of underground economy means a lower official economy and in the same times a lower economic growth rate for the official GDP. For Romania, the statistics are alarming with regard to this phenomenon and the negative effects of increased size of the shadow economy are strongly felt in the GDP and the tax revenue. In our country, according to the Tax Procedure Code, Financial Guard is the only body in the Ministry of Finance authorized to execute checks and other findings at the request of the prosecution. In 2009, in order to achieve its objectives, the Financial Guard participated, in collaboration with other specialized bodies of the ministries and specialized institutions in the country, and similar bodies in other EU states to actions to detect and combat illegal activities.

Therefore, actions aimed Financial Guard following priority:

- Monitoring and intervention in high risk areas with tax evasion (excisable products);
- Follow-spot operators on equipping machines with electronic cash registers;
- Specific actions seasonal activities (institutional character);
- Intra-community acquisitions;
- Import-export operations.

The activity report of the ANAF in 2009, tax audit actions aimed, primarily, target areas were the following: activities of services related to crude oil and natural gas extraction, specialized wholesale trade of food, beverages and tobacco, wholesale fruit and vegetables, construction of residential buildings and non-specialized wholesale trade, trade in various brokerage, brokerage trade fuels, minerals and chemicals for industry, wholesale and other products.

Thus, in 2009, 112.170 checks were made to corporate taxpayers and individuals, of which 83.010 (74%) legal persons, resulting 6082 million lei as additional tax liabilities (with 32.6% more than in 2008). Tax loss was reduced by the amount of 1519.9 million lei. A significant share of the total additional tax liabilities have attracted a value added tax (60%) and corporate tax (27%). Furthermore, tax auditors confiscated goods totaling 96.9 million lei, compared to 36 million lei in 2008. In addition, deficiencies were applied to fines totaling 43.2 million lei and were submitted to the competent bodies to continue the research for a 2610 - number of criminal complaints with a loss of 3123.7 million lei, which is increased activity to combat tax evasion by over 100% compared to 2008.

With regard to areas where there were high levels of the underground economy, these are manufacturing, construction, trade (distribution and retail), where the underground economy has a third of the sector's contribution to GDP, but it is much wider in other areas such as transport, hotels and restaurants.

The most important factors which favors the size and scope of the underground economy, include high level of social contributions paid by employer and employee, complex and unstable legal framework that hinder taxes, hiring black because of high unemployment transition, maintaining subsistence agriculture, low-skilled workers, and consequently a wide spread poverty and low wages, and the large number of SMEs involved in the underground economy.

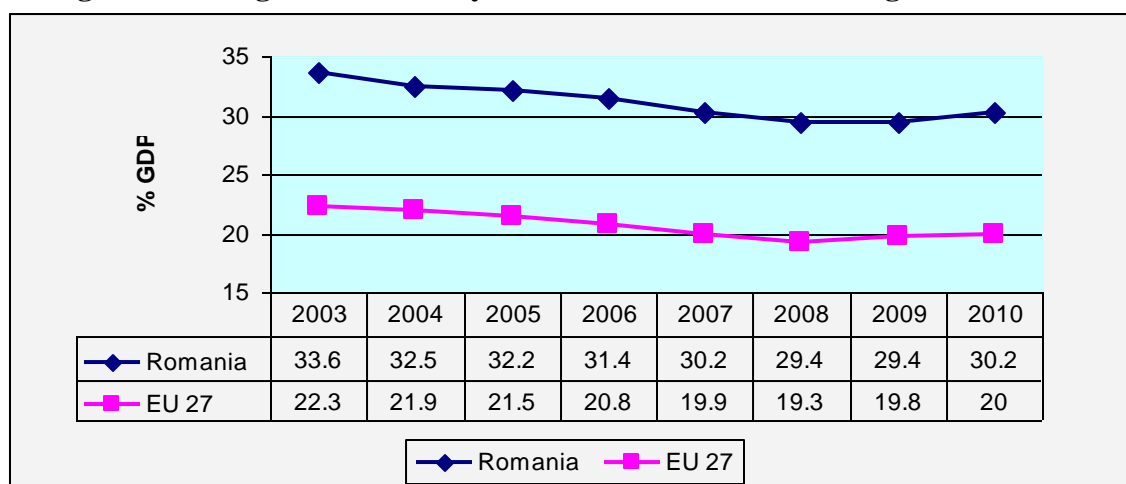
In view of a complete understanding of the size of the underground economy in Romania relative to other EU countries, in the next figure is presented a comparative evolution for underground economy starting with 2003 until 2010 in Romania and in EU27 computed as an average for all 27 countries..

### **The impact of financial crisis on underground economy**

There is an important difference for the entire period almost 10% between EU27 and the level of underground economy from our country. This figure reflect the increasing of underground economy starting with 2008, and for this reason we can appreciate that financial crisis has an important effect on the underground economy – stimulating this kind of economic activities. How can be explained this fact?

First of all, economic crisis increase the burden of taxation, particularly in Romania (minimum corporate tax, increasing of VAT and excises). Other major factor is decreasing the personal incomes, corporate profits and purchasing power. In this context the individuals and companies try to recover this loses through underground activities. Companies accept such a situation to compensate for lost revenue and the employees agree to work illegally in order not to lose his job.

**Figure 1 Underground economy in Romania and EU27 average 2003 - 2010**



Source: Schneider, 2010

In this context of economic crisis many companies prefer hiring black to avoid taxes and social contributions. For avoiding the payment of VAT and excises smuggling of cigarettes and alcohol is increasing. All this means for the state budget lower revenues and this fact was reflected in the huge budget deficit for 2008 and 2009.

### Effects of underground economy

There is no doubt about the increasing of underground economy in the financial crises context. It is important the level of underground economy but analyzing this level is not enough. It is important to analyze the effect of underground activities on the official economic. From this perspective our analysis will be focused on the impact on GDP and the labor market.

Based on data provided by Eurostat we try to analyze the period between 2003-2010 for revealing the correlation of underground economy with official GDP and unemployment rate.

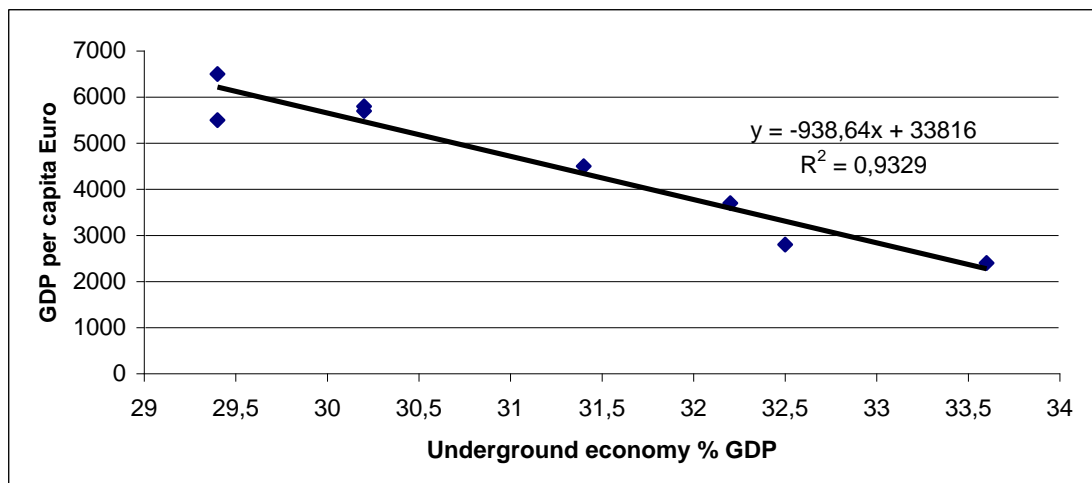
Table 1

Indicators	2003	2004	2005	2006	2007	2008	2009	2010
GDP per capita Euro	2400	2800	3700	4500	5800	6500	5500	5700
Underground economy %GDP	33,6	32,5	32,2	31,4	30,2	29,4	29,4	30,2
Unemployment rate %	7,0	8,1	7,2	7,3	6,4	5,8	6,9	7,3

Source: Schneider, 2010, Eurostat,

The analysis of economy development in the period 2003 - 2010, we see a slight decrease in the size of this phenomenon (about 2%) both for Romania and for the EU27 average. However, the difference between Romania and the European average is relatively constant at around 10%, reflecting a systemic problem of our economy.

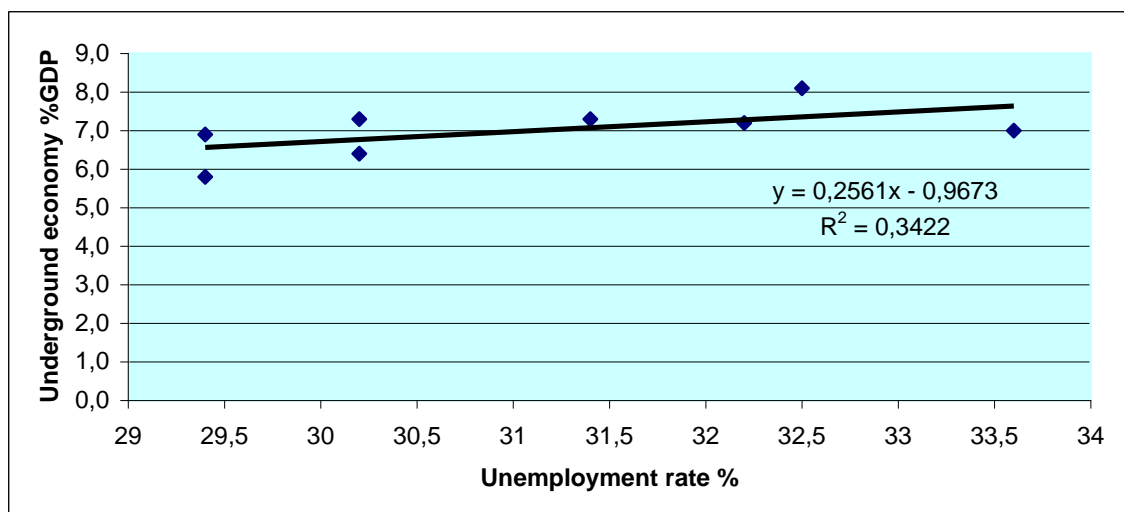
**Figure 2. Correlation between underground economy and GDP per capita in Romania between 2003-2010**



Source: own calculation based on Table 1

As we can see in the previously figure there is an indirect correlation between the GDP per capita and underground economy and also very powerful, more than 93%. This fact confirms that economic crises have an important impact in favor the underground economy increase.

**Figure 3. Correlation between underground economy and unemployment rate in EU27 countries in 2009**



Source: own calculation based on Table 1

Considering the impact of underground economy on the unemployment rate, in this case there is a direct correlation; any increase of underground economy is reflected in increasing of labor force employed without legal forms.

### Conclusion

In what concerns the size of the underground economy with respect to GDP, we found that the dimension ranges from 33.6 percent, in 2003, to 30.2 percent of official GDP in 2010. The underground economy slightly decreases except for last three years when starting the economic crises.

Given these results, the policy recommendations to reduce the underground economy in Romania are based on three pillars: (a) reducing the social security

contributions paid by employer and employee; benefits system, especially for unemployed people; (b) improving the efficiency of public sector together with an increase of economic freedom and a better tax audit system; (c) to reform tax regulation for reducing the bureaucracy and corruption – important factors in realizing underground activities.

Despite these controversies, the underground economy is not always a bad thing. An increase in underground activity during a crisis can avoid a recession more and individuals and businesses earn more money, which they can spend in the real economy.

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