

## **UNDERGROUND ECONOMY AND THE TAX EVASION IN ROMANIA**

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### **Abstract**

*The paper present the features of the underground economy in Romania and the factors' contribution to its formation: undeclared labour of the formal sector (enterprises), value added tax evasion, and the under-reported incomes of the small entrepreneurs' sector (family associations and self-employed). The tax evasion for the main budget revenues is estimated starting from the NIS - based valuations of the underground economy. Annual reduction of the undeclared labour with 10% - 15% could provide the necessary budget revenue for the implementation of fiscal relaxation measures, such as reducing the flat tax or the employers' security contribution.*

**Keywords:** underground economy, undeclared labour, tax evasion, degree of compliance

**JEL Classification:** E01, E26, H26

In recent years, Romania has significantly improved its macroeconomic financial indicators. We notice a reduction of the deficit in public administration from 9% of GDP in 2009 to 2.3% in 2013, followed by a strong adjustment of the current account deficit at 1.1% of GDP in 2013. The interest of foreign investors in the Romanian capital market has increased. However, foreign inflows in the past two years have not been traced in the stimulation of the real economy, but only in ensuring macroeconomic stability. Fiscal consolidation process has put pressure on limiting government spending, ultimately affecting domestic demand in 2013.

Economic growth (+3.5%) in 2013 placed Romania on the 2nd place at EU level, but agriculture was an important factor in accelerating growth. If we exclude agriculture, the GDP growth level is limited, starting from 1.6% in 2011 to 2.5% in 2013. Stimulating domestic supply (GDP without agriculture) in order to help the budget revenue collection, could be possible by implementing fiscal relaxation measures. Currently, the Government has planned to reduce social security contribution (SSC) incurred by employer, by 5 percentage points, but this measure will generate a significant gap in budget revenues. In these circumstances,

compensatory measures should be identified in order to increase the collection level, of which the most important one is reducing the size of the underground economy.

In order to estimate the potential reserve of the budget revenues, it is necessary to analyse the profile and dimension of the underground economy. The underground economy represents the productive legal activities but deliberately concealed from public authorities for such reasons as: to avoid the payment of income tax, value added tax, social security contributions or other taxes, and to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms. The underground economy can be regarded as consisting of two sectors: formal and informal.

The formal sector includes enterprises and public institutions. They are the productive units recognized as legal entities and established according to the law and various government decisions for the public institutions. All the units from the formal sector are registered in the Fiscal Register (maintained by Ministry of Finance), and Statistical Register (maintained by National Institute of Statistics).

The informal sector covers individual entrepreneurs (self-employed) and family associations which activity is settled through the specific law (they lay annual income declarations to the Ministry of Finance). These units are registered in the Fiscal Register and in the Statistical Register.

The undeclared labour represents the most important part of the underground economy of the formal sector. The method used for the estimation is based on the comparison between the labour force supply and demand by branch of activity in order to identify the persons who carry out a legal activity but are not declared to authorities.

The evaluation of labour force supply is made using data from the AMIGO household survey. These survey offers information about the number of persons who declared they have a paid activity in the reference period of time, the number of persons who worked full or part time, who has a second job, by activities or by professions, and also the persons who occasionally worked. Unfortunately, self employed, family associations and collaborators workers are together register in AMIGO. In this condition, is done the assumption that 75% of the total represents the collaborators. The valuation of labour force demand is base on the enterprise annual survey (EAS). The difference between the number of people who declared to work in an enterprise (by AMIGO survey) and the number of people declared by the enterprises as occupied (by EAS survey), represents the undeclared labour. This is evaluated with the same components of legal situation (average gross wages, social security contributions).

Table 1. Number of employees working in underground economy

thousand persons	2008	2009	2010	2011	2012	2013
Employees -AMIGO	6.316,9	6.213,0	6.061,5	6.153,3	6.229,4	6.270,6
Civil Employees	5.046,3	4.774,3	4.376,0	4.348,7	4.442,9	4.520,0
Employees in underground economy	1.270,6	1.438,7	1.685,5	1.804,6	1.786,5	1.750,6
% Employees AMIGO	20.1%	23.2%	27.8%	29.3%	28.7%	27.9%

Source: National Institute of Statistics

In the case of Romanian economy, we notice an increase in the number of employees in the underground economy during the crisis of 2009-2011 (Table1). The share of undeclared labour in the total employee workforce reached 28% in 2013, which means that there is a revenue reserve coming from social security contribution (CAS) and income tax of approx. 38%, due to undeclared labour.

The VAT evasion represents the other important component of the formal underground economy. One part of the VAT evasion represent the VAT for underground economy already estimated and the other part represent the VAT evasion of reported turnover. For the whole VAT, the tax evasion is calculated by the difference between the theoretical VAT and the effective VAT collected by State Budget. Theoretical VAT is calculated for intermediate consumption, final consumption of households, final consumption of general government and gross fix capital formation based on rates of VAT by products defined by the legal quotas.

In order to evaluate the tax evasion of registered individuals in the informal sector, the number of persons (family associations and self-employed) is estimated from the AMIGO labour survey. The evaluation of the value added is based on principle according to which the incomes realized by non-wage workers cannot be less than the average wages earned by employees in the same activity in small units. The income declarations from Ministry of Finance of registered individual entrepreneurs are comparing with the value of these calculations. As a result, the incomes are adjusted, and the tax evasion corresponding to the under-reported value added by the registered units in the informal sector is estimate.

Another important type of non-observed economy in the informal sector is represented by the activities carried on in units non-registered. In this category are included: dressmakers, tailors, workers who repair the cars, workers in construction and restaurants, teachers who teach private lessons, people who rent the house in holiday time. For such activities a distinct valuation is done using specific assumptions and available data sources from the statistical system. These data sources are specific to each kind of activity.

According to NIS and own estimations, the underground economy in Romania (expressed in value-added terms) increased from 18.1% of GDP in 2000 to 23.8% of GDP in 2012 (Table 2).

The estimations indicated that in 2009-2011 the contribution of the undeclared labour in the formal sector to the total underground economy increased to the higher levels (over 65 percent in the total underground economy) because of

the impact of the financial crisis. Significant is the fact that this component reduced its amplitude to 13.7% of GDP in 2012 (from 15.6% in the previous year).

The other important component corresponds to the VAT evasion in the formal sector. The share of VAT evasion in GDP (6.3%) almost doubled in 2012 compared to the previous three years. It is worth noticing that in 2010, when the legal VAT rate was increased from 19% to 24%, TVA evasion continued to decrease to the minimum of 3.4% which corresponds to the 14.7% of the total underground economy. The impact of this measure was felt during the next year, but its effect was however moderate.

The underground economy corresponding to the informal sector (family associations and self-employed) developed by a decreasing trend after 2008, and was set at a share of 3.8% of GDP (16.0% of the total underground economy) in 2011-2012. Small entrepreneurs' sector has experienced an accelerated growth in 2005-2008 due to favourable conditions on lending and growing demand of the population, but this has also led to the development of the underground economy component. Since 2009, the activity of small entrepreneurs continuously decreased below GDP rate, as well as the activity of those in the underground economy.

Table 2. Underground economy in Romania by causes

Percentage of GDP	2008	2009	2010	2011	2012
<b>Underground economy</b>	<b>19.6%</b>	<b>20.9%</b>	<b>23.3%</b>	<b>22.8%</b>	<b>23.8%</b>
Formal sector	13.7%	16.7%	19.9%	19.1%	20.0%
Evasion from labour taxation	9.9%	12.9%	16.5%	15.5%	13.7%
Evasion from VAT	3.8%	3.8%	3.4%	3.6%	6.3%
Informal sector	5.9%	4.2%	3.4%	3.7%	3.8%

Source: Own estimations and National Institute for Statistics (NIS)

Based on the information provided by the Ministry of Finance on the legal collection rates, tax evasion was estimated for the main budget revenues, corresponding to the NIS-based estimations of the underground economy.

Income tax and social security contribution were estimated starting from the value added of the underground labour, by applying the legal rates (16.5% - Employees' security contributions, 27.9% - Employers' security contributions, and 16.0% - Income tax) to the corresponding gross salaries amount. As regards the tax evasion in the informal sector, we considered that small entrepreneurs must pay, to the state budget, income tax and employees' security contributions. Evasion in the informal sector appears to be significant in trade, construction, hotels and restaurants. The results of the estimation on tax evasion by components are presented in the Table below:

Table 3. Evasion by types of tax revenues

Percentage of GDP	2008	2009	2010	2011	2012
<b>Tax evasion</b>	<b>10.0%</b>	<b>10.9%</b>	<b>11.9%</b>	<b>11.7%</b>	<b>13.6%</b>
Taxes on income	1.8%	1.9%	2.2%	2.1%	1.9%

Social security contribution	4.3%	5.1%	6.3%	6.0%	5.4%
VAT	3.8%	3.8%	3.4%	3.6%	6.3%

Source: Own estimations based on underground economy

Tax evasion in Romania is widely spread, only in the case of social security contributions, VAT and income tax, representing 13.6% of GDP in 2012. Tax evasion has developed differently, depending on the type of taxes. Thus, in the case of social security contributions and income tax, namely the taxes corresponding to undeclared labour, we notice an increase of tax evasion in 2008-2011. This is due to the impact of economic crisis that has particularly affected sectors with a high share of underground economy, such as trade and construction. Tax evasion for undeclared labour has reduced its share in GDP in 2011-2012, corresponding to the relaunch of the economic growth. The results show a slow trend of reducing the size of tax evasion for undeclared labour, in the context of low economic growth rates.

Regarding VAT evasion, the situation is opposite, its development from a low level as a share of GDP in 2008-2010 and accelerated growth in 2011-2012. This development was influenced by the reduced rate of VAT (19%) in 2008-2009, on the one hand, and the increase of the average VAT rate from 21.5% in 2010 and 24% in 2011.

The table below illustrates the development of the degree of compliance with the main taxes, as a ratio between the revenue actually collected to the budget and the theoretical income (including tax evasion and revenue actually collected). In 2012, the total average degree of compliance was 60.7%, a decrease compared to the previous year, due to the impact of VAT evasion, which has increased significantly in 2012.

Table 4. Degree of compliance for the main taxes

Percentage of GDP	2008	2009	2010	2011	2012
<b>Tax evasion</b>	<b>67.9%</b>	<b>64.9%</b>	<b>62.3%</b>	<b>64.4%</b>	<b>60.7%</b>
Taxes on income	66.3%	66.0%	61.2%	61.8%	64.8%
Social security contribution	68.7%	65.1%	58.1%	60.2%	62.1%
VAT	67.6%	64.0%	68.6%	70.8%	57.9%

Source: Own estimations based on underground economy

The degree of compliance for taxes on labour decreased very fast until 2010 then it gradually improved during the next years. The lowest level is registered in the case of VAT, of only 57.9% in 2012, the same as in the 2000-2002 period.

If Romania collected half of the taxes existing in the underground economy, then it would hold budgetary revenues, as a percentage of GDP, at the level of EU average. Annual reduction in the size of the undeclared labour with 10% -15% could provide the necessary revenue (an extra of £ 3.5-5.5 billion lei) for the

implementation of fiscal relaxation measures, such as reducing the employers' security contribution with 5 percentage points.

### **Conclusion**

Romania is among the last countries in the EU in terms of collecting budget revenues. Fiscal consolidation measures, implemented in recent years, have ensured the financial stability of the country but they put pressure on reducing budget spending. In these circumstances, any measure of fiscal relaxation is difficult to sustain because it leads to a budget revenue gap, which cannot be covered from other sources.

One possibility would be to reduce the size of the underground economy, particularly with respect to undeclared labour. According to NIS estimations, the underground economy in Romania (expressed in value-added terms) increased from 18.1% of GDP in 2000 to 23.8% of GDP in 2012, being among the highest in Europe. Evasion on the undeclared labour has reached 36 billion lei in 2012 (6.2% of GDP) decreasing by 2.9 billion lei in 2012, compared to 2011. Consequently, extra resources for the budget revenues are available, of at least 3 billion per year, by reducing the share of the underground economy, which will ensure the implementation of fiscal relaxation measures, necessary to relaunch economic growth.

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