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# **SHADOW ECONOMY AND REGIONAL DEVELOPMENT - AN ARGUMENT IN FAVOR OF FISCAL DECENTRALIZATION**

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## **Summary**

The article discusses the regional aspects of the shadow economy in Bulgaria. The main factors that generate motivation for the application of shadow practices are considered and it is concluded that they operate mainly at the national level. It follows that measures to limit and prevent this phenomenon should be primarily national. However, the article argues that regional policies can also be used in this regard. A moderate fiscal decentralization can help to increase the tax morality which is one of the most slowly changing and most intractable factors generating motivation for the implementation of shadow practices. It is also argued that fiscal decentralization in Bulgaria has the potential to improve other aspects of the economic system.

**Key words: shadow economy, regional development, regional policies, fiscal decentralization,**

## **Introduction**

The shadow economy is a phenomenon that is widespread and observed to one degree or another in all countries. It has many different manifestations, and its effects, most of which are negative, extend to different areas. Therefore, there is a need for it to be studied with adequate depth and detail.

The shadow economy can and should be seen in different aspects. In this article, the focus is on its regional aspects, and the presentation is structured as follows. Section 1 discusses what the shadow economy is as a phenomenon and what consequences it has on the various areas of economic life. Section 2 summarizes the research problems and practical issues that arise from the existence of this phenomenon. Section 3 analyzes the regional aspects of the shadow economy in Bulgaria, and Section 4 considers fiscal decentralization as an element of regional policy that can help curb and prevent the shadow economy. Section 5 sets out the main findings of the study.

### **1. What is the shadow economy and what are the consequences of its existence?**

A shadow economy is generally understood to be economic activity that is not officially reported to public authorities. Such production activity, which remains unregistered by state authorities, can be found in many different forms. Examples in this regard are private lessons, car repairs or home repairs paid in cash. Other examples include hiring to work without a formal contract or with a formal contract but also with additional "envelope wages". Sales of goods and services without official documents are also part of the shadow economy. These activities do not describe the shadow economy phenomenon entirely and the list with such examples can be quite long. But the common feature in these cases is that there is economic activity that is not reported to government agencies and therefore is not included in official economic statistics.

In most cases, economic activities using shadow practices are legitimate in principle and if they were officially reported they would contribute to the Gross Domestic Product (GDP) of the country. The reason for an economic activity not to be officially registered may be, for example, too small, insignificant amount or lack of formal requirements for such registration. But in many cases the reason is different. Economic activities often are deliberately concealed from officials to avoid paying taxes, customs duties, excise duties, social security contributions. Or to avoid various regulatory requirements and administrative

procedures (e.g., minimum wages, working conditions, maintenance of certain documentation, etc.). It is these cases that are important from an economic policy point of view.

The existence of a shadow economy has its consequences, which are by no means negligible. First of all, the presence of a shadow economy means that the official economic activity is lower than the actual one - the official GDP is lower than the actual GDP. This in turn means that some of the economic indicators (including some of the most important such as GDP, employment, unemployment, labor productivity) will not accurately reflect the state of the national economy. And accordingly, they can become the basis for making wrong decisions about economic policy.

Another very important consequence of the existence of a shadow economy is the reduction of the volume of public funds. Failure to pay taxes on income, which is actually received, leads to the amount of collected public funds, which does not correspond to the actual economic activity. This is reflected in suboptimal levels of public goods - education, healthcare, national security, infrastructure. And if it is necessary to issue government debt to reach certain desired levels of these public goods, then the existence of a shadow economy will lead to higher levels of government debt, other things being equal.

No less of a problem is the existence of a shadow economy in terms of the functioning of markets and competition. Businesses that apply shadow practices gain an unfair advantage over decent businesses because they can produce goods and services at lower costs. This distorts the competitive environment and provides a larger market share for companies that apply shadow practices at the expense of those that seek to comply with regulations and behave correctly. This, in turn, creates motivation for further expansion of shadow practices.

The consequences of the shadow economy for the labor market are similar. Employed and self-employed people who are willing to accept "envelope wages" and do not register part of their income are more financially advantageous for employers. The reason is that part of the contributions to the social security system should be paid by the employers, and this is often a significant production cost. As a result, such workers have a competitive advantage in occupying jobs over other workers who do not wish to participate in shadow practices. This creates a distorted environment in the labor market, giving preference to improper behavior.

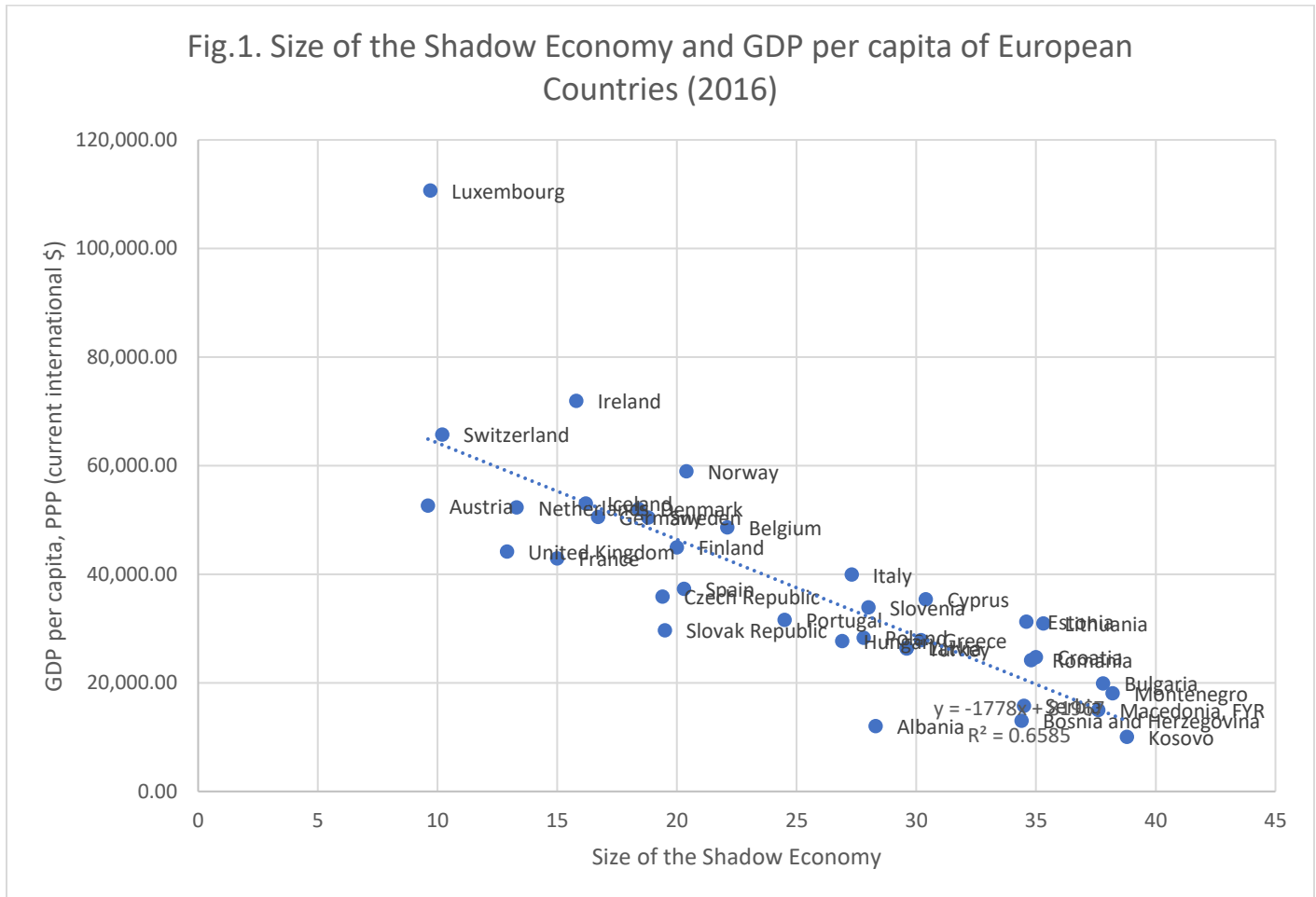
In addition to the issues discussed so far, the existence of a shadow economy makes the access to finance more difficult for economic agents. Whether it is businesses or individuals, participation in shadow practices leads to lower official incomes. This means that in the event of a need for credit, credit institutions, based on official documents, will see less than the actual creditworthiness of such economic agents. Accordingly, the risk of loan repayment will be assessed as higher. This means that there will be difficult access to credit - through higher interest rates, higher collateral or directly by refusing to lend. Thus, working capital and especially investment lending for enterprises will be insufficient, and individuals will have difficulty obtaining consumer and mortgage loans, as well as leasing contracts.

Individuals involved in shadow practices also have reduced access to social security funds. For example, pensions and unemployment benefits directly depend on the contributions that are officially paid by employees and their employers. Health insurance also depends on official contributions. The contributions, in turn, are proportional to official wages. In this way, individuals who have participated in shadow practices (receiving "envelope wages" or working without contracts at all) will eventually receive lower pensions and lower unemployment benefits.

The consequences of having a shadow economy also include another important aspect. It is about working conditions. Working without formal contracts obviously makes it possible to circumvent the regulatory requirements for working conditions. In this way, individuals who work without formal contracts with employers are exposed to certain risks - such as accidents at work, lack of paid leave, poor health conditions, unregulated working hours.

An additional problem is the way in which the financial resources generated by the shadow economy are used. On the one hand, they can be used to purchase goods and services from the official (non-shadow) economy. They can also be used to purchase goods and services from the shadow economy. But on the other hand, they can also be used for corrupt practices because they are unaccountable. Thus, the existence of a shadow economy, in fact, creates an opportunity, creates the means for the existence of corruption.

All the problems listed above ultimately, in the long run, lead to low economic growth. This can clearly be seen from the graph shown in Figure1, where different countries in Europe are depicted as points.



The coordinates of individual points correspond to the size of the shadow economy and gross domestic product per capita for 2016. The size of the shadow economy, as a share of official GDP in percent, is presented on the horizontal axis according to data from Kelmanson et al. (1). GDP per capita in US Dollars, at purchasing power parity, according to data from the World Bank (2) is presented on the vertical axis. As can be seen from the figure, there is a certain relationship between the two indicators. Countries that have a relatively low size of the shadow economy - between 10% and 15% (Austria, Switzerland, Luxembourg, the United Kingdom, the Netherlands), also have a high GDP per capita. And vice versa, countries with a high size of the shadow economy - between 35% and 40% (Montenegro, Kosovo, Bulgaria, Northern Macedonia, Croatia), have a relatively low GDP per capita. In other words, there is empirical evidence that the size of the shadow economy and GDP per capita show an inverse relationship.

## **2. What questions does the existence of a shadow economy raise?**

The existence of a relationship between the size of the shadow economy and the level of gross domestic product per capita raises some important questions. First, the question is what the size of the shadow economy for a country is. It is important to know if this size is small and this phenomenon does not provide significant negative effects or, on the contrary, the size is relatively large and this can lead to significant negative consequences.

If it is estimated that the shadow economy has a relatively large share, this raises two additional groups of questions. One group is related to the identification of the factors that generate motivation for economic agents to participate in shadow practices. The other group of questions is about possible policies to prevent and limit shadow practices.

In all three areas there are serious difficulties and unresolved issues, both on a theoretical and practical level. The shadow economy is hidden by definition, and this makes it very difficult to measure or estimate. At this stage, various methodologies have been proposed in the economic literature that can be applied, but they have limitations and often give very unstable results. Another difficulty is that the shadow economy has many different manifestations in different economic activities, which in turn requires a very comprehensive approach. This complicates both size estimates and possible policies to reduce this size.

An additional difficulty regarding economic policies aimed at preventing and limiting the shadow economy is the need for such policies to be very well balanced. A balance should be struck between limiting shadow practices and freedom of business initiative. Overly restrictive measures can reduce the shadow economy, but also lead to a reduction in the propensity for entrepreneurship and in the motivation to work, which would also be an undesirable effect.

## **3. What are the regional aspects of the shadow economy?**

The topic of the shadow economy can also be considered from a regional point of view. A regional aspect can be identified internationally. As can be seen from the graph in Figure 1, Western and northwestern Europe are characterized by significantly lower amount of shadow economy. Conversely, the countries of Eastern and South-Eastern Europe have a larger shadow economy. This differentiation is regional in nature and deserves to be explored from this perspective.

But in the present article the focus is on the regional aspects from national point of view for the Bulgarian economy. In this respect, the following issues can be analyzed. Is there a difference in the size of the shadow economy for the different regions in Bulgaria? Are there any regional specifics of the manifestations of the shadow economy? And also, can regional economic policy be used as a tool to prevent and reduce shadow practices?

A recent study (3), based on a survey, can provide an idea for some of the above problems. According to it, estimates of undeclared work, which is one of the main forms of manifestation of the shadow economy in Bulgaria, have a relatively even distribution, without outlining particular regional profile. Published in this study National map of undeclared employment shows, that the variance between the different regions is not large and, moreover extreme cases are not grouped in specific regions, they are rather dispersed across regions.

The fact that Bulgaria is relatively homogeneous regionally, in terms of the spread of shadow practices, is not surprising. The reason is that the factors that generate motivation for shadow practices operate in Bulgaria mainly at the national level.

There are many studies in the economic literature that identify factors that potentially stimulate the growth of the shadow economy (among the many publications, see for example (4) and (5)). The theoretical analyzes and empirical data in the literature, indicate that such factors can be classified into four groups:

- Administrative burden - this includes factors such as over-regulation, large bureaucracy, specific requirements for working conditions, labor market regulations;
- Tax burden - in this group tax rates of direct and indirect taxes, customs excise duties, as well as social security payments are usually considered as factors;
- Institutional capacity - factors in this group include the level of competence of institutions, their ability to work effectively, the quantity and quality of public services;
- Tax morality - this includes mainly such factors as mentality, psychological attitudes, historically developed norms.

In Bulgaria, all four groups of factors have an impact and create an environment in which the size of the shadow economy, as estimated by various researchers, is significant. According to studies by the International Monetary Fund and other authors in Bulgaria the share of the shadow economy is the highest among the member states of the European Union. It is estimated to be 37.8 % of the official GDP for 2016 (6).

But for the purposes of the present paper, it is important to note that the above factors are at national level, because the country's territory and population are relatively small. The country is administratively divided into six regions, but in these regions the same regulations, the same tax and social security rates, the same requirements for working conditions and a universal minimum wage are valid. Administrative capacity varies among regions, but this is due to individual differences of personal character and random factors. There is no reason to believe that there are some regional differences in terms of mentality and psychological attitudes. All this predetermines the homogeneity of the regions in terms of the factors that can be expected to generate motivation to use shadow practices. But does this mean that in Bulgaria the objective conditions are such that regional policy cannot have any significance for reducing the size of the shadow economy?

#### **4. Reducing the size and prevention of the shadow economy through fiscal decentralization**

Although in Bulgaria the factors that generate motivation for the application of shadow practices have their impact at the national level, regional policy can contribute to the fight to reduce the size of the shadow economy. The intersection of the policies for limiting and preventing the shadow economy and regional policies can be found in the degree of fiscal decentralization in the country.

In Bulgaria, the public finance system is so organized that the country has a relatively high degree of centralization. Most decisions are based on macro-policies - regulations, administrative requirements, corporate and income tax rates. According to the comparative studies of the World Bank (6) the country ranks 80th in the Index of Fiscal Decentralization from a total of 182 countries studied. Of all the countries in the European Union, only Ireland, Estonia and Cyprus are ranked lower, although very close to Bulgaria. This can be changed to give more financial freedom to local authorities.

What are the consequences of such a package of measures? First of all, this would be a step towards bringing the financial decision-making process closer to the people, which would strengthen, in principle, democracy and democratic processes. But beyond the social side of the issue, it can be expected that such measures will have a positive impact both on economic development and on limiting the shadow economy.

From the point of view of the subject of this article, increasing the degree of fiscal decentralization, as an element of regional policy, will strengthen the link between taxpayers and local budgets. This can improve tax morale and thus could play an important role in limiting and preventing the shadow economy.

Because tax morale, as well as other factors related to people's mentality, are among the factors that are changing very slowly and with great difficulty.

At the same time, the possible impact of fiscal decentralization on economic development has been studied both theoretically and from a practical point of view. The theoretical arguments (7) are quite convincing, and they are based primarily on the understanding that making decisions "closer" to those who will implement them leads to higher efficiency, better accountability, better governance. Local authorities have greater opportunities to offer public services that are in line with people's preferences because they know their needs better. They can also be more creative in policymaking and innovation, which creates potential for economic growth.

On the other hand, empirical research on the economic impact of fiscal decentralization is not entirely unambiguous. There are aspects that need further research, but it is generally accepted that under certain conditions fiscal decentralization would have a net positive result on economic development (8). The basic conditions are good quality of local authorities as well as the degree of decentralization to be moderate, since too much decentralization as well as the excessive centralization is associated with a negative impact on economic growth.

A positive effect can also be obtained in terms of reducing regional inequalities. Empirical evidence, based on a sample of 30 countries from the Organization for Economic Co-operation and Development in the period 1995 -2011, shows (9) that fiscal decentralization leads to a reduction in regional disparities. The conclusions are similar for the countries of Central and Eastern Europe, to which Bulgaria belongs. Indicative in this respect is the publication of Rodríguez-Pose and Krøijer (10). They have investigated the relationship between the level of fiscal decentralization and GDP growth rates in 16 countries of Central and Eastern Europe in the period 1990-2004, using panel data with dynamic effects. The results show that the share of the taxes determined at the local level correlates positively with the rates of economic growth. This supports the view that local governments with their own source of revenue respond better to local requirements and achieve greater economic efficiency.

## 5. Conclusion

In Bulgaria, which is a relatively small country in terms of territory and population, the factors that generate motivation for shadow practices are primarily at the national level. As a result, there are no significant differences between regions in the application of shadow practices. It follows that measures aimed at limiting and preventing the shadow economy should be taken mainly at national level.

Nevertheless, regional policy can also play a role in this regard. The analysis in this article shows that attention should be paid to the possibility of fiscal decentralization, which would bring decision-making on taxation and public spending closer to the people. Such measures will help to overcome a number of negative attitudes in the relations between people and public institutions and, more generally, will improve tax morale. This will affect some of the slowest changing and most difficult to overcome factors that generate motivation to apply shadow practices. Besides the effect on the shadow economy, fiscal decentralization has the potential to impact positively also economic growth and the reduction of regional disparities.

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