

## **Underground Economy and Corruption: the Major Problems of the Romanian Economy**

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**Abstract.** *This paper aims to show characteristics of some negative phenomena such as corruption, tax evasion and underground economy, in the case of Romania. Data on these phenomena are actual and capture the characteristics of our country, comparatively with the other EU countries. Current financial and economic crisis have generated a worsening of these phenomena which, in turn, have deepened the crisis. Limiting tax evasion and fiscal corruption can and should accept to be one of the solutions for improving the public financial balance for Romania.*

**Keywords:** tax evasion; underground economy; corruption.

**JEL Codes:** E62, H26.

**REL Codes:** 8B, 8K.

## 1. Introduction

Romania is one of the EU states that have serious unresolved issues regarding tax evasion and corruption.

Tax evasion has some weak points – monitoring, public transparency, limitation and restriction. It is a phenomenon that increasingly proliferates in our society, aided by public system corruption and bureaucracy, and the resignation of the regulatory institutions, by an attitude of "We do not have what to do."

High corruption is, in turn, a permanent issue in the Romanian society. Corruption has a strong social and cultural determination. This negative phenomenon, almost universal at all levels of government and the state financial control bodies, led to one of the highest level in the EU in terms of tax evasion and tax arrears.

These negative phenomena adversely affect the level of taxation, economic growth, leading to an increased general government deficit and debt (Braşoveanu, Obreja Braşoveanu, 2008a, Braşoveanu, Obreja Braşoveanu 2008b).

In order to lead our country out of this economic and financial crisis and in order to meet the nominal convergence criteria imposed by the EU on public finances, it is a necessity to decrease these phenomena and to increase the collection of public funds on this path (Brondolo, 2009, Gupta, 2005).

## 2. Tax evasion and underground economy

*Tax evasion* is the main cause of the reduction in tax revenue. It is a negative economic phenomenon, present in all economies, in different proportions, but high, due to many determinants, including psychological factors (Alm, Martinez-Vazquez, 2007).

Human nature is against taxation. The state's role should be to limit and restrict this phenomenon and to bring in business economic environment the real amounts stolen through tax evasion.

Tax evasion can be defined as "*all legal and illegal procedures by which, those interested escape, in whole or in part, their taxable material obligations under the tax laws*" (Văcărel, 2008, Rădulescu, 2007).

Based on criteria of legality, tax evasion may be lawful, in consequence allowed, and illegal, fraudulent or tax fraud. Allowed tax evasion can be viewed as a legal reorganization of a business so as to minimize the tax obligation, while illegal tax evasion can be viewed as a business reorganization, for the same purpose. Morally, certain types of avoidance the taxation are as bad as

fraudulent evasion and therefore should be treated in the same perspective. In practice, however, often there is no fracture between legal and illegal, but rather continuous, successive attempts to exploit loopholes in the law leading contributor to the illegal from the legal area. Most often, the illegality is manifested through the preparation of false statements, keeping double accounting records, false, and withholding material taxable, declaring taxable income lower than actual.

Tax evasion is also divided into identifiable, by the state financial control bodies, and unidentified. The proportion of identified tax evasion is too small compared to the total size of tax evasion, including tax evasion and underground economy, tax evasion that is unidentified. Tax evasion is present both in the visible economy, but mostly in the underground economy.

Underground economy exists in all countries, with different proportions in GDP. Underground economy appears in the literature under various names (over 20): occult, hidden, disguised, parallel, annex, dangerous, ghost, invisible, informal, dual, cash, informal, secondary, illegal, gray, shade, unmeasured economy, or even anti-economy. Pierre's definition according to which the underground economy is "all economic activity that occurs outside of the criminal laws, social or fiscal or escape from national accounts, is considered by specialists as the most comprehensive definition of the informal economy" (Radulescu, 2007).

There is a rich literature on the possible causes of the underground economy, which distinguishes between these three types of causes:

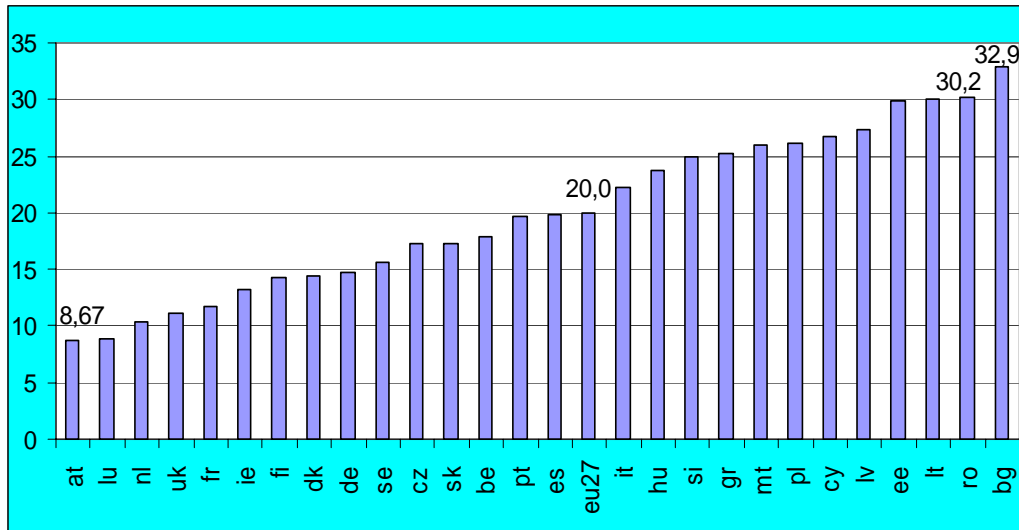
- fiscal pressure of the direct and indirect taxes (Caballé, Panadés, 2007);
- fiscal pressure of the regulations imposed by the State (Levaggi, 2007);
- fiscal morality: the attitude of citizens towards the state (McGee, 2005, Torgler, Valev, 2007).

A high dimension of the underground economy has as main negative effects the decrease of the growth rate of the formal economy. For Romania, the statistics are alarming with regard to this phenomenon and the negative effects of the increased size of the shadow economy are strongly felt both in GDP and the tax revenue.

Our country has a share of 30.2% of GDP of the underground economy in 2010, only Bulgaria is worst at this chapter. The average for the EU-27 is 20% of GDP, which makes our country to have more than 10 pp comparing to this average, the difference could lead to obtaining a considerable sum for the national public budget, assuming that fiscal discipline would increase.

We note that the share of the underground economy is less than 15% in the Nordic countries, Austria, Germany, France, Ireland and Great Britain,

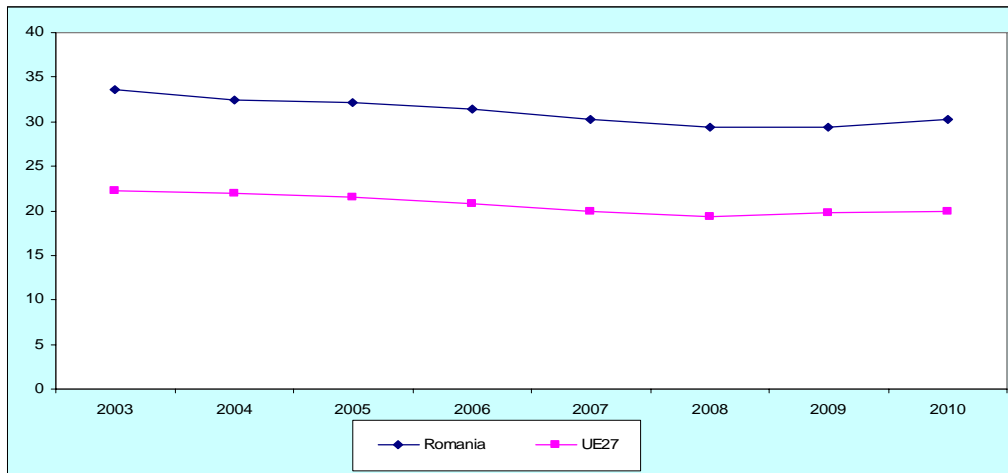
Luxembourg and the Netherlands. Even if these states were recorded for the low percentage, the difference might be taken into account, considering that the smallest amount of it is still significant, being 8.67% (in Austria).



Source: Prof. Friedrich Schneider estimates.

Figure 1. The underground economy in EU member states in 2010

Analyzing the evolution of the underground economy in the period 2003-2010, the comparison between Romania and EU-27 average member, it can be seen a slight reduction in the size of this phenomenon, about 2 percentage points for both our country and for the EU-27 average. The difference between Romania and EU-27, however, is relatively constant at around 10 percentage points, which clearly reflects a systemic problem of our economy.



Source: Prof. Friedrich Schneider estimates.

Figure 2. The underground economy in Romania and the EU27 average in 2003-2010

### 3. Corruption

For a long period, economic analysts have considered corruption as a cultural and political matter, and it might be impossible to decrease or to remove it (Andrei, Roşca, Matei, 2008). Thus, elimination of corruption was not seen as an objective of the reforms of development, but it was considered a natural component of a country, as exogenous, like, for example, its geography (Martinez-Vasquez, Arze, Boex, USAID, 2006).

Corruption manifests itself in different areas, in various shapes and complex interactions, but it dominates the tax and budget arena (the number of cases and especially the size, as this high-level corruption here). Corruption is rampant not only in developing countries but also in developed countries. Although the potential for corruption is specific to each country, it was found that the types and extent of budgetary and fiscal corruption are influenced by the country's general tax structure and fiscal management systems used by that country (Martinez-Vasquez, Arze, Boex, 2006). For example, a complex tax system, with large variations in tax rates, can cause taxpayers to bribe collectors of tax revenue. Also, poor control of expenditures reduces the risk that officials should be caught and it stimulates corruption.

Oxford English Dictionary defines corruption as *"the perversion or the destruction of integrity or reliability in the performance of public duties by bribery or favor."* According to Romanian Explanatory Dictionary, corruption is *"departure from the morality, from the honor and from the duty."* The most

used definition of corruption in the public sector: "*public servants abuse for their earnings.*" Public office is abused in order of their earnings when a public authority to accept, request or leads to bribery. Public position can be abusively used for personal benefit even if no bribery occurs, through patronage and nepotism, theft of state assets or diversion of public revenues. Not all forms of corruption involve direct monetary payments; government officials can get more subtle benefits from corrupt acts, such as political support.

There must be made the distinction between corruption and tax evasion: even if tax evasion may include bribe an official, tax evasion itself is the act of the private entity and it does not require public sector officials.

When it comes to corruption in terms of fiscal and budgetary policies, it can take three forms:

1. *Corruption at the level of the public funds or tax collection;*
2. *Corruption at the level of the distribution of expenditures;*
3. *Corruption from quasi-fiscal activities (such as privatizations).*

Although the negative relationship between corruption and fiscal system is intuitive and apparently, this negative correlation coefficient does not necessarily imply a causal relationship between two variables. For example, it might be the case that both high corruption and low tax revenue collection can be caused by some common external factors, such as low levels of development and high levels of poverty. Such examples show that there is a general increase in tax revenues just by lowering corruption.

Possible explanations for the negative relationship between corruption and revenue collection:

1) whether the official who collects tax revenues are involved in corrupt practices (either by direct theft of public funds or by allowing taxpayers to avoid paying taxes in exchange for bribes), then corruption will generate a decrease in direct tax revenue size collected.

2) corruption may act indirectly to reduce the tax base or the level of the entire economic activity, finally resulting in the reduction of budgetary revenues.

a) corruption reduces the tax base by reducing the formal sector; the higher the corruption and underground economy, the lower is the tax base (formal sector) and the lower is the revenue collection. The direct relationship between the size of the shadow economy and corruption has been established based on data from 145 countries by Friedrich Schneider (2007).

b) corruption leads to decreases in GDP or economic growth, so it reduces the tax base in the whole society (Braşoveanu, Obreja Braşoveanu, 2009b);

c) corruption may direct an important part of public funds to extra budgetary accounts. These funds are used less effectively in areas that are not a priority and can be removed from their destination;

d) other mechanisms: corruption increases transaction costs of the business, corruption leads to lower investments, corruption decreases productivity, as firms compete in terms of bribes and not quality, companies that are successful in illegal businesses in the informal sector do not pay taxes for these activities, as a result, the underground firms have a competitive advantage over firms in the formal economy, some of which were forced to leave the formal economy.

The appearance and the degree of development of corruption are determined by two major factors: motivational factors and the existence of opportunity.

*a) Motivational factors of corruption*

Corruption is toward the rational self-interest. Most important motivation to become corrupt is that of personal financial gain. Corrupt behavior of public servants can be explained as a result of economic calculations. Anticorruption strategies should be oriented towards economic initiatives and opportunities for civil servants leading to this behavior.

They were identified several motivating factors that determine the decision to become corrupt officials: *ethical and moral standards, the probability of being discovered, small penalty, reward of officials, pressure from tax evaders.*

There is a double causal relationship between tax evasion and corruption: the presence of tax evasion will generate motivation for corruption because it increases the bribe offered by the taxpayers, while corruption decreases the effectiveness of penalties and the probability of auditing as a tool of control. Tax evaders believe that, even if discovered, they can avoid legal penalties or other sanctions by bribing auditors.

The degree of tax evasion in an economy is determined primarily by the general level of taxation stipulated legal, not by the level determined by the revenues collected. High levels of taxes and low quality of public services lead to higher levels of tax evasion. The high level of taxation is also an explanation for tax evasion.

It is also the current situation in which our country finds: although we have some of the highest tax rates for both VAT and social contributions as required (two components that hold more than two thirds of modern tax systems of EU Member States), our country is the last of the EU in terms of government revenue collected as a share of GDP. This is due to the high level of tax evasion. Corroborating these facts with the low quality of public services, it is clear that tax evasion will tend to increase during the next period. Corruption is undoubtedly the engine of this growth.

*b) Opportunities for corruption*

A proverb says “I do if I could, but I can not, so do not do” (Martinez-Vasquez, Arze, Boex, 2006). This statement illustrates the difference between the motivational factors of corruption and the existence of opportunity for corruption. Even if an officer is inclined to carry out acts of corruption, they may not materialize unless there is an opportunity. There was thus a proportional increase in the level of corruption with the opportunities offered by the structure of tax administration.

Important factors that create the opportunity for corruption in government revenue administration: *lack of vigilance and control in tax administration, complexity of the tax system, discretionary power of civil servants, civil politicization public.*

Staff changes in the tax system through political reason are a common practice in developing countries, where labor laws are absent or weak. In some cases the changes are so large and important so that the stability of the institutions is shaken. Where the number and frequency of change of civil servants is high, officers temporarily see their positions as opportunities to get rich quickly. Usually, officers are party members serve its political interests, rather than community interests. Corruption among officials increases due to the lack of merit-based recruitment practices, lack of regular inspections and lack of civil protections against abuses of authority by superiors. Often, even if there are regulations against such abuses, officials do not know their rights and obligations, or are blackmailed by politicians.

Romania is perceived as one of the most corrupt countries in the EU, with Greece and Bulgaria (see annual reports of Transparency International in 2009 and 2010 Corruption Perceptions Index (CPI)).

Table 1

**Evolution of the CPI for the EU in 2008-2010**

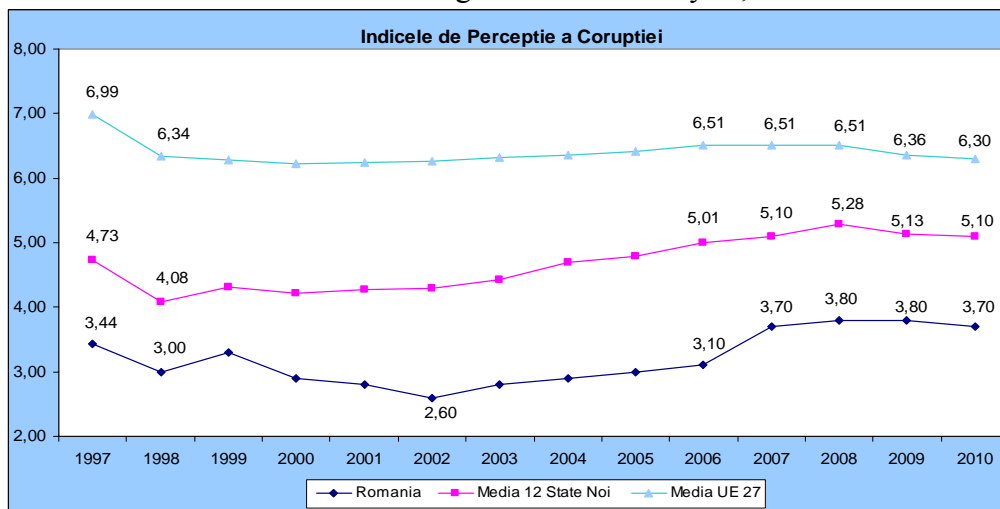
		2008	2009	Changes 09/08	2010	Changes 10/09
1	Denmark	9.3	9.3	0	9.3	0
2	Sweden	9.3	9.2	-0.1	9.2	0
3	Finland	9	8.9	-0.1	9.2	0.3
4	Netherlands	8.9	8.9	0	8.8	-0.1
5	Luxembourg	8.3	8.2	-0.1	8.5	0.3
6	Germany	7.9	8	0.1	7.9	-0.1
7	Ireland	7.7	8	0.3	8	0
8	Austria	8.1	7.9	-0.2	7.9	0
9	U.K.	7.7	7.7	0	7.6	-0.1
10	Belgium	7.3	7.1	-0.2	7.1	0
11	France	6.9	6.9	0	6.8	-0.1
12	Slovenia	6.7	6.6	-0.1	6.5	-0.1



		2008	2009	Changes 09/08	2010	Changes 10/09
13	Estonia	6.6	6.6	0	6.5	-0.1
14	Cyprus	6.4	6.6	0.2	6.3	-0.3
	UE 27	6.51	6.36	-0.15	6.3	-0.06
15	Spain	6.5	6.1	-0.4	6.1	0
16	Portugal	6.1	5.8	-0.3	6	0.2
17	Malta	5.8	5.2	-0.6	5.6	0.4
18	Hungry	5.1	5.1	0	4.7	-0.4
19	Poland	4.6	5	0.4	5.3	0.3
20	Czech Republic	5.2	4.9	-0.3	4.6	-0.3
21	Lituania	4.6	4.9	0.3	5	0.1
22	Slovakia	5.9	4.5	-1.4	4.3	-0.2
23	Letonia	5	4.5	-0.5	4.3	-0.2
24	Italy	4.8	4.3	-0.5	3.9	-0.4
25	Greece	4.7	3.8	-0.9	3.5	-0.3
26	Romania	3.8	3.8	0	3.7	-0.1
27	Bulgaria	3.6	3.8	0.2	3.6	-0.2

Source: Transparency International Romania.

But 2010 is a better year for our country than for Greece and Bulgaria, which had a worsening in the ratings comparing to our country, so that Romania has climbed two places compared to 2009. In 2010 compared to 2009 it may be seen a worsening of the CPI, so a higher perception of corruption for 15 countries, an improvement in this perception for the six states and six countries keep the same CPI. EU 27 average for this indicator has fallen almost insignificant in the last year, 0.06.



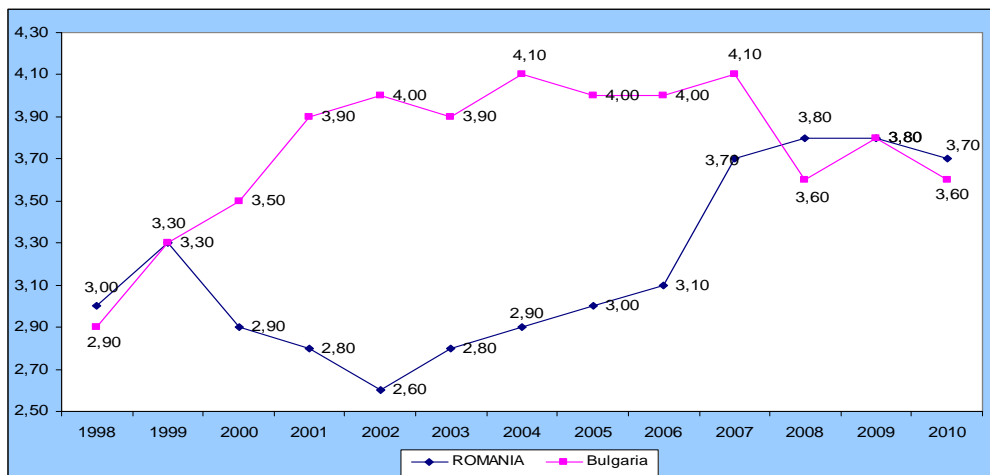
Source: Transparency International Romania.

Figure 3. Evolution of CPI in the EU 1997-2010

If you compare the evolution of CPI in our country and the EU-27 average or the average determined for the 12 newest EU member states, it might be observed:

- a parallel evolution in the period 1997-2010 relative to the average 12 NMS, this means that the gap of our country from this average has remained relatively constant, ie 1.3,
- a reduction of the gap compared to EU 27 average, from 3.55 in 1997 and 3 points, 34 points in 1998 to 2.6 points in 2010.

Overall this period, Romania and Bulgaria shared the last two positions, our country is really perceived to have, in general, a higher corruption than neighboring country during 1998-2010.



Source: Transparency International Romania.

Figure 4. Evolution of CPI in Romania and Bulgaria 1997-2010

#### 4. Conclusions

The behavior of some economic agents to not pay the taxes or the contributions, because they are not sanctioned by the state, it means the increase of taxation on the shoulders of those who are honest and pay these obligations. Reducing tax evasion and corruption, and tax arrears would be equivalent with reduction the actual taxation.

Tax evasion and great corruption, unsanctioned by state authorities, have degraded our society also from a moral perspective, and it is unreasonable for those who break the rules to succeed, and those who are correct pay also for the incorrect ones.

Corruption and tax evasion are therefore major problems of our society, even more major in the context of the current economic and financial crisis and our country's desire for EU integration. These negative phenomena should be treated with priority, and legislative and administrative reforms should be supported by a careful monitoring of these phenomena and their reduction.

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#### List of abbreviations and symbols

GDP = gross internal product

EU 27 = European Union after 1 January 2007, with 27 Member States

27 EU Member States: AT = Austria, BE = Belgium, BG = Bulgaria, CY = Cyprus, CZ = Czech Republic, DE = Germany, DK = Denmark, EE = Estonia, EL = Greece ES = Spain, FI = Finland, FR = France, HU = Hungary, IE = Ireland, IT = Italy, LT = Lithuania, LU = Luxembourg, LV = Latvia, MT = Malta, NL = Netherlands, PL = Poland, PT = Portugal, RO = Romania, SE = Sweden, SI = Slovenia, SK = Slovakia, UK = United Kingdom