

Non-Observed Economy and Corruption: Links and Consequences

Analytical Commentary

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Non-observed economy and corruption are closely linked and fuel one another. The spread of corruption in public institutions allows economic operators to avoid paying their taxes and then escape punishment. At the same time, corruption is an additional barrier for small entrepreneurs from the non-observed economy to enter the legal one. Such 'vicious' relations between corruption and non-observed economy have increased in recent years in the Republic of Moldova and are a major challenge for the country's sustainable development.

What Does Non-Observed Economy Mean?

The non-observed economy comprises all the economic activities that escape the direct purview of state authorities (Box 1). The fact that some economic activities are hidden and missed by state authorities has a negative impact on the country's development prospects. The socio-economic development prospects are negatively influenced by the fact that people engaged in non-observed economy have extremely low productivity and that unregistered companies have no incentives to invest and do not pay taxes. The monetary cost of such developmental pattern results in lower tax collections than those that would have been generated by a completely formal economy. However, smaller tax collections to the public budget launch a chain reaction of reduction in government expenses on public services, infrastructure, salaries, pensions, etc.¹ Thus, there appears a vicious circle, which is difficult to break in practice without implementing structural policies, but also anticorruption policies, as is shown below.

Box 1. Components of Non-Observed Economy

The non-observed economy is comprised of the following components:

- **Informal sector production** – result of the activity of unregistered enterprises and/or the size of which, according to the number of the employees, is below the threshold set by statistical authorities and that have some market production. Usually, these enterprises are unregistered and are part of the households sector (i.e. teams of uncertified builders, street vendors, unlicensed taxi drivers, etc.). In most cases, households 'establish' such enterprises in order to have an occupation and earn certain income, in the context of lacking opportunities on the official labour market or of the existence of some barriers to accessing the formal economy;
- **Households production for own consumption** – economic activity resulting in goods and services produced by households for their own consumption and/or accumulation without establishing enterprises (e.g. households that grow vegetables and fruits both for their own consumption and for selling them on

¹ A. Lupusor, A. Fala, A. Popa, D. Cinusa, I. Morcotilo, '2017 State of the Country Report', Expert-Grup, Chisinau, 2017 .

market);

- **Underground production** – legal production that is unregistered or unreported to the state's administrative and fiscal bodies, due to business entities not reporting it. The main reason why economic operators do not report their production to state control bodies is tax evasion, in other words, they don't want to pay taxes, social contributions or other payments (e.g. an enterprise does not conclude employment contracts with all its employees);
- **Illegal production** – all the goods and services forbidden by law to be sold, distributed or owned (e.g. drugs etc.). This category also includes legal activities that become illegal when conducted by unauthorized persons (e.g. poaching, unlicensed activities, etc.).

Source: National Bureau of Statistics, 'Measurement of Elements of Non-Observed Economy in the Republic of Moldova', Chisinau, 2003.

The share of non-observed economic activities in the Moldovan economy is significant. According to official data, in the last few years, the share of non-observed economy has oscillated between 22% and 24% of the country's GDP, except for illegal production.² The most worrying thing is that the share of underground production, in other words – of tax evasion, has doubled in the last decade. The share of this non-observed economy component increased from 4% of GDP in 2007 to 8% in 2016. In addition, the share of the people employed in this sector has increased significantly in past years – from 30% of the total employed population in 2012 to 35% in 2017. These worrying trends speak of the failure of structural reforms and of the business environment in recent years, but also of the authorities' failure to fight corruption in the country.

In fact, corruption is one of the important factors that influences the evolution of the non-observed economy and needs to be taken into account when developing policies in this area. Because of corruption, state control institutions are neither able to detect and punish illegal activities and tax evasion, nor to facilitate the informal entrepreneurs' transition into the formal sector. At the same time, the expanding non-observed economy also fuels the corruption phenomenon, as it serves as a source of 'dirty money' used for bribing civil servants.

What Is the Link Between Non-Observed Economy and Corruption?

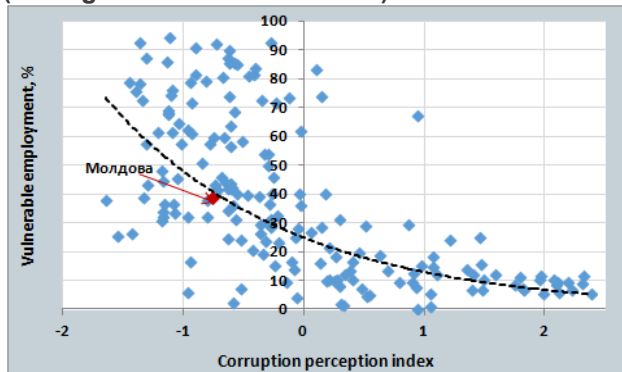
Corruption and non-observed economy are interdependent phenomena that fuel one another. Countries with a significant share of the non-observed economy also have a higher level of corruption (Figure 1).³ The positive relationship between the non-observed economy and corruption is explained by the fact that in the countries with a high share of non-observed economy, the economic operators and individuals engaged in informal activities use corruption to avoid detection, taxation and penalties by public authorities (i.e. unlicensed taxi drivers or street vendors). In addition, the companies from the formal sector can also not pay taxes or social contributions for their employees and avoid penalties by bribing tax officers and inspectors (i.e. the under-the-table salary phenomenon). Finally, bribing customs staff, police officers and the staff of other enforcement bodies will lead to even more illegal activity (i.e. smuggling and money laundering). In turn, the proliferation of corruption in public

² The data on the non-observed economy, published by the National Bureau of Statistics, does not include the illegal production component due to the difficulty of highlighting and compiling statistics in this area.

³ A. Buehn, F. Schneider, 'Corruption and the Shadow Economy: A Structural Equation Model Approach', IZA DP No 4182, 2009.

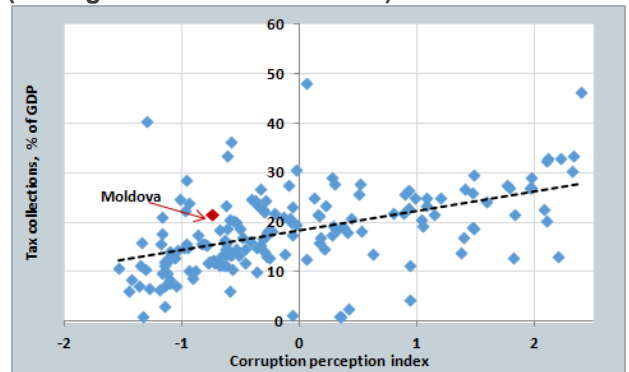
institutions, but especially in those with regulatory functions, will lead to the failure of policies designed to combat non-observed economy, with all the negative consequences for the sustainable development of any country. Moreover, corruption in public institutions serves as an additional barrier for many companies from the informal sector to enter the legal market, as many of them are on the breakeven point and at the subsistence threshold, and have no financial resources for bribery. Thus, there is appearing a vicious circle between corruption and non-observed economy, because the money generated in this sector is used to bribe officials who are responsible for fighting non-observed economic processes.

Figure 1. The relationship between vulnerable employment and the perception of corruption (average values for 2002-2015)⁴



Source: Author's calculations based on World Bank data

Figure 2. The relationship between tax collections and the perception of corruption (average values for 2002-2014)



Source: Author's calculations based on World Bank and IMF data

One of the most serious repercussions of corruption on sustainable development is the erosion of state capacity to collect taxes. In the economies with significant shares of non-observed processes, which are also influenced by corruption, the public administration cannot collect enough taxes in the budget and depend on other funding source.⁵ The more corrupt a country is, the lower the country's own tax accumulations in GDP are (Figure 2). However, lower public budget accumulations generate a series of issues for the sustainable and accelerated development of poor countries. Thus, due to low budget revenues, the state is unable to increase investments in infrastructure (i.e. schools, hospitals, and roads), and rise public salaries and social payments for vulnerable groups (i.e. pensioners, the poor, people with disabilities).

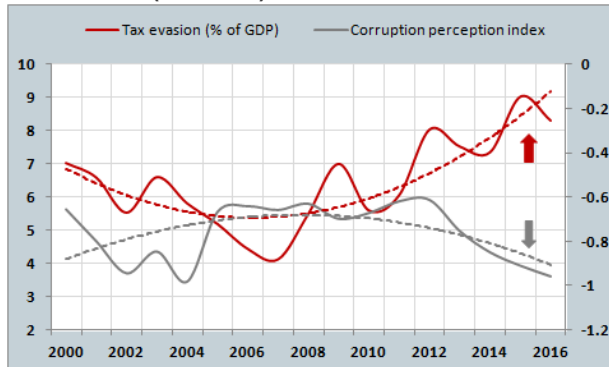
The problem of corruption and tax evasion has become more acute in the Republic of Moldova in recent years. In the period between 2000 and 2016, the correlation between the non-observed economy and the level of corruption in the Republic of Moldova, as worldwide, was positive, but not very strong (only 0.3). At the same time, if we do not consider the whole non-observed economy, which depends on several factors and has several components, but focus only on the tax evasion component (underground production) then the correlation will increase to 0.4 (Figure 3). However, the correlation becomes even stronger after 2012, when the level of corruption perception worsened sharply, almost to the historical minimal values, accompanied by an increase in tax evasion. Thus, the increase in corruption in recent years,

⁴ The official statistical data on non-observed economy are not available globally, which is why in Figure 1 as a proxy indicator was used the vulnerable employment. The corruption perception index is taken from the World Bank (Global Governance Indicators), ranging from -2.5 (worst performance) to +2.5 (best performance).

⁵ A. Baum, S. Gupta, E. Kimani, S. Jules Tapsoba, 'Corruption, Taxes and Compliance', IMF WP/17/255, 2017.

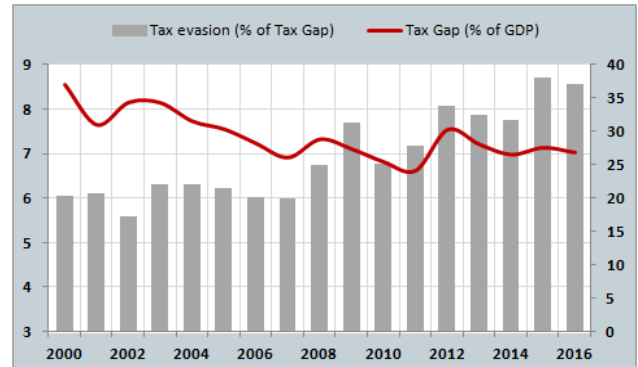
has also led to a rise in tax evasion, which has also led to a decrease in potential budget revenues.

Figure 3. The relationship between corruption level (right axis) and tax evasion in the Republic of Moldova (left axis)



Source: Author's calculations based on National Bureau of Statistics and the World Bank data

Figure 4. The dynamics of total tax gap (left axis) and of that resulting from tax evasion (right axis)



Source: Author's calculations based on National Bureau of Statistics data

The expansion of corruption and of the non-observed economy leads to a greater tax gap – the difference between tax revenues collected and potential ones. In recent years, the total tax gap is estimated at around 7% of GDP, which is the equivalent to about MDL 9.5 billion in 2016.⁶ Thus, due to the existence of a non-observed economy, the annual public budget does not collect revenues accounting for at least 7% of GDP. However, the amount of potential tax revenues is actually higher, because the losses associated with illegal production in the national economy were not taken into account. Nevertheless, the share and scale of underground production (i.e. of tax evasion) has been increasing in the budget foregone revenues since 2009. By 2009, only about 20% of the total foregone revenues could have been attributed to tax evasion, but then they increased to 37% in 2016, i.e. to around MDL 3.5 billion (Figure 4). Thus, we can say that the indirect cost of corruption generated by the non-observed economy is the increase in the forgone revenues to the public budget.

Conclusions and Recommendations

Corruption and non-observed economy are interdependent phenomena that fuel one another. Usually, countries with a high level of corruption also have a significant share of non-observed economic activities in GDP. These non-observed activities, including corruption, generate more direct and indirect costs for the society. Thus, the non-observed economy generates financial flows, which need to be hidden from public authorities in order to avoid taxation and/or penalisation of actors operating in this sector. Economic operators resort to bribery and other forms of corruption in order to avoid taxation and penalisation. In its turn, a high level of corruption in public institutions serves as an additional barrier for many informal enterprises willing to enter the legal market. Many of these companies are too small to afford to bribe several civil servants. These mutual relationships between corruption and non-observed economy lead to colossal losses for the public budget due to missed taxes and perpetuate poverty among many people who are forced to work in the informal economy sector.

⁶Estimation based on the methodology of A. Cobham 'Tax evasion, tax avoidance, and development finance', Queen Elisabeth House Working Paper, No 129, 2005.

The phenomenon of corruption and tax evasion has gained momentum in the Republic of Moldova in recent years. The indirect costs to the public budget caused by non-observed economy are estimated at around 7% of GDP, or about MDL 9.5 billion in 2016. About 37% of this amount is related to tax evasion, which has grown since 2009. The cost of missed income is even higher if illegal production in the country is also taken into account. Thus, combating corruption and diminishing non-observed economy can bring additional income amounting to a few billion of MDL to the public budget. As long as the Republic of Moldova depends on external sources of financing and has a budget deficit of 2%-3% of its GDP, one of the strategic objective will be to increase tax income by combating tax evasion. All modernisation reforms in the country can be jeopardised if these worrying trends continue.

The development and implementation of a set of systemic policies, including the fight against corruption, is the only solution to curb the non-observed economy. These policies must target every single component of the non-observed economy and include extensive structural, tax and institutional reforms.⁷ At the same time, as shown above, corruption is an important factor that influences the non-observed economy and if this phenomenon is not combated, the rest of the reforms will have meagre impact. Thus, the fight against corruption is a key element to be included in non-observed economy mitigation policies.

⁷ A. Lupusor, A. Fala, A. Popa, D. Cenusă, I. Morcotilo, 'State of the Country Report 2017', Expert-Grup, Chisinau, 2017.