

## THE UNDERGROUND ECONOMY: COMPONENTS

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**Abstract:** *The aim of the studies is to understand the notion of underground economy and to make recommendations for improving the fraud management and control systems. We study the underground economy in terms of its components. The basic component without which we cannot talk about fraud is the economical agents with heterogeneous skills, seeking opportunities from the point of view of the disparities between the laws of the Member States of the European Union and the uncertainties of the national law regarding the risky commercial activities of enterprises. Asymmetrical provision between the laws of the Member States of the European Union imply an environment that offers the economical agents the possibility to take advantage of these disparities in order to operate an underground economy. Confronted with these underground economies the States choose financial policies that would determine the economical operators from the black market to respect their financial obligations. Member States are responsible for preventing and resolving irregularities and fraud in the areas managed in a distributed manner. In order to protect the Community's financial interests, Member States are primarily responsible for establishing management and control systems that comply with the requirements of Community law as well as for verifying the efficient operation of systems through audits by designated bodies for the prevention, correcting irregularities or fraud. The analysis has shown that the gradual approach is easier to understand, if the statistical data being analyzed, after the theoretical elements are presented. It is recommended that any classification of types of fraud be made according to the specific circumstances and the environment in which the organizations operate. The responsibilities of the Member States for setting up management and control systems that comply with Community requirements to verify the operational efficiency of these systems through audits by the bodies designated for the prevention, detection and correction of irregularities and fraud will be analyzed. Correlation with statistical data will clarify OLAF's financial recommendations to EU institutions or national authorities that also manage EU customs revenue collection. It will be highlighted that the customs activities of the Member States' are the first line of defense against any attempt to defraud the EU budget. Since its inception, OLAF has been monitoring the actions taken by national judicial authorities following its judicial recommendations to see the outcome of these cases on the ground and to find out whether they have led to allegations or other judicial measures. The key inference of the analysis is the study of the components of the underground economy according to legal provision, politic environment from the different states of the European Union with the purpose of improving the policies for controlling this phenomenon.*

**Keywords:** *gray economy; informal economy; illicit activities; fraud; tax evasion.*

**JEL Classification:** A14.

## **1. Introduction:**

The Underground economy has a great number of components which requires the definition and the identification of its characteristics. The shadow economy is known by different names, such as the hidden economy, gray economy, black economy or lack economy, cash economy or informal economy. It manifests itself as a companion of the official economy which under certain circumstances it can replace or to which it is complementary by influencing its evolution.

The Underground economy contains activities which are the results of illicit transactions with goods or services, or of fraud, tax evasion, work without legal forms and money laundry.

## **2. Fraud**

The main element of the underground economy is fraud even if it takes different forms from one state to another. Tax fraud is to fraudulently evade the taxes or to consciously omit to fulfill the tax obligations at the due terms, whether a part of the sum was hidden consciously, or the insolvency was organized or by any illegal means the paying of the taxes was obstructed.

Fraud involves two mandatory components: a material element – the breaking of the tax law and desideratum to elude the taxes.

The intra-community VAT system was often abusively used by the so-called Intra-Community Fraud (MTIC) scheme.

Ghost companies represent a company that doesn't exist from the point of view of the commercial activity, registered in a fictive headquarters, created especially for eluding the paying of taxes (it's generally used for only one deal).

We exemplify a fraudulent scheme in which a supplier from member state no.1, the so-called intermediary company, delivers goods (exempted from the VAT) to the second dealer from state no. 2, the so-called ghost company. This dealer takes advantage from the intra-community delivery which is exempted from paying VAT and resells the same products on the internal market of the state no.2, at very competitive prices. He can offer such prices as although he collects the VAT from his customer, he doesn't pay it to the fiscal authority, and thus increasing his margins for profit. Later the ghost company disappears without a trace and so the collect of VAT becomes impossible in the state where the goods or services were consumed. In another alternative of the scheme, a client of the ghost company (the broker) sells or pretends to sell the goods abroad, sometime to the intermediary company and claims from the fiscal authorities to which the return of the VAT belongs the refund of the VAT paid to the ghost company. The same transaction can be repeated in a circular fashion, this type of fraud being called a "carousel"

Sometimes the goods don't even exist. The fraud scheme can be complicated even more when the ghost company sells the goods to a „buffer" dealers, from which some might be honest, in order to make tracking them even more difficult. The revenue is

transferred to companies registered in tax-heavens ([https://www.eca.europa.eu/Lists/ECADocuments/SR15\\_24/SR\\_VAT\\_FRAUD\\_RO.pdf](https://www.eca.europa.eu/Lists/ECADocuments/SR15_24/SR_VAT_FRAUD_RO.pdf), p.12-13).

### 3. Tax Evasion

Along the fraud, tax evasion represents the action of evading the paying to the state the taxable matter. There are two kinds of tax evasion:

- the "licit" or tolerated (intra-legal), this kind of evasion implies the bending of the law by the tax payer, by using an unforeseen combination of laws and thus unregulated by the state. This term mustn't lead to the impression that this kind of phenomenon is permitted by the law. This kind of evasion is only possible due to some deficiencies of the laws.

### 4. Work Without Legal Forms

Another component of the underground economy is work without legal forms, and represents the work outside or at the edge of the law. The phenomenon consists of the understanding between the employer and the employee to have work relationships without paying (completely or partial) the taxes and social contributions. By working without legal forms, one infringes:

- the social legislation with negative effects for the employer concerning the retirement benefits, work accidents, unemployment benefits, etc.
- the fiscal legislation with negative effects for the state budget;
- work legislation with negative effects for the worker without legal forms (the exploitation of women and children, the duration of the work time);

### 5. Money Laundering

It is the process by which offenders attempt to hide the real origin of income from criminal activities. Money laundering is the most dangerous component of the underground economy. Through the money laundering process is give an appearance of legality some profits obtained illegally by criminals who, without being compromised, benefit subsequently from the amounts obtained.

(<http://www.onpcsb.ro/pdf/MANUAL%20INSTRUIRE%20-%20ROMANA.pdf>)

This dynamic process of money laundering from crimes takes place in three stages consisting of:

1. the movement of funds
2. hiding traces of money to avoid any kind of investigation
3. making money available to criminals, hiding the occupational and geographical origin of the funds again.

A) The definition of money laundering in Romanian legislation is found in the Law 656/2002 art.1 let. a)

The individuals persons and legal entities targeted by Law 656/2002 are:

- a) banks, branches of foreign banks and credit institutions;
- b) financial institutions;
- c) insurance and reinsurance companies;

- d) economic agents that perform gambling activities, pawnshops, sales and purchases of art objects, metals and precious stones, dealers, tourism, services and any other similar activities involving the putting into circulation of values;
  - e) individual persons and legal entities with grant legal, notary, accounting, financial-banking assistance, in compliance with the legal provisions on professional secrecy
  - f) persons with attributions in the privatization process;
  - g) post offices and legal entities that provide money transmission services, in lei or in foreign currency;
  - h) real estate agents;
  - i) currency exchange offices
  - j) any other individual person or legal entities for acts and deeds committed outside the financial-banking”
- B) The definition of money laundering in European Union legislation can be found in Council Directives 91/308 / EEC of 10 June 1991 and 2001/97 / EC of 4 December 2001.

## 6. Conclusion

At the proposal of the European Commission, since 2011, several initiatives have been taken to step up the fight against fraud and corruption affecting EU public money.

The Commission's proposal for amending the legal framework of OLAF aims to increasing the efficiency and speed of OLAF investigations, at strengthening procedural guarantees at reinforcing OLAF's cooperation with Member States and improving its governance.

The Communication on the protection of EU financial interests by criminal law and administrative investigations sets out how the Commission intends to protect European taxpayers' money against illegal activities, including threats posed by corruption inside and outside the EU institutions.

The Communication draws attention to possibilities for improving the criminal law framework and procedural tools for investigators and prosecutors, as well as on possible institutional developments ([https://ec.europa.eu/anti-fraud/sites/antifraud/files/docs/ec\\_antifraud\\_strategy\\_en.pdf](https://ec.europa.eu/anti-fraud/sites/antifraud/files/docs/ec_antifraud_strategy_en.pdf), p.4-5).

As a result of the efforts to fight against fraud, in October 2017, the European Parliament approved the establishment of the "European Prosecutor". Within this institution, which will focus on frauds with European money, prosecutors appointed by Romania will also work.

The establishment of the institution also means minimum penalty limits that EU Member States will have to take over in their own legislation. In cases of conviction, following the investigations of the European Prosecutor, the stolen money will be confiscated.

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