



MONITORING THE HIDDEN ECONOMY IN MACEDONIA, ALBANIA AND KOSOVO

TRENDS, POLICIES OPTIONS (2016-2017)

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LIST OF ABBREVIATIONS

AL	Albania
EU	European Union
FP	Financial Police
GoM	Government of Macedonia
GoA	Government of Albania
GoK	Government of Kosovo
IC	Inspection Council
ILO	International Labour Office
IMF	International Monetary Fund
IMF	International Monetary Fund
KS	Kosovo
MK	Republic of Macedonia
MLSP	Ministry of Labour and Social Policy
NBRM	National Bank of the Republic of Macedonia
PRO	The Public Revenue Office
SLI	State Labour Inspectorate
SMI	State Market Inspectorate
SSO	State Statistical Office
WB	World Bank
WEF	World Economic Forum

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“Monitoring the Hidden Economy in Macedonia, Albania and Kosovo:Trends, Policies and Options”

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EXECUTIVE SUMMARY

Informal, parallel, clandestine, grey, underground, shadow, unregulated, subsistence, coping, non-monetized, alternative – whatever of these names one chooses to attach to the phenomenon of hidden economy, or traditionally called **'grey economy'** in the region, there is a growing acceptance that at different scales the hidden economies are here to stay due to their resilient nature and adaptive capacities to changing political, legislative and economic environments.

Corruption seems to be the overarching topic surrounding the main factors defining the hidden economy landscape in the three countries. According to businesses **'Corruption'** is the most important factor for the existence of the hidden economy according to 45.7% of businesses in Macedonia, 72.9% in Albania, while in Kosovo **'Corruption'** is in second place (48.6%) just after **'High tax burden'** (60%). Bribing, as a tool for corruption is one of the 11 hidden economy practices explored by the conducted **business surveys which in deed confirm the large extent of bribing with 1/3 of businesses in Albania (35.7%) and 1/4 in Kosovo (22.9%) and only 1/10 in Macedonia (8.6%) claiming these practice being used 'constantly' or 'in most cases.'**

Accordingly, among the **top 3 measures proposed by businesses in the three countries for reducing the hidden economy suggest that certain good governance deficiencies are contributing to creating fertile ground for development of hidden economy:**

- **Reducing taxes;**
- **Reducing/tackling corruption;**
- **More effective business stimulations;**
- **Increase efficiency of the court system;**
- **Implementing stricter laws.**

KEY POINTS - PART 1

- *The large **unemployment rate (22.6% in MK, 13.9% in Albania in Q2 2017 and 30.5% in Kosovo as of Q1 2017)**, is one of the most important indicators that give rise to hidden economic activities and practices.*
- *The main focus in tackling undeclared work, just as most Eastern European Countries, is on Labor Law violations. Measures aimed at **improving detection and repressive measures** are the **dominant policy approach** in these countries.*
- *Hidden salaries remain the most acute concern, with the **employment income being partially or completely undeclared for almost half (44%) of employees in Macedonia (a rise from 40% in 2014), 36% in Albania and 37% of employees in Kosovo.***
- *Education matters in the informal economy. **Only 56.8% of employees** with primary education in Macedonia, **20.6% in Albania and none in Kosovo** have acquired a written contract for their primary job compared to over 80% for employees with university degrees.*

KEY POINTS - PART 2

- *Non-issuance of fiscal bills and Tax evasion in Macedonia are the first and second leading reasons for detected irregularities in the period of 2006-2016 (PRO).*
- *The percentage of least frequently taxed services is the largest for Kosovo (74%), second largest in Albania (65%) and third in Macedonia (54%). (Figure 21).*
- *Percentage of respondents stating they have not received a fiscal receipt/invoice after purchasing certain goods in the past year in Kosovo is 57.1%, Albania 43%, and a low of 11.8% of respondents in Macedonia (Figure 22).*
- *Macedonian revenues to GDP are at 29% in 2016, Albanian and Kosovan are at 27%. All are much lower than the EU-28 average of 45% of GDP.*
- *Non-issuance of fiscal receipts for the excise goods alcohol and tobacco (Figure 8) in 2016 sees almost a doubling in non-compliance to 20% in Macedonia. This percentage is worse in Albania (52%) and Kosovo (40%).*

Persistence of the high share of hidden economy in the GDP of the three developing countries Macedonia, Albania and Kosovo threatens to heighten social tensions and to create an environment where corruption and other illicit or semi-legal business activities can thrive. An important indicator is the revenues to GDP ratio which despite 10 years of growth the ratio has remained the same or deteriorated. **Macedonian revenues to GDP are at 29% in 2016 (33% in 2008), Albanian and Kosovan are at 27% which are much lower than the EU-28 average of 45% of GDP** In addition, **tax avoidance is especially widespread among the poorest members of the society**, which makes the underprivileged especially vulnerable as they may find themselves being criminally prosecuted for unpaid taxes or charged with paying large penalties

Undeclared work is one of the main manifestations of **hidden economy affecting people within a variety of socio-economic environments** which at

the same time is characterized with possible **negative outcomes ranging from social tensions, rising inequalities and income gaps to corruption and criminal activities**. Two countries have EU candidate status, and Kosovo has signed the stabilization and association agreement with the EU but all three are characterized by higher unemployment rates than the EU average of 9.6% (Apr. 2015), consequently high levels of undeclared work estimated by some studies to be more than 30% of the GDP of the three countries and rising inequality.

The current report indicates that the percentage of hidden salaries remains the most acute concern, with the **employment income of some 44% of employees in Macedonia, 36% in Albania and 37% on Kosovo are at least partially undeclared**. Moreover, **9% of employees in Macedonia, 17% in Albania and 20.9% in Kosovo work without a contract**, and are not being paid any social security contributions whatsoever. The interviewed business representatives confirmed wide scale violations of the *Labour and Tax Code* within their sectors. In fact **25.7% of businesses in Macedonia, 52.8% in Albania and 31.5% on Kosovo** claimed that (not accounting for the full remuneration paid out) hiring workers on contracts with hidden clauses is common practice in their sector. Moreover, **large-scale tax evasion seems to continue to pose a serious problem** for these economies and social systems as governments try to adjust them in order to be compatible with the principles of the market economy without imposing too extensive erosion of the social fabric and the existing social benefits.

Despite the fact that there is a consensus and often pressure from EU (through the EU Progress reports) for the governments of the three countries to proactively fight hidden economy and increase the efficiency of coordination between law enforcement bodies, such policies should be implemented with due care. Various parts of the hidden economy are an essential part of these

developing economies (i.e. handicraft and subsistence economy, private lessons of school-teachers, construction works, car repair services, child and elderly home care, etc.), and as such the government should look into ways to curtail it and limit its negative effects in the long-run, but preserving the source of employment and income, and entrepreneurial activity, which they are in the short run.

The governments should aim to tackle black and grey economy harsher, starting with big law-breakers, and leave it to the longer-term measures and to the economic growth to tackle the subsistence (informal) economy, and micro businesses.

Finding the right balance will without a doubt be a delicate and difficult task. Legalization strategies might have a direct positive effect in terms of eliminating non-compliance and tax evasion, but might also scale-down the markets due to increased transaction/compliance

costs or provide unjust preference to market players, who are insiders in the law-enforcement circles. So, at the end of the day the social and monetary cost of a programme that reduces the hidden economy in a specific niche might be higher than the cost and negative consequences of the hidden economy itself. The scale of hidden economy indicates **deficiencies in the interaction between public and private stakeholders, ranging from over-regulation, lack of fiscal and tax discipline of enterprises, or complicated business registration mechanisms, to ineffective inspection authorities, and inefficient and unfair judicial systems.**

Improved data sharing and coordination between different governmental bodies and also the civil society organizations are imperative to successfully combating the negative consequences posed by undeclared labour and all facets of the hidden economy. Working to establish partnership relations with businesses and the citizens would be of particular importance for sustaining successful effects from hidden economy policies.

The civil society organizations should also increase their capacity to play a more active role in monitoring, and tackling the hidden economy issues through follow-up and promotion of best practices in the area. Better results and performance based evaluations of existing policies and further expert research in this area is also necessary in order for short and long-term effects to take place. Taking novel steps and enhancing already established good European practices that improve the general macroeconomic situation of these countries is and will be the most efficient strategy to curb the hidden economy.

Governments change and so might their particular policies and measures in accordance with the party ideology and their political campaigns. However it is essential to establish long-term strategies and overarching goals that go beyond party politics, are built on consensus, on sound

KEY POINTS - PART 3

- *Whereas around half of businesses in Macedonia in 2014 stated that the tax rates for respective taxes were 'as high as they should be' - with a notable exception of the company tax and social security - in 2016 these values have dropped to 30-35%.*
- *1/3 of businesses in Macedonia (31.4%) and two thirds in Albania (60%) and Kosovo (62.3%) have confirmed that manipulating with VAT is a common practice. Macedonia sees deterioration in this manner (by 50%) as only 21.6% of businesses have confirmed this practice back in 2014.*
- *'Corruption' is the most important factor for the existence of the hidden economy according to 45.7% of businesses in Macedonia, 72.9% in Albania, while in Kosovo 'Corruption' is in second place (48.6%) just after 'High tax burden' (60%).*
- *The hidden turnover is more significant in Albania where 84.3% of companies confirmed the presence of this practice out of which a large portion (40%) confirmed the practice to be used 'in most cases.'*

scientific data which is supported by best practices in the field. Establishing a consensual long term goal in the field of tackling the hidden economy and alleviating its negative consequences over the population and the country's economy can and should be an area of cooperation among political parties in power and the opposition in order to improve the livelihood of their electorate, especially the most vulnerable categories of citizens.

I. INTRODUCTION

Often words such as “**shadow**”, “**underground**”, “**informal**”, “**undeclared**”, “**grey**”, and “**unobserved**” are interchangeably used with “**hidden**” to describe inevitably the same phenomenon but from a different perspective. To clarify - throughout the text ‘**hidden economy**’ will be used to describe economic activities and practices which are legal (non-criminal) as to their nature but remain undeclared to the authorities unlike “Black” economy that refers to illegal (criminal) activities and practices. Although all these terms, encapsulated by the term “hidden” from here after, carry a negative connotation it must be noted that in the short to mid-term the hidden economy can aid societies and its population to recover from severe economic crisis or transition, for example, from socialist to market based economy. However, in mid to long-term it jeopardizes workers safety net, increases inequality, unfair competition and economic imbalances.

A factory worker has a second job at night as an unlicensed plumber for small household; an electrician installs a new water boiler and gets paid in cash while he avoids declaring that income to the tax authorities; an IT professional besides his minimum wage contract receives an additional ‘envelope’ wage; A single parent, mother of 2, in the employer’s benefit agrees to keep working on temporary service contract basis in order to keep her job and maintain basic sustenance level. These are all examples, or variations, of undeclared labor.

Table 1 - Cost & Benefits of Undeclared Work.

Costs	Benefits
For legitimate businesses: Causes unfair competition for legitimate businesses. Encourages 'rate to the bottom' as legitimate businesses evade to compete with shadow businesses.	Test-bed for business start-ups.
For undeclared businesses: Growth hindered because unable to access capital, secure business support or openly advertise. Pressured into exploitative relationships with legitimate businesses.	Can test-trade the viability of their business venture.
For undeclared workers: Lack access to credit and financial services, partly to limited credit history. No entitlement to labor rights (e.g. minimum wage, sick pay, redundancy rights). Higher barriers of entry to formal market due to inability to provide employment history. Cannot build-up rights to state pension and other contributory benefits, and access occupational pension schemes. Lack access to health and safety standards, as well as bargaining rights and voice.	Source of income. Reduces barriers to entry into work because much undeclared work is for close social relationships.
For customers: Lack legal recourse if a poor job is done, insurance cover, guarantees in relation to the work conducted, and certainty that health and safety regulations have been followed.	More affordable products or services for consumers.
For governments: Causes loss of revenue for the state in terms of non-payment of income tax, national insurance and VAT. Reduces money available to governments to pursue social integration and mobility. Loss of regulatory control over the quality of jobs and services.	Puts brake on burdensome regulatory regimes.

Source: Colin C Williams (2014)

"Confronting the Shadow Economy: Evaluating Tax Compliance and Behavior Policies"

<http://blogs.lse.ac.uk/politicsandpolicy/europes-hidden-economy-how-governments-can-bring-un>

There are wide regional and country differences in the size, scope and main sectors of operation of the undeclared economy in Europe which, according to Eurofound figures, averages around "18% of EU GDP, ranging from below 8% of GDP (Austria) to over 30% of GDP (Bulgaria). Undeclared

work is most prevalent in the construction industry, but is also widespread in household services, private security, industrial cleaning, agriculture, and the hospitality and catering industry.¹

Table 2 - Rates of social security contributions in the period (2006-2016) in Macedonia.

	2006	2007	2008	2009	2010/ 2016
Pension and disability contributions	21.2%	21.2%	21.2%	19%	18%
Health Insurance contributions	9.2%	9.2%	9.2%	7,5%	7.3%
Unemployment Insurance Contributions	1.6%	1.6%	1.6%	1.4%	1.2%
Additional Health Insurance contributions in case of accidents at work and work related injuries				0.5%	0.5%
Personal Income Tax	15%	12%	10%	10%	10%
Total Tax Burden (Macedonia)	47%	44%	42%	38,4%	37%

Source: KPMG (2012), the Public Revenue Office (PRO) (2014) and Trpeski, Tashevskaa (2012), <http://www.oeconomica.uab.ro/upload/lucrari/1420122/24.pdf>

Unavoidably the policy and economic landscape of the country in question creates particular sets of incentives which then produces specific costs and benefits of engaging with and/or in the hidden economy (See typical costs and benefits in Table 1). Depending on this landscape the economic entities tailor and select their hidden economy practices in order to maximize from the market, regulatory and governance deficiencies. And these practices further develop and utilize new technologies which then become another challenge for tackling the hidden economy such as the emergence of anonymous and instant cryptocurrency transactions.

Hidden economy practices are not always a part of, as its name suggest, low profile activities in the economy. The Panama Papers leaks have revealed a matrix of high profile tax evasion practices which have hidden much needed revenue streams towards the EU economies and towards the quantity and quality of the public services their Governments are supposed to provide. What has become clear is that there is a need for more complete cross-border transparency and international tools to deal with the problem as hidden economy and tax evasion practices are a global phenomenon despite having a local character. However, as certain EU countries (Ireland, Luxembourg) as tax havens are guided by self-interest, the move to immediately seal the cracks within the EU tax system will surely be a bumpy one.

According to 2013 estimates reported by Reuters, the European Union loses around 1 trillion EUR per year in public revenues annually due to tax evasion and fraud.² Given that EU's GDP summed up to 12.7 trillion EUR in 2013, tax evasion and fraud represented an estimated 7.9% of its annual GDP in 2013. Even though replicating the same percentage of tax evasion on non-EU countries might give an underestimated estimate it is useful for the scale and contrast that it provides.

1 European Parliament News (02.02.2016) "European platform to tackle undeclared work." Accessed 19.07.2016

2 Francois, Lenoir, EU losing 1 trillion euros a year to tax dodging. Reuters (21.03.2013). Retrieved from: <http://www.reuters.com/article/2013/04/12/us-eu-tax-vanrompuy-idUSBRE93B0KC20130412>

Assuming that developing countries such as Macedonia, Albania and Kosovo would have a tax evasion problem of at least 7.9% of their GDP it would mean that Macedonia loses on tax evasion around 720 million EUR annually or two times the annual budget of its Health Insurance Fund. Albania potentially loses close to 810 million EUR annually or more than 6 times its annual defense budget. Kosovo loses slightly more than 470 million EUR annually or more than 7 times the annual budget of the Kosovo Security Forces.³ Even though these figures are just estimates they do portray the scale of non-realized budgetary revenues and the lost potential of directing those revenue to improving quantity and quality of public services.

The government doesn't really have the resources to track down every individual or business that employs different tactics of tax evasion. What the government is keeping track of is lost revenues. According to the Internal Revenue Service in the USA, about \$500 billion in taxes were lost last year because of unreported wages, versus \$384 billion in 2001. (CNBC, 24.04.2013)

Tackling tax evasion and fraud, being just a part of the policies targeting hidden economic activities, is not just a way to increase government revenues, but also a way to increase the fairness of the tax system, and improve tax acceptance and trust among its citizens and businesses, promote human rights, and enable appropriate protection to the most vulnerable in our societies.

In line with that, there are couple of terms that have been overused in the past political campaigns and are almost without exception a part of each heads' of state speech are job creation, private sector development (SMEs), budgets, taxes and revenues. That is why the hidden economy remains a topic of interest for policy makers, economists and academics alike as it affects each of those issues to a varying degree and carries a potential to solve some of the shortcomings instilled in them through action or inaction.

There is a growing acceptance that at different scales the hidden economies are here to stay due to their resilient nature and adaptive capacities to changing political, legislative and economic environments. The belief in the opposite, that the hidden economy can be eradicated it is not only unlikely but also counterproductive as it can carry substantial benefits to the local population and the economy by using it as a buffer in times of hardship or transition. In fact, globalization and deregulation of the world economy seem to have generated conditions in which the heterogeneous hidden economies can thrive and expand.⁴ In fact informal businesses, especially start-up enterprises which initially function informally can carry a significant potential value for the economy as their activities can be tied up with innovation and entrepreneurship which can have high value added over the long term. The heterogeneity of the phenomenon of hidden economy is visible by just looking at the different adjectives attached to it: informal, parallel, clandestine, grey, underground, shadow, unregulated, subsistence, coping, non-monetized, alternative, and so on.

This monitoring report provides an overview of hidden economy in general, and undeclared labor and tax evasion in particular, in Macedonia, Albania and Kosovo including its main causes and consequences. Additionally it offers a macroeconomic overview of the main characteristics

³ The estimates are made by contrasting the 7.9% tax evasions with the 3 countries nominal GDPs for 2015.

⁴ Castells, M. and Portes, A. 'World underneath: The origins, dynamics, and effects of the informal economy', in: The Informal Economy: Studies in Advanced and Less Developed Countries, ed. Portes, A. et al. Baltimore: Johns Hopkins University Press.

considered to incentivize and maintain the hidden economy, while at the same time providing context in the form of processed survey data (of the general population and businesses) that also grasps the perceptions surrounding this very important issue. Furthermore, it delivers an outline of where this phenomenon might be headed, how these three countries compare and what measures should be taken to tackle it.

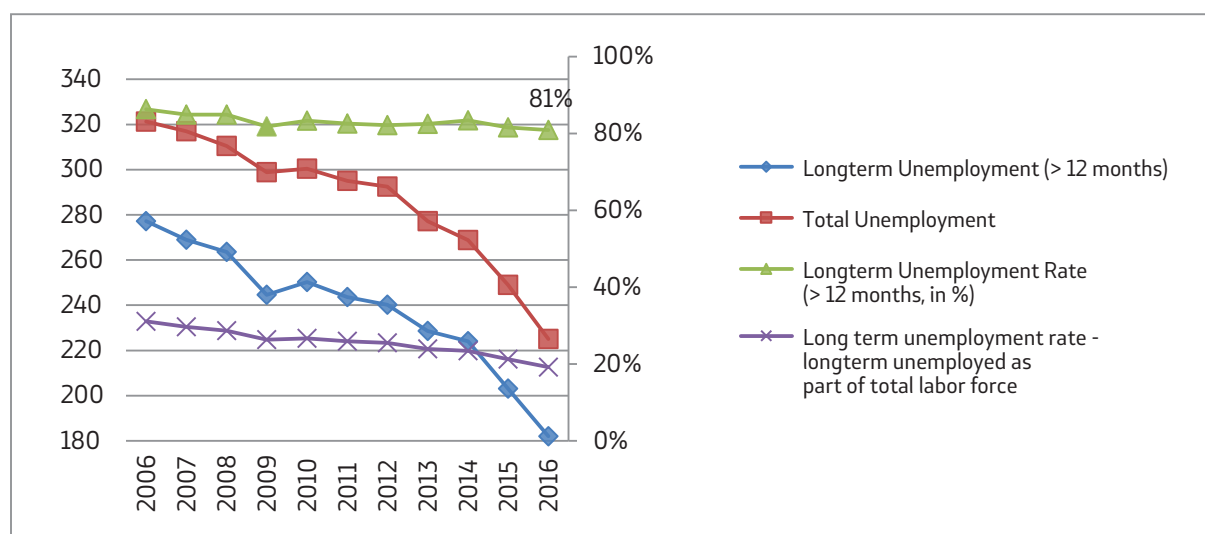
“Improving government performance to achieve social goals means switching from a tax-evading economy with no infrastructure and with mistargeted safety nets to a tax-paying formal economy with relatively small but efficient social safety nets. However, many of these reforms are not likely to be successful without a reduction in corruption and bureaucratic inefficiency.” (Alesina 1999) p.229

Source: Bank of Albania, “Albania’s Informal Economy: An Impediment to Economic Development” (2001), accessed 07.10.2016 <https://www.bankofalbania.org/web/pub/JanPeterOlters_240_1.pdf>

II. MACRO-ECONOMIC FACTORS AND THE LABOR MARKET

The layout of the labor code, the unemployment rate (and its sub-categories), the national tax system represent the bulk of a complex web of factors determining the extent and structure of undeclared labor. Tightening the grip around hidden economy however is a double edged sword. On one hand by government and its regulative bodies having loose control, in a way tolerating it, it allows significant loss of potential revenue and improvement of the quality and quantity of public goods and services.

Figure 1 - Different unemployment rates in Macedonia.



Source: SSO.

On the other hand, if governments rush for using negative incentives (punitive measures, better enforcement) are used to tighten the grip on hidden economy it can produce very real and problematic side effects: reduced disposable income and higher labor costs would translate into decreased consumption, exports, and GDP. What can follow next is a decrease in formal employment on account of the hidden employment as companies struggle to increase price efficiency and productivity.

High unemployment rate, youth and long-term unemployment fuels informality in Macedonia.

Thus, monitoring and managing the hidden economy is a fine balancing act between the need for enforcement of present and future measures and satisfying the present needs of the overall economy in order for society to thrive and establish long term prospects.

The most important and aggravating indicator related to the hidden economy in Macedonia is the fluctuating and high unemployment rate of 23.7% (2016). The extremely high rate of long-term unemployment (80.9% of the unemployed in 2016) suggests that a large share of the jobless have to engage in some form of hidden activity in order to achieve at least a basic level of subsistence. These undeclared workers are most likely to engage in industries and services where cash transactions are regularly performed, including a variety of handicraft services, the green bazaars, etc. The very high share of this subsistence sector of the hidden economy makes it even more difficult for the government to target other forms of undeclared employment, without infringing on the human rights of the former group. Many studies have confirmed the stubborn

levels of undeclared work in Macedonia estimated to be at 34.9% of GDP.⁵

Discretion in the application of rules and related corruption have a more important effect on the informal economy in Albania.

The unemployment in Albania is not as severe as in the other two countries but is still well above the EU average and **stands at 13.9% (Q2 2017)** and as such can certainly be a source of informality. There is very scarce information about the size of the undeclared economy. However by using different measurement methodologies the assessments range between 30 to 45% of the total GDP of Albania⁶, which is in line with Schneider's (2002)⁷ estimate and Albania's Statistical Institute (INSTAT) which estimate the informal economy at 1/3 of the country's GDP in 2000.⁸ According to the ILO approximately 27% of non-agricultural workers are wage employees in the informal economy, and this is mostly in the construction sector.⁹

High youth unemployment rate hurts economic growth in Kosovo.

Kosovo is a lower-middle-income country with has witnessed a modest economic growth rate since the end of the war in 1998-1999. It has about 1.8 inhabitants and a large diaspora population living in Western European countries. According to UNDP, one out of four Kosovars currently lives abroad and their remittances make up to one fifth of GDP.¹⁰ To that effect, the economy is heavily dependent on remittance payments from abroad and solid inflow of donor support.¹¹

POPULATION SURVEY METHODOLOGY

CRPM/IDM/D4D population survey 2016

The data presented below are based on three methodologically identical population surveys, representative regionally and demographically, conducted in May and June 2016 in Macedonia (1097 participants), Albania (1102 participants) and Kosovo (1100 participants). Additionally, results of the same population survey conducted in Macedonia in October 2014 are presented for a comparative overview of the changes over a two-year period. Face-to-face household surveys are one of the direct methods for assessing hidden economic activity and provide qualitatively different and more varied information compared to the traditionally used indirect approaches which usually present the hidden economy as % of the GDP. According to the survey results, the primary and secondary occupation landscape can be seen in Table 3.

Table 3 - Percentage of respondents who reported to have primary and (different types of) secondary occupation.

	MK	AL	KS
Primary occupation	50.9	54.5	50.7
Secondary paid occupation	10.5	23.8	3.2
Activities related to household production	10.3	24.6	14.1
Paid services to friends/family	1.6	3.8	25.8
Unpaid services	5.2	7	25.1

Source: CRPM/IDM/D4D population survey 2016

5 Williams, C.C., Baric, M. and Renooy, P. (2013) Tackling Undeclared Work in Macedonia. Dublin: Eurofound.

6 ETF (2010), "Albania Country Information Note 2010 -2012", ETF, Turin, <<http://www.etf.europa.eu>>

7 Schneider, Friedrich, 2002, "The Value Added of Underground Activities: Size and Measurement of the Shadow Economies of 110 Countries all over the World," Johannes Kepler Universitat Linz, Mimeo. (First version, June 2002).

8 According to Schneider's (2002) estimation method, the size of Albania's informal sector is comparable to those in Lithuania (30.3 percent), Croatia (33.4 percent), Bosnia and Herzegovina (34.1 percent), Romania (34.4 percent), and Bulgaria (36.9 percent).

9 International Labor Organization (ILO), "Albania Decent Work Country Programme Document 2008–2010" (2008), accessed 07.10.2016, www.ilo.org/public/english/region/eurpro/.../dwcp_albania.pdf

10 UNDP. Kosovo Human Development 2014. September 2014, p. v.

11 World Bank. Republic of Kosovo: Kosovo Public Finance Review. June 2014, p. 1.

Kosovo is behind in terms of economic growth if compared to neighboring and European countries. It has the lowest gross domestic product (GDP) per capita at 2,900 Euros in 2013.¹² In South East Europe, Kosovo has the highest poverty rate with almost 30 percent of population living below the poverty line and the highest unemployment rate at 30.9 percent.¹³ According to the official labor statistics it has remained well above 30 percent in the last four years. World Bank estimates indicate unemployment to be highest among youth exceeding 55 percent¹⁴. Given the poor quality of education and limited job opportunities, it makes it difficult for youth to enter the labor market. As a consequence, many of them engage in low-skilled labor and/or informal economy. To many economists, the informal sector is disruptive to the national economy and a deterrent to development. According to Riinvest institute's interpretation of World Bank data the unemployment rate in Kosovo exceeds 30 percent, grey market reaches 40 percent of the country's GDP¹⁵ and inequality of 26.7 (GINI index 2013).¹⁶ The state budget, therefore, loses more than 300 million euros annually (just accounting for lost potential VAT), that could have been otherwise used to improve the quality and quantity of public goods and services. Among many other things, it leads to loss of revenue, and reduces the availability of employment benefits and rights.¹⁷

Many authors (Loayza 1997, and Johnson, Kaufmann, and Shleifer, 1997) claim that economies with large informal sectors, such as in Macedonia, Albania and Kosovo, tend to be stuck in a vicious circle of low-quality public goods and a high degree of fiscal evasion. The authors have analyzed a substantial number of Eastern European and former Soviet Union transitional economies and they found that businesses react to an increasing degree of politicization of private-sector activities with a tendency of withdrawing from the formal sector¹⁸, which implies that, without synchronous reforms to strengthen market-supporting institutions, macroeconomic stabilization is not sufficient for maintaining high economic growth. Friedman (2000) further enhances their finding by claiming that selective application of rules/rule of law, and the corruption that this system inefficiency produces, seems to have a more important effect¹⁹ than for e.g., higher marginal tax burden, which are frequently cited as a principal reason for large informal sectors.

World Economic Forum annual global competitiveness indexing, based on established 12 pillars/factors (See Figure 2), reveals the policy landscape that unavoidably has an impact on the informal economy in a regional and temporal context. Macedonia experienced worsening of the indicators which brought her ranking 8 positions (68th) in the period of 2016-2017. Largest space for improvement remains in the pillars: infrastructure, market size, technological readiness and innovation. Unlike other years, mostly due to the prolonged political crisis, **policy instability now represents the most problematic factor for doing business in Macedonia** followed by access

12 Ibid, p. ii.

13 Ibid, p. 1.

14 World Bank, The World Bank Group in Kosovo, Country Snapshot (2015). Accessed 07.10.2016
<<http://www.worldbank.org/content/dam/Worldbank/document/eca/Kosovo-Snapshot.pdf>>

15 Riinvest Institute, "To Pay or Not to Pay - A business perspective of Informality in Kosovo" (2013).
<http://riinvestinstitute.org/publikimet/pdf/BUSINESS_INFORMALITY_5mm_bleed_no_inside_ENG_FINALV_31396438573.pdf>

16 The World Bank GINI Index data (2006-2013), Accessed 15.09.2016
<<http://data.worldbank.org/indicator/SI.POV.GINI?locations=XK>>

17 Colin C. Williams, "The undeclared sector, self-employment and public policy", International Journal of Entrepreneurial Behavior & Research, Vol. 11 Iss: 4, pp.244 – 257, accessed 28.09.2016
<<http://www.emeraldinsight.com/doi/pdfplus/10.1108/13552550510603289>>

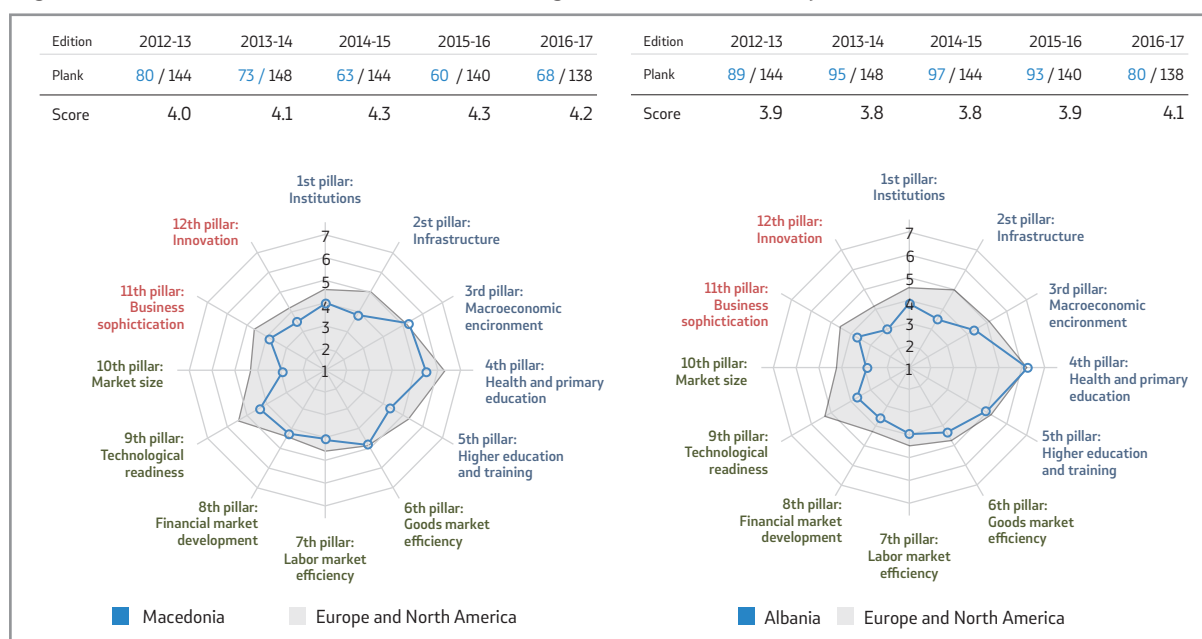
18 Johnson, Simon, Daniel Kaufmann, and Andrei Shleifer, (1997), "The Unofficial Economy in Transition" Brookings Papers on Economic Activity, No. 2, pp. 159-221.

19 Friedman, Eric, Simon Johnson, Daniel Kaufman, and Pablo Zoido-Lobaton, (2000), "Dodging the Grabbing Hand: The Determinants of Unofficial Activity in 69 Countries," Journal of Public Economics, Vol. 76 (June), pp. 459-93. P.481.

to financing, inadequately educated work force, and poor work ethic in national labor force. Albania improved its ranking by 13 positions (80th) and in the 2016-2017 period shares the same space for improvement as Macedonia - infrastructure, market size, technological readiness and innovation. However **the most problematic factors for doing business in Albania start with corruption at the top and followed by tax rates, inadequately educated work force, access to financing, and once again, policy instability.** In the latest 2017-2018 WEF report²⁰ Albania improved by 5 more positions (75th) but their most problematic factors changed slightly with the first being tax rates, followed by corruption, access to financing, and tax regulations.

These rankings, year by year, provide a general picture of potential or contemporary elements of undeclared labor and tax evasion and help researchers target the sources and manifestations of hidden economic activities.

Figure 2 - Macedonia's and Albania's rankings in the Global Competitiveness Index (2016-2017).



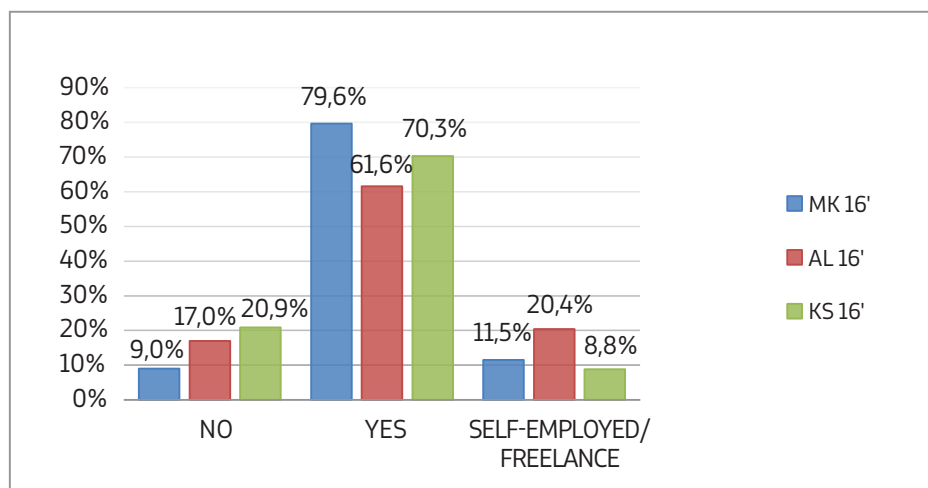
Source: World Economic Forum

http://www3.weforum.org/docs/gcr/2015-2016/Global_Competitiveness_Report_2015-2016.pdf.

20 Global Competitiveness Index (2017-2018). Source: World Economic Forum
<http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017%E2%80%932018.pdf>.

III. UNDECLARED LABOR – SURVEY RESULTS

Figure 3 - Do you have a written contract for your primary job (Q.3)?



Source: CRPM/IDM/D4D survey 2016 (population).

Almost half of all employees in Macedonia have part of their salary hidden, and every fifth employee in Kosovo and Albania work without a written employment contract. Written employment contracts represent an important instrument with which employees acquire legal protection under the labor law and ensure payment of social and healthcare contributions. The lack of a written contract thereof represents a source of employee insecurity and an incentive for hidden economic activities such as undeclared labor coupled with unfair competition among employers which usually follows hidden economic activities. The international Labor Organization has also concluded that “On average, compared to formal workers, informal workers have lower earnings and face higher risks, are less likely to enjoy economic opportunities and legal protections, and are less able to exercise economic rights and collective voice.”²¹ Figure 3 shows that **9% of all Macedonian employees work without a contract (a rise from 7% in 2014)**, and are not being paid any social security contributions whatsoever.

The percentage of these employees **in Albania and Kosovo is double and represents 17% and 21%** respectively of all employees. Using the absolute values for no contract responses from Figure 2 and compiling them with the data from Figure 5 below indicates that the percentage of hidden salaries remains the most acute concern, with the **employment income of around ½ of employees in Macedonia (44%, a rise from 40% in 2014), 36% in Albania and 37% Kosovo being partially or completely undeclared.**²²

21 ILO (2013) *Labour inspections and undeclared work in the eu*. Accessed on 25.08.2016

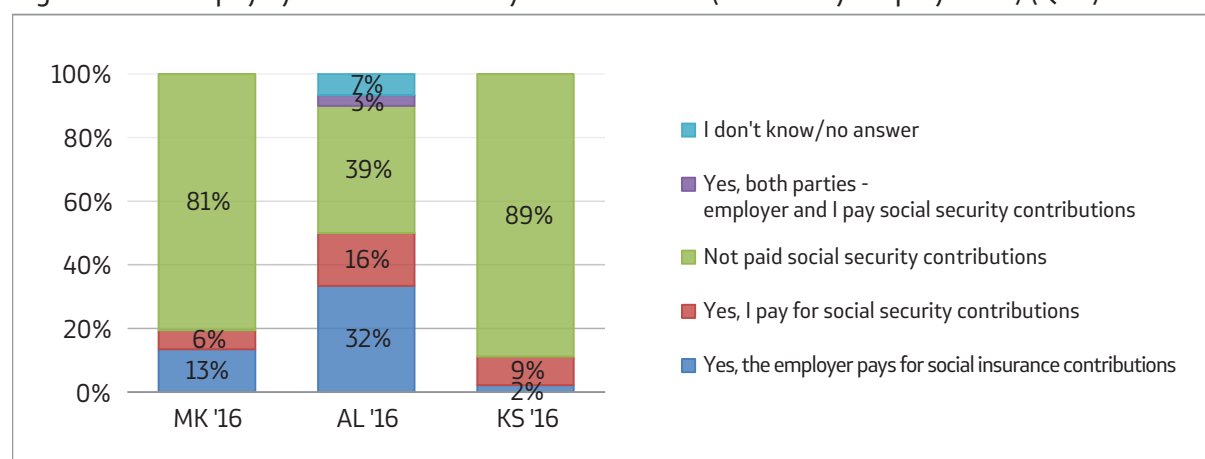
<http://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---lab_admin/documents/publication/wcms_220021.pdf>

22 The different percentages for the category “No Contract” in Figure 4 vs Figure 2 can be accounted to the use of the absolute values from Figure 2 or question Q.3 from the survey into the percentage calculation of the values in Figure 4 or question Q.7A from the survey. Simply adding the “No Contract” percentages from Figure 2 to Figure 4 would not have been methodically correct.

Secondary/additional employment plagued by absence of written contracts

When it comes to secondary / additional occupation, including the self-employed, the situation is more concerning with the vast majority of secondary occupations in Macedonia and Kosovo (**around 90%**) being performed without a written contract. In cases where contracts do exist, they are usually fixed term, authorship agreement, or another type of temporary service contract. Albania seems to fair better than the other two countries with still sizeable 55.6% of employees with secondary occupation not having a written contract (including the self-employed).

Figure 4 - "Who pays your social security contributions?(secondary employment) (Q.13)"



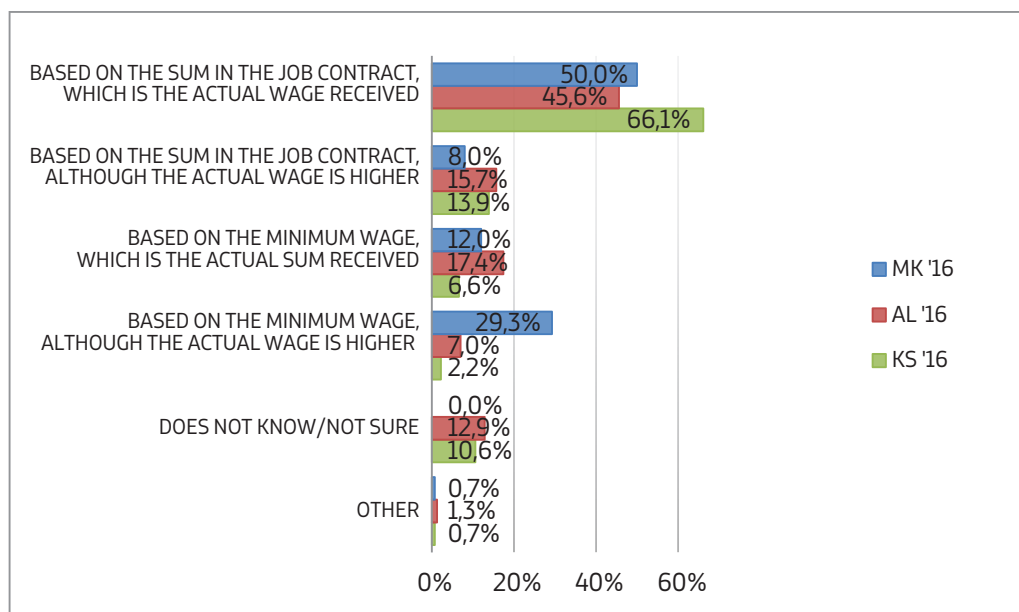
Source: CRPM/IDM/D4D survey 2016 (population).

In line with this, social security contributions are also not being paid in more than 80% of the cases in Macedonia and Kosovo, and 39% in Albania. Additionally, healthcare insurance for secondary employment is not paid by 77.3% of employees in Macedonia, and 100% in Kosovo.

Secondary/additional employment characterized by extremely low levels of payment of social security, healthcare contributions and personal income tax.

Albania again fares much better in this respect due to the different payment system for social and healthcare contributions where comparatively just 1/3 of secondary employment employees not having it paid. **Around 60% of respondents in Macedonia and Albania, and almost 90% in Kosovo do not report and/or pay personal income tax for their additional activity.**

Figure 5 - What is the wage amount on which your social security contributions are being paid by your employer (Q.7A)?



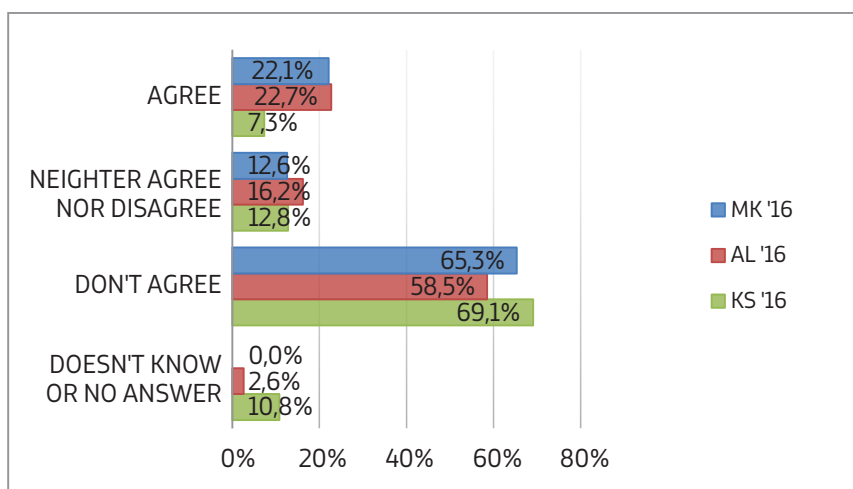
Source: CRPM/IDM/D4D survey 2016 (population)..

Having or not having a contract does not necessarily show the full spectrum of hidden employment. As presented in Figure 5 the difference between the wages written in the contract and the actual amount paid (through envelope wages or other types of temporary service contracts) also provides a good insight that inspectors and labor ministers can use to appropriately tweak their measures aimed at tackling undeclared labor. As the first figure shows, more than **1/3 (37.3%) of employees in Macedonia, 1/4 (22.7%) in Albania and 1/5 (20.5%) in Kosovo have their social security contribution paid by employers on contracted wages that are lower than the actual wage they receive.** The situation in Macedonia is slightly worse than in 2014. While in Macedonia and Albania around half of employees have wages paid that equal the amount established in their contracts Kosovo employees fair better in this category with 66.1% confirming this good practice. The difference, again, might be accounted by the fact that Kosovo employers are not legally bound to pay for their employees' health insurance.

Negative perceptions over state social and healthcare insurance might fuel incentives for informality

While assessing their level of agreement with different statements related to the hidden economy, it becomes evident that the current level of satisfaction with their wage for many workers is much more important than the long-term security implied with regularly paid social and healthcare contributions. Specifically, **22.1% responded that they would rather be an undeclared worker with a higher wage, than a declared one with a lower wage in Macedonia, 22.7% in Albania and, interesting enough, just 7% in Kosovo.** Kosovars have positive perceptions over formal economy and view it as more stable in the long-term given the benefits they will ultimately gain in terms of pension contributions.

Figure 6 - Level of agreement with the statement 'I would rather be an undeclared worker with a higher wage, than a declared one with a lower wage' (Q MK11 E)..

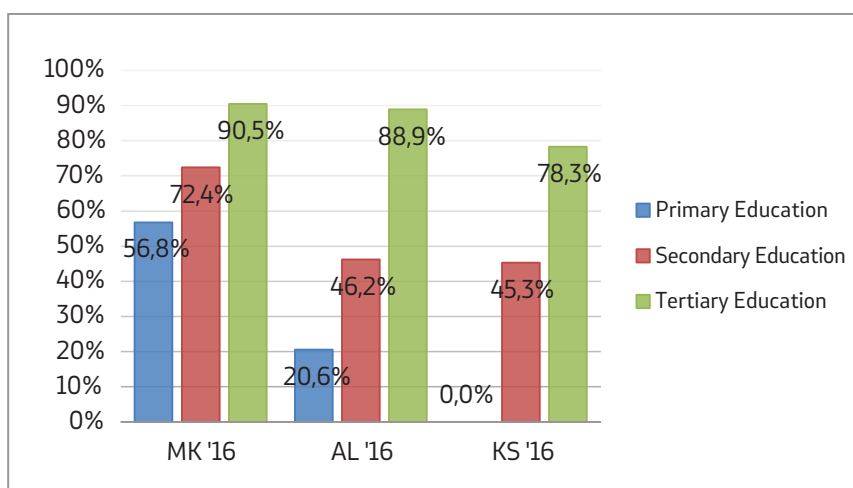


Source: CRPM/IDM/D4D survey 2016 (population).

Disagreement with the statement on the other hand is solid across all three countries ranging from 65.3% of employees in Macedonia (improvement from 58.6% in 2014), 58.5% of employees in Albania, to a high of 69.1% in Kosovo.

Education, not surprisingly, plays an important role in shaping perceptions, future decisions, and available job opportunities in the context of the specific labor market and its elements of demand and supply. The data strongly indicates that education plays a significant role in the distribution of written contracts acquirement which is evident by looking at the different levels of educational attainment. This is a hint for regulatory bodies as to where to dedicate more resources in detection but also in increasing targeted educational measures on a local and national level.

Figure 7 - Percentage of population with written contract for primary job according to educational attainment % (Q3 vs Q.D3).



Source: CRPM/IDM/D4D survey 2016 (population).

The data shows noticeable differences with regards to educational attainment levels where only 56.8% of employees in Macedonia, 20.6% in Albania and none in Kosovo²³ with primary education have acquired a written contract for their primary job. The situation for employees with tertiary education further enhances the importance of education as 90.5% of employees in Macedonia with tertiary education, 88.9% in Albania and 78.3% in Kosovo have acquired a written contract for their primary job (See Figure 7). The data clearly show, unsurprisingly, that the probability of working under a written job contract increases with the level of educational attainment, and this is especially drastic when employees move from attaining primary to secondary education.

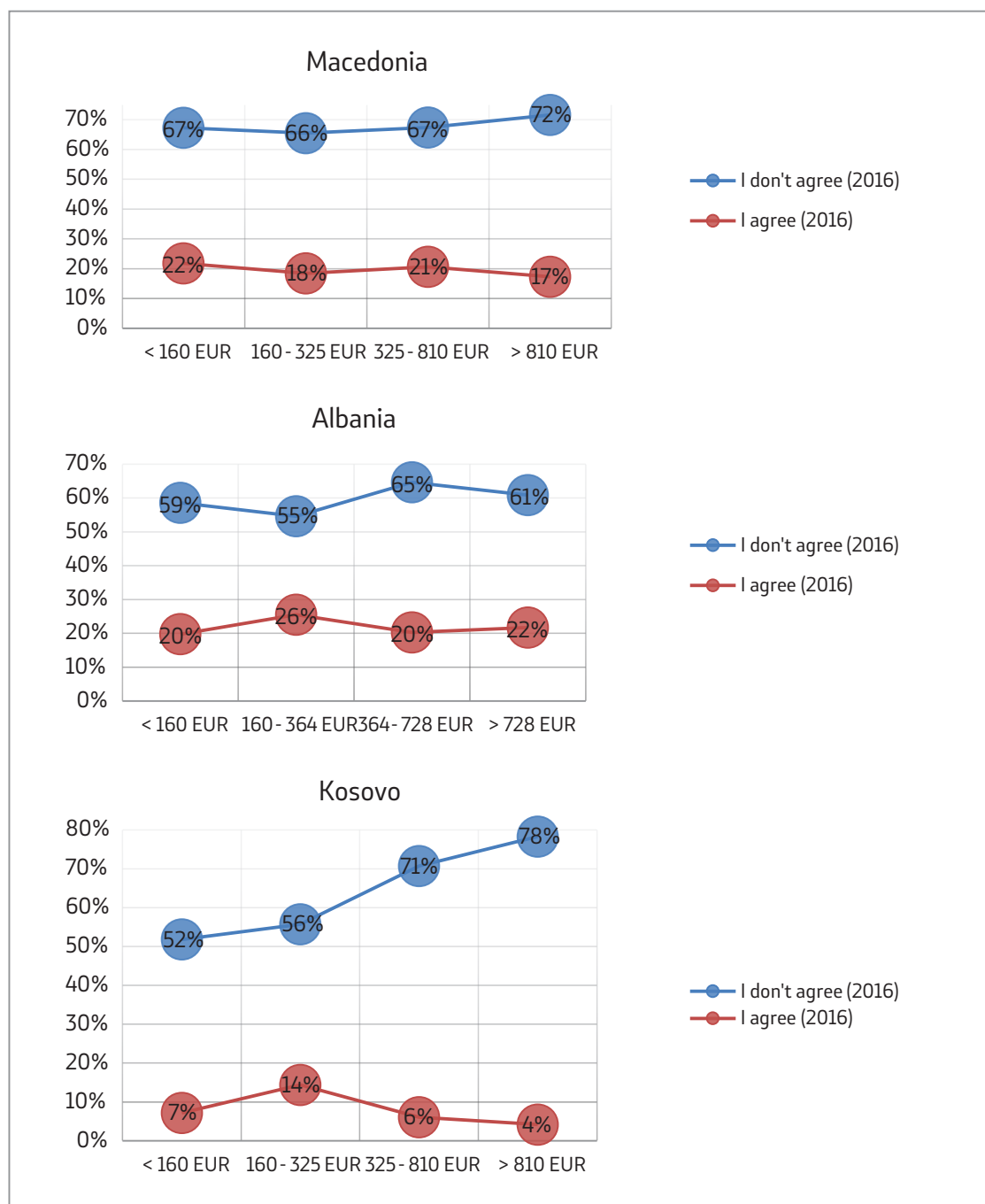
Mashing up the data from the previous question with the total household income present an additional view into the incentives for engaging in hidden labor and/or tax evasion (See 8). Between 67% and 72% of Macedonian employees disagree with the statement while between 22% and 17% of them agree with the statement similarly across all household income levels. This is a big improvement from 2014 (flattening of the agreement/disagreement curves) especially in the household income levels ranging from 0 to 325 EUR. Kosovo employees appears to follow similar perceptions as the ones in Macedonia in 2014 which goes in favor of the argument that the problem of undeclared work is in great deal related to the high poverty levels and is actually a coping mechanism used by individuals when trying to make ends meet with the finances they have. Nevertheless, this type of opinion and consequent behavior enhances the risk of economically disadvantaged groups to become even more at risk when in need of social security safety net.

Progressive tax system implemented without positive measures to incentivize high earners to declare labor and pay their taxes is deemed to enhance incentives for hidden economic activities i.e. tax evasion.

The data on Albania however tells a different story. Generally what we want to see is upward curving disagreement slopes and downward curving agreement slopes. This is in line with the fact that Albanian employees living in households earning up to 728 EUR agree and disagree with the statement in percentages relatively similar to what can be seen in Macedonia and Kosovo. **However level of agreement decreases from 65% to 61% for wealthier employees—living in household earning incomes larger than 728 EUR.**

23 The reason for this is that the in survey sample from Kosovo just 9% of respondents have primary education or less. And of those almost all are unemployed or just have a secondary activity with no employment contract.

Figure 8 – Macedonia, Albania and Kosovo, (Dis)agreement with the statement ‘I would rather be an undeclared worker with a higher wage, than a declared one with a lower wage’ and monthly household income (Q. D27B vs. MK11E).



Source: CRPM/IDM/D4D survey 2016 (population).

There can be many intertwined factors responsible for this discrepancy but one of them might be related to the fact that since 2014 Albania canceled its 10% flat income tax rate and introduced progressive income tax of 13% for incomes between 220 and 950 EUR as well as a 23% income tax of employees with income larger than 950 EUR.²⁴ The progressive income tax is an additional tax burden which might incentivize higher earning employees to have a negative attitude

²⁴ Invest in Albania website, Short overview of the Albanian tax system. Accessed 05.10.2016
<<http://invest-in-albania.org/taxation-system/>>

towards formalizing businesses which in turn can lead them to seek ways in avoiding to declare their activity or other measures to evade paying taxes despite having the means to do so. The findings that will be presented in the following brief on hidden economy and tax evasion will provide more context and data on the possible relation among these factors.

IV. THE HIDDEN ECONOMY SURVEYS AND INDEXES

The methodology developed for calculating the hidden economy index based on the specific population and business surveys has been developed by the Center for the Study of Democracy – Bulgaria and adjusted with the help of CRPM to be used in Macedonia, Albania and Kosovo. The index consists of **Hidden employment** on one hand and **Hidden turnover** on the other.

Hidden Employment – this index summarizes employment victimization in terms of major ways to hide taxes and social and health security at the expense of both the state and the worker. It includes three sub-indices (undeclared work, hidden social security and hidden health security):

1.1. Undeclared work places

1.1.1. Share of employed without formal contracts

1.1.2. Share of employed with hidden clauses

1.2. Hidden social security

1.2.1. Share of employed without social insurance

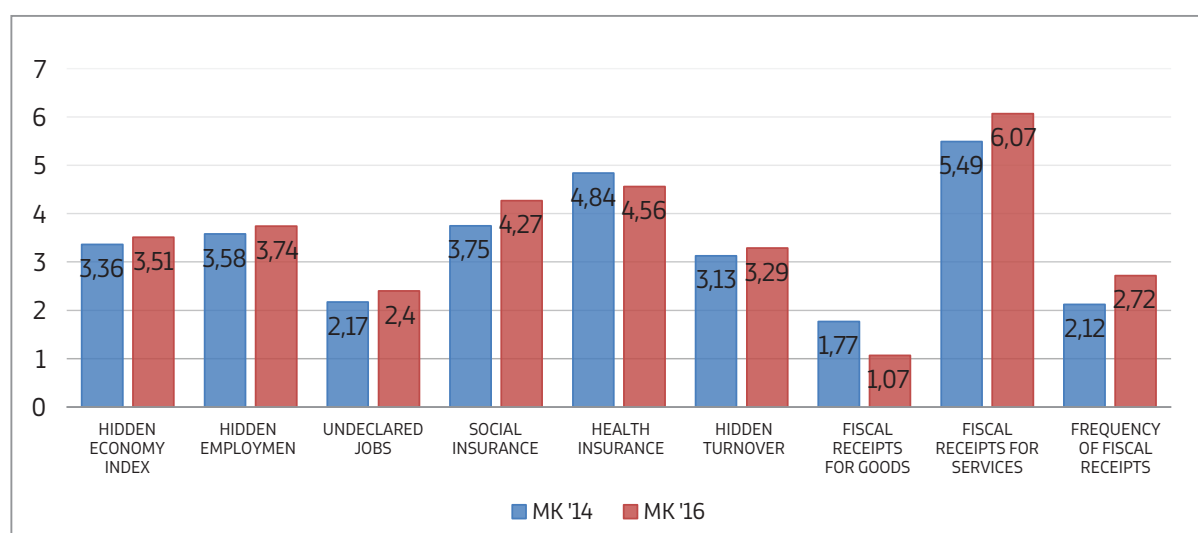
1.2.2. Share of employed with partially hidden social insurance

1.3. Hidden health security

1.3.1. Share of employed without health insurance

1.3.2. Share of employed with partially hidden health insurance

Figure 9 - Hidden Economy Index and sub-indices (population) for Macedonia (2014-2016)..



Source: Population survey CRPM/CSD 2014 and CRPM/IDM/D4D Survey 2016

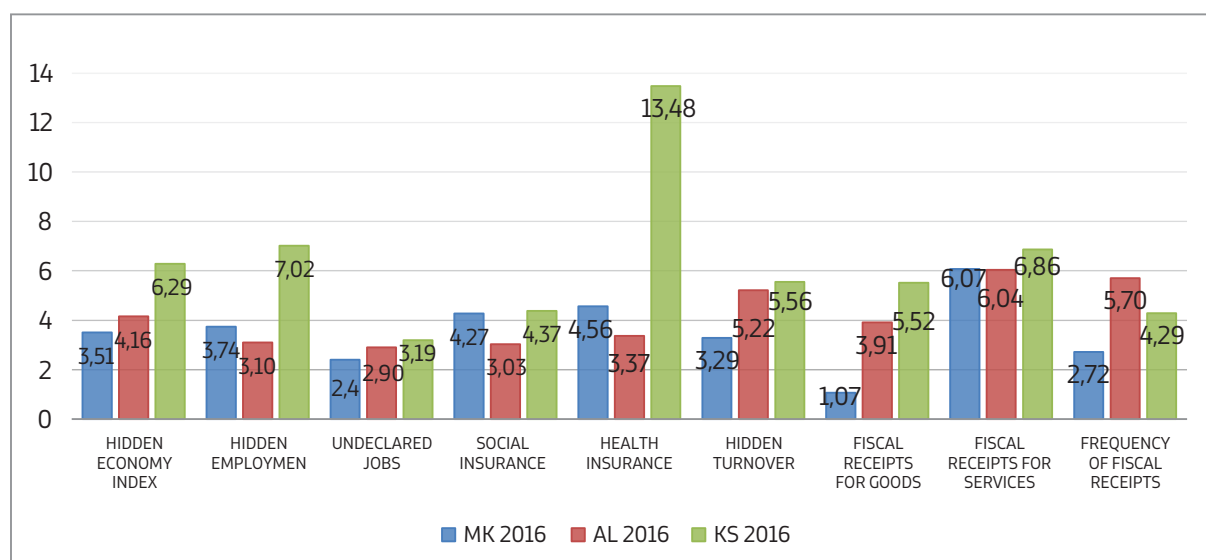
Hidden Turnover – captures the extent to which documents and fiscal receipts are not being issued on purchase. The index includes the following sub-indices:

2.1. Frequency of not issuing of tax receipts for certain larger sales;

2.2. Frequency of not issuing of tax receipts for certain services

2.3. Average-weighted frequency of not issuing fiscal receipts for purchasing certain groups of goods from retail shops.²⁵

Figure 10 - Hidden Economy Index and sub-indexes (population) for Macedonia, Albania and Kosovo.



Source: Population survey CRPM/CSD 2014 and CRPM/IDM/D4D Survey 2016

The hidden economy index paints an interesting picture for each country separately and for the smaller region as a whole and its underlying economic realities. For example, Macedonia experienced **slight worsening (larger values) from 3.36 in 2014 to 3.51 in 2016** across the board in most categories of the hidden economy index for 2016 (See Figure 10). **Improvement** is only evident in categories **Health Insurance (index of 4.56 down from 4.84)** and **Fiscal Receipts for Goods (index of 1.07 down from 1.77)**. As it is noted throughout the text, Macedonia has been entangled in a **major and ongoing political crisis since 2014** which has affected the efficiency of the government institutions as a whole and is highly likely to be the one of the driving factors for the negative changes in the Hidden Economy Index.

As we will go more in detail in the subsequent parts of this analysis we will confirm the survey and index findings which suggest that there is a better fiscal discipline in Macedonia compared to the other 2 countries judging by the sub-indexes for **Fiscal Receipts for Goods and Frequency of Fiscal Receipts**. Where those index values are 1.07 and 2.72 (respectively) in Macedonia those same categories carry more than double the values with them being 3.91 and 5.70 in Albania and 5.52 and 4.29 in Kosovo.

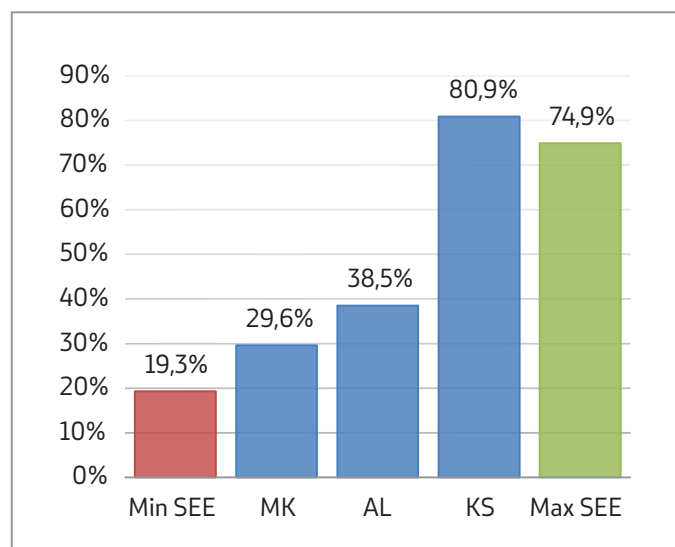
Citizens are aware and accept the widespread hidden economy as inevitable part of everyday life; they are apprehensive of its negative impact over the local economy and that it spurs unfair competition among businesses. They also consider bribing to be generally tolerated behavior, and at the same time that it's one of the factors for the prevalence of hidden economy.

Kosovo has the highest hidden economy index (largest values), index of 6.29 followed by Albania (4.16) and Macedonia (3.51) and is leading in most of the index subcategories. Hidden employment index of 7.02 is almost double the values for Macedonia (3.74) and Albania (3.10). Healthcare Insurance category breaches the maximum index limit of 10 due to the fact that employers on Kosovo are not responsible for paying their employees' health insurance.

²⁵ Hidden Economy Index methodology as defined by the Center for the Study of Democracy (CSD) – Bulgaria.

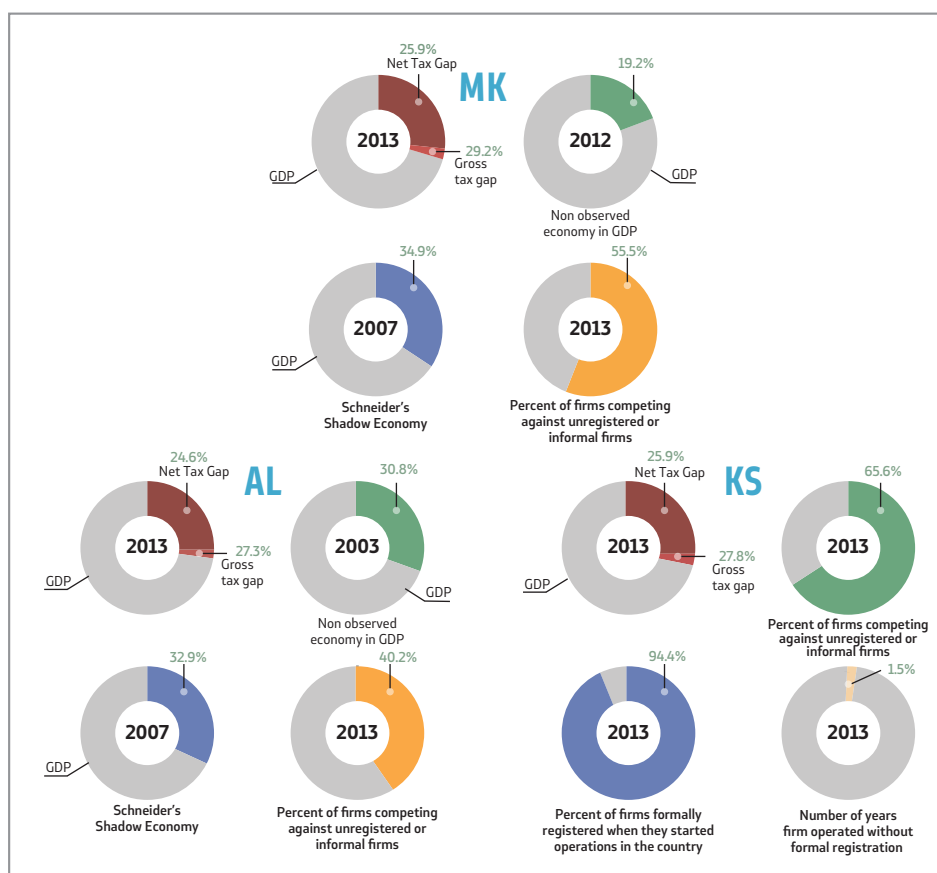
SELDI's Regional Assessment Report 2016 which is guided by the same methodology that assesses the hidden economy index shows similar patterns (Figure 11 and Figure 12). **Macedonia (29.6%) is close to the minimum value of the index encapsulating the countries of Southeast Europe (SSE) which ranges from minimum 19.3% to maximum 74.9% of the index. Albania stands in the middle with 38.5% while Kosovo exceeds the SSE maximum with reaching 80.9% of the index for SSE countries.**

Figure 11 - Hidden Economy Index according to SELDI's measurements in 2016.



Source: SELDI, Hidden Economy and Good Governance in Southeast Europe: Regional Assessment Report 2016.

Figure 12 - Key Hidden Economy Indicators for Macedonia, Albania and Kosovo.



Source: SELDI, Hidden Economy and Good Governance in Southeast Europe: Regional Assessment Report 2016.

V. TAXES AND REVENUES

There are wide regional and country differences in the size, scope and main sectors of operation of the undeclared economy in Europe which, according to Eurofound figures, averages around "18% of EU GDP, ranging from below 8% of GDP (Austria) to over 30% of GDP (Bulgaria). Undeclared work is most prevalent in the building industry, but is also widespread in household services, private security, industrial cleaning, agriculture, and the hotel, restaurant and catering industry."²⁶ Unavoidably the policy and economic landscape of the country in question creates particular sets of incentives which then produces specific costs and benefits to engage with the hidden economy. Uncovering those specific positive and negative incentives inherently leads to policy solutions.

Tax evasion follows this distinctness among countries which is generated, among other factors, by the specific social and healthcare insurance systems, tax rates, and efficiency of its tax authorities and adopted compliance measures, awareness, as well as trust in government institutions.

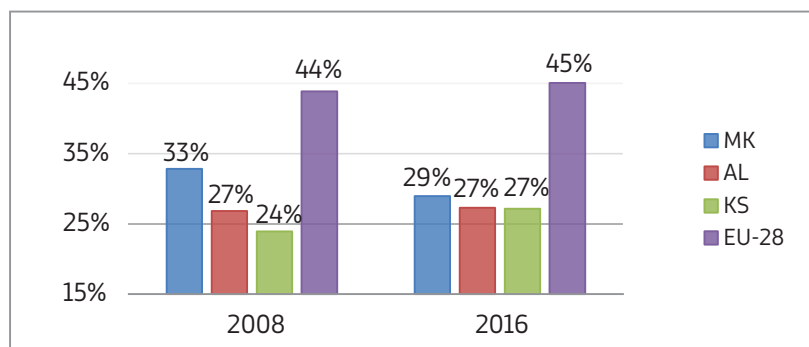
	Albania	Macedonia	Kosovo
Social security contributions (total rate)	27.9% (11.2% employee rate, 16.7% employer rate)	27% (13.5% employee rate and 13.5% employer rate)	10% (5% employee rate and 5% employer rate)
Corporate income tax	15%	10%	10%
VAT	20%	18%	18%
Individual income tax	Progressive rate 0%, 13% and 23%	Flat rate 10%	Progressive rate 0% (0-80 eur), 4% (81-250 eur) and 10% (> 450 eur)

Source: IMF Country Report No. 16/143, Albania, June 2016

Comparing levels of government revenues as a share of GDP or per capita across countries, provides an indication of the importance of the public sector in the economy in terms of available financial resources and is determined by past and current political decisions a government takes. General government revenues can also be used as an indicator of undeclared activities in the informal economy or how much of the economic activity escapes government oversight and taxation, especially in developing countries. **Macedonian revenues to GDP are at 29% in 2016, Albanian and Kosovan at 27% which are much lower than the EU-28 average of 45% of GDP (Figure 13).** Even though it is understandable for most of developing countries to have such a low revenues-to-GDP ratio it is a worrying prospect if that ratio does not improve during the course of 8 years. Even more so, Macedonia experiences a worsening of the revenues-to-GDP ratio from 33% in 2008 to 29% in 2016 despite the positive movements in its economy, increased FDIs, increased social security and healthcare contributions, and increased tax revenues. Albanian revenues-to-GDP ratio has remained the same in the past 8 years (but shows improvement from 2006 to 2016 moving from 26% to 27.1%) while the Kosovan experiences a slight improvement from 24% in 2008 to 27% in 2016.

26 European Parliament News (02.02.2016) "European platform to tackle undeclared work." Accessed 19.07.2016 <<http://www.europarl.europa.eu/news/en/news-room/20160129IPR11935/European-platform-to-tackle-undeclared-work>>

Figure 13 – General Government Revenue as % of GDP.



Source: IMF World Economic Outlook

<https://knoema.com/IMFWE02014Apr/imf-world-economic-outlook-april-2014?tsId=1025200>

1. Macedonia

Mojsoska-Blazevski's (2011)²⁷ research on the influence of labour legislation changes over the employment rate and the size of the informal economy showed a marginal effect of the flat tax policy. The author finds that **'the reduction of social security contributions had a positive impact on the employment rate, in contrast with the impact of the flat tax reform.'** She concludes that the social security and tax reforms aimed at reducing labour costs had the following positive effects: (a) helped employees during the crisis, (b) had an effect on employment, (c) increased the net wage, (d) diminished the extent of informal economy, (e) improved tax compliance, and (f) increased the number of individuals insured in the pension system.²⁸

The overall tax burden in Macedonia remains low in the period of 2010-2016. However the tax burden remained relatively high in particular for low skilled labour, "caused by the minimum base for payment of social insurance contributions, which was prescribed at 65% of the national average wage rather than on the individual wage and at around 50% for health insurance on average (differentiated by branches, with higher relative burden on branches with lower average wages)."²⁹

Looking at the statistical data (Figure 14) coming from the Public Revenue Office (PRO), a **positive trend has been evident in tax revenues from pension and disability, and healthcare contributions**, especially since 2008 with an average annual increase of total contributions by 4.95%. However, revenues from pension and disability contributions and employment contributions have not increased dramatically. In fact, throughout the 2008-2016 period, the annual revenues increased by a total of 29% and 20% respectively since 2008 and remain at average annual values of 29 billion MKD (471 mln. EUR) and 1.8 billion MKD (29.2 mln. EUR) respectively. The positive trend in total tax revenues from social security contributions stems predominantly from the rapid increase in revenues from healthcare contributions, which in 8 years has more than doubled from 11 billion MKD in 2008 to 23 billion MKD in 2016. This could be attributed as

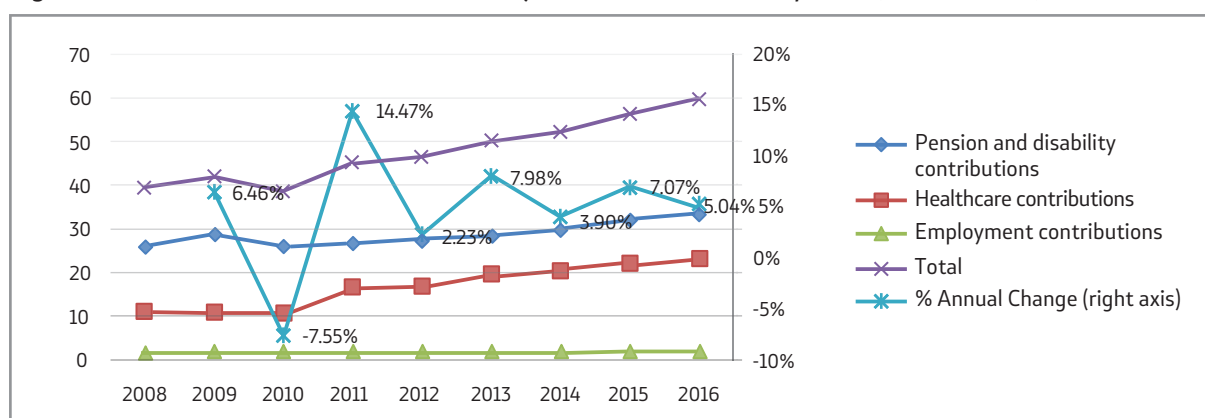
27 Dzhekova, Franic, Mishkov, C. Williams (2014), "Tackling the Undeclared Economy in FYR Macedonia" GREY Working Paper No. 3, University of Sheffield. Retrieved from: http://www.grey-project.group.shef.ac.uk/wp-content/uploads/2014/08/WP3-Tackling-the-Undeclared-Economy-in-FYROM_10072014.pdf

28 Dzhekova, Franic, Mishkov, C. Williams (2014), "Tackling the Undeclared Economy in FYR Macedonia" GREY Working Paper No. 3, University of Sheffield. p.44-45. Retrieved from: http://www.grey-project.group.shef.ac.uk/wp-content/uploads/2014/08/WP3-Tackling-the-Undeclared-Economy-in-FYROM_10072014.pdf

29 Trpeski P., Tashevska B. (2012) *Labour Tax Wedge in the Republic of Macedonia – Trends and International Comparison*. Annales Universitatis Apulensis Series Oeconomica, 14(2), 2012, p.575. Retrieved from: <http://www.oeconomica.uab.ro/upload/lucrari/1420122/24.pdf>

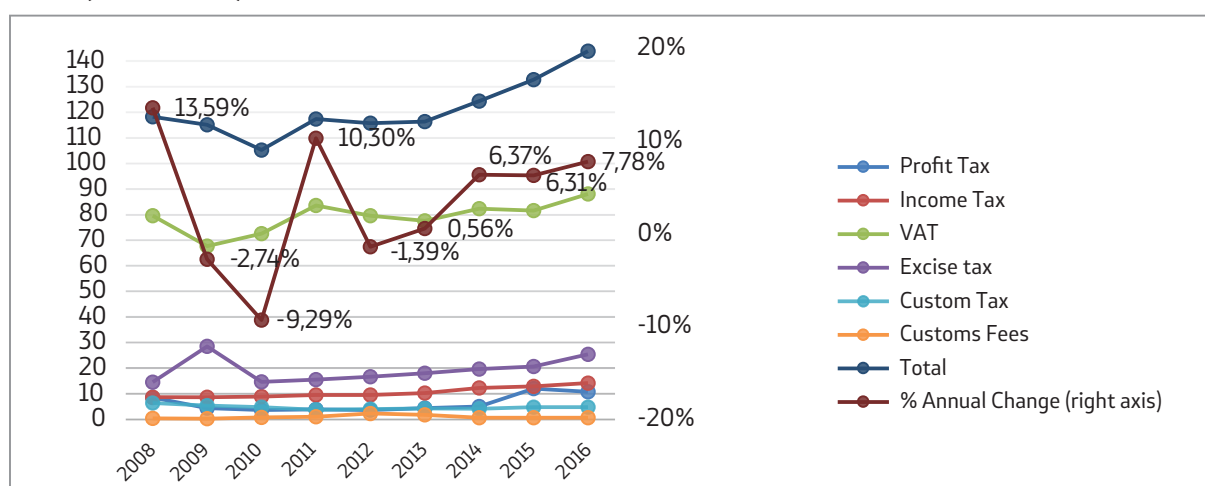
a positive effect of the consecutive amendments applied to the Law on Mandatory and Social Security Contributions (LMSSC).³⁰

Figure 14 - Tax revenues from social security contributions for the period (2008 - 2016).



Source: Public Revenue Office of Macedonia.

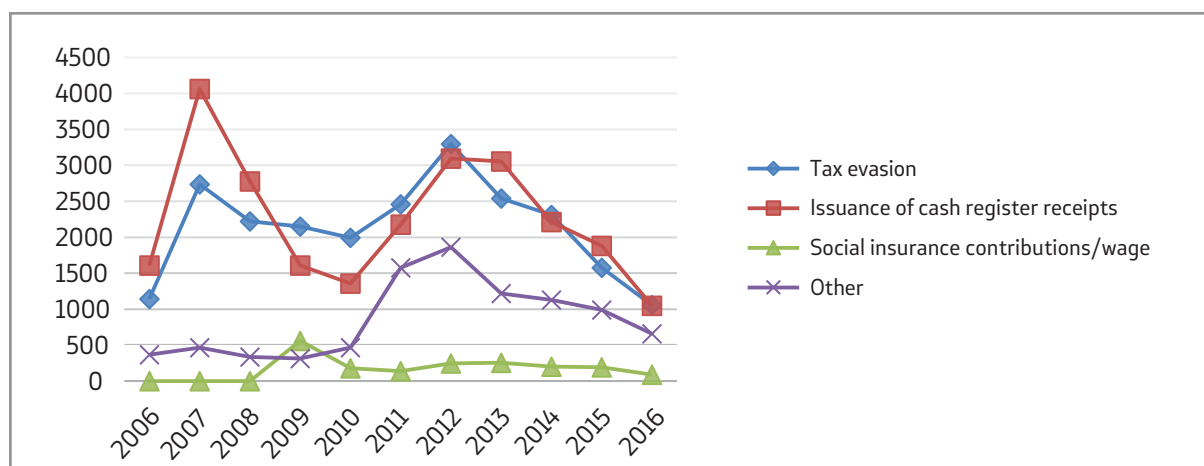
Figure 15 - Tax collection rates of the Public Revenue Office and Customs Administration in Macedonia (In bln. MKD).



Source: The PRO <http://ujp.gov.mk/mk/statistika/naplata/1/0/0> and Custom <http://www.carina.mk/DesktopDefault.aspx?tabindex=0&tabid=57>

30 Dzhekova, Franic, Mishkov, C. Williams (2014), "Tackling the Undeclared Economy in FYR Macedonia" GREY Working Paper No. 3, University of Sheffield. Retrieved from: http://www.grey-project.group.shef.ac.uk/wp-content/uploads/2014/08/WP3-Tackling-the-Undeclared-Economy-in-FYROM_10072014.pdf p.44

Figure 16 - Reports of irregularities through the Macedonian PRO's hot line (198) and E-report

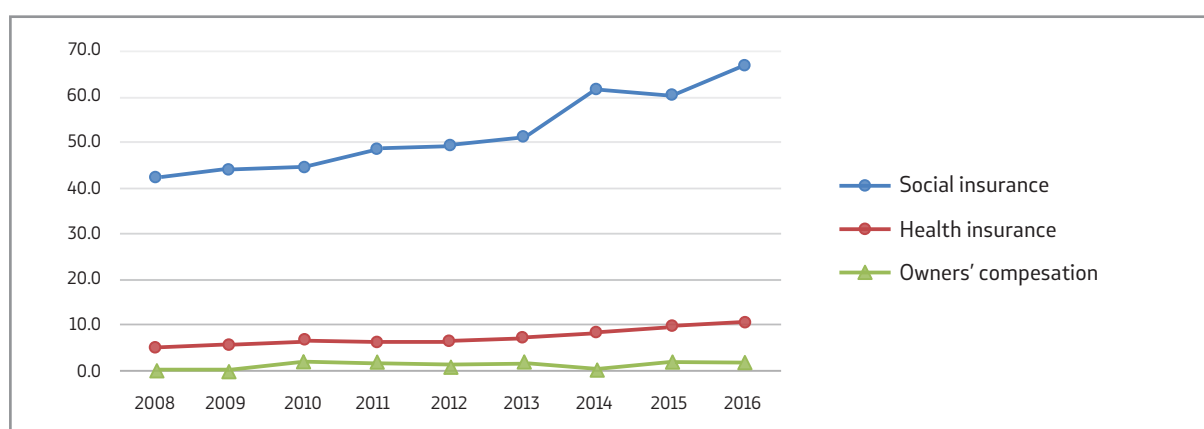


Source: PRO statistics <http://ujp.gov.mk/mk/statistika/naplata/9/0/0>

2. Albania

Since 1997 Albania is making efforts to establish a system of taxes and fees according to EU member countries. A flat tax rate of 10% as well as other fiscal facilities were implemented 2008, which lead to an increasing overall tax revenue at least till 2011. However it must be noted (as in Figure 13) Revenues as a % of GDP have decreased or remained the same since 2008 or at 27% of GDP. Furthermore tax revenues to GDP fell from 26.9% of GDP in 2008 to 24.8% of GDP in 2012 during the secondary economic crisis spured by the 2008 crisis, thus the impact of flat tax has not been so positive regarding tax revenues, although it acted as an amortization for the businesses during the economic crisis after 2008. In 2013 Albania's new elected government signed a three-year agreement with the International Monetary Fund (IMF), cash securing in exchange for obligation to tighten fiscal discipline³¹. This support helped to reverse the decreasing tax revenues that Albania experienced in the period 2011-2013, mainly through an increase of revenues coming from social contributions and profit tax. Tax rates were enhanced across the board such as corporate taxes, from 10 to 15% as well as the excise taxes. In 2014 the personal income tax was changed from a flat tax rate to a progressive tax rate system. Because 60% of the taxpayers are below the zero-rate threshold, this reform weakened revenue collection.

Figure 17 - Tax revenues in Albania from social security contributions for the period (2006- 2015) in bln. leki.



Source: Ministry of Finance of Albania.

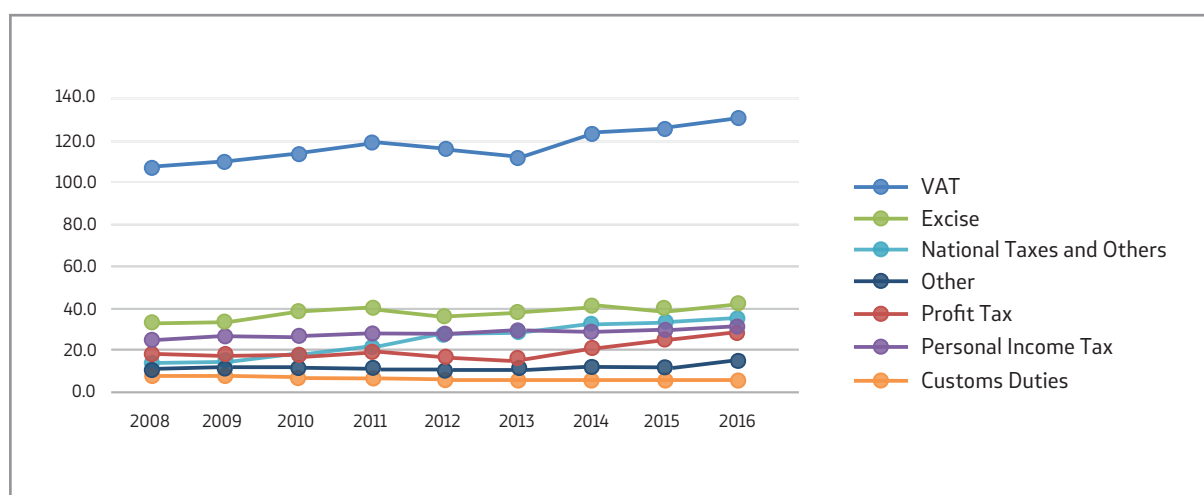
³¹ Balkan Insight:
<http://www.balkaninsight.com/en/article/albania-government-starts-major-crackdown-against-fiscal-evasion-09-01-2015> - sthash.Y4xeKWdm.dpuf

The increase in excise duty rates for tobacco and gasoline products in 2015, didn't have an increasing effect on tax collections. The reason for this might be the anticipation of duty raise and therefore noncompliance of imports and exports or, less likely, simply a decrease in consumption of those goods. The government decided in 2016 to draft and implement a law with which it abrogated the small business tax as well as exempted small and micro businesses from profit taxes, which will likely decrease tax collections but stimulate economic processes.³² Because of the low tax efficiency, numerous tax exemptions and challenges with tax compliance, tax revenues are expected to slightly increase until 2019. Additionally, the Albanian government is planning to abolish the VAT threshold from 35,000 EUR to zero (possibly from 2018), in an effort to tackle informality of small businesses.

Tax Evasion

The state of tax evasion in Albania is not clearly identifiable, mainly because there are no accurate statistics or reports of the responsible institutions³². Due to the developing bureaucracy and high volume of cash transactions, it is difficult to collect the necessary data. According to the International Monetary Fund, the VAT noncompliance derived from C-efficiency can be taken as approximation to tax evasion. They estimate a compliance gap of 34-39% of the potential VAT³³, which is slightly higher than the regional average and has an increasing trend since 2008. Potential VAT revenues for EU countries is 15 %. This increasing trend seems to be caused by worsening compliance, mostly because of substantial smuggling and fraud in excise duties in Albania such as road fuels and cigarettes.

Figure 18 - Tax collection rates in Albania of the Public Revenue Office (In bln. Lek).



Source: Ministry of Finance of Albania.

Albania's black economy is estimated to be at 33% of the GDP³⁴ in 2014, which is largely above the European average of 18.6%.³⁵ In September 2015, the government launched a campaign against informality aiming to address the tax evasion issue, particularly through better control, registering employees and small business as well as countering tax noncompliance. Although it was highly expected from the main actors, due to its intensity and stronger focus on smaller businesses it did

32 International Monetary Fund, Staff Report Albania 2016, <https://www.imf.org/external/pubs/ft/scr/2016/cr16142.pdf>

33 Hysen Muceku, Altin Muca, 'Informal Economy in Albania – Its Costs in the Country Development' (2014) 5(9) Mediterranean Journal of Social Sciences 642, 64

34 International Monetary Fund, Albania June 2016 <https://www.imf.org/external/pubs/ft/scr/2016/cr16143.pdf>

35 Bright Line Law: An insight into tax evasion, money laundering and the Albanian black economy 2016 (<https://www.brightlinelaw.co.uk/Latest-News/An-insight-into-tax-evasion-money-laundering-and-the-albanian-black-economy-1.html>)

not have the expected results and contributed to the deterioration of the business climate in the country. Currently the approach of tax office has changed, being more collaborative and focused mainly on smarter targeting through risk analyses.

The complexity of the tax system places a substantial burden on business. The number of tax payments and hours needed to pay taxes are 19 and 43%, respectively, higher than the Western Balkan average. General government revenues, both tax and non-tax, are lower in Albania than the ones experienced by its neighbors. Consequently, public spending is rather parsimonious.

The tax burden is lower in Albania than in most other Balkan economies at least up until 2014. Compared with most neighboring countries, the Albanian tax collections are modest for most of the main tax sources. In particular, income taxes, property taxes, and above all social security contributions are substantially lower in Albania. Only revenues raised by VAT and CIT approach levels that are in line with those of comparator countries. Therefore, Albania relies as much on indirect taxes as on direct taxes: the share of VAT and excise tax revenues of total tax revenues is about 49%.

Albania's lower tax revenues are partly a consequence of the lower efficiency of taxes on wages (Figure 18). Tax efficiency is the ratio between each tax revenue for each tax (in percent of GDP) and the top tax rate. Tax efficiency for social security contributions and personal income tax appears to be lower in Albania than in other Balkan countries. For corporate income and value added taxes, tax efficiency in Albania is roughly in line with neighbors' performance, but there is a broad range of results.³⁶

3. Kosovo

In 2009 Kosovo becomes a member of the International Monetary Fund (IMF) and signed a „Stand-By Arrangement“, which will assure the support of Kosovo as well as establish the obligation of meeting numerous quantitative performance criteria. With this arrangement, tax laws for VAT, personal income tax and corporate income taxes were approved and workshops for taxpayers in all regions were implemented which have helped taxpayers to adjust to the amended tax legislation and the derived obligations.³⁷ Together with the installation of the Electronic Cash Registrars (ECR), which announced an obligation of registering cash money electronically, the overall tax revenues increased strongly and steadily. A big share is due to VAT which was increased in 2009 from 15% to 16% and in 2016 to 18%.³⁸

Because Kosovo relies heavily on indirect taxes collected at the border and has only a share of 14% of direct taxes, the Tax Administration Office recommended in 2011 to increase direct taxes. This included broadening tax bases for corporate income tax (otherwise a flat corporate income tax CIT) and an increase of the progressivity of personal income taxes (PIT), which could explain the changes in this year.³⁹ Both were set at 10% in 2013 from where the revenues remained increasing and had to compensate a minor decline in revenue collection from adverse price developments which affected the value of imports and thus lowered customs receipts.⁴⁰

The revenue in 2016 should have benefit from higher excises taxes (tobacco, alcohol and road fuels) and from the increase in V.A.T. from 16 to 18% of this year,⁴¹ as well as a new approach of

³⁶ IMF-Albania taxation

³⁷ Tax Administration of Kosovo, Annual Report 2010,

http://www.atk-ks.org/wp-content/uploads/2010/09/Raporti-Vjetor-2010_v_fundit_shtyp_ENG.pdf p. 18

³⁸ Vat Live, VAT news (16.09.2015) <http://www.vatlive.com/vat-news/kosovo-raises-vat-to-18/>

³⁹ International Money Fund, Staff Report 2011 <http://www.imf.org/external/pubs/ft/scr/2011/cr11374.pdf>

⁴⁰ International Money Fund, Staff Report 2013 <http://www.imf.org/external/pubs/ft/scr/2013/cr13379.pdf>

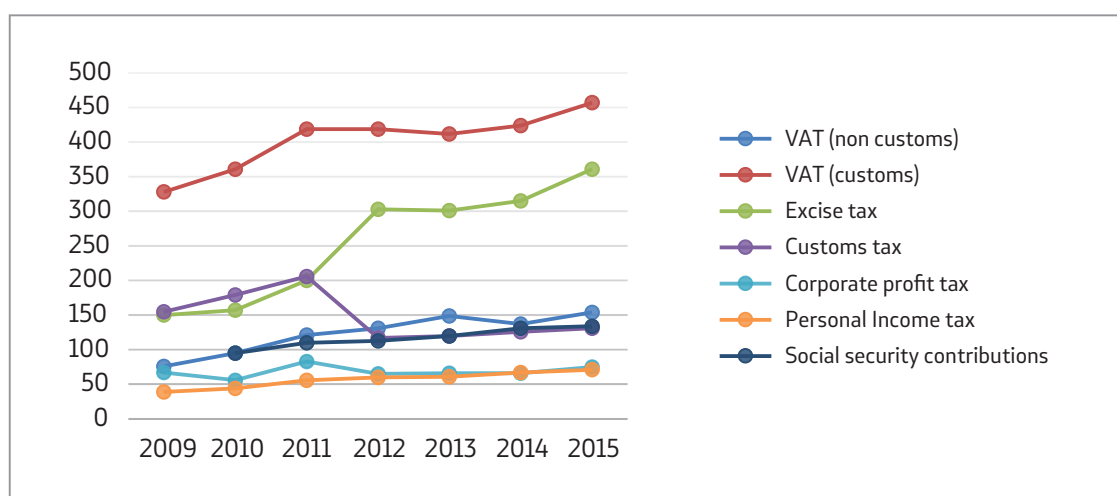
⁴¹ International Money Fund, Staff Report 2016, <http://www.imf.org/external/pubs/ft/scr/2016/cr1622.pdf>

mobilization of non-tax revenues. Due to the relatively positive growth performance of Kosovo's economy – even though not optimal for a developing country, tax revenues are expected to be maintained at stable rates of increase until 2020.⁴²

Social Contribution and Tax Evasion

In 2012 there was a growing recognition that the social and pension support system needs to be reformed especially taking into account the costs applied to the system coming from insuring certified and new war veterans which together would exceed its sustainability levels. These pension schemes were also discouraging employees from keeping their jobs, looking for jobs or truthfully declaring their income.⁴³ The year of 2017 will be the first time that health insurance contributions and not only pension contributions will be mandatory. The health insurance contribution will be in the amount of 7% of the gross income, equally shared by employer and employee of 3.5% and this is expected to strongly enhance the revenues.⁴⁴

Figure 19 - Tax and social security contributions revenues in Kosovo for the period (2009 - 2015).



Source: Kosovo Agency of Statistics, Tax Administration of Kosovo, Ministry of Finance of Kosovo.

Data about tax evasion is so far not clearly detected, mainly because of the still developing bureaucracy system, high volume of cash transactions and citizens fearing to report noncompliance and lose their current jobs. The authorities though are advancing in developing a centralized procurement system to detect corruption, and to improve governance by making public expenditures and revenues more efficient.

Social insurance system bares its own local marks and it is somewhat complicated. Just as is the case with Macedonia, Kosovo pension system consists of 3 pillars which differ mostly by the model of funding and the population strata that it is designed to cover:

- **The First Pillar** – is a means-tested basic social assistance scheme which is also applicable to the elderly. This pillar is integrated into the Central Government and its financing and functioning resembles the most pay-as-you-go (PAYG) one pillar state funded pension funds. Pension expenditures under this scheme are considered to be social benefits.

⁴² Policy Report Pension System Kosovo 2012 [http://legalpoliticalstudies.org/download/Policy Report 06 2012 eng.pdf](http://legalpoliticalstudies.org/download/Policy%20Report%2006%202012%20eng.pdf)

⁴³ KPMG Tax News Kosovo (21.12.2016): <https://home.kpmg.com/al/en/home/insights/2016/12/tax-news-kosovo--new-administrative-instruction-on-the-implement.html>

⁴⁴ Loxha Arberesha, Group for Legal and Political Studies (06/2012) "Pension System in Kosovo: review of current state, main challenges and gaps" [http://legalpoliticalstudies.org/download/Policy Report 06 2012 eng.pdf](http://legalpoliticalstudies.org/download/Policy%20Report%2006%202012%20eng.pdf)

- **The Second Pillar** – is a mandatory pension funded scheme. This scheme was implemented from August 2002, when only big employers and national agencies were mandatory for contribution. Since 2003 the mandatory saving scheme is expanded in order to cover all the employers of Kosovo and the self-employed. Unlike Macedonia, where these funds are managed and matured through conservative investment strategies through two private insurance companies, in Kosovo the Mandatory pension savings are administrated and managed by the Kosovo Pension Saving Trust. KPST handles pension contributions amounting to 10% of gross wages from both, **employers and employees (5% + 5%)**, as well as the self-employed: 10 % of the earned income. KPST also invests these assets in long term and stable financial instruments.
- **The Third Pillar** – is a voluntary scheme funded for those who wish to invest more in their social security. This scheme is optional for business and other financial institutions and can be funded either from employers' contributions or employees.⁴⁵

Even though tax rates and the way the social insurance system is set up is important in determining the incentives that define the hidden economy, and more so tax evasion practices, without proper enforcement and awareness raising mechanisms the incentives to evade taxes unavoidably prevail as economic subjects seek ways to be more competitive. Without doubt market competition is a positive and a desirable condition in our economies as long as the economic entities play by the same established rules and laws and respect the principles of fair competition. A study in Kosovo (2013) on informality of businesses, found that almost 62.7% of companies are certain that if they decide to evade taxes they can easily do so without getting caught. Surprisingly however, in terms of tax audit intensity, 37.3% of the respondents believe that there is a high or very high chance of getting caught evading taxes.⁴⁶ Presumably they are relying on the well-established hidden economy practice of bribing the tax inspector. The situation is much alike other SEE countries.⁴⁷

The lack of human resources prevents SEE governments from effectively monitoring tax and customs officers' operations. The absence of monitoring, interconnectedness and automated information sharing among relating government agencies increases the likelihood of tax and customs officers being involved in corrupt practices. These in turn frequently relate to hidden economic practices of business entities. While Bulgaria (currently and in the past), Croatia and Macedonia (recently) and Albania (planned) focus on technology, Montenegro and Kosovo focus on raising awareness about public finance and tax compliance through various campaigns. These campaigns have aimed at involving the general public in a larger scale, and promote soft enforcement of integrity rules. The public, however, seems to be sufficiently aware and sensitive when it comes to corruption among tax officials: a quarter of the respondents in SELDI's survey believed that almost all tax officers were involved in corruption and 37% thought that most of them were involved.⁴⁸ The only available, tax gap estimate (for the fiscal years 2011 and 2012), is based on Schneider's Shadow Economy estimates for the Western Balkan countries, and was produced by Harremi. A subsequent consultancy report by AL-Tax Centre from Albania, which resembles the former in methodology, but with no direct reference to it, presented its second tax gap as-

45 Balkan tax report <http://www.norway-kosovo.no/NR/Balkan%20Taxation%20report.pdf>

46 RIINVEST Institute (2013) "To pay or not to pay – A business perspective of informality in Kosovo". http://www.riinvestinstitute.org/uploads/files/2016/October/17/BUSINESS_INFORMALITY_5mm_bleed_no_inside_ENG_FINALV_313964385731476693005.pdf

47 SELDI (2016) "Shadow Power – Assessment of Corruption and Hidden Economy in Southeast Europe" <http://seldi.net/publications/publications/shadow-power-assessment-of-corruption-and-hidden-economy-in-southeast-europe/>

48 Ibid

assessments in the region for the fiscal year 2013. Macedonia tops the group with a gross tax gap of 29.2% of GDP, but due to differences in the cost of enforcement and possibly the tax refund system, three countries are at the top in terms of net tax gaps – Macedonia, Montenegro and Kosovo, with 25.9 % of GDP.⁴⁹

Regarding the tax administration, businesses claim that they often get bribed and the tax inspectors misuse their authority. On a scale from 1 to 10 (1-never, 10-very often) businesses average on 4.48. They also believe that tax officials often abuse their authority (Mean: 4.35, 1-Never, 10-Always).⁵⁰

However, low taxes do not by default imply a small informal sector, as there are many other factors that help determine whether firms choose to operate informally. In this regard, strengthening of the tax administration is necessary to broaden the tax base and ensure consistent tax collection. Other measures than can help limit the informal sectors can be simplifying procedures and respectively shortening of the time and cost to start a business, especially at the municipal level. Furthermore, a quick government response is necessary in outlining procedures and strengthening administrative capacities relating to the regulatory regime of doing business, especially with regard to business licensing, construction permits, etc. This is something that is foreseen in the SME Development Strategy for Kosovo 2013-2017 compiled by the Ministry of Trade and Industry (MTI).⁵¹

49 Hidden economy assessment report, CSD. Also available at SELDI's hidden economy country fact sheets (2016) <http://seldi.net/publications/publications/hidden-economy-fact-sheets-2016/>

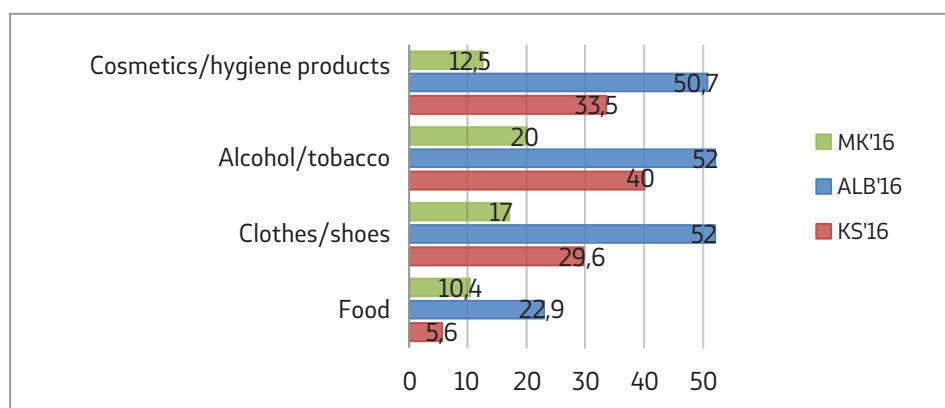
50 RIINVEST Institute (2013) "To pay or not to pay – A business perspective of informality in Kosovo". http://www.riinvestinstitute.org/uploads/files/2016/October/17/BUSINESS_INFORMALITY_5mm_bleed_no_inside_ENG_FINALV_313964385731476693005.pdf

51 Ministry of Trade and Industry of Kosovo "Private Sector Development Strategy 2013-2017" (2013) http://www.kryeministri-ks.net/repository/docs/PRIVATE_SECTOR_DEVELOPMENT_STRATEGY_2013-2017.pdf

VI. POPULATION SURVEY FINDINGS

There are vast differences within the three countries when it comes to issuing fiscal receipts for purchased basic products/groceries. In particular, the non-issuance of such receipts is especially prevailing in Albania, somewhat less in Kosovo, and the least frequent in Macedonia. Apparently, cosmetics/hygiene products, alcohol/tobacco and clothes/shoes are the most likely products to be sold without being taxed, while food is most likely to be taxed, especially in Macedonia and Kosovo (See Figure 20).

Figure 20 - % of respondents stating they've rarely or never been issued fiscal receipts for purchased products during the past month.



Source: Population survey CRPM/IDM/D4D 2016 Q.25 (population).

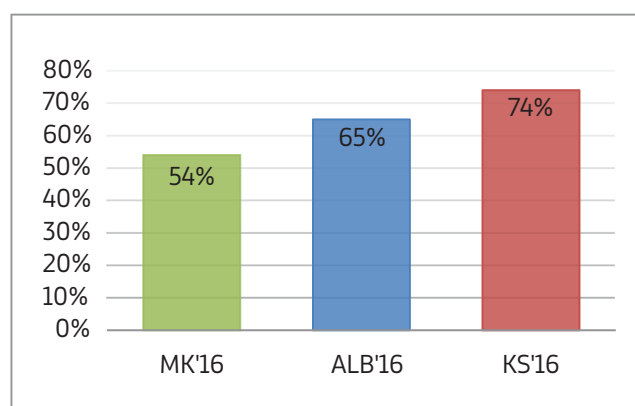
Macedonia in 2016 in terms of non-issuance of fiscal receipts for the excise goods alcohol and tobacco (Figure 20) sees almost a doubling in noncompliance from 12% in 2014 to 20% in 2016. This is important as it can indicate lost revenues, inefficient inspections (especially in the Customs Administration), and consequent proliferation of contraband and smuggling of these types of highly taxed goods. The situation in Albania however seems more grave and worse than the other two countries with more than 50% of the respondents stating that they have rarely or never received fiscal receipts for **a)** cosmetics/hygiene products, **b)** alcohol/tobacco, **c)** clothes/shoes.

However, when it comes to issuing receipts for received services, the situation is rather grave in all three countries. Figure 21 shows the average percentage of respondents stating that they have not received fiscal receipts for (some of) the 13 outlined services in the questionnaire. **The percentage of least frequently taxed services is the largest for Kosovo (74%), second largest in Albania (65%) and third in Macedonia (54%).**

However, there are vast differences with regards to the type of service. Specifically in Macedonia receipts are most frequently given (85%) for **a)** professional services (accountants, psychologists, architects, etc.) and **b)** transportation services (75%); while least frequently given for: **a)** repairmen/auto mechanic services (30%); **b)** household maintenance (17%); **c)** renting assets/premises (30%); **d)** craftsmen services 36% (hairdressers, tailors/seamstresses, beauticians). In Albania fiscal receipts are most frequently given for **a)** Catering and restaurant services (84%) and **b)** transportation services (66%) while least frequently given are for: **a)** household maintenance (6%); **b)** home repair (8%); **c)** renting assets and premises (11%); **d)** senior and child care services (15%). It is similar in Kosovo with most frequently issued receipts being for **a)** catering and restaurant (77%) and **b)** transportation services (47%). The least frequently given receipts for services

on Kosovo are for: **a)** vehicle and electronics repair (6%); **b)** home repair (11%); **c)** renting assets and property (14%); **d)** senior and child care services (15%).

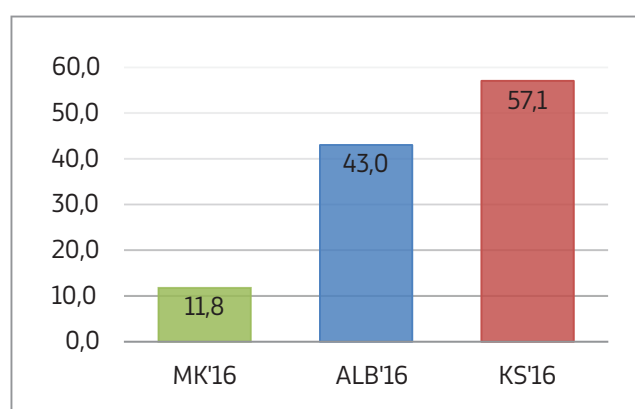
Figure 21 - % of respondents stating they haven't received receipt for purchased services during the last three months.



Source: Population survey CRPM/IDM/D4D 2016 Q.26B (population).

Finally, when it comes to purchasing larger goods (such as cars, furniture, technical equipment etc.), **the frequency of issuing of fiscal receipts/invoices is the lowest in Kosovo with 57.1% of respondents, somewhat better in Albania with 43% of respondents and rather good in Macedonia with just 11.8% of respondents** (See Figure 22).

Figure 22 - % of respondents stating to have not received a fiscal receipt/invoice after purchasing certain goods in the past 2 years.

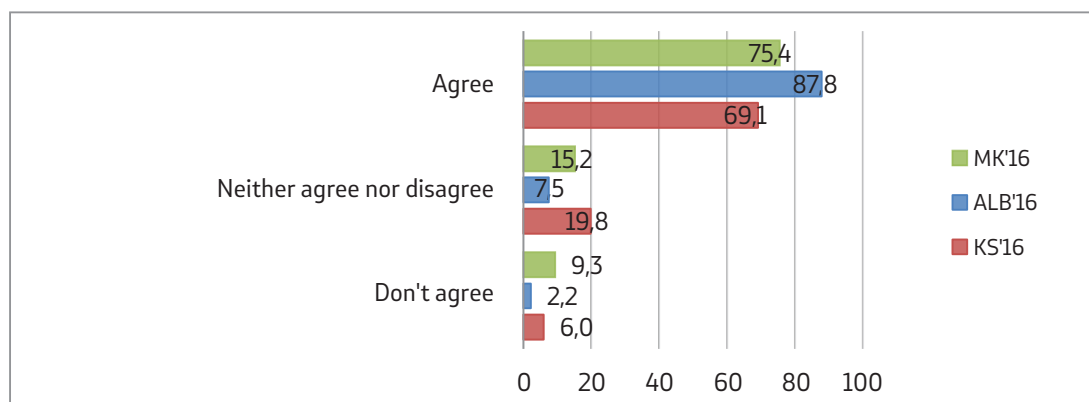


Source: Population survey CRPM/IDM/D4D 2016 Q.24 (population).

It seems as if the continuous fiscal reform in Macedonia since 2007, has resulted in strengthened control over sellers of goods and services, and increased awareness of the importance of issuing fiscal receipts and their connection to quantity and quality of public services.

Regardless of the differences in issuing receipts and paying taxes for goods and services, the perceptions regarding the usefulness of taxes do not differ to the same extent. Specifically, the vast majority of respondents (especially in Albania) agree with the statement that "Unpaid taxes negatively influence the local economy", showing understanding of the importance of taxes (Figure 23).

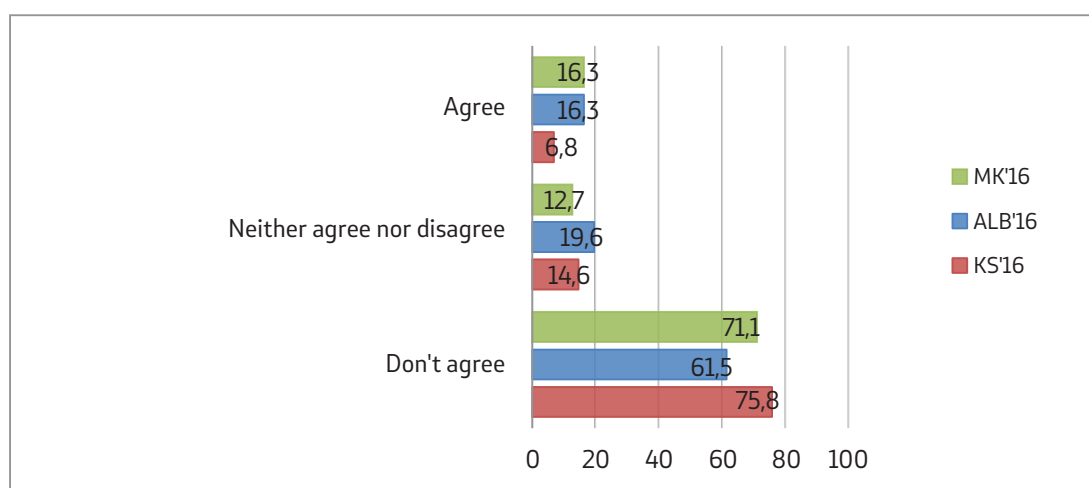
Figure 23 - (Dis)agreement with the statement "Unpaid taxes negatively influence the local economy."



Source: Population survey CRPM/IDM/D4D 2016 Q.MK11B (population).

However, somewhat contradictory (Figure 24), 16% of respondents from Macedonia and Albania also stated that "Not paying taxes should be tolerated" (more frequently selected by respondents with lower household income), indicating that although considered important for the local economy, the tax morale is still relatively low in all three countries.

Figure 24 - Dis(agreement with the statement "Not paying taxes should be tolerated."



Source: Population survey CRPM/IDM/D4D 2016 Q.MK11G (population).

VII. BUSINESS SURVEY FINDINGS

For the majority of businesses interviewed in Macedonia, the current tax system does not represent a problem for development of their business (28.6%) or represents an insignificant problem (31.4%), regardless of the size of the company, or in total 60% of the business in 2016 (compared to 65% in 2014). Similar as in 2014, the largest detected problems are the unfair competition, assessed as a medium and big problem by 64.3% of businesses, political situation in the country (50%), and crime, theft and unrest (50%). Businesses have increased their negative perceptions about the political situation in Macedonia by 1/3 and today 37.1% perceive it as a problem (compared to 26.5% in 2014).

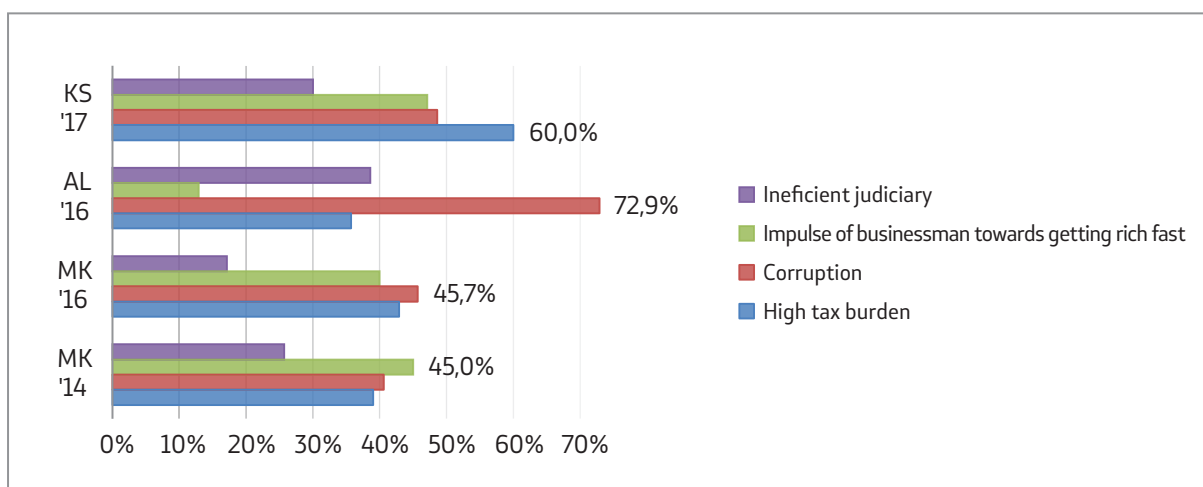
These negative perceptions are also evident when businesses are asked to point out the most important factors responsible for the occurrence of the hidden economy.

A signal for the Government of Macedonia – corruption now is a bigger business concern compared to 2014.

In 2016 Macedonian businesses seem to be more concerned about corruption and measures to tackle it rather than with more effective simulative measures for businesses.

Namely, factor number one chosen by 45.7% of businesses in Macedonia is ‘corruption’. Nevertheless, apart from the general satisfaction with the tax system in the country, taxes are considered to play an important role in the occurrence of hidden economic activity. Specifically, the ‘high tax burden’ is considered to be the second most important factor for the existence of hidden economy, selected by 42.9% of business representatives, after the ‘impulse of businessmen towards getting rich fast’ (40%) (Figure 25).

Figure 25 - Most important factors for the existence of hidden economy (Q.C14).

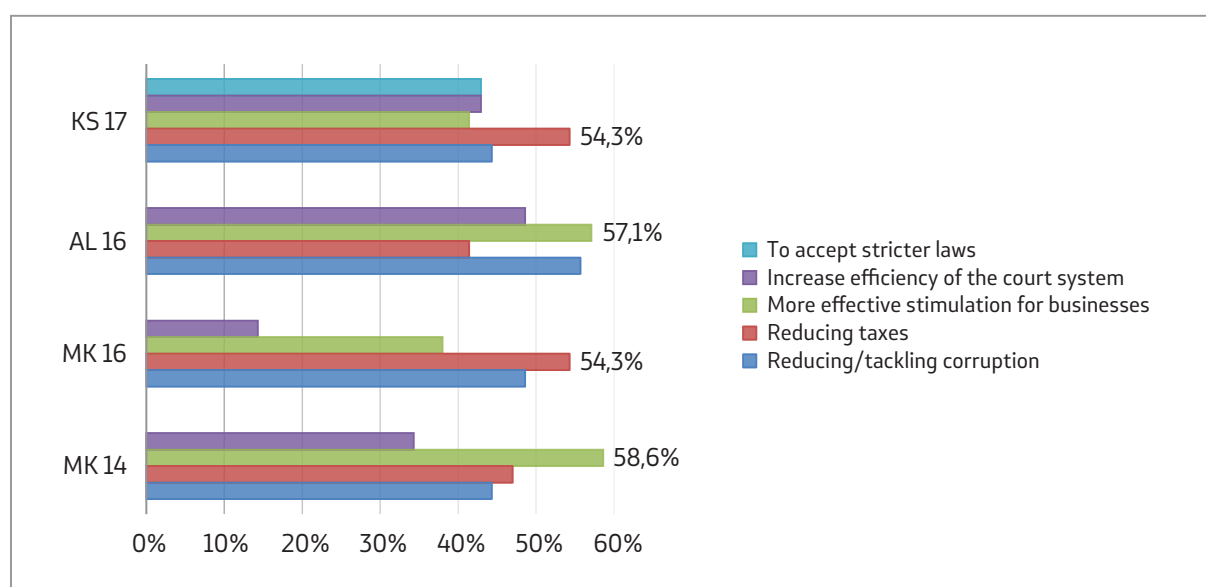


Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business).

Consequently, and in line with the findings from the 2014 CRPM/CSD business survey, the top three measures proposed by **Macedonian businesses** for reducing hidden economy include – **‘reducing taxes’** selected by **54.3%** of businesses; **‘reducing/tackling corruption’ (48.6%)**; and **‘introducing more effective stimulation for businesses’ (38%)**, (See Figure 28 & Figure 26). The difference is that in 2016, as showcased by both Figure 25 and Figure 26, **Macedonian businesses view corruption as a bigger problem for the economy** and put more importance of the need of implementing **measures that reduce or tackle corruption**. Similarly, in **Albania tackling/reducing corruption is second most chosen measure by businesses (55.7%)** for reducing the hidden economy and **more effective stimulation for businesses, selected by 57.1% of business representatives as the most favored measure**.

	MK '14	MK '16	AL '16	KS '16
Factor Nr.1	Impulse of businessman towards getting rich fast (45%)	Corruption (46%)	Corruption (73%)	High tax burdening (60%)
Factor Nr.2	Corruption (40%)	High tax burden (43%)	Inefficient judiciary (39%)	Corruption (48.6%)
Factor Nr.3	High tax burden (39%)	Impulse of businessman towards getting rich fast (40%)	High tax burden (36%)	Impulse of businessman towards getting rich fast (47.1%)

Figure 26 - Measures for reducing the Hidden Economy. (Q. C15).



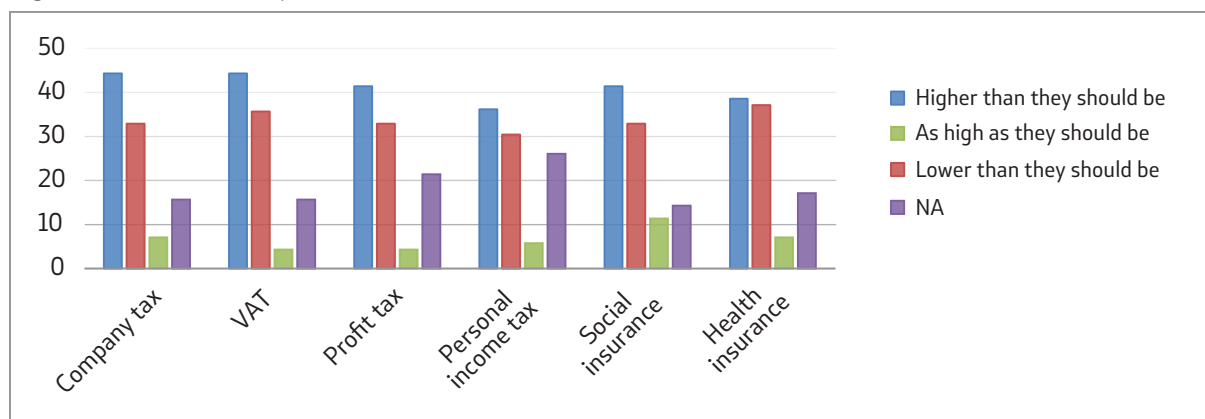
Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

However almost half of Albanian businesses (48.6%) stated a need for increased efficiency of the court system which might be an indicator for some functional deficiencies of the court or legal system in the country.⁵² This can be attributed, to the very high risk the businesses and citizens experience in the judicial system of Albania such as bribing court officials in exchange for favorable judicial decisions and the lack of accountability of judges and prosecutors alike. Glob-

52 GAN Business Anti-Corruption Platform report on Albania
<http://www.business-anti-corruption.com/country-profiles/albania>

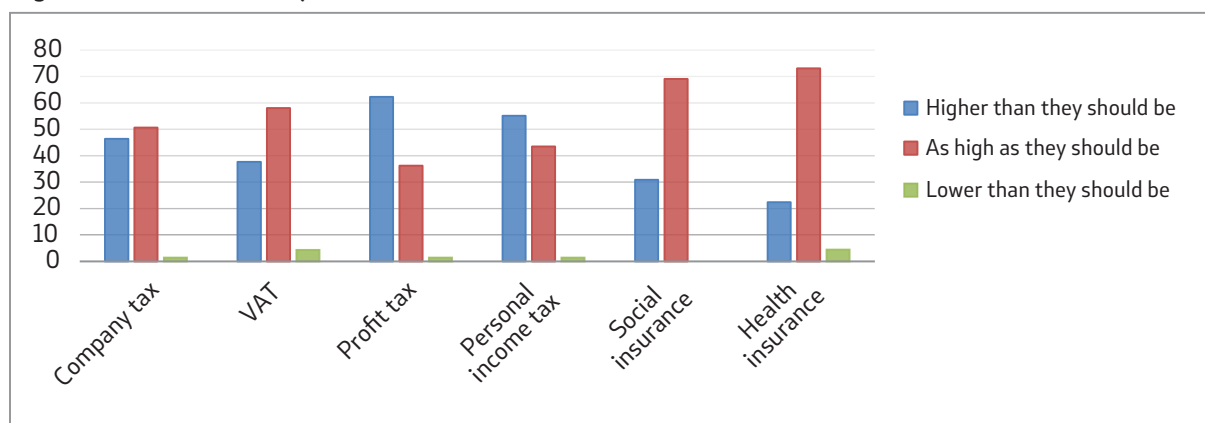
al competitiveness reports 2015-2016⁵³ through 2017-2018 and EU progress report 2015⁵⁴ give additional weight to this claim. Bribing is one of the 11 hidden economy practices explored by the conducted **business surveys which in deed confirm the large extent of bribing with 1/3 of businesses in Albania (35.7%) and 1/4 in Kosovo (22.9%) and only 1/10 in Macedonia (8.6%) claiming these practice being used 'constantly' or 'in most cases.'**

Figure 27 - How would you assess the size of different tax rates in Macedonia? Q. C17.



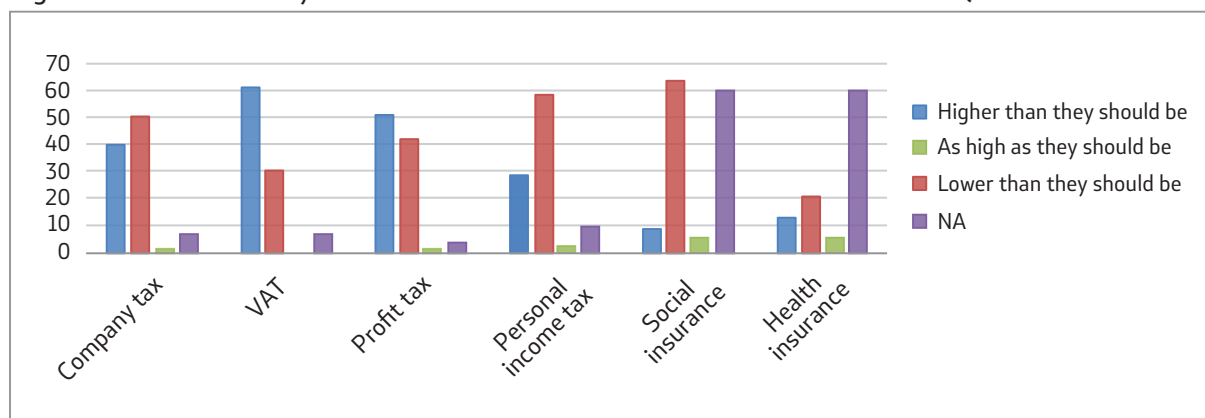
Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

Figure 28 - How would you assess the size of different tax rates in Albania? Q. C17.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

Figure 29 - How would you assess the size of different tax rates in Kosovo? Q. C17.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

53 World Economic Forum: Global Competitiveness Report 2015-2016
<http://reports.weforum.org/global-competitiveness-report-2015-2016/>

54 EU Progress Report 2015 https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2015/20151110_report_albania.pdf

A 2016 judicial system reform should address some of the detected deficiencies which also have an impact on the extent of hidden economy practices used. More time is necessary to evaluate whether the aims of this reform, as well as the new Constitution, will redefine the judiciary and the prosecution system, counteract the extensive corruption in the justice system, reveal and break the bonds of judges and prosecutors with politics and crime etc., and generally bring more accountability and transparency in the Albanians justice system.

In fact corruption is such a big issue in Albania that ¾ of interviewed businesses (72.9%) claim corruption to be the most important factor for the existence of the hidden economy, followed by 'inefficient judiciary' (38.6%) and 'high tax burden' (35.7%).

Kosovo shares many of the business concerns present in Macedonia and Albania about factors of and measures for tackling the hidden economy in the country. **The most important factor** for the existence of hidden economy is **'High tax burden' (60%), followed by 'Corruption' (48.6%) and 'impulse of businessmen towards getting rich fast' (47.1%)**. Not surprisingly, **top three suggested measures** to reduce the hidden economy **are decreasing taxes (54.3%), reducing/tackling corruption (44.3%) and sharing the third spot at 42.9% business approval are 'implementing stricter laws' and 'more efficient judiciary.'** The last 2 suggested measures are related to their views evident from some of the answers in the survey that many of the legal offences and breaches go unpunished.

In relation to business satisfaction with the tax rates of different taxes there seems to be a change in perceptions in Macedonia. Whereas **around half of businesses in 2014 stated that the tax rates for respective taxes were 'as high as they should be' and with a notable exception of the company tax and social security, in 2016 these values have dropped to around 30-35%** (see Figure 28).

In 2016 more businesses voice opinions that the 'taxes are higher than they should be' than 'as high as they should be'.⁵⁵ Given that there hasn't been significant changes in the established tax rates since 2014 the reason for the perception skewness might be the growth of negative business perceptions related to the ongoing political crisis that affects GDP growth (despite projected GDP growth of 3.5% and 3.7% for 2017 and 2018 by the National Bank of R. Macedonia), general business prospects, future domestic and foreign direct investments as well as construction and its related branches which were the leading engines of the Macedonian economy up to 2016. Latest report by the NBRM for Q2 2017 confirm these fears⁵⁶. Q2 sees a GDP contraction to 1.8% growth, increased inflation forecast to 1.3% and 2% for 2017 and 2018 respectively and a negative balance of FDIs for Q2 2017 of -14.8 million EUR. Negative balance of FDI's is especially indicative of lost business trust and cannot be explained by the economic trends in the world economy.

Business perspectives over the height of taxes in **Albania differ significantly in relation to Macedonia. Albanian businesses overwhelmingly claim that taxes are 'as high as they should be' with 69% and 73% of businesses claiming social and healthcare contributions rates respectively are set at proper levels.**

In relation to company tax and VAT more than half of businesses again claim that the taxes are as they should be. However business disagree to a larger extent when it comes to the **established rates for profit tax and personal income tax and 62% and 55%, respectively, of the Albanian businesses surveyed claim that these taxes are higher than they should be.**

55 Note: Compared to 2014 in 2016 there are significantly more respondents that responded with NA to this question which might be the reason for the skewness towards negative business perceptions of taxes.

56 Monthly Report of NBRM (13.09.2017). Retrieved from:
<http://nbrm.mk/ns-newsarticle-soopstenie-na-nbrm-1392017.nspk>

Kosovo shares many of the business sentiments present in Macedonia and Albania but at the same time presents its own challenges to its business landscape. **Business satisfaction with the taxes is quite mixed but points to general dissatisfaction with more than half of the businesses claiming that the VAT (61.4%) and profit tax (51.4%) are higher than they should be.** However from the 3 countries Kosovan businesses show an overwhelming satisfaction of the **personal income tax with 58.6% of businesses claiming that it is 'as high as it should be'**. This goes in line with the fact that 60% of the Kosovar businesses (the most compared to Macedonia and Albania) chose 'high tax burden' as the most important factor for the existence of the hidden economy.

Governments very often produce detailed strategies for combating the negative effects of the hidden economy and assigning activities to multiple state and not so frequently to non-state actors which involve dozens or hundreds of measures across several laws and ministries. This approach works only if the country has a well-functioning and coordinated government. However in most of the cases these strategies are used for reporting in front of international institutions. Especially in developing countries with substantial parts of the population living on or below the poverty line the Governments are less likely to take a tougher stance on enforcing measures, such as the ones dealing with the hidden economy in order to avoid causing large scale social unrest.

"VAT-related losses occur either through conventional, non-organized tax evasion (not issuing taxable receipts, underreporting sales of actual products and services, or overvaluing spending on inputs) or through more organized abuse of the system involving fictitious transactions with absent or insolvent traders (i.e. carousel fraud). The former involves one (i.e. retail without tax receipts) or a maximum of two parties (business to business, when manipulating the amount on invoices) during transactions. The latter involves complex networks including real businesses (i.e. real producers, logistical companies, accountants' offices) and zero assets companies owned by poor, uneducated or even convicted people, among whom multistage paper transactions are made."
SELDI.net – Hidden Economy and Good Governance in Southeast Europe: Regional Assessment Report 2016.

When Governments do not comply completely with their own strategies, and their agencies do not coordinate well, they are not penalized by voters during elections, and agencies which do not coordinate well are not penalized administratively. These incentives for governments not to comply with their own strategies are even more pronounced when the policies at hand are emotionally charged and mostly concern measures directly affecting vulnerable groups (unemployed, undeclared workers, low income households) which carry the potential for high media coverage and very high potential to hurt the voting base of the party in power. Thus, smart policies that take into account particular vulnerabilities and take a more consultative approach before putting measures in place will have a better chance to be accepted by the general population and thus followed through by governments.

There are various methods that businesses utilize in order to avoid or manipulate with tax reporting and tax compliance. Some of the most common ones are:

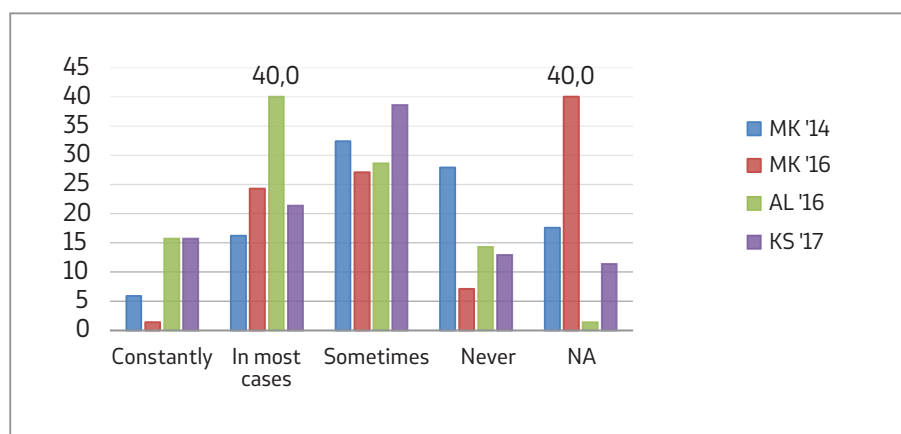
- **Hiring a worker without contract or with contract with hidden clauses;**
- **Reporting lower revenue and/or turnover;**
- **Non-payment of duties, taxes and excise;**

- Giving and taking bribes;
- Not issuing bills and invoices;
- Insisting on performing cash payments;
- Performing procurement without tender;
- Executing deals in kind;
- Executing illegal inflow or outflow of assets;
- Manipulating the VAT tax payment;
- Using accounting tricks in order to pay lower taxes;

These hidden economy practices vary across countries in accordance with the specific policy and tax leakages shaped by the measures that have been undertaken and others that have not yet been implemented. For example measures such as forcing businesses, from retail, trade and hospitality sectors, to install GPS enabled fiscal cash registers tries to combat VAT fraud and evasion while giving access to the country's Public Revenue Service to substantial amount of real time data which they can use to monitor and better target audits and inspections to higher risk groups and at the same time avoid unnecessarily burdening tax payers who comply with the tax regulations.

The hidden economy survey for businesses performed in 2014 in Macedonia and in 2016-2017 in Macedonia, Albania and Kosovo gives a rare look into the frequency of use of the 11 hidden economy business practices by some entities in the private sectors in these countries. As described previously, one of the ways to avoid taxes is to report lower turnover than the actual one and in Macedonia 54.4% of the surveyed companies confirmed that this hidden economy practice is used within their sector 'constantly', 'in most cases', or 'sometimes' (Figure 30). It must be noted however that the 'NA' answers for Macedonia for 2016, particularly for the hidden economy practices of businesses, have more than doubled compared to the survey results from 2014 which increase the likeliness of the results presented for Macedonia to be underestimated. **The hidden turnover is more significant in Albania and Kosovo where 84.3% of companies confirmed the presence of this practice in their respective sectors out of which large portions have confirmed the practice to be used 'constantly' and 'in most cases' by 55.7% of businesses in Albania and 37.1% in Kosovo.**

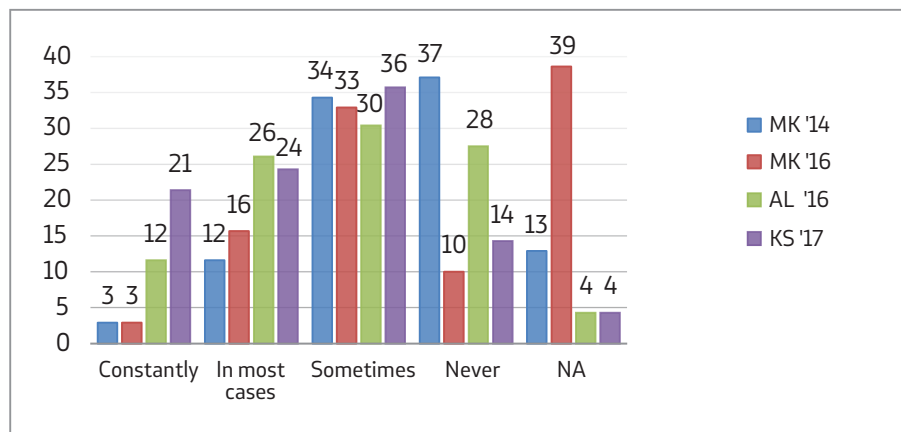
Figure 30 - How frequently companies tend to report lower turnover than the actual, Q 12G.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

Reporting lower revenue is yet another hidden economy practice of avoiding the tax authorities reach (Figure 32). Similar as in 2014 more than half of businesses in Macedonia (54.4%), $\frac{3}{4}$ of businesses in Kosovo (74.3%) and almost all businesses in Albania (84.3%) have confirmed this practice to be performed constantly, in most cases or sometimes. In fact one quarter of Albanian (22.9%) and Kosovar (24.3%) businesses have stated that this is performed 'constantly.'

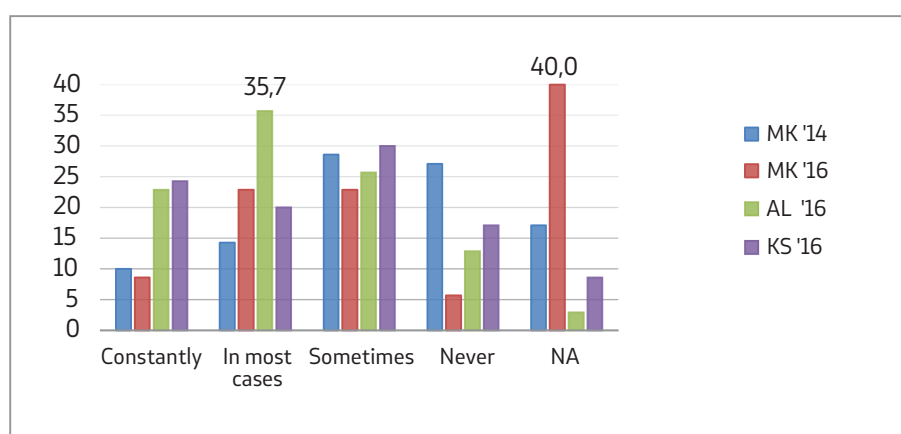
Figure 31 - Not issuing fiscal bills and invoices, Q 12F.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business).

By using the results from the 2016 hidden economy population surveys we can confirm some of these findings especially by using the data on provision of fiscal receipts. For example, 17% in Macedonia, 52% in Albania and 29.6% of respondents from Kosovo have confirmed that they have never or rarely received fiscal receipts when purchasing clothes and shoes. For tobacco and alcohol 20% in Macedonia, 52% in Albania and 40% from respondents in Kosovo have also confirmed that they have never or rarely received fiscal bills. Although cases of never receiving fiscal receipts are relatively rare across all three countries and are kept below 18%, there are notable exceptions such as for Albania for the categories alcohol/tobacco (26.5%), books (28.3%), and for Kosovo also for books (26%). The business survey confirms, and goes beyond, these findings from population surveys in part with the fact that **52% in Macedonia, 68% in Albania and an extensive 81% of surveyed businesses in Kosovo have confirmed that non issuance of fiscal receipts/invoices is performed constantly, in most cases and sometimes in their respective sectors** with predominance of the 'sometimes' answer (Figure 31).

Figure 32 - How frequently companies tend to report lower revenue than actual, Q 12C.



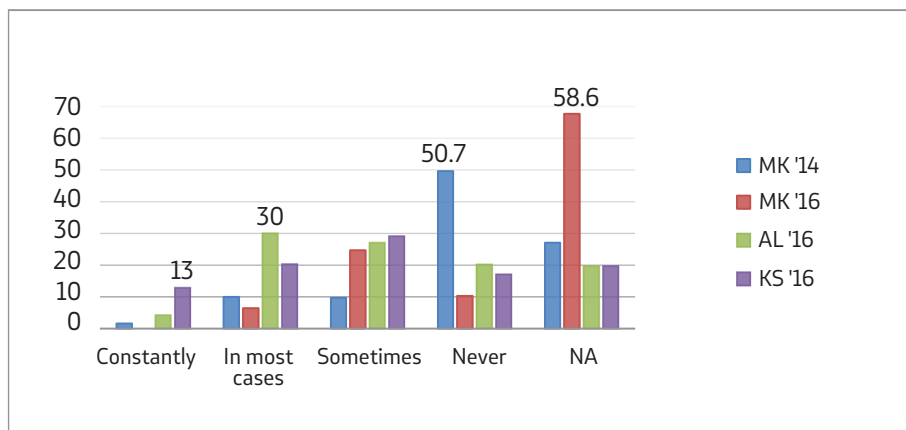
Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

As previously described, the population and business surveys in Macedonia, Albania and Kosovo portray business environments with noticeable tendencies of businesses to hide part of their revenue streams/turnover which in turn negatively affects fair competition and government oversight, and with that public revenues.

Another method employed by some businesses in order to pay lower taxes is manipulating with the VAT and employing accounting tricks (Figure 33 and Figure 34). 1/3 of businesses in Macedonia

(31.4%), and 2/3 in Albania (60%) and Kosovo (62.3%) have confirmed that this practice is used 'constantly', 'in most cases' or 'sometimes' with predominance of the latter two categories. Macedonia in 2016 sees deterioration in this manner as only 21.6% of businesses have confirmed this practice in 2014, or a deterioration of stunning additional 50% from its 2014 values (**Figure 33**).

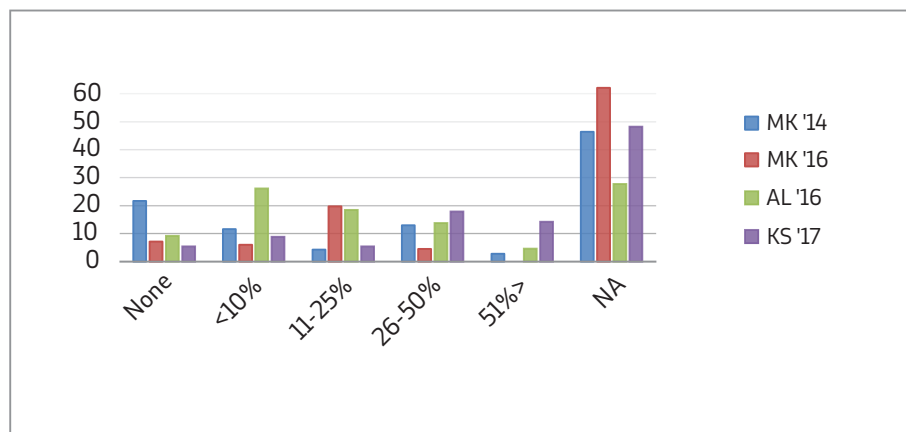
Figure 33 - How frequently companies tend to manipulate with the VAT? (Q.C12_L).



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business).

Similarly, as we can see from **Figure 34** that **1/4 of companies in Macedonia (24.2%), 1/3 of companies in Albania (32.3%) and 1/4 of companies from Kosovo (23.3%) believe that between 11% and 50% of companies in their sector pay lower taxes than they should by employing these hidden accounting tricks.** However it needs to be noted that in general companies in Macedonia are less forthcoming with acknowledgments of this practice happening in their respective sector as large part of them didn't not provide an answer or did not know.

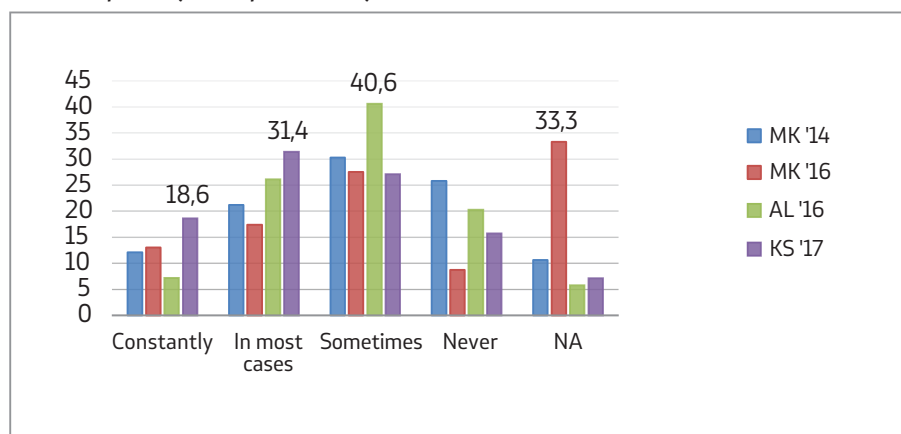
Figure 34 - What percentage of companies in your sector pay lower taxes than they should by using accounting tricks, Q. C25B.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business).

Another important aspect which was the focus of the population survey is the extent of hiring workers without work contracts or contracts with hidden clauses. The business survey confirms the widespread use of this practice in line with the values provided with the population survey and **1/3 of businesses in Macedonia (30.4%) and Albania (33.3%), and 1/2 of interviewed businesses in Kosovo (50%) claimed that these type of workers are hired 'constantly' or 'in most cases.'** As for providing workers with contracts with hidden clauses 25.7% of businesses in Macedonia, 52.8% in Albania and 31.5% on Kosovo claimed that this happens 'constantly' or 'in most cases' in their sectors.

Figure 35 – How frequently companies in your sector hire workers without work contracts? Q. C12A.



Source: CRPM/IDM/D4D 2016-2017 survey and CRPM/CSD Survey 2014 (Business)

VIII. CONCLUSION

Undeclared work is one of the main manifestations of **hidden economy, affecting people within a variety of socio-economic environments** which at the same time is characterized with possible **negative outcomes ranging from social tensions, rising inequalities and income gaps, to corruption and criminal activities**. Macedonia and Albania have EU candidate status, and Kosovo has signed the stabilization and association agreement with the EU but all three are characterized by higher unemployment rates than the EU average of 9.6% (Apr. 2015) consequently high levels of undeclared work estimated by some studies to be more than 30% of the GDP of the three countries and rising inequality.

The large **unemployment rate (22.6% in MK, 13.9% in Albania in Q2 2017 and 30.5% in Kosovo as of Q1 2017)**, is one of the most important indicators that give rise to hidden economic activities and practices. However despite recent findings of greater efficiency of soft measures the main focus in tackling undeclared work, just as most Eastern European Countries, is still largely on Labor Law violations. Even though recently there are measures aimed at **improving detection/better targeting; still employing repressive measures is the dominant policy approach** in these countries. Hidden salaries remain the most acute concern, with the **employment income being partially or completely undeclared for almost half (44%) of employees in Macedonia (a rise from 40% in 2014), 36% in Albania and 37% of employees in Kosovo**.

Substantial 9% of all Macedonian employees with primary employment work without a contract (a rise from 7% in 2014), and are not being paid any social security contributions whatsoever. The percentage of these employees **in Albania and Kosovo is double and represents 17% and 21% respectively** of all employees. Secondary employment is plagued by even starker figures. 40% of secondary job employees in Albania and above 80% in Macedonia and Kosovo work without contracts and no social and healthcare contributions are being paid.

Education matters in undeclared labor. **Only 56.8% of employees with primary education in Macedonia, 20.6% in Albania and none in Kosovo have acquired a written contract for their primary job compared to over 80% for employees with university degrees**.

More than **1/3 (37.3%) of employees in Macedonia, 1/4 (22.7%) in Albania and 1/5 (20.5%) in Kosovo have** their social security contribution paid by employers on contracted wages that are lower than the actual wage they receive. Secondary/additional employment is plagued by absence of written contracts and **around 90% of these employees** in Macedonia and Kosovo (Albania being the exception here) **have no written contract** and only very few are dedicated in paying their social security, healthcare contributions and personal income tax. Even though there is a tendency to label undeclared workers and their economic activities as “bad” one has to be aware that also “... in reality it is a natural and unprovoked reaction of the incapability of the formal economy to satisfy the needs of a part of its society members.”⁵⁷

The tax burden, one of the many factors that contribute to tax evasion, is the first front where public policies should, and very often are, targeted in order to change a system that gives incentives for engaging in tax evasion and fraud. The tax burden relates not only to the amount paid but also to the ease of, and difficulties involved in, paying such tax and social security contributions.

57 Mema, Fatmir and Zef Preci (2003), “Comments on: Hidden Economy a Barrier for a Sustainable Development”, Fourth Conference of Bank of Albania “The Albanian Economy: Progress and C 2003, Saranda, Series of books on scientific conferences, 63-69. P. 63.

Non-issuance of fiscal bills and tax evasion in Macedonia are the first and second leading reasons for detected irregularities in the period of 2006-2015 (PRO). The percentage of least frequently taxed services is the largest for Kosovo (74%), second largest in Albania (65%) and third in Macedonia (54%). Percentage of respondents stating they have not received a fiscal receipt/invoice after purchasing certain goods in the past year in Kosovo is 57.1%, Albania 43%, and a low of 11.8% of respondents in Macedonia (Figure 22).

As far as awareness goes and the importance of taxes being paid the results show that on average more than three quarters (3/4) of the respondents in Macedonia, Albania and Kosovo agree that unpaid taxes negatively influence the local economy and disagree with the statement that not paying taxes should be tolerated. As the available research shows, it is not just the level of tax rates that affect the spread and scope of tax evasion and undeclared labor but also the ease of doing/formalizing business and the ease of fulfilling administrative procedures. These depend greatly on the government efforts of simplifying, reducing and streamlining procedures, especially the ones that provide unintended incentives for informality.

Social security currently does not pay off in the eyes of private employers and employees and this is a decisive factor for evasion. Simultaneous reduction of the cap and rates of social security with increase of the base of those paying could be helpful. Data from Macedonia already suggests that reducing rates for social insurance might actually increase revenues through higher compliance.⁵⁸

It is also necessary **to increase the capacity of the administration** to detect non-compliers and to collect its debts. This could include introduction of **risk management system** ((selectively inspecting those with the highest potential negative impact), but the most important measure would be to unify the tax administration with that responsible for social security contributions collection. Additionally, the level of enforcement of regulations in all three countries needs to be strengthened in order for effects to take place.

All three countries must improve the way **remittances are measured and assessed** by the state authorities, as the official transfers (accounted through the International Transaction Reporting System) represent only a small fraction of all remittances. **Cryptocurrencies (such as Bitcoin, Litecoin, Ethereum, Dash, Monero, Ripple etc.) will play a more significant role as they mature and are being accepted as means of quick and anonymous transfer of assets beyond the control of the authorities thus being a perfect instrument for hidden economic activity, legal and illegal.** More importantly, the development stages of cryptocurrencies trading, especially with bitcoin, resembles 'financial pyramid' scheme. For those reasons, especially concerning remittances, governments and central banks should take note early on in the developing stage of cryptocurrencies and their regulation to protect its citizens by addressing the challenge head on as this new mode of anonymous and near instant payment system carries a risk to bypass some, if not most, conventional forms of government oversight in foreign exchange transactions.

Having said that, it is also necessary **to simplify and reduce transaction costs associated with remittances** to reduce their hiding. Sending remittances home officially is usually extremely expensive and regressive. But, still, whatever way people find to send money home it still could be optimized through a modern financial system and the cost differential to be used for socially productive purposes.

The governments of Macedonia, Albania and Kosovo have to remain devoted to and continue with reforming and investing in the operational capacities of their respective Public Revenue Office,

58 **Shurkov, E, Mickovska R.A.**, (2014) "Hunting the Shadows – Tax Evasion Dynamics in Macedonia" Policy Brief Nr. 33, Dec. 2014.

Retrieved from: http://www.crpm.org.mk/wp-content/uploads/2015/03/PolicyBrief33_ENG.pdf

Financial Police, and the State Market and Labor Inspectorate especially in the fields of performance assessment, electronic interconnectedness, data sharing, and electronic services for individuals and businesses. At the same time it has to **make sure that: the tax burden remains low enough to maintain steady but increasing rates of revenue, develop and maintain stimulating business environment, simplify procedures for opening new businesses and formalizing established businesses, and use past policy experiences to avoid creating incentives that push businesses and individuals towards tax evasion and fraud.**

Business perceptions over what they consider to be the biggest factors contributing to the existence of the hidden economy can provide road maps to governments on what important policies to focus on in order to achieve biggest impact. According to businesses governments should make more focused and concerted efforts to tackle corruption, minimize tax burden and improve the efficiency of the judiciary if they want to decrease the level of hidden economic activity. This is especially true for **corruption which was singled out by 46% in Macedonia, 73% in Albania and 49% on Kosovo as the most important factor for the existence of the hidden economy and followed by inefficient judiciary, high tax burden (Factor nr.1 in Kosovo) and impulse of businessmen for quick profit.**

Even though according to businesses high tax burden is among the top three factors for the existence of the hidden economy they still are generally satisfied with the level of taxes but Macedonia shows a worrying trend. Whereas **around half of businesses in Macedonia in 2014 stated that the tax rates for respective taxes were 'as high as they should be' and with a notable exception of the company tax and social security, in 2016 these values have dropped to 30-35%.** Growing political instability and perceived corruption, as noted throughout the text, could be to blame for this disparity. This is a signal for the GoM that immediate steps need to be taken to restore stability and return business trust to the 2014 levels before it starts affecting economic growth, and with that public revenues. With decreased economic growth, or in worst case recession, the present dynamics of the hidden economy as well as the available policy landscape and measures, the vicious circle of hidden economic activities will without doubt be intensified.

Albania on the other hand differs significantly in relation to Macedonia and the surveyed Albanian businesses overwhelmingly claim that taxes are 'as high as they should be' with 69% and 73% of them claiming social and healthcare contributions rates respectively are set at proper levels.

Accordingly, among the **top 3 measures proposed by businesses in the three countries for reducing the hidden economy suggest that certain good governance deficiencies are contributing to creating fertile ground for development of hidden economy:**

- **Reducing taxes;**
- **Reducing/tackling corruption;**
- **More effective business stimulations;**
- **Increase efficiency of the court system;**
- **Implementing stricter laws.**

Working in the hidden economy often is not a matter of rational and profit maximizing behavior by individuals and business entities but is often determined by educational attainment, culture or it can even be socially embedded. Thus an effective hidden economy countering policy also needs to be a comprehensive social policy. Designed policies need to target formalization of the whole economic value chain and clusters of economic actors and relationships instead of just focusing

on case by case legislation or increasing penalties and control of non-compliance.⁵⁹ As the results from the population and business surveys show in Macedonia, Albania and Kosovo, designing a comprehensive policy against hidden economic activities unavoidably needs to be linked with the country's present policies for countering corruption and improving law enforcement and embedded in their respective economic growth strategies. However, there is a growing acceptance that at different scales the hidden economies are here to stay due to their resilient nature and adaptive capacities to changing political, legislative and economic environments.

Hidden economic activities can also be the carriers of great value added for the economy in the form of innovation and entrepreneurship as start-ups test their business models in the shadows to avoid some or all of the initial capital costs/business costs and redirect them into developing the business. The survey should provide governments of the three countries with a clearer view of its good governance deficiencies **(unfair competition, tax evasion, lack of social security and legal protection for workers, impact on government revenues, and stagnating quality/quantity of social services)** and develop measure to curb them or **harness its potential such as the one initiated by start-up entrepreneurship, labor flexibility during transitions, remittances**, etc. It is up to governments to make the decisions but it is up to researchers to provide the policy tools in the form of research and data which then governments can use for evidence based policymaking for the benefit of their societies.

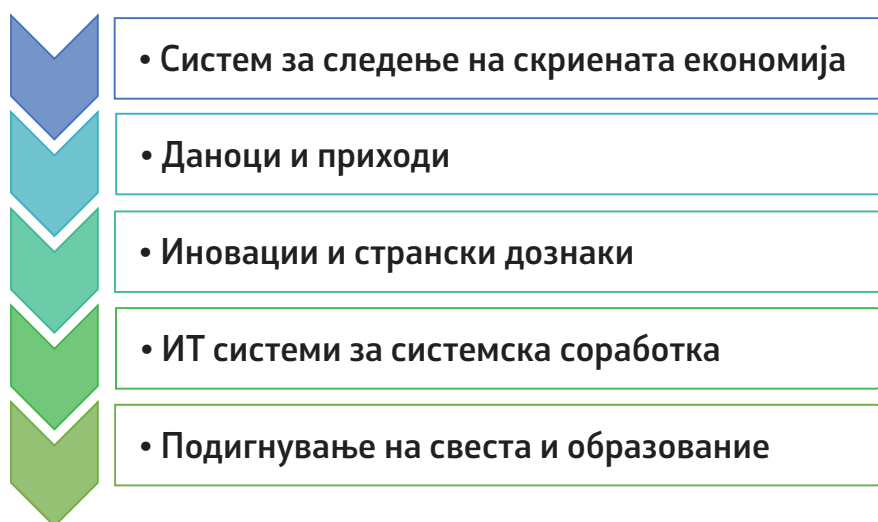
IX. RECOMMENDATIONS

Macedonia, Albania and Kosovo have **a serious problem** with the size and the proliferation of the hidden economy and its different components. The Hidden Economy Index presented in this report confirmed that both its business and households sectors see the hidden economy as a substantial obstacle to their operations and **a widely accepted practice**. Hidden employment is the component that stands out as the most urgent and problematic issue to tackle. This is particularly true for the most **vulnerable groups, such as lower income, lower education households**, which are most often victimized through hidden employment at the backdrop of the very unemployment rate in the country. A third of the employed under-declare income, and another 6% do not have a contract at all. These results, despite notable discrepancies in the different data sources, conform to the findings of the Labor Force Survey, the System of National Accounts calculations, as well as to other national and international, academic and policy studies.

The Government of Macedonia has understanding of the problem, and under pressure from the EU, has increasingly engaged in deliberate policy action to tackle the hidden economy. Appointing the Ministry of Labor and Social Policy as the coordinator of the action plan on countering the hidden economy clearly demonstrates the government's apprehension that it is hidden employment that needs the most urgent attention. **The GoM's overall economic policy towards lowering tax rates and improving the ease of doing business deserves commending as it seems to have contributed to the lowering of non-compliance. However recent planned restructuring of the tax system and planned move to progressive taxation (a.k.a tax increases) holds likelihood of exacerbating further the hidden economy.** But the authorities in Skopje, as well as in Tirana and Pristina, should carefully reconsider their longer-term strategy, as general government revenues have fallen steadily below 30% of GDP after 2011, which is a worrying indication of their **capacities to provide better public services in the future**. This implies a drastic increase in the efficiency of delivering public goods to the public, which does not seem to materialize.

The governments need to step up their efforts in tackling the hidden economy by **ensuring better coordination and collaboration** between the key different ministries and institutions, such as the Ministry of Labor and Social Policy, Ministry of Finance, and the Ministry of Economy. In addition, there is a need for a much bigger involvement of **the parliament and the political parties** in finding working long-term solutions, as it is likely that the problem is here to stay irrespectively of the power constellation. **Ethnic Albanian parties** in Macedonia should be particularly active in providing and following up on ideas, as data suggests hidden economy issues are particularly pronounced among the ethnic Albanian population which evidently it is also where the largest part of the most vulnerable groups are.

Important allies to all governments in their efforts to tackle the hidden economy should be active civil society organizations, as well as the social partners. It is advisable that these be brought together to meet two to four times annually under the auspices of the leading ministry to review progress and chart new ideas. Their work should be aided through the **establishment of a regular monitoring mechanism**, such as the Hidden Economy Index, as well as of formal *ex ante* and *ex-post* policy evaluations of particular measures, based on best EU **evaluation standards**. The EU Delegation should also be involved in the work of the Task Force to ensure EU support and compliance with the overall EU accession process.



1. Hidden Economy Monitoring System

The hidden economy is a highly complex phenomenon and **requires systemic and complex solutions**, and not just campaigns targeting isolated manifestations. **Formalization of businesses** might also be a **long and complex process with impacts market structure, rebalancing of the market power of existing players and consumers, and employment**. Hence, governments should plan their policies to tackle the hidden economy accounting for the impacts of the process and making sure it is fair and transparent. **Sequencing of reforms** is of paramount importance for limiting the social cost of transition from hidden to formal economy and preventing unfair advantages for business owners, who are close to law enforcement and control officials in charge of legalization processes. In order to design and implement a long-term comprehensive program to tackle the hidden economy it is important to have:

Organizations	Priority	Recommendation
	1	A widely accepted by policy makers, business associations and civil society holistic measurement system of the hidden economy , which will allow for thorough, reliable, valid, timely and sensitive to changes assessment of its dynamics, its causes, costs and effects. The Hidden Economy Indexes could serve as a first iteration to developing such a system.
	1	An efficient inter-ministerial and public-private coordination and cooperation mechanism to counter hidden economy should be in place. The coordination should be planned on different levels – both analytical and strategic (e.g. with Organized Crime Threat Assessment regularly implemented by the Ministry of Interior) and operative (e.g. with simultaneous inspections by different control units or information exchange between them).
<ul style="list-style-type: none"> > Task Force on hidden economy > The Social and Economic Committee > Ministry of Labor and Social Policy 	2	<p>The Task Force on Hidden Economy should prepare a Strategy and action plan with appropriately sequenced reforms to be accepted by policy makers, business associations and civil society.</p> <ul style="list-style-type: none"> o The action plan should provide for a regular monitoring of hidden economy against the implementation of reforms with the measurement system described above. o The action plan should provide cost-benefit and impact analysis for different formalization strategies that can be applied in order to guarantee a transparent and fair process;
	3	The inter-ministerial and public-private coordination and cooperation mechanism should provide technical and business interoperability between the information systems of all engaged with countering the hidden economy.

2. Taxes and Revenues

Social security contributions, though are in a league of their own, as people overwhelmingly consider they do not get the protection they (should) pay for. When the cap for social security is significantly higher compared to the average salary, and also the rate is higher, there is a huge incentive not to report the salaries partially or in full. It is important that authorities focus on finding a long term balance, which would require less intervention later on, even if it necessitates stronger budget support at present. The following is a non-exclusive list of ideas, which might help ease the situation with social security non-payment:

<i>Organizations</i>	<i>Priority</i>	<i>Recommendations</i>
> Public Revenue Service	1	Increase tax compliance readiness: Social security currently does not pay off in the eyes of private employers and employees and this is a decisive factor for evasion. Simultaneous reduction of the cap and rates of social security with increase of the base of those paying could be helpful. Currently, it seems that the pension system works fine primarily for the privileged public officials and managers of state owned enterprises. Data from Macedonia already suggests that reducing rates for social insurance might actually increase revenues through higher compliance. ⁶¹
> Public Revenue Service, > Financial Police, > Market and Labor inspectorates > Customs	2	Increase the capacity of the administration to detect non-compliers and to collect debts. This could include introduction of risk management system (selectively inspecting those with the highest potential negative impact), but the most important measure would be to unify the tax administration with social security contributions collection.
	1	Existence of various exceptions in the tax base for VAT is a strong incentive for VAT fraud , so broadening and harmonization of the VAT tax base would serve as an important instrument to limit the hidden economy.
> Public Revenue Services > Ministry of Finance	2	Expedite VAT returns in-line with increased institutional interoperability and data sharing. According to businesses, VAT returns are lagging significantly (especially in Macedonia) and increasing overall financial and administrative burden on companies and increases incentives to operate within the informal economy.
	3	Abolish the municipal corporate tax (firmarina) , which although not substantial generates a lot of confusion and frustration as is evident from business survey responses. Alternatively, the policy makers can look into the possibility of tax payment in semi-annual or quarterly instalment payments in order to spread the burden across a wider period and soften its negative effects especially on micro businesses, which take longer periods to accumulate income and profit.
> Public Revenue Service > Customs Administration	2	Further develop e-services that advance Paperless Tax Administration. In accordance with experience from the implementation of such systems in other tax administrations that the new IT system with only 1% increase in the tax/contributions collection rate the return of investment pays out after the first year of implementation of the new IT system. The new system should increase efficiency and interoperability among different agencies.

60 **Shurkov, E, Mickovska R.A.** (2014) "Hunting the Shadows – Tax Evasion Dynamics in Macedonia" Policy Brief nr. 33, Dec. 2014. Retrieved from:
http://www.crpm.org.mk/wp-content/uploads/2015/03/PolicyBrief33_ENG.pdf

3. Innovation and Remittances

The economies of the three countries, and domestic consumption in particular, are highly dependent on remittances, domestic private transfers, unrecorded production and retail of agricultural products, and the provision of various services to households and individuals on a non-market basis. Although some of the remittances are used as investments, most of it goes in the hidden economy and even in unregistered firms (relatively large extended family handicraft informal organizations). A significant share of the long-term unemployed are actually participating in the hidden economy and/or relying directly or indirectly to a combination of remittances and hidden economy through relatives. So, **a pragmatic policy to foster entrepreneurship and investments in the formal sector based on remittances** might contribute to the creation of new workplaces and economic growth and lower the hidden economy. In particular, this report has the following recommendations on the remittances policy:

<i>Organizations</i>	<i>Priority</i>	<i>Recommendations</i>
<ul style="list-style-type: none"> > National Banks, > Public Revenue Services > National Statistical Offices > Chambers of Commerce, > Ministries of Economy > FDI Agencies > NGOs working in social entrepreneurship 	1	<p>Improve the way remittances are measured and assessed by the state authorities, as the official transfers (accounted through the International Transaction Reporting System); Simplifying and reducing transaction costs associated with remittances to reduce their hiding and engage remittances receivers as potential investors and mentors to businesses rather than just as cash cows to be taxed. This can be done through A) Securitization of diaspora savings or even remittances (diaspora bonds) and B) Provide necessary training (or fund it) of personnel. A special emphasis and support given to initiatives that would likely materialize in the formalization of unregistered businesses and generally reduce the hidden economy.</p>
<ul style="list-style-type: none"> > Employment Agencies, > Ministries of Labor and Social Policy 	2	<p>Develop co-financing schemes for engagement of unemployed with different magnitude of support based on type of unemployment and area of projects (youth unemployment, long-term unemployment, etc.). Long-term unemployment is usually turning into permanent loss of employability for most of this group in the region, which calls for sustained government social support.</p>
<ul style="list-style-type: none"> > National Banks > Public Revenue Service > Financial Police 	1	<p>The National Banks of the three countries should develop a regulatory framework for cryptocurrencies and closely monitor the development of this market as it also relates to remittances. They can do so by using the latest regulatory developments and regulatory experience (July-September 2017) in the cryptocurrency markets coming from China, USA, Russia, Vietnam, Australia etc. This will assure that citizens have basic legal protection while maintaining the potential benefits that can materialize from the crypto currency technology.</p>
<ul style="list-style-type: none"> > Employment Agencies > Ministries of Labor and Social Policy 	1	<p>The Employment agencies have to improve the success rate of programs dedicated for employment of members of vulnerable groups (Roma unemployed and social assistance receivers) through cooperation with external social partners and NGOs. Subsidizing the employment of users of social assistance and integration of the Roma population into the formal economy is important for reducing social tensions.</p>

<ul style="list-style-type: none"> > Ministries of Labor and Social Policy > Employment Agencies > Parliaments 	2	<p>Strong political engagement in fighting income inequality on a state and regional level especially concerning the vulnerable groups (low income, low educated, women, long-term unemployed, ethnicities). Political party agendas should reflect a clear strategy for decreasing income inequality among its respective electorate that goes beyond the prerequisites for proportional employment of ethnic groups in the public administration, especially in the case of Macedonia (in relation to 2001 Ohrid Framework Agreement (OFA)). Even though these prerequisites improve the general position of ethnic groups, they do show lack of any focus on vulnerable groups which is further exacerbated by corruption and clientelism plaguing political system and the society as a whole.</p>
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4. Institutional Interoperability IT Systems

Hiding imports at the customs is one of the most potent hidden economy activities, which provides quick returns for the perpetrators, and send shock waves of informality down the value and retail chain. The situation at the Macedonian customs shows some alarming indicators. Citizens and businesses perceive corruption at the customs as high. Mirror statistics prove that, for instance, only 67% of officially exported goods from Greece to Macedonia in 2014 (as reported by Greek customs) has been officially imported in Macedonia from Greece (as reported by Macedonian customs). Limiting hidden imports can be achieved through:

<i>Organizations</i>	<i>Priority</i>	<i>Recommendations</i>
<ul style="list-style-type: none"> > Public Revenue Service, > Customs Administrations > Financial Police > National Banks 	1	<p>Highlighting the linkages between smuggling and contraband and political party financing through the undue savings from import duties and taxes. Hidden imports could be traced down to specific groups of goods, and then linked to the main importers involved, and whether they have party funding or kin relationships with decision-makers. Although ComExt database has always been public, it is rarely if at all used by investigative journalists, custom officials, revenue agency or law enforcement officers.</p> <p>Implement rotations (officer rotations, shift rotations, randomized computer generated check schedules) at the customs to prevent routinizing the corrupt relationships between officers and companies/truck drivers. Introduce random checks by mobile units, unaware of what they will be checking, randomly generated routes etc.</p>
	1	<p>Strengthen country-wide whistle-blowing programs piloting them in the customs. The program within customs should be synchronized with the rotation management, and random checks and this might have a considerable effect on corruption and hiding.</p>
<ul style="list-style-type: none"> > Customs Administrations 	1	<p>Introduce sophisticated IT systems, which can connect Customs Administrations within the countries but also to their neighbors in order to expand capacities to real-time data and automatic fraud detection and, red-flagging of imports or importers. Comext database can be utilized for this purpose.</p>

> State Labor Inspectorates	1	The State Labor Inspectorates (SLI's) should develop a reporting system that is compatible with the major data management systems and software. A more detailed view of the irregularities they detect such as unregistered workers, unpaid wages, envelope wages etc., and the context in which they happen can give analysts and advisors within the MLSP and EA as well as external researchers, powerful tools for comprehensive analysis of the labor market and its irregularities, which can be linked to the hidden economy. This reporting system, however, has to be compatible and adopted by other related institutions and agencies that provide publicly available data on their activities, such as the Financial Police (FP), State Market Inspectorate (SMI), Customs, etc. This data management compatibility among institutions will increase their interoperability, and will provide researchers with ample detailed data that can lead to faster policy recommendations, proof-based policy evaluations, and data and feedback for improving policy implementation, which has been noted as a continuing problem by the EU progress reports.
> Financial Police	2	The Financial Police (FP) should implement the same data management system as the SLI, and ensure data exchange with the Public Revenue Office (the PRO). Additionally, it should develop a data exchange system with the courts, which process the cases they have provided against the perpetrators especially in terms of revenues lost and fees collected. The PRO can have a leading role in the design of this connection between the FP and the Courts due to their extensive experience in data exchange and implementing reporting and data management systems. This data will provide insights into the scale of these offenses as well as the efficiency of the FP and the courts in processing such cases, which is important for discouraging new offences and encouraging tax morality. This is especially important in Albania's case as efficiency of the court system was flagged as an important factor for the hidden economy.

5. Awareness raising and Education

Increasing the awareness among the public, especially among minors – the future citizens, on the risks and costs to society linked to undeclared work and tax evasion will facilitate a cooperative spirit among government agencies and citizens from all ages as well as business representatives. Informing citizens about the positive effects of complying with regulations, the insurance nature of social security contributions and how these are proportionally connected with the citizen's personal responsibility of complete payment of taxes will pave the ground for present and future citizens to be valuable and contributing members of a better society.

<i>Organizations</i>	<i>Priority</i>	<i>Recommendations</i>
> Public Revenue Service (PRO) > Ministry of Education > Ministry of Labor and Social policy (MLSP) > State Labor Inspectorates (SLI)	1	As part of Civic Education curriculum include sessions dedicated to tax evasion and undeclared work with speakers from the Public Revenue Office, State Labor Inspectorates and/or NGO sector. Teaching pupils of their future responsibilities as fully fledged citizens of a society in terms of their responsibility to pay taxes and how their non-payment negatively influences the very public goods and services they receive in the forms of schools, education, healthcare and other infrastructure. Awareness raising campaign targeted at youths to promote successful transition from school to decent work.

<ul style="list-style-type: none"> > Public Revenue Service, > State Labor Inspectorates 	3	Create a database on research done within the field of hidden economy as well as compiled best practices and make it available on the websites of the Public Revenue Service and State Labor Inspectorates.
<ul style="list-style-type: none"> > Public Revenue Service (PRO) 	1	Campaign of 'public shaming' by the PRO publishing a black list of unpaid debts and late paying debtors on a monthly basis.
<ul style="list-style-type: none"> > Public Revenue Service (PRO) > Employment Agency (EA) > State Labor Inspectorates (SLI) 	2	Provision of government subsidized entrepreneurship training (quarterly or on demand) for business representatives and HR and Financial managers. This will provide access for businesses to education and practical advice on the benefits of formalization of businesses and of complying with tax and labor codes. The PRO, EA and SLI can also provide tips and best practices on how to avoid unnecessary and costly inspections as well as an annual brief in the latest most important changes in the tax and labor code.

Macedonia, Albania and Kosovo, as most EU 28 countries, employ measures targeting undeclared work and tax evasion which **focus predominantly on repressive and punitive measures**, despite some recent measures towards enabling formalization of labor and businesses. Their Governments should consider, first, **changing the balance among the existing punitive measures** (progressive punishments fees) and second, **the balance between punitive measures and incentives**. Businesses across the three countries claim that incentives are lacking - pointing out that this is a primary reason to hide economic activity. Coupled with preventative measures such as **increased and better targeted outreach and education measures towards the main risk groups**, should be able to overhaul the balance of measures in favor of enabling formalization.

However, there is evident **absence of evaluations of different policies and measures**, especially in-depth assessments which go beyond the basic numeric indicators. This in turn prevents more valid estimations of the effectiveness of different policies and particular measures. **Evidence-based policy making is a must in order to achieve the appropriate balance between punitive, preventative and stimulating measures.**

Last, but not least, **the unpredictability of laws** has been restated in 2016-2017 as a **big problem** by almost half of businesses in Macedonia and Kosovo. It should serve as an important indicator to governments and policy makers. **Frequent and deep changes do not give enough time for businesses to adapt and later fully comply with the new laws despite their willingness to do so which can push them towards informality as they are seeking for ways to comply.**

X. LITERATURE

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