

## **HIDDEN ECONOMY IN SOUTHEAST EUROPE: BUILDING REGIONAL MOMENTUM TO MITIGATE ITS NEGATIVE EFFECTS**

**Policy Brief, December 2016<sup>1</sup>**

Institutional asymmetry and non-alignment between formal and informal institutions provide better explanation of undeclared work's prevalence in Southeast Europe compared to more traditional rational cost-benefit optimization models for workers and employers.<sup>2,3</sup> Similarly, the institutional incongruence might explain better the discrepancies in international trade statistics as provided by countries in SEE and by their partners. Research has shown that the level of corruption in importing countries affects the export structure of their counterparts.<sup>4</sup> Flows of goods and money across borders in SEE are instrumental for economic growth, but also the way it happens fuels illegitimate practices.

Policy approaches against hidden economy could focus on **direct controls** to detect and punish non-compliant firms and employees or positively discriminate compliers by less inspections or providing grants, in-

### **KEY POINTS**

- **Not declaring** in full or partially **economic activities in SEE remains widespread** in virtually all areas of government – permissions and licenses, labour contracts, social security, taxes and custom duties. It signals a persistent gap between formal and informal institutions and lack of coherent enforcement of rules.
- **Corruption pressure** is higher towards those engaged in the hidden economy. At the same time their susceptibility to corruption is also higher, confirming the institutional incongruence.
- The immense **diversity of the scale** (from 19 % in Croatia to 81 % in Kosovo\*), **prevailing patterns** (no written contracts in Turkey, non-payment of health care contributions in Kosovo\*, envelope wages in FYR of Macedonia and Bulgaria, non-formalised business in Albania), **formal vs informal wage average** (higher formal wages in Bosnia and Herzegovina, Albania and Turkey and lower in Kosovo\* and Bulgaria) requires country specific **tailor-made policies and sequencing of reforms**.
- Working in the **hidden economy in SEE is often socially embedded**, culturally and educationally predetermined, and not simply a matter of a rational choice to maximise personal benefit. An effective economic policy to mitigate the negative effects of undeclared work should not be purely monetary or fiscal, but a comprehensive social policy.
- **Mirror statistics** suggests significant institutional deficiencies within custom offices as only 10 % of imports to non-EU SEE countries from EU countries or themselves have less than 5 % discrepancy as reported by the imported and exporter.

<sup>1</sup> This policy brief has been prepared by Dr. Todor Yalamov, Assistant Professor, Sofia University and SELDI expert, and has been reviewed by Professor Colin Williams, Dr Peter Rogers, and Ruslan Stefanov from the University of Sheffield Management School. It is based on findings from SELDI's work on hidden economy in SEE as well as the GREY Marie Curie project.

<sup>2</sup> Williams, C.C. and Horodnic, I.A., 2015. Explaining the prevalence of illegitimate wage practices in Southern Europe: an institutional analysis. *South European Society and Politics*, 20(2), pp. 203-221.

<sup>3</sup> Williams, C.C. and Horodnic, I.A., 2015. Tackling the informal economy in Southeast Europe: an institutional approach. *Southeast European and Black Sea Studies*, 15(4), pp. 519-539.

<sup>4</sup> Lambsdorff, J.G., 1998. An empirical investigation of bribery in international trade. *The European Journal of development research*, 10(1), pp. 40-59.

\* Kosovo (under UNSCR 1244/99).



**direct controls** by closing the gap between formal and informal institutions and **managed comprehensive legalisation campaigns**. As **hiding, not- or miss-declaring economic activities are a rational response to deficiencies in the institutional environment**, indirect controls might not be effective either so a third converging target might be better for policy makers to aim. Some opportunistic firms capture law enforcement institutions and the legalisation process itself so they can guarantee a dominant position for themselves after the legalisation process ends. So, any policy option countering the undeclared economy should guarantee procedural justice in terms that the legalisation would not result in an unfair structure of the market.

## Macroeconomic Performance and International trade

The current policy brief provides different estimates of hidden economy characteristics in nine SEE countries<sup>5</sup> based on the findings of the *SELDI Hidden Economy Survey 2016*,<sup>6</sup> *Eurostat's ComExt database*<sup>7</sup> and other available sources.

SEE countries differ in size and openness of economies. Montenegro and Kosovo\* are micro economies, FYR of Macedonia, Bosnia and Herzegovina and Albania are small, Bulgaria, Serbia and Croatia middle, and Turkey

is big. In terms of openness, Bulgaria stands out with 131 % of trade as a share of GDP. Montenegro, Serbia and FYR of Macedonia, and Croatia are moderately open. Turkey, Kosovo\* and Albania are relatively closed. All countries, with the exception of Montenegro have significant mirror statistics discrepancies<sup>8</sup> with the major trade partner. Between 54 % and 80 % of these imports are hidden and in one case official imports exceed by 85 % compared to data obtained from the trade partner.

The discrepancies per country and trade with the EU28 plus non-EU SEE countries are substantial. For Turkey it is 26 %, followed by Montenegro 28 %, Bosnia and Herzegovina 31 %, FYR of Macedonia 36 %, Kosovo\* 39 %, Serbia 51 % and Albania 52 % of reported import. If discrepancies are recalculated based on the ratio trade to GDP, then Serbia, FYR of Macedonia and Albania are in worse situation.

SEE countries had an average real per capita GDP growth rate for the past 15 years of 3-4 % per annum, which is **insufficient to support rapid convergence with the EU**. SEE has a stable, **low labour force participation rate**<sup>9</sup> since 2000 (between 41 % in Kosovo\* and 56 % in FYR of Macedonia). Romania, Albania and Serbia have experienced falling employment, whereas FYR of Macedonia and Bulgaria have grown. The rest remained stable.

**Table 1. Mirror statistics for selected economies: % more (+)/less (-) reported imports from SEE countries vis-a-vis the export reported by their trading partners (2015)**

	AL	BA	BG	DE	GR	HR	IT	MK	ME	NL	RO	XK
AL		32	-25	20	-23	-39	-46	1	35	-52	-20	11
BA	31		1	2	-22	-26	1	8	-7	-20	11	
ME	36	3	-44	52	-3	-17	-4	19		-12	-1	-78
MK	21	1	-19	-28	-27	-21	2		1	12	-44	-7
TR	81	27	-9	-22	-7	-7	-14	22	-60	-57	-7	132
XK	27		1	85	286	3	180	-8	15	-25	10	
XS	-10	7	-27	-20	-7	-38	-27	1	-41	-55	-44	

Source: ComExt database, 2016.

<sup>5</sup> These are: Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Kosovo\*, FYR of Macedonia, Montenegro, Serbia, and Turkey. For simplicity, in this brief we refer to them interchangeably as the SELDI countries, SEE countries or Balkan countries. The Western Balkan countries mean non-EU Balkan countries.

<sup>6</sup> The brief summarises the findings of the SELDI background study *Hidden Economy and Good Governance in Southeast Europe: Regional Assessment Report 2016*.

<sup>7</sup> <http://epp.eurostat.ec.europa.eu/newxtweb/mainxtnet.do>

<sup>8</sup> Mirror statistics is the comparison of what a country reports as imports (exports) from another country and what the latter reports as exports (imports) to the former. Theoretically it should be the same or very close.

<sup>9</sup> Includes the population aged 15+.

**Unemployment** in the region is higher than in EU28 and is a **serious cause for concern**. Far more worrying is the **long-term and youth unemployment** in each country. Bosnia and Herzegovina and Kosovo\*, for example, have higher youth unemployment rates than Greece and comparable to Spain – two of the worst performing EU economies. In Bosnia and Herzegovina, long-term unemployment is at 90 % and in other Western Balkan countries it is between 70 % and 80 %, which means that non-youth unemployed are practically excluded from the economy and **left to survive on remittances and the hidden economy**, or forced to live in extreme poverty. Many households in all SEE countries still rely on the subsistence economy (producing their own food and bartering) to make a living.

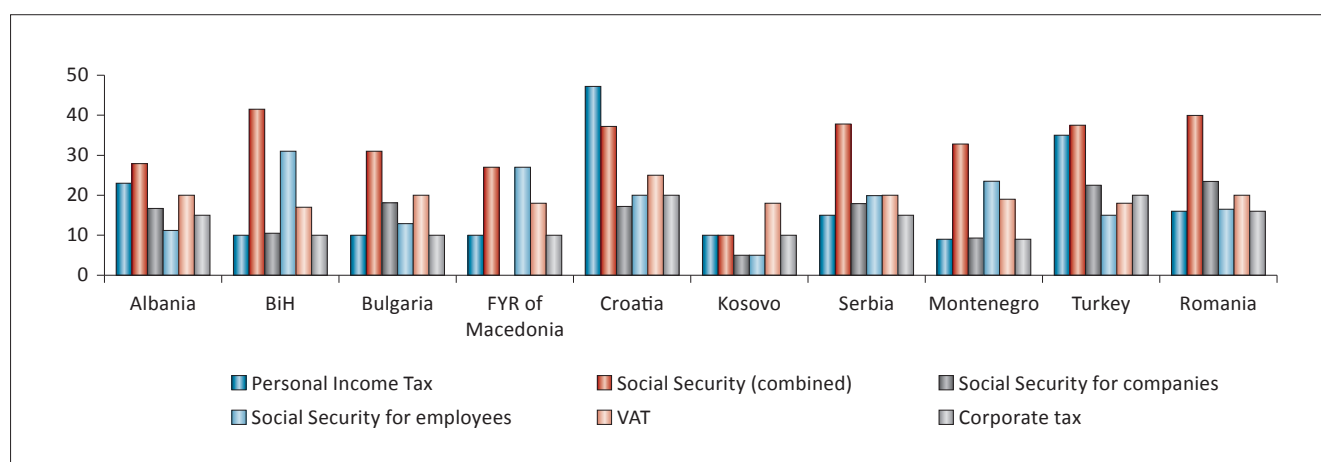
**Emigration** has been a powerful valve easing the problem of domestic unemployment and poverty through employment abroad, with flow of remittances back to relatives at home. A percentage point increase in remittances is associated with a 1.8 percentage point decrease in employment across SEE countries. **The link between remittances, hidden employment and the hidden economy is positive** in SEE.<sup>10</sup> Remittances fuel internal consumption (green markets as a rule are almost entirely hidden), serve as a social safety net (encouraging riskier hidden employment) and increase domestic investments and entrepreneurship, frequently hidden (suitcase trading, crafts, agriculture). Albania and Bosnia and

Herzegovina have experienced a strong relative fall in remittances, but their share of GDP remains high. In 2000, remittances were as high as 29 % of GDP in Bosnia and Herzegovina and 16.5 % in Albania. Remittance levels dropped to 11 % and 9 % of GDP in 2015. Since 2005, the regional remittance leader has been Kosovo\*, with an average of 18.8 % of GDP, and 16.7 % for 2015. Kosovo\* is 19<sup>th</sup> and Serbia 39<sup>th</sup> worldwide according to this indicator.<sup>11</sup>

## Paying Taxes and the Hidden Economy

Tax avoidance occurs when the expected marginal utility of public goods and services, minus the cost of the risk of being caught for non-compliance is much lower, in terms of private gain, than the marginal alternative cost of paying the amount due. Tax and social security contribution rates explain between 35 % and 52 % of the variation of Schneider's Shadow Economy in SEE.<sup>12</sup> Yet, the *SELDI Hidden Economy Survey 2016* sheds doubt on the assumption that high tax rates drive the tendency to hide, as Croatia, with the highest tax rates, had the lowest hiding rates, while Kosovo\*, with the lowest tax rates, had the highest hiding rates (Figures 1 and 2). This is in line with the institutional incongruence thesis and earlier comparisons between Nordic states with Southern Europe. Evasion is attributed to factors such as income levels, tax morale, and

**Figure 1. Selected tax rates for Southeast Europe, 2015**



**Source:** Trading Economics, [tradingeconomics.com](http://tradingeconomics.com)

<sup>10</sup> Compare also to A. Ivlevs: *Remittances and informal employment: evidence from transition economies*, mimeo, 19.4.2016.

<sup>11</sup> Data from the World Bank.

<sup>12</sup> Schneider, Friedrich, Buehn, Andreas and Montenegro, Claudio E., 'New Estimates for the Shadow Economies all over the World', 2010.

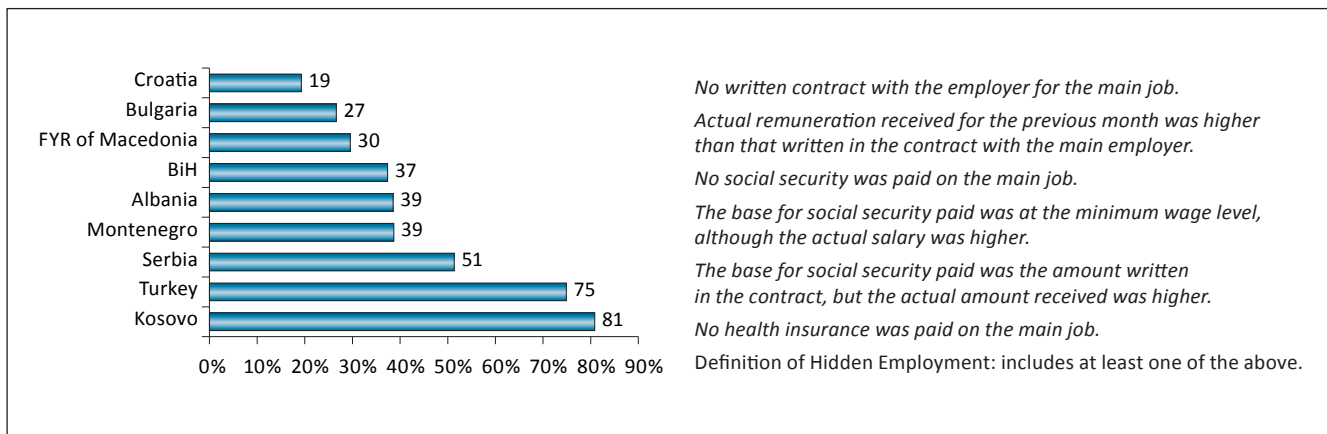
satisfaction with public services.<sup>13</sup> Tax morale is linked to perceived quality and trust in institutions and expectations what others are doing.<sup>14</sup> If about half the civilian labour force (as is the case in Turkey, and Bosnia and Herzegovina) stays outside, or at the margins of the formal social security system for 15 years, **a new morale will already be ingrained in the new generation.** In such families, **trust in institutions is detrimentally low** and in certain cases, may degenerate into active distrust and feelings of affiliation to another country or nation.

While taxes in SEE may be generally low, their **administration costs** outweigh the advantages, as in the case of Albania (companies see tax administration, not taxes, as an obstacle in itself), and Bulgaria (where taxes have some of the lowest rates and are few in number, but administrative compliance for SMEs is too costly), or in Bosnia and Herzegovina (where tax complexity is enormous<sup>15</sup> due to the intricate composition of state, conflicting institutions and political instability).

The relative proportions of different taxes suggest a diverging pattern between Southeast European

countries and the EU, where society as a whole pays relatively more than the business sector. In 2012, people in Southeast Europe paid between 2.05 % (FYR of Macedonia and Bosnia and Herzegovina) and 4.61 % (Serbia) in personal income taxes as a share of GDP. For the region, this is on average just 3 %, four times less than in Lithuania and Italy, and half that of Portugal. It could be argued, based on these data, that there is significant underreporting of income (salaries or self-employed earnings) and, consequently, of social security contributions. While the differences between SEE countries based on income tax revenues as a share of GDP alone is small (only 2.56 p.p.), social security systems differ substantially. The lowest level of funding is in Albania (around 4 % of GDP) and the highest in Bosnia and Herzegovina (around 16 % of GDP). The countries’ ranking corresponds to the social security rates paid by employees – 11.2 % in Albania and up to 31 % in Bosnia and Herzegovina on taxable income. This could well be interpreted according to higher tax gaps on personal income and social security in relation to VAT in the region, and because companies are better positioned to avoid taxes, while individuals who wish to reduce their tax bills usually only have evasion as an option.

**Figure 2. Employed in the Hidden Economy ( % of those employed in a main paid job, for which at least one of the below was true)**



Source: SELDI Hidden Economy Survey, 2016.<sup>16</sup>

<sup>13</sup> Hanousek, J. and Palda, F., 2003. Why people evade taxes in the Czech and Slovak Republics: A tale of twins. *The Informal Economy in the EU Accession Countries: Size, Scope, Trends and Challenges to the Process of EU Enlargement*. Sofia: CSD, pp. 139-174.

<sup>14</sup> Riinvest Institute, ‘To pay or not to pay- A business perspective of informality in Kosovo’, 2013.

<sup>15</sup> Taxes paid on wages in Republika Srpska differ substantially from the Federation of Bosnia and Herzegovina: 56 % and 73 % respectively on net salaries.

<sup>16</sup> Sample sizes are as follows: Albania (1050), Bosnia and Herzegovina (1007), Bulgaria (1008), FYR of Macedonia (1001), Croatia (955), Kosovo\* (1000), Serbia (1061), Montenegro (1040) and Turkey (1219). Field research was conducted from January to February 2016 by professional interviewers. More information on the methodology applied is available on request from the SELDI secretariat.

## Patterns of Hidden Economy in SEE

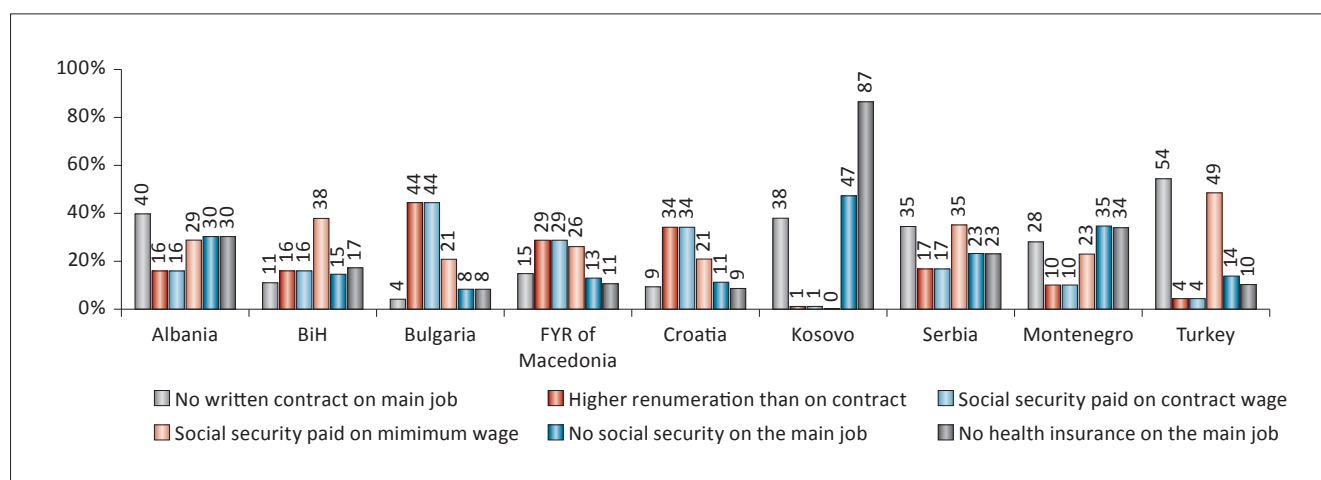
Besides enormous differences between levels of hiding, which are as low as 19 % for those engaged in economic activity in Croatia, and as high as 81 % in Kosovo\* (Figure 2), the countries have different hiding patterns and hence different problems to tackle. There is a strong variation across the region regarding how many of those employed are **working without contracts**. In Croatia, FYR of Macedonia, Bulgaria and Bosnia and Herzegovina the levels are low (below 5 %), and in Albania, Serbia and Montenegro (15 %, 17 % and 11 % respectively), moderate, or around the regional average (15 %). In Turkey (41 %) and Kosovo\* (31 %) they are the highest. More than half of all hidden employment in Turkey is characterized by the absence of a formal contract. The main reason for this is evading social security payments. Similarly, more than a third of hidden employment in Serbia, Kosovo\* and Albania do not possess labour contracts. Lack of contracts is not just a symptom of hidden labour and tax evasion. It also signals **inefficient labour markets**, lack of protection and a poor level of trust in the judicial system. Employees without contracts often work significantly longer hours (including night shifts, weekends and holidays) with no additional compensation, do not use sick leave and are locked in their jobs without the opportunity of upward employment mobility. When workers decide to leave

(change job), they often forfeit the last month's wages or receive only the amount officially stated in their contract. Bulgaria might be a **positive example** to others in the region, as it managed to address the lack of labour contracts even before EU accession through a combination of mandatory registration of contracts and intensified, continuing inspections.

Virtually all Kosovars who are in hidden employment also evade **health insurance payments** completely (87 %). The reason for this is their dissatisfaction with access to and the quality of health services (especially in rural areas), and prevailing corruption.<sup>17</sup> The other countries from the region which face severe constraints in funding their health care systems are Montenegro and Albania, where every third person in hidden employment does not pay any health and social security contributions at all.

On average, 20 % of workers with contracts in SEE receive **envelope wages**, i.e. a higher figure (not declared to the authorities) than that stated in their labour contract. The outliers in this respect are Turkey, at over 40 %, and Croatia, at just 8 %. Almost half of hidden employment in Turkey pay social security on the minimum wage and save on the difference to their actual salary. The problem is similar in Serbia and Bosnia and Herzegovina, where between 35 % and 38 % of those active in the hidden economy pay social security on the minimum wage. In FYR of Macedonia, a third of employees use similar tactics.<sup>18</sup>

**Figure 3. Prevalence of different types of hidden employment in Southeast Europe**



Source: SELDI Hidden Economy Survey, 2016.

<sup>17</sup> Uka, Fitim. "Satisfaction with Health care Services and Perceptions on Presence of Corruption". UNDP.

<sup>18</sup> Hit and Miss – The Dynamics of Undeclared Labour in FYR of Macedonia, CSD and CRPM, Policy Brief No. 31, November 2014, p. 11.

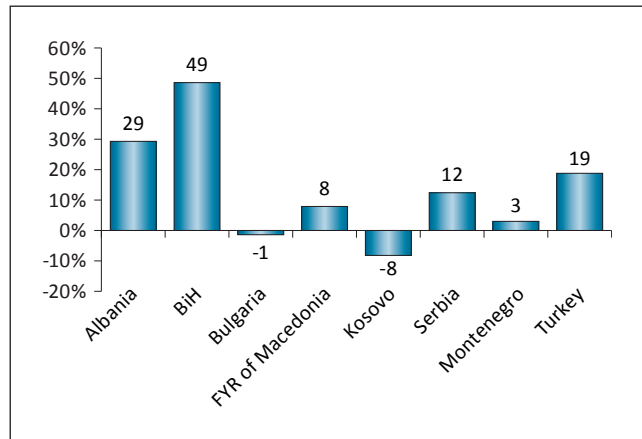


Participating in hidden employment is sometimes a matter of choice, but more often it is a reinforcing social net that creates specific tax morale. Compared to the official economy, people who are employed in the hidden economy in Southeast Europe are slightly younger (2 years on average), more likely to be male (62%), and tend to know others who are also hiding income from the authorities. The age difference is due to the participation of youth (under 30 years of age) in hidden employment, outnumbering those in formal workplaces. This finding has important policy implications, as often, policy measures seem designed for individual transactions (employment or revenue reporting) and do not reflect **the social embeddedness of the phenomenon**.

The *SELDI Hidden Economy Survey 2016* found that **people in SEE earn more in the formal than in the hidden economy** despite widespread belief that the opposite is true. The premium is as high as 50% in Bosnia and Herzegovina and 30% in Albania. Surprisingly, in Bulgaria and Kosovo\*, the premium is negative, suggesting employees in the hidden economy earn more than those who are completely formally employed, and this may indicate serious tax policy issues and non-participation or lack of trust on the part of higher earners in the official economy (Figure 4). Those who work in jobs that offer higher pay have educational backgrounds and skills at the level of advanced graduates (masters) and are more often found in the formal economy. In Montenegro, the lowest decile employed in the hidden economy earns on average 36% of the average income of the lowest decile in official economy.<sup>19</sup> As deciles move up, the gap diminishes, but income earned within the informal economy never exceeds that in the formal one.

The *SELDI Hidden Economy Survey 2016* shows that people in SEE who are part of the hidden economy work longer hours than those in the formal one, engage more often with work at home and on private premises, and are more relaxed (not judgmental) towards morale in society (they do not believe that there is a serious moral crisis in society). Yet, their feeling of **happiness** is slightly lower than the country average, though this does not affect their subjective self-positioning in the social hierarchy. The only exception is FYR of Macedonia, where hidden employment lowers self-esteem significantly in terms of one's place in society.

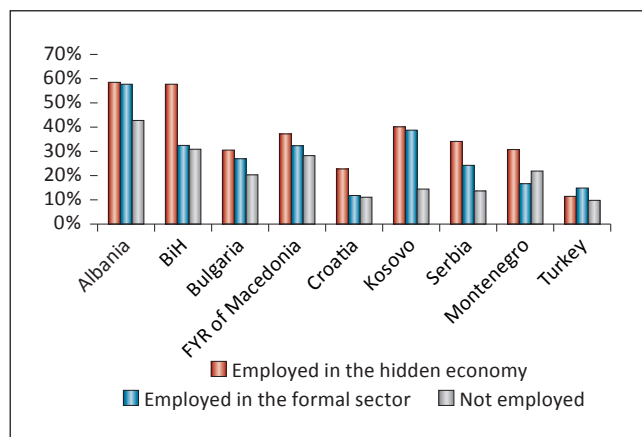
**Figure 4. Wage premium in the formal economy over the hidden economy**



Source: SELDI Hidden Economy Survey, 2016.

Those in hidden employment in SEE are more often subject to **corruption pressure** – both because of work-related incidents (inspections that reveal irregularities and prescribe fines) and home-related issues (access to health, access to finance, and access to education all require social and health security taxes to be paid or bought under the table). On average, the corruption pressure gap is 5% but in Bosnia and Herzegovina it is up to 25%, and in Montenegro, up to 14% (Figure 5). Corruption pressure is also related to the ability to pay, as across the region it has least influence on the unemployed.

**Figure 5. Corruption pressure (share of those in respective employment situations)**



Source: SELDI Corruption Monitoring System, 2016.

A key message from the *SELDI Hidden Economy Survey 2016* is the **social and market embeddedness of the**

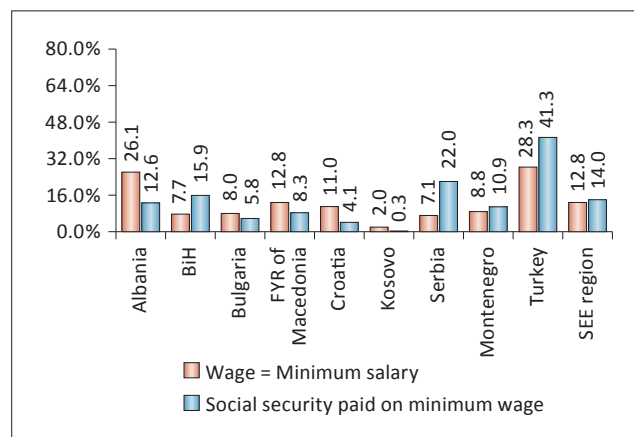
<sup>19</sup> UNDP, National Human Development Report for Montenegro, Informal work: from challenges to solutions, 2016.

**hidden economy phenomenon**, which requires the sequencing of policy measures and improvement of the overall level of enforcement of the rule of law in society. Firms which start unregistered and spend more time operating in the shadows have significantly higher subsequent annual sales, employment and productivity growth rates, compared to those that registered from the outset.<sup>20</sup> Consequently, strict control on start-ups may be detrimental to development. Approaches which help to formalize a cluster of companies relying on a complex nexus of social relationships, including informal investment through remittances (as in FYR of Macedonia, Kosovo\* and Bosnia and Herzegovina) might be more effective than labour and tax inspectors conducting raids (which often only creates more corruption pressure and results in making hidden businesses and employees poorer).

## The Role of Minimum Wages

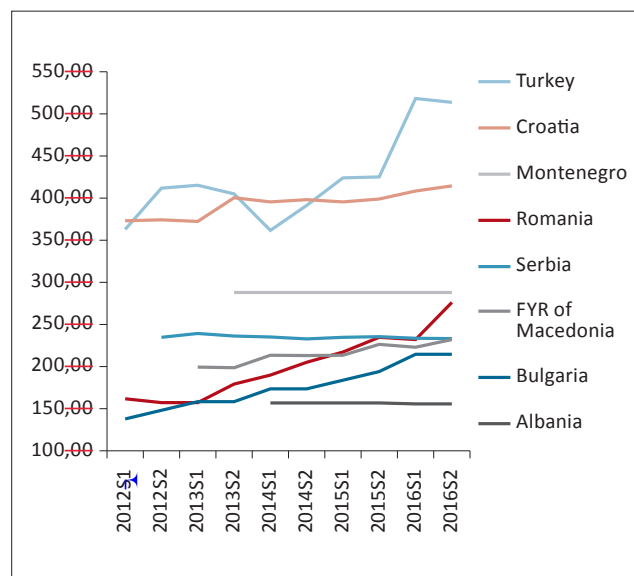
Minimum wages make economic policy sense (besides being a threshold for the collection of revenues from those having formal contracts) for two countries only, Albania and Turkey, where 26 % and 28 % respectively of employees receive the minimum wage and a total of 39 % and 70 % respectively of **employees pay social security on this minimum wage** (Figure 6). In all other countries, the proportion of employees who receive the minimum wage is between 2 % (Kosovo\*) and 11 % (Croatia). Only in Serbia there is a significant number of employees (22 %) who receive higher salaries than the minimum wage, but report the minimum wage as their income level for social and healthcare security payments. In many cases, governments tie specific prices of public services and the salaries of public officials to the minimum wage. Therefore, by increasing the minimum wage, they increase public revenue and (tacitly) spend more on public administration. Montenegro's Human Development Report 2016<sup>21</sup> confirms that the stricter enforcement of minimum wages for informal workers might be rather a burden for self-employed people (the majority of the lowest decile groups) due to the associated costs that they would be obliged to pay to the government. Therefore, policy makers across the region should study income levels carefully, especially for the poorest 20 % of employees, who earn a total of between 5 % (Romania

**Figure 6. Role of minimum wages for personal income and social security payments in SEE**



Source: SELDI Hidden Economy Survey, 2016.

**Figure 7. Minimum wage dynamics in SEE (2012 – 2016 measured semi-annually)**



Source: Eurostat, 2016.

and FYR of Macedonia) and 9 % (Kosovo\* and Albania) of the total income earned by all employees for every SEE country. Increasing the minimum wage for these lower income people might entail a negative welfare change, due to increased spending on services tied to the minimum wage (medical services, kindergarten fees and various administrative services). Tax reforms might be needed, including concerning VAT spending by the poorest decile.

<sup>20</sup> Williams, C.C., Martinez-Perez, A. and Kedir, A.M., 2016. Informal entrepreneurship in developing economies: the impacts of starting-up unregistered on firm performance. *Entrepreneurship Theory and Practice*.

<sup>21</sup> UNDP, National Human Development Report for Montenegro, Informal work: from challenges to solutions, 2016.

In Serbia, for example, the ratio of the minimum to the average wage was at 50.1 % as of February 2016, which is very high by international comparison. This level was already reached in 2012, during the parliamentary elections, as a government concession to the unions in order to ensure political support for the ruling coalition. Setting a high minimum wage brought about a reduction in demand for low-skilled labour and led to an increase in the level of non-compliance among businesses. As a result, there was a decline in formal, and an increase in hidden employment.

## Policy Recommendations

- Countries should plan and implement **holistic legalisation programs, sequencing** complex measures to **move** undeclared or partially declared businesses **towards** full compliance, aligning with the principles of **fair transition** or **procedural justice, employment protection** and **mitigating the negative effects** of hidden economy. These programs would obviously differ from country to country, but would employ both direct and indirect controls and would target both the supply and demand sides of hidden economic activities (labour, sales).
- All **National Statistical Institutes** should implement carefully the Eurostat/OECD methodology for **non-observed economy adjustments to GDP** and publish timely and comprehensive descriptions of imputations by non-exhaustiveness type and economic sector.
- The use of **mirror statistics** under well-defined algorithms might contribute both to the **fairness of enforcement process** and to quick full compliance in terms of imports and exports.
- **Prioritize** and **sequence reforms** on **tax gap areas**, which have **the strongest negative social impact** (for example, health care security evasion in Kosovo\*, non-existent labour contracts in Turkey, and excise duty evasion in Bosnia and Herzegovina and Albania). Businesses and citizens should be **widely consulted** on these areas, so that society at large feels **engaged** in needed reforms and raise their **trust in institutions**. Conduct **regular tax gap assessments** (including per type of tax), following a common methodology and adjust policies according to findings.
- Design policies to **target formalization of the whole economic value chain** (or significant parts of it) and **clusters of economic actors and relationships**, as opposed to focusing on case-by-case legalisation, by increasing penalties and direct control of non-compliance. Reforms should tackle the social embeddedness of hidden economy, its cultural and educational predetermination.
- In remittance-incentive countries (e.g. FYR of Macedonia, Kosovo\* and Bosnia and Herzegovina), stakeholders should design schemes to **reduce the cost of transferring remittances**, and **match domestic entrepreneurship development schemes and foreign donor programs**, offering special incentives for legalising workers abroad.
- **Rely more on technology** (electronic payments, cash registers with fiscal memories linked in real time to revenue agencies, electronic filing of tax forms, points of single contact, etc.), automation and algorithms (risk profiling and sampling for inspections), and **less on personal judgement**.
- Policies tackling the hidden economy should be linked to those **countering corruption and improving law enforcement**, while embedding them all in the overall economic growth strategy of the country. Countries in **SEE need to double their annual average real GDP per capita growth rates at least**, if they are to achieve and sustain lasting governance change.
- Countries in SEE should **cooperate** with each other, especially on **cross-border issues** linked to hidden economy – trade and travel.