

The Economics of Blurs and Shadows – The Hidden Economy in Macedonia

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A shady business never yields a sunny life.

B. C. Forbes

1. Introduction

The multiple definitions of hidden economy use terms such as “black”, “underground”, “illegal”, “undeclared” or “shadow” to clarify this socio-economic phenomenon. Manifestations of hidden economy occur in both developing and developed economies. 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. While hidden economy yields various consequences and its ripples spread across many social strata, it always has a particularly negative impact on the societies’ most vulnerable and marginalized groups. This impact develops further into a vicious cycle of ever increasing lack of trust in the administrative and tax system, insufficient financing of public goods and services, social exclusion, corruption and protruding inequality. Often seen as an unfortunate side effect of today’s economy, “informal economy had become a permanent, but subordinate and dependent, feature of capitalist development (Portes, Castells and Benton 1989),”¹ while producing different scales of informal economic activity in different societies. In effect, large scaled hidden economic activities undermine the basic values on which democratic societies are built, hence deepening another phenomenon, namely inequality. “On average, compared to formal workers, informal workers have lower earnings and face higher

KEY POINTS

- According to the research being done on the issue of hidden economy, its share in Macedonia, depending on the measurement method used, **ranges from 24% to 47% of GDP** with a tendency to decrease.
- The decreasing, but still large **unemployment rate (28.4% as of Q2 2014)**, as one of the most important factors that give rise to hidden economic activities and practices, indicates a crossover from the informal to the formal sector.
- The indicators of **non-observed economy (NOE)** and **observed informal employment** by the SSO indicate a tendency of decreasing hidden economy and increasing formalization of labor.
- **Attracting FDIs through improving the business environment, increasing the capacity of the self-employment program of the Employment Agency, and reforming the inspectorates** will remain some of the most crucial factors in encouraging the formalization process of labor and businesses and thus decreasing hidden economic activities.

¹ Chen, Martha, Alter, *The Informal Economy: Definitions, Theories and Policies* (2012). Retrieved online on 07.03.13 from: http://wiego.org/sites/wiego.org/files/publications/files/Chen_WIEGO_WP1.pdf

risks, are less likely to enjoy economic opportunities and legal protections, and are less able to exercise economic rights and collective voice.”²

As the economic crisis hit the EU27 in 2008, it provided the EU with an additional impetus to tackle issues such as underreporting and undeclared work. At the same time, it highlighted the differences among Europe’s regions, with hidden economy levels differing in Western, Southern and Eastern Europe.

As an EU candidate country, Macedonia must join the fight against hidden economy and ensure that its policies and measures follow EU’s best practices, while at the same time looking for innovative solutions that are adjusted to the local context.

This policy brief provides an overview of the hidden economy in Macedonia, including some of its main causes and consequences. At the same time, it offers a macroeconomic overview of the characteristics considered to favor the prevalence of the hidden economy, while outlining the basic definitions and different hidden economy measurement methods. Furthermore, it reviews the latest policy developments in Macedonia in the area of hidden economy and delivers an outline of where this phenomenon is headed and what measures are, and should be taken, to tackle it.

2. Definitions and Measurement Methods

2.1 Definitions

A wide variety of terms and definitions have been put forward by economists and policy makers throughout the relevant literature. The socio-economic phenomenon has been given a wide array of labels, including informal, shadow, hidden, or underground economy, with an even wider reference within each language. While all terms and definitions touch upon the same general matter of un-recorded economic activities, they each differ slightly depending on their purpose. For example the European Commission focuses more on undeclared work which defines it as “any paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States.”³ This definition covers diverse activities while excluding criminal activities. The World Bank’s model of informality (Chen, 2012) identifies the causes (see Box 1) and composition (see Box 2) of the hidden economy. Some of the field’s main authors, such as Schneider and Williams

Box 1 - World Bank 2007 Model of Informality: Causes

Causal Theory #1: Different Forms of *Exit*

- **Opportunistic evasion:**
 - tax-evasion
 - illegal activities
 - avoidance of labour codes:
 - unprotected workforce
 - subcontracted production
- **Defensive evasion** in response to...
 - burdensome state
 - captured state
 - weak state
- **Passive evasion and state irrelevance:**
 - pre-modern or bazaar economy
 - informal or non-state institutions

Causal Theory #2: Different Forms of *Exclusion*

- **Labour market segmentation**—prevents workers from getting formal jobs
- **Burdensome entry regulations**—prevents enterprises from formalizing
- **Hiring practices of firms**—in response to excessive tax and regulatory burdens (Chen,2012)

² ILO (2013) *Labour inspections and undeclared work in the eu*. Retrieved from: http://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---lab_admin/documents/publication/wcms_220021.pdf

³ European Commission Communication COM(2007) 628 final. Retrieved from: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0628:FIN:EN:PDF>

(2013, p. 23-27)⁴, state that the shadow economy: “includes all market-based production of legal goods and services that are deliberately concealed from public authorities for the following reasons:

- to avoid payment of income, VAT or other taxes;
- to avoid payment of social security contributions;
- to avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc.; and
- to avoid complying with certain administrative obligations” (p. 25)

Moreover, according to the Center for the Study of Democracy (CSD) the particular nature of the different economic activities can be organized into four economic sectors:

- **“official** economy (legal and reported);
- **informal** economy (legal, yet unreported). It includes home-made produce and domestic labor, unpaid voluntary work, some of the activities of the self-employed and small businesses with no obligation to declare their activities, etc.; this is the so-called self-subsistence economy;
- **illegal (black)** economy (illegal and unreported). It includes illegal activities or unlawful production of commodities, as well as economic activities carried out by illegal economic entities;
- **undeclared (gray)** economy (legal, yet un- or under-reported). It includes un- or under-reporting the activities of legally-operating businesses, not registering the entire staff, as well as underreporting income. This concept also covers tax evasion and the avoidance of social and healthcare security payments.”⁵

Box 2 - World Bank 2007 Model of Informality: Composition

“Three Pairs” of Economic Agents

- **Labour:**
 - with insufficient human capital to get formal job
 - who quit formal job in order to: be their own boss, make more money, avoid taxes, and/or enjoy flexibility
- **Micro-firms:**
 - with no intention or potential for growth, hence no intention of engaging with state
 - who are stymied by high barriers to entry
- **Firms:**
 - who are avoiding taxation and other regulations

It is within the scope of this policy brief to use the terms “hidden economy” and “informal economy” in order to refer to the deliberate concealment of economic activities and will be used as synonyms throughout the policy brief.

2.2 Hidden Economy Measurement Methods

There are several different methods (direct and indirect) for measuring the hidden economy. The most prominently used are listed in Table 1.

⁴ Schneider, Friedrich; Williams, Colin “The Shadow Economy,” The institute of Economic Affairs 2013 Retrieved on 01.06.2014 from: <http://www.iea.org.uk/sites/default/files/publications/files/IEA%20Shadow%20Economy%20web%20rev%207.6.13.pdf>

⁵ Stefanov R, Tsanov M, “Reader with Best Practices in Monitoring the Hidden Economy,” CRPM/CSD 2014, 161

Table 1 - A list of most used methods for measuring hidden economic activity

Direct approaches	Indirect approaches
<ul style="list-style-type: none"> • Representative studies of hidden economic activity • Studies of time budgeting • Tax audits 	<ul style="list-style-type: none"> • Monetary methods • Income-expenditure discrepancy methods • Labour supply-demand discrepancy methods • Physical input (vs. official product) methods (electricity consumption) • Multiple indicators – multiple causes

In order to understand the discrepancy between the different measurement methods, a short comparison among the relevant methods, together with a look at their advantages and disadvantages, is shown in Table 2.

Table 2 - Comparison of different hidden economy measurement methods

Source: <http://journals.uran.ua/index.php/2225-6407/article/viewFile/16014/13630>

Approach	Author, Country	Advantages	Disadvantages
Fiscal Audit	Internal Revenue Service (1963 USA).	Comprehensive results; determination of insolvent business sectors, markets;	Sampling errors; measuring only the part of shadow economy; revelation moment results; un-readability of results; difference of audits quality; difficulties to separate real shadow activities.
Survey/questionnaire	Nogensen, H. K. et. all. (19995) Denmark, Lithuanian Institute of Free Market (2013) Lithuania.	Detailed information about the structure of shadow economy; Possibility to classify the results by age, economic activity, sex etc.	Results of lower reliability; lack of openness of respondents; complexity of survey structure; discomfort to tell about unfair activities; false perception of the terms
Discrepancy between national expense and income	Tiho, Y., Hyun, J. K. (1998) Korea, Taiwan.	Simplicity if method; availability of statistics, simple methodology.	Errors in national accounts methods does not reveal the real situation of shadow economy.
Labor force approach	Nastav, B., Bojnec, S. (2007) Slovenia, Croatia.	Attractiveness of theoretical methodology; Research about labor market.	Discrepancies in labor force can be influenced by other factors; people can work in both markets; method results are not reliable.
Transaction approach	Feige, E.L. (1996); Schneider, F., Enste, D. (1999) Canada, Germany, USA	Application and attractiveness of theoretical methodology part	Inaccessibility of statistical data, critics of base year, when shadow economy does not exist.
Electricity consumption method	Originally developed by Kaufmann, D. and Kaliberda, A. (1996). Kyle, S., et al (2001) Bulgaria; Garvanlieva, V., Andonov, V., Nikolov, M. (2012), Macedonia.	Availability of statistics; one of the best physical approaches; elasticity between electricity consumption and GDP is close to 1.	Usage of other energy resources; impact of technical and technological progress, difference of elasticity in various countries; inaccuracy of method.
Currency demand/monetary approach	First used by Cagan, P. (1958). Later improved by Tanzi, V. (1983) JAV. Chatterjee, S., et al (2006) India	One of the most used applicable methods; Availability of statistics	The assumption of single factor – currency; shadow economy is not implemented only in form of cash; Critics of base year without shadow economy;; complexity of assessment of money velocity.
MIMIC approach	Schneider, F., Enste, D. (2000) the majority of countries; Klaric, V. (2011) Croatia; Naraskeviciute, V.	Inclusion of more than one cause; application of many authors in many countries; evaluation of causes and	Possibility for dominance of single variable; large amount of data; results depend on chosen causes; need of base year.

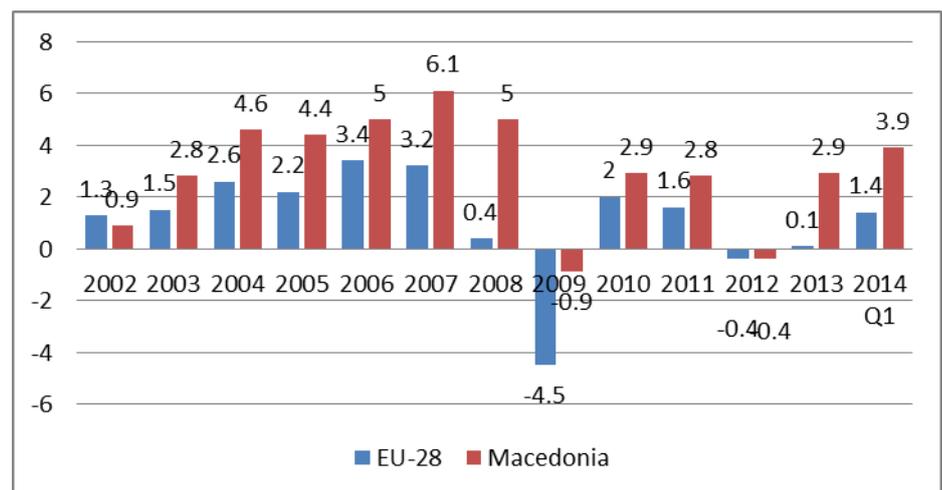
	Dauksaite, A. (2013), Lithuania, Ukraine; Dell'Anno, R. (2003, 2007) Italy Portugal. ; Garvanlieva, V., Andonov, V., Nikolov, M. (2012), Macedonia	indicators; comprehensive approach.	
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In the case of Macedonia there is a prevalence of **indirect methods** of measuring the hidden economy. On one hand, most researchers and institutions have been focusing their attention to the two-sector dynamic general equilibrium model⁶, Electricity Consumption Method (ECM)⁷, Multiple Indicators – Multiple Causes (MIMIC)^{8,9}, and the national Labor Force Surveys (LFS) of the State Statistical Office as well as the supply-demand method of using adjustments of national GDP for non-exhaustiveness as a measure of estimating the non-observed economy (NOE). **Direct methods**, on the other hand, have been represented by intermittent country-level direct population surveys¹⁰, and enterprise surveys¹¹.

3. Macroeconomic Overview Macedonia

According to the National Bank of Macedonia's (NBRM) latest estimates, the GDP in Q1 of 2014 has increased by 3.9 % (Figure 1). NBRM's forecasts are that GDP growth for 2014 will be maintained at 3.7% with a potential of further growth of 4.4% in 2015. NBRM forecasts inflation for 2014 to be held at 1%, thus encouraging consumer spending. On the other hand, SSO registered a deflation of 0.2% in June 2014, which might negatively affect government

Figure 1 - Real GDP Growth of EU vs. Macedonia (% annual change),
Sources: Eurostat, SSO, NBRM



revenues in the long run. Despite these new figures, the inflation in Q1 2014 was 0.6% and the uncertainties enveloping the conflicts in Iraq and Ukraine, as well as the recent regional floods, will put inflationary pressure on food and energy prices and keep the inflation rate at a stable and acceptable level.

Government deficit is forecasted at 3.5% in 2014 (decrease from 4.1% in 2013). This fiscal stimulus will be most notably used in construction and large infrastructural projects that generate secondary effects in the economy by impacting dozens of economic branches and increasing employment. This stimulus is visible and has led to increase in gross capital formation mainly attributed to construction works (65.7%) and machinery and equipment (30.5%).

⁶ Elgin, C. and Öztunali, O. (2012) *Shadow Economies around the World: Model Based Estimates*. Istanbul: Bogazici University, Department of Economics.

⁷ Garvanlieva, V., Andonov, V., Nikolov, M. (2012) *Shadow Economy in Macedonia*. Skopje: Center for Economic Analyses

⁸ Ibid,

⁹ Schneider, F., Buehn, A. and Montenegro, C. (2010) *Shadow Economies All over the World. New Estimates for 162 Countries from 1999 to 2007. Policy Research Working Paper 5356*. Washington D.C.: World Bank Group.

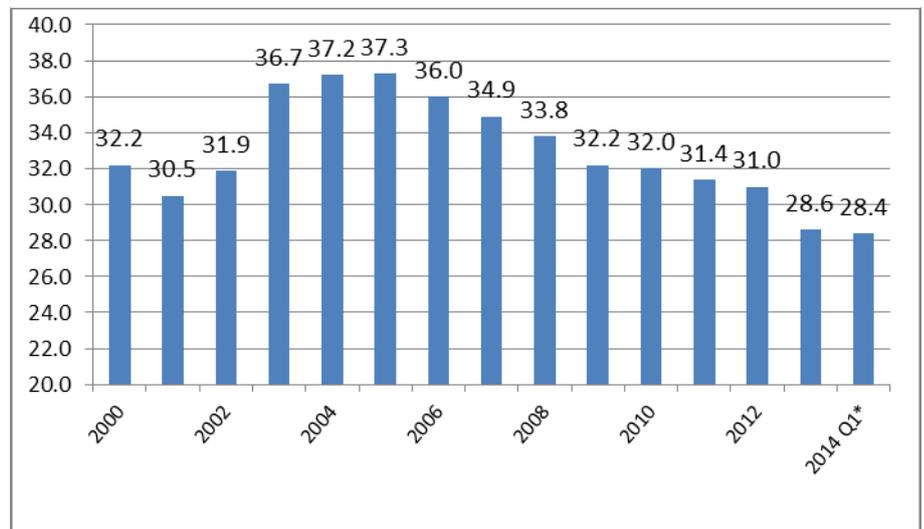
¹⁰ Stankovic, M. and Stankovic, B. (2012). *Social and economic aspects of the shadow economy in the Republic of Macedonia: A study*. Social Science Research Network [Online]. Available from: <http://ssrn.com/abstract=2162922> (Accessed 30 June 2014).

¹¹ World Bank. (2014) *Enterprise Survey 2013. Country Profile Macedonia*. Washington D.C.: World Bank Group.

Industrial output has also soared by 9.7% (May 2014 est.) on an annual basis corresponding with increased employment in industry by 6.7%.¹² Furthermore, as of May 2014¹³, the deposits from households and enterprises increased by 8.5% on an annual basis which sum up to 4.3 billion EUR. Accordingly, in May 2014 there was an increase in total credit growth of 7.6% (above NBRM's forecast of 7.3 %) on an annual basis. This is an indication that savings have finally encouraged additional lending by banks.

Moreover, while Macedonia continues to have a fiscally stable and increasingly export-oriented economy due partly to the drastic annual increase in exports especially from the Foreign Direct Investment (FDI) companies, the FDI as a whole remains modest since the onset of the crisis, ending up with EUR 251 mln in 2013 and 87 mln in Q1 2014. In order for Macedonia to be able to change its exports structure towards larger added value goods, a significant increase in FDI is needed in the following period. According to the

Figure 2 - Unemployment Rate in Macedonia (in %)– Source: SSO



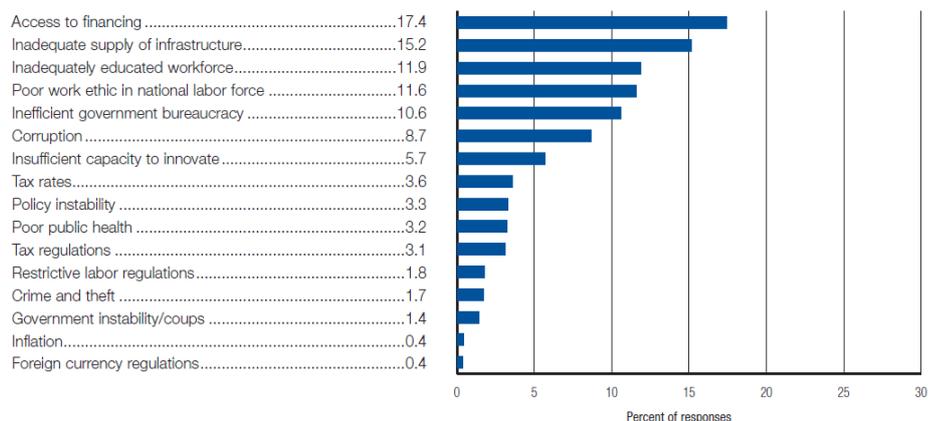
Chief Executive Officer of the Directorate for Technological Industrial Development Zones (TIDZ), Viktor Mizo, **the exports coming from these zones have amounted to 25% of total exports in 2013 and are expected to surpass 30% of total exports by the end of 2014.**¹⁴ Clustering FDI is important for speeding up structural transformation and so is technological spillover from one company to the broader sector or even across sectors.¹⁵ Enabling technology to spread from TIDZ to the rest of the economy will play an instrumental role in the structural transformation of the economy.

Furthermore, the labor market continues to be affected by its inherited structural unemployment from the early 1990s. **As of Q1 2014, unemployment is 28.4% (272.115), with a tendency to decrease further.** Despite a significant decrease (37.2% in 2004), unemployment, especially at this scale, represents one of the most significant factors in generating hidden economic activities. Even within the context of the economic crisis of 2008, the unemployment rate has decreased by 5.4% in the following years, showing an increased capacity of the

Figure 3 - Barriers to Doing Business.

Source: World Economic Forum – World Competitiveness Report 2013-2014, p.260¹⁸

The most problematic factors for doing business



¹² State Statistical Office, press release 04.07.2014. Retrieved from: <http://www.stat.gov.mk/PrikaziSoopstenie.aspx?rbtxt=78>

¹³ National Bank of the Republic of Macedonia (NBRM), Macroeconomic Indicators, July 2014. Retrieved from: <http://nbrm.mk/?ItemID=B9701F65DF112443A3220275D11AC18E>

¹⁴ "The foreign Investors increase the exports" Kurir, 22.07.2014. Retrieved from:

<http://kurir.mk/makedonija/ekonomija/166096-Stranskite-investitori-go-zgolemuvaat-izvozot>

¹⁵ IMF Country Report No. 13/179 (p. 12-15). Retrieved from: <http://www.imf.org/external/pubs/ft/scr/2013/cr13179.pdf>

Macedonian economy to absorb new workers and consequently offer better conditions for them to crossover from the informal to the formal economy. Despite the successful strategies of lowering the unemployment rate, the total long-term unemployment each year since 1996 remains above 80% (82.1%, 2012 est.). Similarly youth unemployment remains high, at 54.6% of total unemployment in March 2014, with a tendency to decrease further. In contrast, total, long-term unemployment (as % of total unemployment) and youth unemployment in EU28 countries in May 2014 was 10.4%, 48.7% (Q1. 2014), 22.2% respectively.¹⁶

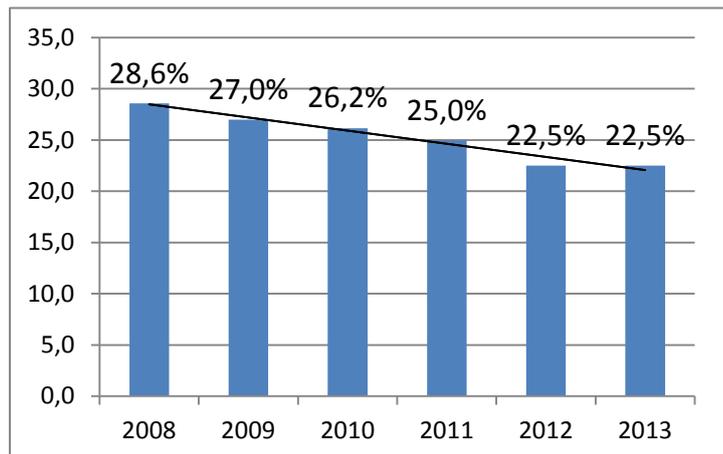
The fluctuations in labor productivity can be explained by its three main factors: investment, saving in physical capital and new technology and human capital. The latest figures from the Ministry of Finance (as of Q4 2013) **show a disturbing tendency of decreasing labor productivity** (-0.9% in Q4 2013), followed by a decrease of real gross wages (-0.5% Q4 2013).¹⁷ Additionally, as indicated in the World Competitiveness Report 2013-2014 (See Figure 3), there are other factors that influence labor productivity in Macedonia such as inadequately educated workforce and poor work ethics among the national labor force¹⁸. Therefore, labor productivity figures and factors should be closely monitored in the near term, in order to avoid long-term market inefficiencies and thus increased participation in the informal sector.

4. Level of Hidden Economy – Macedonia

During the past 24 years, the Macedonian economy has faced a strong development of SMEs, which led to the adoption of a variety of new, often confronting and vague, measures and policies, especially within the economic legislative. This, in effect, gave rise to the hidden economy in the country. Up until 2007, overburdening with taxes and contributions has hampered the business environment and gave further impetus to the already rising hidden economic activities. The progressive personal tax system (15%, 18% and 24%), depending on the realized income, produced incentives for employers and employees to underreport their income and activities or even to go as far as not to declare their economic activity as a whole. By working outside of the formal economy, individuals can avoid taxes, social security payments, derail paperwork, and bypass labor and tax regulations. As research (AT Kerney, 2014) has shown a strong correlation between the country's tax rate and its scale of hidden economy, the GoM in 2007 and 2008 decided to adopt a flat tax rate system, where personal income taxes were lowered to 12% in 2007 and 10% in 2008 across the board for all income groups. Even though the hidden economy remains high, the effects¹⁹ of this particular measure are increased tax discipline, increased simplicity of the tax system, improved business environment, increased attractiveness for FDIs, increased contributions to the budget, and overall decrease in the rate of hidden economic activities.

According to the Public Revenue Office (PRO) the

Figure 4 - Observed informal employment (as % of total employment y-o-y basis) Source: Labor Force Survey 2013, State Statistical Office (SSO)



¹⁶ Eurostat News Release, 01.07.2014, Euro Indicators May 2014. Retrieved from:

http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-01072014-AP/EN/3-01072014-AP-EN.PDF

¹⁷ Ministry of Finance of RM, Quarterly Economic Report Q4 2013. Retrieved from: http://www.finance.gov.mk/files/u1/K-4-2013_mk.pdf

¹⁸ World Economic Forum (WEF), Global Competitiveness Report 2013-2014. Retrieved from: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf, p. 260

¹⁹ Garvanlieva, V., Andonov, V., Nikolov, M. (2012) *Shadow Economy in Macedonia*. Skopje: Center for Economic Analyses. Retrieved from:

http://www.cea.org.mk/documents/studii/CEA%20SHADOW%20ECONOMY%20IN%20MACEDONIA%20FINAL_4.pdf

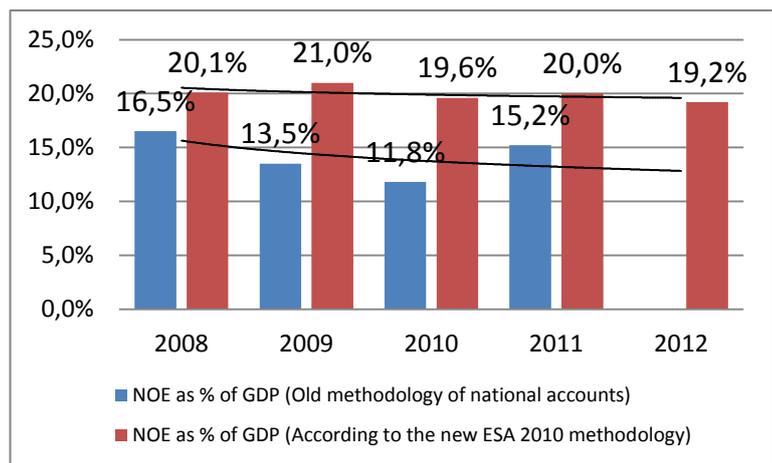
hidden economy is especially present within the industry and services sectors where transactions are customarily performed with cash in-hand payments. More specifically, it is present within the following sectors:²⁰

- Construction
- Hospitality
- Transport
- Trade within the green bazaars
- Textile industry
- Vehicle maintenance
- Household maintenance
- Furniture production
- Paintworks
- Cosmetic services
- Other handicraft works
- Real estate rental
- Translation services and professor services
- Hardware and software maintenance services etc.

According to CEA (2009) the handicraft economy represents a significant part of the non-industrial economic activities that are usually used by households. CEA analyzed sectors such as additional education, cleaning services, motor vehicle services, home maintenance, green markets, hair style and make up services, software and hardware services, cutting firewood and fortune tellers. The conclusion was that households spend on average 22.8% of their income in the handicraft economy, which, as indicated by the PRS is part of the informal economy. For instance, the research indicated that households annually spend 41.645 MKD on the green markets, an amount that equals almost two average Macedonian net salaries (21.175 MKD according to SSO for Apr. 2014).

Depending on the used method, for Macedonia the hidden economy estimates range from 24% of GDP by using the ECM method (Electricity Consumption Method) (CEA, 2012), 30% of GDP according to the Ministry of Economy (using LFS estimates presented by Novkovska, 2013²¹), to a staggering hidden economy estimate of 46.9% (CEA, 2011) as a share of GDP by using the MIMIC method (Multiple Indicator Multiple Causes). Taking aside the discrepancy between the results produced by these methods they all show that the share of hidden economy is substantial and steps will have to be taken in the direction of tackling it, while also

Figure 5 - Non Observed Economy (NOE) in Macedonia 2008-2012, as % adjustment of annual GDP. Source: SSO GDP Reports



Revised NOE adjustments to GDP for 2008-2012 are available at <http://www.stat.gov.mk/Publikacii/3.4.14.04.pdf>

²⁰ Public Revenue Office (PRO), "How to protect ourselves from and act against the grey economy" 01.02.2010. Retrieved from: http://www.ujp.gov.mk/files/attachment/0000/0071/ISBN_978-608-4592-02-0_Brosura_Kako_da_se_zastitimo_i_deluvame_protiv_sivata_ekonomija_2010_08-7104_1.pdf

²¹ Novkovska, B. (2008) Measuring Non-standard and Informal Employment in the Republic of Macedonia. Paper presented at the workshop *Measurement Informal Employment in Developed Countries WIEGO*, Kennedy School of Government, Harvard University, 31 October – 1 November 2008. Retrieved from: http://wiego.org/sites/wiego.org/files/publications/files/Novkovska_Measuring_informal_empl_Macedonia.pdf

utilizing the right approach to long-term monitoring of the hidden economy in Macedonia.

According to the Labor Force Survey 2013 conducted by the SSO, the observed informal employment as a percentage of the total employment as of 2013 stands at 22.5% (Figure 4). SSO uses observed informal employment to encompass all undeclared employees (those without social and legal protection coverage), regardless if they work in: regular firms, un-registered or un-incorporated entities, own-account enterprises or in the household sector. What is noticeable is the decreasing trend of the observed informal employment over the past few years, an indication of labor crossover towards formalization of employment. Given the recent economic crisis and its prolonged impact, fears over an increase in undeclared economy emerged. However, despite an insignificant rise in undeclared economy in the period of 2008-2009, by using estimates from Schneider's (2012) Multiple Indicators Multiple Causes (MIMIC) measurement method, it has been concluded that "the current economic crisis has not reversed the previous trend of an ongoing incremental decline in the size of the undeclared economy as a proportion of GDP."²²

Additionally, the SSO has also detected a decrease in Non-Observed Economy (NOE) as can be seen in Figure 5. However by using the new ESA 2010 methodology of national accounts NOE shows a flatter trend line that is maintained around 20% of GDP throughout the period 2008-2012. NOE refers to all productive activities that cannot be enveloped by the by the basic data sources which are utilized for assembling national accounts. These activities include: underground, informal (including activities performed by households aimed at their own final use) illegal, and other activities which are omitted due to deficiencies within the basic data collection.

In accordance with the data provided by the NBRM the average participation of cash in the money mass of the country in the period of 2001-2010 was set at a staggering 44%. According to NBRM In 2012, 79% of the value of total transactions performed with payment cards were attributed to cash withdrawals from ATMs²³. Cash provides anonymity during payment transactions and cannot be tracked thus becoming a powerful tool and stimulator of hidden economy. Prevalence of cash on the other hand, due to lack of judicial protection of business entities, avoidance of obligations among economic entities, inefficient reimbursement mechanisms conditions the companies to demand and fulfill payments by using cash²⁴ (Nenovski, 2012).

5. Actions against hidden economy: EU and local level

An array of approaches and policy measures is available for the purpose of tackling the hidden economy. They are generally preconditioned by the understanding of the underlying causes of hidden economic activities and hence, can be divided into two main approaches.

- A **neo-liberal approach** argues that the undeclared economy is a direct result of high taxes, over-regulation of the economy and too much government interference in the realm of welfare provision. Therefore, economies should pursue tax reductions, deregulation and minimal state intervention to prevent the growth of undeclared economy.

²² Colin C. Williams, Piet Rennoy, (2013) "Tackling undeclared work in 27 European Union Member States and Norway: Approaches and measures since 2008." (Eurofound, 2013, p.5) Retrieved on 22.04.2014 from:

<http://www.eurofound.europa.eu/publications/htmlfiles/ef13243.htm>

²³ http://www.nbrm.mk/WBStorage/Files/WebBuilder_Prezentacija_Strategija_PS_2013_2017.pdf, p.20

²⁴ Nenovski, Tome; (2012) "The Grey Economy in Macedonia: Macroeconomic Aspects, Implications and Possible Problem Solutions", (20 Journal of Sustainable Development, Vol. 5, Issue 10, March 2014. Retrieved from:

<http://www.fbe.edu.mk/JoSDv10.pdf>

- A **social democratic** approach argues that the undeclared economy is a by-product of the deregulation of economies and reductions in state welfare provision, and that one should therefore bolster state expenditure on the labour market and welfare provision to tackle the undeclared economy.²⁵

5.1 EU level

Williams and Rennoy (2013) maintain that “there is a strong correlation between larger undeclared economies and underregulation (rather than over-regulation). The types of austerity measures pursued, therefore, are strongly correlated with the size and growth of undeclared economies.”²⁶ Policy measures and actions taken for the purpose of tackling the hidden economy often follow the above mentioned approaches. Therefore, most EU28 countries accept the social democratic approach, through enforcing welfare policies and labor market measures.

According to Schneider (Schneider, 2012), despite a small increase during the economic downturn of 2008 and 2009, most EU28 countries are witnessing a continuous decrease of the informal economy ranging from 22.3% of GDP in 2003 to 18.4% in 2012. The year 2013 has seen the lowest level of EU hidden economy within the past 10 years, with an average of “18.5 per cent of economic activity.”²⁷ Though small, the increase did point out an interesting matter regarding the distribution of hidden economy among the EU MS. It introduced the so-called “three-lane road”²⁸ by placing the differences among Europe’s regions under the spotlight. Specifically, it showed that the post-crisis recovery and decrease of the hidden economy developed differently in Western, Eastern and Southern Europe.²⁹

While differences among regions persist and, for instance, Eastern Europe’s “shadow economy is much larger in relation to the size of the official economy than in Western Europe,”³⁰ EU’s policy makers are actively addressing the issue by employing various actions. Such actions include the EC’s Action Plan on combating tax fraud and tax evasion³¹ and the EC’s proposal to create a Platform “to improve cooperation at EU level in order to prevent and deter undeclared work more effectively.”³² Further methods are to be taken, and policy advice includes measures ranging from prevention, increased auditing and monitoring, tax reforms and the increase in usage of electronic payment methods.³³

At the same time, however, while the scale of hidden economy in EU28 is not at an alarming scale and is actively being addressed, there is another influencing factor to be considered across the EU borders. It is

²⁵ Colin C. Williams, Piet Rennoy, (2013) “*Tackling undeclared work in 27 European Union Member States and Norway: Approaches and measures since 2008.*” (Eurofound, 2013, p.25) Retrieved on 22.04.2014 from: <http://www.eurofound.europa.eu/publications/htmlfiles/ef13243.htm>

²⁶ Ibid., p.29

²⁷ AT Kerney (2013), *The Shadow Economy in Europe*, Retrieved from: http://www.atkearney.com/financial-institutions/featured-article/-/asset_publisher/j8lucAqMqEhB/content/the-shadow-economy-in-europe-2013/10192

²⁸ Ibid.

²⁹ Ibid.

³⁰ Eastern Europe the shadow economy is much larger in relation to the size of the official economy than in Western Europe - See more at: http://www.atkearney.com/financial-institutions/featured-article/-/asset_publisher/j8lucAqMqEhB/content/the-shadow-economy-in-europe-2013/10192#sthash.XxJbFcrE.dpuf

³¹ European Commission, COM (2012) 722 06.12.2012, *An Action Plan to strengthen the fight against tax fraud and tax evasion* Retrieved from: http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf

³² European Commission, *Undeclared work: Commission proposes new Platform to improve prevention and deterrence*. Press Release 09.04.2014. Retrieved from: http://europa.eu/rapid/press-release_IP-14-387_en.htm

³³ Wohlbier, Florian; Jensen, Jonas (2012), *Improving Tax Governance in EU Member States: Criteria for Successful Policies*. © European Union, 2012. Retrieved from: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp114_en.pdf

the EU as whole, and particularly the EU companies that perform business outside of the EU that hold the responsibility to fight the hidden economy in third countries, such as Macedonia. In line with that, the European Economic and Social Committee (EESC) “calls for the fight against the shadow economy to look beyond EU borders and for corporate social responsibility to be applied where minimum decent working standards are lacking in third countries subcontracting for EU companies.”³⁴

5.2 Macedonia

The case of Macedonia shows no clear and long term commitment to either the neo-liberal or the social democratic approach, but displays a mixture of crossovers between them. The neo-liberal approach, especially since 2006, has been the main driver of most reforms embodied through measures such as the introduction of the flat tax rate across the board instead of the complicated progressive tax code, the simplification of labor and tax regulations, the simplification of start-up business procedures, fiscal cash registers reform, and the gross salary reform. Furthermore, by following a consistent growth in GDP, inflow of FDIs, economic output in general and decrease in unemployment rate, a social-democratic policy trend can be identified, particularly towards measures such as progressive minimum wage, increase in social transfers, introduction of self-employment and agricultural subsidies, and sustainable reinforcement of labor rights.

The focus of all Macedonian governments, especially since 2006, has been to promote measures with the sole purpose of attracting FDI and decreasing unemployment. However, despite a large body of legislation that deals with countering and sanctioning hidden economic activities, public policy measures that dealt directly with the negative consequences of the hidden economy were lacking. Recently, there has been a renewed interest in tackling hidden economic activities, spurring basic labor rights, and reforming institutions and inspection services that deal with the hidden economy. This renewed interest is embodied through the measures listed in the table below.

Table 3 - Recent measures taken to tackle undeclared economy (2014)

Approach	Type of recently implemented measure
Enabling regular employment MLSP Employment Agency	The hidden economy action plan ³⁵ – annual actual plans under the cap of the Ministry of Labor that coordinate the activities and tasks among several government institutions and bodies such as the Employment Agency, and the Public Revenue Office. Temporary service contracts reform – In July 2014 the GoM proposed a set of amendments ³⁶ to the several Laws, were passed by the Parliament, among other changes, amending the nature of temporary service contracts. ³⁷ The amendments of the laws stipulated that employers that employ workers with temporary service contracts and whose gross wage exceeds the minimum wage in 2015 (9.500 MKD) have the duty, by law, to pay healthcare, social and

³⁴ European Economic and Social Committee (2013), *A strategy against the shadow economy and undeclared work*. Retrieved from: <http://www.eesc.europa.eu/?i=portal.en.soc-opinions.26023>

³⁵ Ministry of Labor and Social Policy, Action Plan for decreasing the grey economy in Macedonia for 2014, Feb. 2014. Retrieved from: www.mtsp.gov.mk/content/word/siva.doc

³⁶ Laws amended concerned: Law on Labor Relations, Law on Mandatory Fully Funded Pension Insurance, on Mandatory Social Security Insurance Contributions, Law on Healthcare Insurance, Law on Pension and Disability Insurance (Official Gazette of the Republic of Macedonia, No 113/2014.) Available at: <http://www.mtsp.gov.mk/zakoni.nsp> or

³⁷ “Social and Health contributions of temporary service contracted workers will be paid by themselves or the employers,” Ekonomija, Dnevnik, 24.07.2014. Retrieved from: <http://www.dnevnik.mk/?ItemID=DF568DAA03CAA64C94F86366E42ECA51>

employment contributions. What this measure aims at accomplishing is to:

- decrease the difference between full employment and temporary service contracts in terms of social and health contributions to the state welfare system
- give disincentives to employers predominantly using temporary service contracts for the purpose of avoiding social and healthcare contributions
- enable workers that predominantly use temporary service contracts to be eligible for pensions insurance
- add pension and healthcare contributions towards the pension and health funds in order to increase sustainability and quality of providers of public services
- give a more realistic view of the employment rate in Macedonia, as presented by the Employment Agency, by registering workers employed with temporary service contracts as employed rather than, as it has been the case so far, leaving them unregistered.

Self-employment program of the Employment Agency of Macedonia – One of the reforms that received positive public attention and involvement is the stimulation of self-employment in order to increase employment in the formal sector as well as to give an additional boost to the private enterprise sector. Compared to 2004, the number of self-employed persons doubled by 2013 (from 53.252 to 98.182), according to SSO data (2013). However, the reform must be further improved, since, for instance, only 25 % (SSO, 2013) of the total self-employed persons are women. Given this small percentage, there are still a larger number of women that could be better targeted with the self-employment program in order to assure their passage into the formal economy. According to the Employment Agency, since the inception of the self-employment program (2007-2014), 5835 micro and small enterprises were initiated with 72% of them being sustainable and still functioning successfully.

<p><i>Increasing Tax Compliance</i> Ministry of Finance Public Revenue Office</p>	<p>“Ask for a Receipt” campaign – the most recent campaign, started in late 2013 with the goal of raising public awareness on the negative effects of underreporting transactions. Specifically, the campaign gave incentives to participate in the formal economy by keeping fiscal bills following any purchase within Macedonia and submitting them to a monthly lottery. The participants then had the chance to win prizes ranging from cars and apartments, to store vouchers</p>
<p><i>Inspections and Control</i> Inspection Surveillance Council (incl. State market inspectorate, State Labor Inspectorate, etc.)</p>	<p>Inspection Surveillance Council – in line with the above-mentioned action plan is the formation of the new Inspection Surveillance Council (Official Gazette of the Republic of Macedonia” Nr. 50/2010, 147/2013, 41/2014³⁸). The Council is to oversee the work and coordinate activities among the 29 different state inspectorates, while working towards increasing the efficiency of the inspectorates while decreasing costs.</p>
<p><i>Education and Awareness Raising</i></p>	<p>Awareness campaigns in agriculture and construction - ILO supported the Government of Macedonia in setting up and implementing awareness-raising</p>

³⁸ Law for Inspection Surveillance Council, (consolidated text)

http://www.mio.gov.mk/files/pdf/dokumenti/zakoni/Zakon_za_inspekcijski_nadzor_konsolidiran_tekst.pdf

Ministry of Education and Science

campaigns with the goal of increasing awareness of the negative effects of undeclared work, especially among SMEs³⁹. Accordingly, the advantages of formalising businesses were pointed out within the agricultural and construction sectors, while special attention was given to decent working conditions.

Awareness campaign for students - The Government of Macedonia has initiated a campaign to raise awareness of the negative aspects of working informally while engendering tax morality. The campaign targeted vocational school students in the first instance, as they were seen as the most likely group to engage in undeclared work.⁴⁰ However, in 2011, the European Commission stated in a progress report that the impact of these publicity campaigns in Macedonia was limited. They drew attention to the fact that efficient cooperation and coordination between enforcement bodies was still lacking and that the budget allocated to the active labour market programme was still inadequate.⁴¹

Enabling formalization/compliance Public Revenue Office

Simplifying start-up business procedures - By reducing the time, procedural steps and financial costs required to start a business, the government of Macedonia aims to make entry to the formal sector easier. A 'one-stop shop' system has been initiated and implemented, including an online application system for registering companies, an electronic system for the classification of companies under court procedures for insolvency, and an electronic system for the registration of collateral and leasing⁴² (BTI, 2012). Additionally, according to a report published by the European Commission in 2012, improvements have been made in the sphere of increasing efficiency and transparency of the courts and related legal procedures. The result was a decline in court cases from 5,782 at the end of 2011 to 2,152 in mid-2012 (BTI, 2014)⁴³.

As shown in the figures below (Figure 6, Figure 7), a positive trend is evident over the years in Macedonia toward improving governance performance in the areas of regulatory quality and control of corruption. Despite the fact that this improvement cannot be attributed solely to the effects of the measures explained above, it does indicate in general that policies concentrating on tackling the negative consequences of the hidden economy are moving in the right direction. Additionally, even though there is much more to be done, the economic performance shows that macroeconomic policies are also following the same positive trend.

³⁹ ILO (2012), "Awareness raising campaigns to reduce undeclared work occupational risks and improve gender equality at work", available at: http://www.ilo.org/global/about-the-ilo/media-centre/press-releases/WCMS_183459/lang-en/index.htm.

⁴⁰ Eurofound, Labour Market, Tackling Undeclared Work in Europe, 31.07.2014. Retrieved from: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>

⁴¹ European Commission (2011), *The former Yugoslav Republic of Macedonia 2011 Progress Report*, COM (2011) 666 final, Brussels.

⁴² Bertelsmann Stiftung, BTI 2012 — Macedonia Country Report. Gütersloh: Bertelsmann Stiftung, 2012. Retrieved from: <http://www.bti-project.org/fileadmin/Inhalte/reports/2012/pdf/BTI%202012%20Macedonia.pdf>

⁴³ Bertelsmann Stiftung, BTI 2014 — Macedonia Country Report. Gütersloh: Bertelsmann Stiftung, 2014. Retrieved from <http://www.bti-project.org/fileadmin/Inhalte/reports/2014/pdf/BTI%202014%20Macedonia.pdf>

In conclusion, the Macedonian economic policy arena is on the right track towards lowering the hidden economy in the country. On one hand, the latest steps are a top-down approach taken towards increasing the capacities of the government bodies in tackling some of the challenges of the hidden economy and generally go in line with its promise to reform the public administration in order to better address the needs of the citizens. On the other hand, a bottom-up approach is necessary in order to achieve a holistic approach to tackling the negative effects of the hidden economy. Labor unions, business associations,

Figure 6 - Control of Corruption

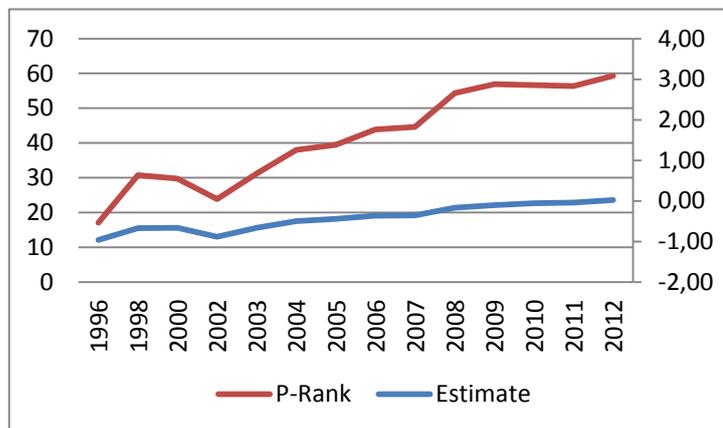
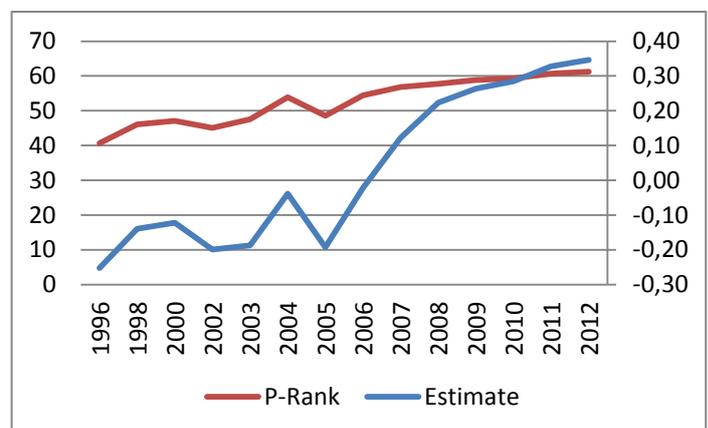


Figure 7 - Regulatory Quality



Source: World Bank Worldwide Governance Indicators (WGI), <http://info.worldbank.org/governance/wgi/index.aspx#home>. **Estimate** of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance).

P-Rank or Percentile rank among all countries (ranges from 0 (lowest) to 100 (highest) rank)

workers who don't declare irregularities, SSO's and the media can all be granted a larger stake and responsibilities in the policy formulation process, as well as data gathering in order to avoid a disconnect between policies proposed and the actual circumstances on the ground.

6. Conclusion and Recommendations

Based on the available data, there is a significant gap between the different hidden economy estimates in Macedonia that can be attributed to the use of different models for measuring the hidden economy. However, all estimates indicate that the hidden economy in Macedonia is high, thus representing a serious social problem. Possible negative outcomes include social tensions, rising inequalities and income gaps, as well as corruption and criminal activities. Within the context of EU integration, as well as given regional conflicts and natural disasters, Macedonia has a lot on its plate in tackling hidden economy. However, by combining its already existing actions with some new measures, the Macedonian government should be able to control and even lower the level of hidden economy.

Therefore, informal economy must be addressed on several levels, using a **two-pronged approach**, while also ensuring targeted communication towards all layers of the Macedonian society. The latter can be pursued through a bottom-up approach that includes the civil society, which, in spite of moving in the right direction lately, is still behind in developing a culture/portfolio, as well as methods and skills in monitoring public policies, especially in corruption and the hidden economy, and producing measures and instruments to adequately respond to these public policy challenges. At the same time, with the FDI, employment levels and the GDP expected to increase in the following period,⁴⁴ it is the vulnerable groups of the Macedonian society that might not receive the appropriate care during this transition. The

⁴⁴ IMF Country Report No. 13/179, June 2013, (p. 12-15). Retrieved from: <http://www.imf.org/external/pubs/ft/scr/2013/cr13179.pdf>

suggested **two-pronged approach** will ensure that such groups proportionally benefit from the growth of the formal economy.

Specifically, the **two-pronged approach should include:**

- **Top-down approach:** Government investing in reforming its public institutions and agencies dealing with hidden economic activities. More actions similar to the deployment of the Inspection Surveillance Council, Hidden Economy Action Plan, Awareness campaigns, Labor law reforms and simplifying business procedures are needed.
- **Bottom-up approach:** With CSO's taking responsibility, together with representatives of the media, public institutions, and the business sector, in creating a sustainable and adequate hidden economy monitoring system. Finally, this multi-stakeholder synergy will be used to provide viable policy recommendations, which are to deal with the negative consequences of the hidden economy.

Through this approach, the government and CSO's should work towards addressing six general goals:

1. create more jobs.
2. register informal enterprises and regulate informal jobs.
3. extend state protections to the informal workforce, especially the working poor.
4. increase the productivity of informal enterprises and the income of the informal workforce.⁴⁵
5. diversify Macedonian exports structure
6. close educational gaps.

By following steps one through four, as Chen (2012) argues, the self-employed would like to receive the benefits of operating formally in return for paying the costs for entry into the labor market; "including: enforceable commercial contracts; legal ownership of their place of business and means of production; tax breaks and incentive packages to increase their competitiveness; membership in trade associations; protection against creditors and clear bankruptcy rules; and social protection."⁴⁶ Informal wage workers, on the other hand would be enabled to obtain a formal wage job, with a secure contract, worker benefits, membership in a formal trade union, and employer contributions to their social protection. Chen notes that "formalizing wage work requires a focus on employers, as employers are more likely than employees to avoid compliance with labour regulations."⁴⁷

By diversifying the structure of Macedonian exports, with more value added products, new sets of skills and trainings can be absorbed by the labor force. In doing so, increasing its competitiveness and productivity of labor on the supply side as well as answering the needs of businesses for more skilled and mobile labor on the demand side. Enhancing technological spillovers to the local economy will only enhance the FDI's impact and its positive externalities. Additionally, closing the educational gaps by ensuring attendance and high standards of local school and universities, especially primary and secondary education, will enhance technology absorption and economic output.⁴⁸

⁴⁵ Ibid p.17 (Chen, 2012)

⁴⁶ Ibid. p.15 (Chen,2012)

⁴⁷ Ibid p. 15 (Chen,2012)

⁴⁸ Ibid p.15 (IMF, 2013)