

HIDDEN ECONOMY IN SOUTHEAST EUROPE: MONITORING AND POLICY IMPLICATIONS FOR GOOD GOVERNANCE

Policy Brief No. 6, October 2016

Measuring and monitoring the hidden economy is primarily justified by the need to understand and anticipate better the overall economic dynamics and effects of policy measures envisaged or taken. Despite differences in naming and approaches in assessing hidden economy across countries, it is generally accepted that **hiding economic activities is a rational response to deficiencies in the institutional environment**. Corruption appears at the margins between the formal and informal economy, where businesses and individuals pay rent or capture institutions to stay hidden and/or non-compliant, to facilitate cheaper, smoother legalization, if inevitable or necessary. Yet, despite the significance of the phenomenon and its impact on virtually all public policies, this information, as a rule, is not readily available to the general public in Southeast Europe (SEE) or is only available after considerable delay. So in order to understand actual GDP, one should consider alternative assessments.¹ The current policy brief contributes to the assessment of the size and characteristics of the hidden economy in nine SEE

¹ Such as the assessments of undeclared work through direct methods led by Professor Colin Williams, or the comparative assessments of Professor Friedrich Schneider, based on indirect methods. Both approaches have been taken up by the European Commission recently.

KEY POINTS

- The **hidden economy in SEE remains wide-spread**, perpetuates informality, which is linked to corruption, and denotes a substantial gap between formal and informal institutions. This gap is due both to underdeveloped formal market institutions, and also to the lack of coherent enforcement of rules, often related to corruption. Those engaged in the hidden economy are more likely to face corruption pressure than the rest of the population throughout the region.
- The immense diversity of the scale (19 % in Croatia and 81 % in Kosovo), prevailing patterns (no written contracts in Turkey, non-payment of health care contributions in Kosovo, envelope wages in Macedonia and Bulgaria, non-formalised business in Albania) and statistical estimation of the hidden economy in GDP across Southeast European countries requires **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 maximising personal benefit. An effective anti-hidden economy policy should not be purely economic or fiscal, but a comprehensive social policy.
- Working entirely in the formal sector, as compared to the hidden economy, means earning significantly higher wages in Bosnia and Herzegovina, Albania and Turkey, slightly higher wages in Macedonia, Serbia and Montenegro and about the same or slightly lower in Kosovo and Bulgaria. However, the sustained high-levels of the hidden economy in SEE, coupled with systemic petty corruption, low trust in public institutions and, in some cases, ambiguous national identity, has resulted in **changes in tax morale** and lower revenues for governments in the region.



This publication has been produced with the financial assistance of the European Union and the Central European Initiative (CEI). The contents of this publication are the sole responsibility of the SELDI initiative and can in no way be taken to reflect the views of the European Union and the CEI.



countries² based on the findings of the *SELDI Hidden Economy Survey 2016*.³

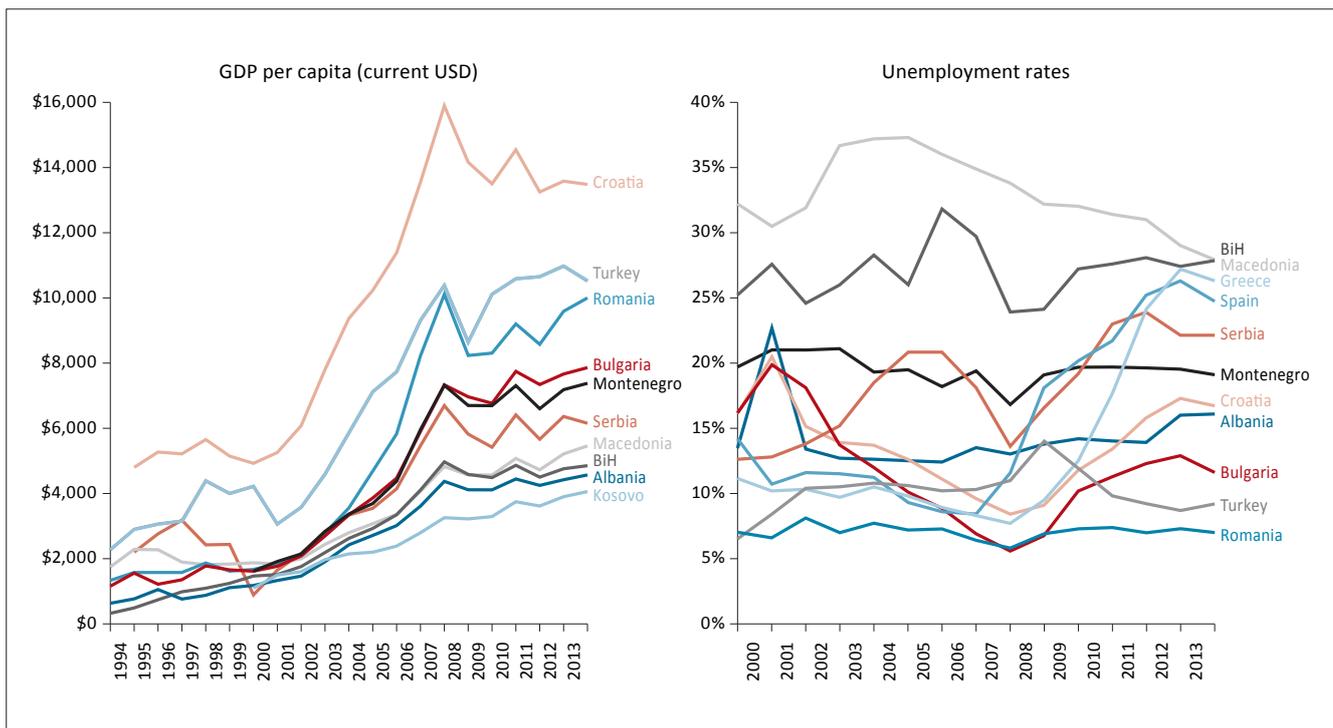
Macroeconomic Performance and the Hidden Economy

All SELDI countries have 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** or a comfortable environment for reducing the hidden economy and corruption. These countries have had stable, **low labour force participation rates**⁴ since 2000 (the lowest being Kosovo with 41 % and the highest being Macedonia with 56 %). Romania, Albania and Serbia have experienced falling employment since 2000, where-

as Macedonia and Bulgaria have grown and the rest remained stable, with slight fluctuations around the 2008 crisis. There are significant gender differences in Kosovo (21 % of the women above 15 years of age and 24 % of those aged 20 to 64 are economically active with just 14 % employment rate), in Turkey (30 % women’s activity rate of those above age of 15) and in Bosnia and Herzegovina (46 % women’s activity rate with 32 % employment in 20 to 64 bracket). The highest female labour participation rate is observed in Bulgaria – 48.6 % in 2014.

Unemployment in the region is a serious cause for concern and is higher on average than in the EU28. Far more worrying is the **long-term and youth unemployment** in each of these countries. Bosnia and Herzegovina and Kosovo, for example, have higher

Figure 1. GDP per capita (current USD) and unemployment rates



Source: World Bank.

² These are: Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Kosovo, 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.

³ The brief summarises the findings of the SELDI background study *Hidden Economy and Good Governance in Southeast Europe: Regional Assessment Report 2016*. This report was based on the methodology of the Bulgarian National Hidden Economy Index, developed by the Center for the Study of Democracy, see CSD (2016), [Hidden Economy Indexes in Bulgaria 2002 – 2015: Results and Methodological Notes, Center for the Study of Democracy, Sofia, 2016](#).

⁴ Includes the population aged 15+.

youth unemployment rates than Greece, and comparable to Spain, two of the worst performing EU economies in this respect in the wake of the global economic crisis. 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 (Figure 1). Many households in all SEE countries still rely on the subsistence economy (producing their own food and bartering) to make a living.

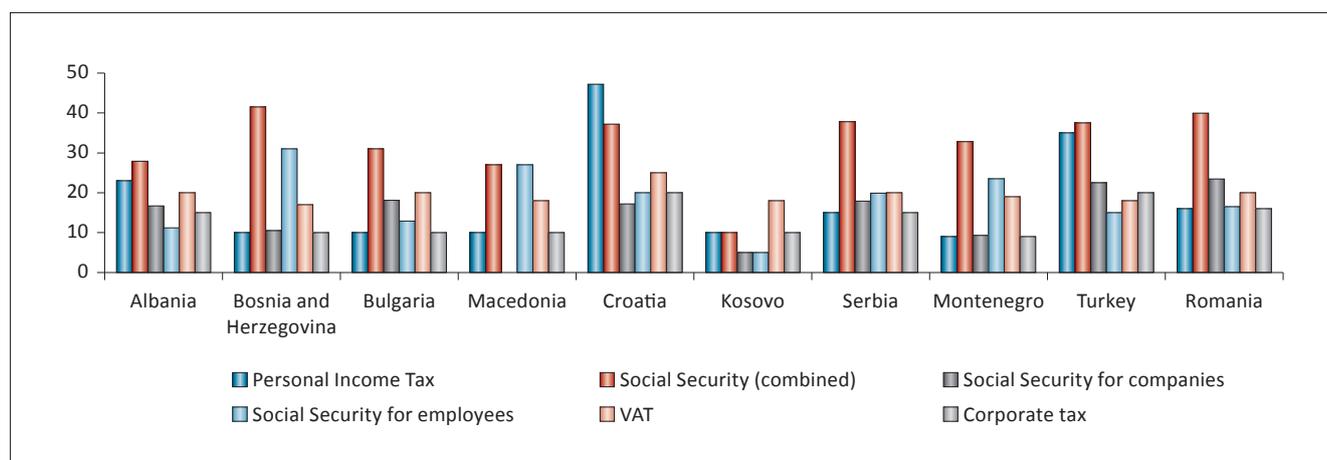
For many countries in transition, including those in SEE, **emigration** has been a powerful valve easing the problem of domestic unemployment and poverty through employment abroad, with the subsequent flow of remittances back to relatives at home. A percentage point increase in remittances is associated with a 1.8 percentage point decrease in employment across SELDI countries. By all accounts, **the link between remittances, hidden employment and the hidden economy is positive** in SEE.⁵ 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). Often, emigrants themselves take up hidden employment in receiving European countries. Albania and Bosnia and Herzegovina have experienced a strong relative fall in remittances received, 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 19th and Serbia 39th worldwide according to this indicator.⁶

Paying Taxes and the Hidden Economy

Individuals and companies in SEE have been competing in tax avoidance, wholly or partially, mainly because the expected marginal utility of public goods and services provided and consumed, 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. The level of tax and social security contribution rates explains between 35 % and 52 % of the variation of Schneider's Shadow Economy in SEE.⁷ The

Figure 2. Selected tax rates for Southeast Europe, 2015



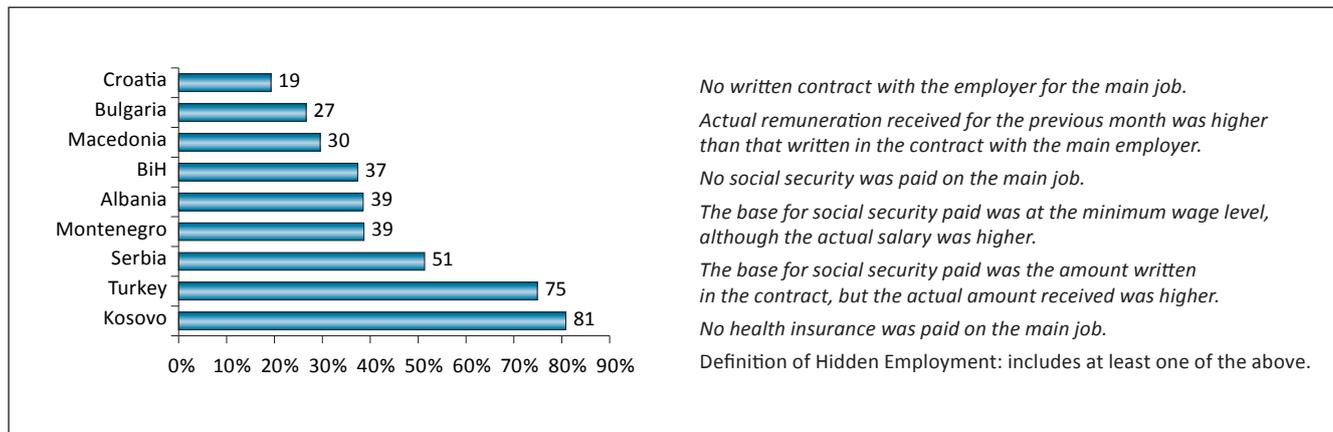
Source: Trading Economics, tradingeconomics.com

⁵ Compare also to A. Ivlevs, [Remittances and informal employment: evidence from transition economies](#), mimeo, 19.4.2016.

⁶ Data from the [World Bank](#).

⁷ [Schneider, Friedrich, Buehn, Andreas and Montenegro, Claudio E., New Estimates for the Shadow Economies all over the World, 2010.](#)

Figure 3. 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, 2016.⁸

majority of companies studied by World Bank Enterprise Surveys in Eastern Europe and Central Asia are mostly concerned by tax rates when asked about their biggest obstacle to business (17.8 %). Montenegro (38 %), Romania (43 %) and Turkey (37.4 %) are far above the SEE average (19.5 %) and wider ECA average (19.5 %). Serbia (16.1 %) is below the regional average, but higher than the world average (12.1 %). 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 2 and 3).

This contradiction between higher tax rates and lower hidden economy has been pointed out earlier, when comparing the Nordic states with Southern Europe, but this time, the comparison comes from very similar countries, which were part of a single federation until recently. It is attributed to factors such as

income levels, tax morale, and satisfaction with public services.⁹ Tax morale is linked to perceived quality and trust in institutions and expectations regarding what others are doing.¹⁰ Some consider tax evasion as a psychological tax contract between citizens and the authorities, influenced by factors such as education, geography and age.¹¹ 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 opposition, fuelled by feelings of affiliation to another country or nation. This is still wide-spread in the region.

While taxes in SEE may be generally low, their **administration costs** might outweigh the advantages, as in the case of Albania (companies see tax administration, not taxes, as an obstacle in itself), and Bul-

⁸ Sample sizes are as follows: Albania (1050), Bosnia and Herzegovina (1007), Bulgaria (1008), 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.

⁹ 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.

¹⁰ Riinvest Institute, *To pay or not to pay – A business perspective of informality in Kosovo*, 2013, http://www.fes-prishtina.org/wb/media/Publications/2013/BUSINESS_INFORMALITY_ENG_FINAL.pdf

¹¹ Feld, Lars and Frey, Bruno, *Tax Evasion, Tax Amnesties and the Psychological Tax Contract*, 2007.

garia (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 enormous¹² due to the intricate composition of state, conflicting institutions and political instability).

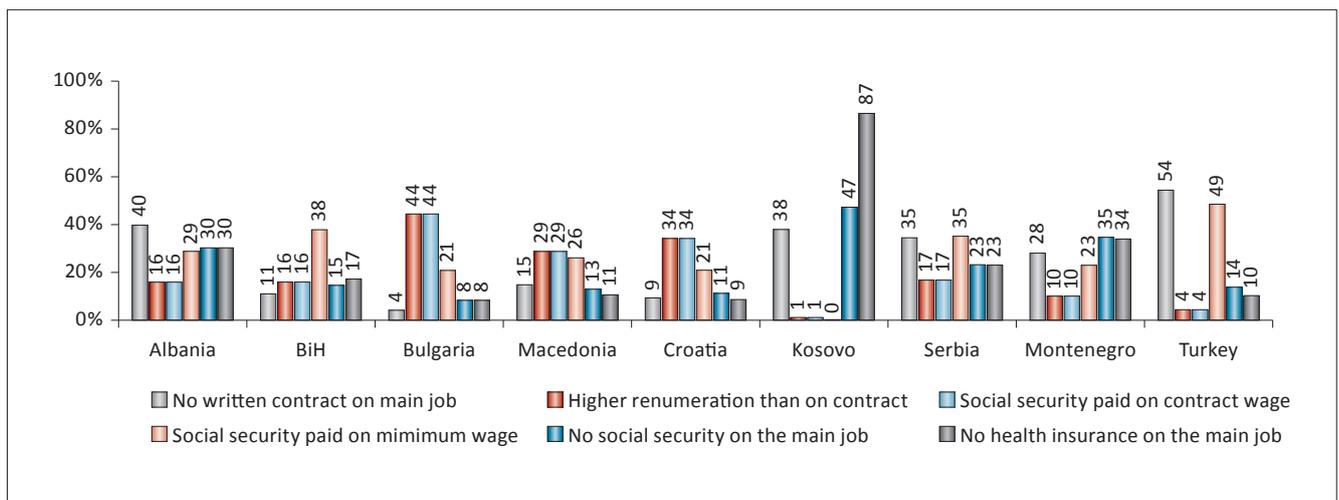
The relative proportions of different taxes suggest a diverging pattern between Southeast European countries and the EU, where society as a whole pays relatively more than the business sector. In 2012, people in Southeast Europe paid between 2.05 % (Macedonia and Bosnia and Herzegovina) and 4.61 % (Serbia) 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. Hence, even based on this data only, it could be argued 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.

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 3), 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, 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

Figure 4. Prevalence of different types of hidden employment in Southeast Europe



Source: SELDI Hidden Economy Survey, 2016.

¹² Taxes paid on wages in Republika Srpska differ substantially from the Federation of Bosnia and Herzegovina: 56 % and 73 % respectively on net salaries.

reason for this is evading social security payments. Similarly, more than a third of all employees who hide from the authorities in one way or another 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.¹³ 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 SELDI countries 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 all those who participate in the hidden economy 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 Macedonia, a third of employees use similar tactics.¹⁴

Participating in hidden employment is sometimes a matter of choice, but more often it is a reinforcing social net that creates a 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 5). 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.¹⁵ As deciles move up, the gap diminishes, but income earned within the informal economy never exceeds that in the formal one.

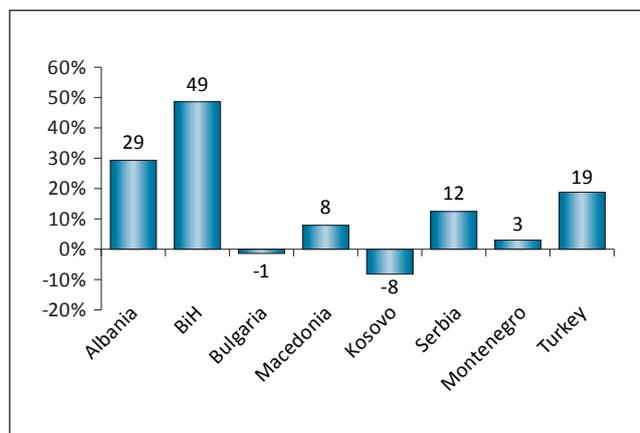
The *SELDI Hidden Economy Survey 2016* shows that people in SEE who are part of the hidden economy

¹³ Uka, Fitim, [Satisfaction with Health care Services and Perceptions on Presence of Corruption](#), UNDP.

¹⁴ CSD and CRPM, Policy Brief No. 31, *Hit and Miss – The Dynamics of Undeclared Labour in Macedonia*, November 2014, p. 11.

¹⁵ [UNDP, National Human Development Report for Montenegro, Informal work: from challenges to solutions, 2016.](#)

Figure 5. Wage premium in the formal economy over the hidden economy



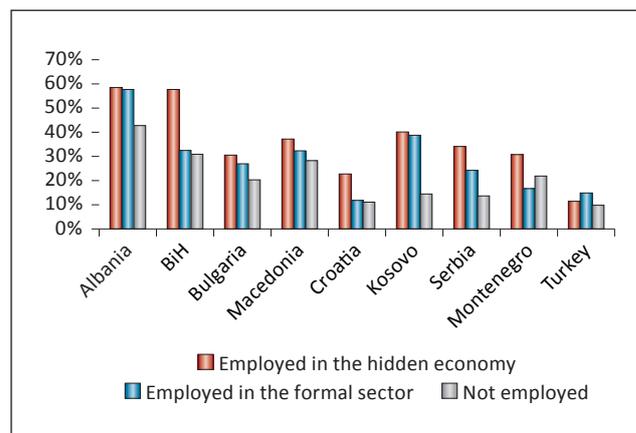
Source: SELDI Hidden Economy Survey, 2016.

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 Macedonia, where hidden employment lowers self-esteem significantly in terms of one's place in society.

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 6). Corruption pressure is also related to the ability to pay, as across the region it has least influence on the unemployed.

A key message from the analysis of the *SELDI Hidden Economy Survey 2016* is the **social and market embeddedness of the hidden economy phenomenon**, which requires the sequencing of policy measures

Figure 6. Corruption pressure (share of those in respective employment situations)



Source: SELDI Corruption Monitoring System, 2016.

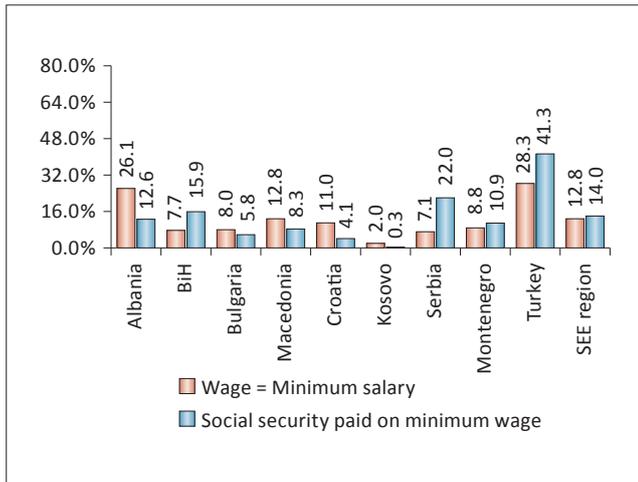
and improvement of the overall level of enforcement of the rule of law in society. Firms which start unregistered and spend more time operating in the shadows have significantly higher subsequent annual sales, employment and productivity growth rates, compared to those that registered from the outset.¹⁶ 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 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

Another important finding from the analysis is that minimum wages make economic policy sense (besides being a threshold for the collection of revenues from those having formal contracts) for only two countries, 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**

¹⁶ Williams, C.C., Martinez-Perez, A. and Kadir, A.M., *Informal entrepreneurship in developing economies: the impacts of starting-up unregistered on firm performance. Entrepreneurship Theory and Practice, 2016.*

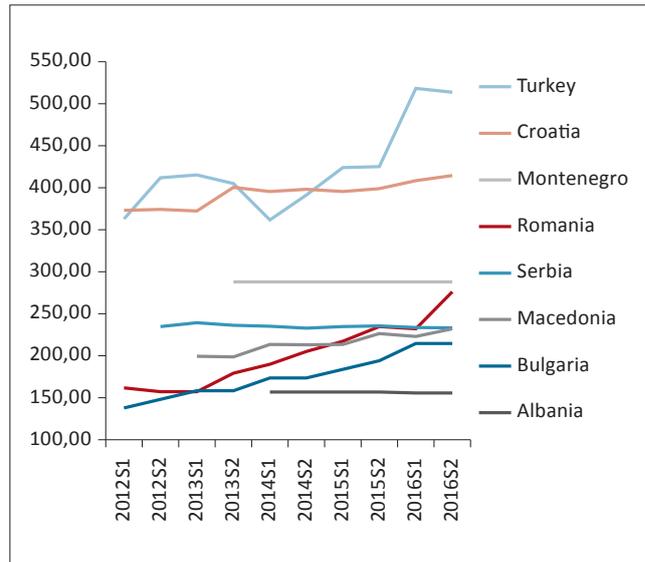
Figure 7. Role of minimum wages for personal income and social security payments in SEE



Source: SELDI Hidden Economy Survey, 2016.

wage (Figure 7). In all other countries, the proportion of employees who receive the minimum wage is between 2 % (Kosovo) and 11 % (Croatia). Only in Serbia is there a significant number of employees (22 %) who receive higher salaries than the minimum wage, but who 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 2016¹⁷ 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 and Macedonia) and 9 % (Kosovo and Albania) of the total income earned by all employees for every SELDI country. Increasing the minimum wage for these lower income people might entail a

Figure 8. Minimum wage dynamics in SEE (2012 – 2016 measured semi-annually)



Source: Eurostat, 2016.

negative welfare change, due to increased spending on services tied to the minimum wage (medical services, kindergarten fees and various administrative services).

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. The higher minimum wage and, consequently, the higher minimum threshold for social security contributions, increased motivation for hiding income, which could not be offset by means-tested benefits aimed at poor households, and ultimately prevented low-earning workers in the hidden economy to legalise their work.¹⁸

¹⁷ UNDP, National Human Development Report for Montenegro, *Informal work: from challenges to solutions*, 2016.

¹⁸ J. Koettl, *Does formal work pay in Serbia? The role of labour taxes and social benefit design in providing disincentives for formal work*, Technical Note, World Bank, 2010, p. 9.

Policy Recommendations

- 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. Use **mirror statistics** to calibrate international trade statistics and proxy contraband and trade-related tax evasion.
- **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 will feel **engaged** in needed reforms and raise their trust in institutions. So far, even policies which are appropriate in principle have provoked resistance by businesses and civil society, as top-down driven (e.g. in Albania and Serbia).
- 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 monitoring control of non-compliance. Working in the hidden economy in SEE is often socially embedded, culturally and educationally predetermined, and not simply a matter of a rational choice maximising personal benefit/utility. Hence, an effective anti-hidden economy policy would not be purely economic or fiscal, but a comprehensive social policy.
- In countries where remittances are an important source of investment in the hidden economy (e.g. Macedonia, Kosovo and Bosnia and Herzegovina), 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. Remittances often link the hidden economy in Southeast Europe with the hidden economy in EU Member States (where the senders frequently work). So, countries have incentives to resolve this problem in partnership.
- **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.
- Conduct **regular tax gap assessments** (including per type of tax), following a common methodology and adjust policies according to findings. Cross-check hypotheses with statistical assessments of the size of the hidden economy and independent, survey-based analyses of characteristics.
- Policies tackling the hidden economy should be linked to those **countering corruption and improving law enforcement**, while taking note of the need to embed 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.