



Employment and Social Affairs Platform

**Diagnostic Report on undeclared
work in Kosovo^{*}**

Report prepared by Dr. Ardiana Gashi, with Prof. Colin C Williams

DRAFT
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^{*} This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.



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List of abbreviations

ALMM-Active Labour Market Measures

EARK-Employment Agency of Kosovo*

EO-Employment Offices

ERP-Economic Reform Programme

KBRA-Kosovo* Business Registration Agency

KPI- Key Performance Indicators

KPST-Kosovo* Pension Savings Trust

KTA-Kosovo* Tax Administration

LFS-Labour Force Survey

LiT-Life in Transition Survey

MLSW-Ministry of Labour and Social Welfare

MTI-Ministry of Trade and Industry

TESD-Tax Administration operates a Taxpayers Education and Service

WBES-World Bank Enterprise Survey



Executive Summary

This diagnostic report evaluates the extent, nature and drivers of undeclared work in Kosovo* followed by recommendations regarding how this sphere can be tackled.

Extent and nature of undeclared work in Kosovo*

The size of the undeclared economy is estimated to be equivalent to about 32% of GDP in Kosovo*, according to a recent European Commission study (2017). The World Bank Enterprise Survey, meanwhile, reveals that 65.6% (about 7 in 10) of surveyed formal enterprises with five or more employees in Kosovo* assert that they compete against unregistered or informal firms, and 58.8% (about 6 in 10 formal enterprises) identify the practices of informal competitors as a major constraint. These percentages are significantly higher, compared with Europe and Central Asia region in general, as well as higher than the global figures. These findings indicate that a large share of formal enterprises compete against, and are constrained by, those operating in the undeclared economy.

The businesses more likely to state that they compete against firms operating in the undeclared economy are in the manufacturing sector but when disaggregating by sub-sector, retail services are most likely to compete against firms in the undeclared economy. By size, small-sized enterprises are more likely to witness such unfair competition. Whilst women-owned enterprises are less likely to be unregistered at start-up, over three-quarters (nearly 8 in 10) of enterprises with women as top managers reported that they compete against firms operating in the undeclared economy, compared with two thirds (7 in 10) of enterprises with men as top managers.

According to a study commissioned by European Commission in 2017, it is estimated that there are about 45,000 employees working full time in the undeclared sector. Construction, agriculture and the retail trade sector are characterised with the highest prevalence of undeclared work. Labour Force survey data reveals that nearly one quarter of employees (1 in 4) hold vulnerable jobs, i.e. are either unpaid family workers or self-employed without employees. A distinct feature of vulnerable employment in Kosovo* is that unpaid family work constitutes one third of vulnerable employment, a significantly higher proportion than the corresponding average for the EU28 (10.2%) and new member states (13.9%).[†] This suggests that being an undeclared worker in Kosovo* is not a voluntary choice, but rather a ‘survival strategy’ in the absence of opportunities in the declared economy (Krstić and Gashi, 2016). Considering the criterion of possessing an employment contract, in 2017, 21.5% of employed persons did not have a contract (i.e., were in unregistered employment), exhibiting an increase compared with previous years. Youth, men and individuals with lower educational attainment are at a greater risk of being in unregistered employment.

[†] According to the Key Indicators of the Labour Market 9th Edition (indicator KILM 3 for 2014). Unweighted average, Malta is not included (software downloaded from <http://kilm.ilo.org/2015/install/>).



Drivers of the undeclared economy in Kosovo*

In the past few years, significant advances have been made in understanding the determinants of the undeclared economy by a new institutional approach. To explain the undeclared economy, this asserts that every society possesses institutions which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable. In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions which prescribe ‘citizen morality’ (i.e., socially shared rules, usually unwritten).

The undeclared economy, from this institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. These formal institutional failings are of four types: (i) formal institutional voids, such as a weak welfare ‘safety net’ which forces citizens into undeclared work to survive; (ii) formal institutional inefficiencies, or resource misallocations by formal institutions; (iii) formal institutional uncertainty, and/or (iv) formal institutional weaknesses and instability. These failings result in citizens viewing as socially acceptable what is deemed illegal by the state. The undeclared economy arises, therefore, due to the failings of formal institutions which leads citizen morality to not be aligned with state morality.

Analysing the evidence on which formal institutional failings are significantly associated with the growth of the undeclared economy, multiple studies have revealed that the undeclared economy is bigger in economies where there is: lower GDP per capita; higher perceived levels of public sector corruption and lower quality governance; lower expenditure on labour market interventions to help the most vulnerable groups; lower social expenditure, and greater inequality and deprivation.

Unless these failings of formal institutions are addressed, then the asymmetry between state and civic morality will persist, and consequently so too will the prevalence of the undeclared economy. How, therefore, can these failings and imperfections in formal institutions that lead to an extensive undeclared economy be addressed?

Organisation of the fight against the undeclared economy: institutional framework

In 2014, the government of Kosovo* developed a National Strategy of Kosovo* and Action Plan for the Prevention of and Fight against the Undeclared Economy, Money Laundering, Terrorist Financing and Financial Crimes 2014-2018. The Ministry of Finance carried the main responsibility for coordination of the activities related to the drafting, revision, adoption, and implementation and monitoring of the National Strategy and Action Plan 2014 – 2018, but this was developed jointly with several relevant institutions. However, there is room for considerable improvement when joining-up the actions of government institutions. Whilst labour law violations are the responsibility of the Ministry of Labour and Social Welfare, tax non-compliance responsibility lies with the Ministry of Finance. To further improve coordination and pursue a joined-up approach across government, cross-cutting strategic objectives and targets, as well as individual Ministry-level strategic objectives and targets, could be set by the government.



Given that tackling the undeclared economy requires the involvement of all social partners, initiatives to encourage even greater involvement of the social partners is recommended. During interviews with social partners, they expressed a strong interest to play a larger and more active role in tackling the undeclared economy.

Current policy approach and measures: an evaluation

Kosovo* has until now relied on a relatively narrow approach and range of measures to support the transition from the undeclared to the declared economy and reduce undeclared work. An enforced compliance approach, rather than a voluntary cooperation approach, has been pursued, and the policy measures have focused upon deterring the undeclared economy, mainly by increasing the risks of detection. Little emphasis has been given to on the one hand, improving the benefits of and incentives for declared work, and on the other hand, more indirect tools to deal with the formal institutional failings so as to reduce the asymmetry between state morality and civic morality, such as awareness raising campaigns and dealing with the imperfections and failings of formal institutions (e.g., by facilitating procedural and redistributive justice and fairness, and pursuing wider economic and social policies). The result has been a lack of transfer of good practice from elsewhere to Kosovo*. This includes both the shift from the use of solely deterrence measures to the broader use of incentives, as well as the use of a wider more integrated holistic approach that targets and tackles the major drivers of the undeclared economy. The current National Strategy and policy documents of responsible institutions for tackling undeclared work, largely focus on detection while paying less attention to the role of the preventive measures.

A National Action Plan: policy recommendations and sequencing

The plan recommended here is based on a multi-stakeholder diagnostic of the causes, circumstances and forms of the undeclared economy in Kosovo*. It is also based on the experiences of both the International Labour Organization (ILO) and the European Commission's European Platform Tackling Undeclared Work, that the transition to the declared economy can best be facilitated through: (i) an integrated strategy, (ii) a policy mix and (iii) institutional coordination. A comprehensive approach and measures are proposed to tackle the undeclared economy in this Report. The plan foresees a coordinated and evidence-based approach based on a package of policies that involve: more effective deterrence measures; simplifying compliance to help individuals operate in the declared economy; the provision of various incentives to businesses to operate in the declared economy as well as a range of indirect tools to resolve the failings of formal institutions so as to engender a culture of trust and commitment among the population to operating in the declared economy.

If there is to be a transition from the undeclared to the declared economy, the current rift between state morality and citizen morality that results in macro-level failings and imperfections of the formal institutions must be addressed. These include:

- Continue to increase the growth in GDP per capita;



- Improve governance and further reduce the perceptions of public sector corruption, which remains poor with Kosovo* ranked 85th out of 167 economies globally on public sector corruption;
- Pursue greater expenditure on labour market interventions to help the most vulnerable groups;
- Persist with increasing social expenditure, welfare provision and attempts to decrease the levels of poverty.

Running alongside these broad macro-level policies, each ministry responsible for different aspects of tackling undeclared work should seek to implement the following policy recommendations that broaden the range of approaches and measures used, as well as draw upon international good practice in what is considered an effective and efficient approach.

On the one hand, and reflecting the need for a cross-government approach, there are a range of measures that all ministries involved in tackling undeclared work should implement. These policy measures that cross-cut all ministries include:

- Implementing a holistic integrated strategic approach towards tackling undeclared work;
- Improving the effectiveness of electronic systems for data mining, the inter-operability of data bases and data sharing;
- Introducing supply chain responsibility in public works contracts;
- Introducing a ‘white list’ of legitimate employers for public procurement contracts;
- Introducing voluntary disclosure initiatives;
- Improving the provision of formalisation advice;
- Using service vouchers in sectors where undeclared work is rife whilst evaluating whether these are substituting for declared or undeclared employment;
- Launching public awareness campaigns on the benefits of declared work;
- Increasing social partner involvement.

On the other hand, there are a range of additional policy measures specific to the following stakeholders:

Ministry of Labour and Social Welfare

- Training of labour and inspectors;
- improve formalisation advice services in cooperation with social partners;
- Increase the outreach of awareness raising campaigns;

Ministry of Finance:

- Improve formalisation advice services in cooperation with social partners; and
- Introduce a tax rebate incentive scheme in the domestic services and home repair and renovation sectors;

Ministry of Education:

- Educate children of the benefits of paying taxes and working declared.

Social partners:



- Introduce a voluntary supply chain responsibility initiative;
- Work with ministries to improve formalisation advice services; and
- Cooperate with government on public awareness campaigns on the benefits of declared work among both citizens and businesses.

1. Introduction: background context

The Government of Kosovo* puts the topic of the transition from the undeclared to declared work high on its policy agenda. Kosovo*'s economic growth has been steady, performing relatively better than neighbouring Western Balkans economies. Opting to join the European Union, economic policies and reforms were undertaken aiming to strengthen the legal and institutional framework and the public infrastructure of the economy (World Bank, 2017). Despite positive and inclusive growth, Kosovo* remains one of the poorest economies in Europe and with low GDP per capita (World Bank, 2017). The achieved economic growth, has not translated into jobs, particularly for women and youth. Kosovo*'s labour market is characterised by a low economic activity rate (42.8% in 2017), low employment (29.8%) and high unemployment rate (30.5%), all these exhibiting a significant gender divide.

In 2018, the Kosovo* government approved the Sectoral Strategy and Action Plan of Ministry of Labour and Social Welfare 2018-2022 and Action Plan for Increasing Youth Employment 2018-2020.

The overall goal of the Sectoral Strategy 2018-2020 is to improve public policies and services in the area of employment and welfare of citizens as a prerequisite for inclusive development and integration of Kosovo* into the European Union. The following objectives are planned to be implemented for fulfilment of the goal of the strategy:

- Reduce inactivity, increase employment, develop skills in line with labour market demands and better labour market management;
- Improvement of working conditions and reducing undeclared work through strengthening oversight mechanisms and strengthening social dialogue;
- Improving social welfare through expanding and increasing the quality of protection and social and family services, having special focus on groups in need and gender equality; and
- Realization of rights to benefits for pensioners and pensioners of war categories through the development of a sustainable pension system, harmonization of the legal framework and institutional, human and technological capacity building.



The Action Plan for Increasing Youth Employment 2018-2020, aims to increase employment and improve employability for young people, to be achieved through the following objectives:

- Increasing the access of young people to the labour market through the provision of quality employment services and active employment measures;
- Increasing employment through entrepreneurship development;
- Harmonization of vocational education and training with labour market requirements and the provision of career guidance and counselling services; and
- Increasing the quality of practical learning at school and professional practice outside school.

The Government of Kosovo*, trade unions and employer's organizations acknowledge the importance of constructive social dialogue as a tool and mechanism for facilitating transition from undeclared work to declared work, the creation of more and better jobs, a more inclusive labour market and a more business-friendly environment. However, there is a need to strengthen the dialogue, so they jointly contribute to combating and preventing undeclared work.

In a context marked by widespread undeclared work, tackling the undeclared economy is increasingly seen as a major economic and social challenge in Kosovo*. There is consequently an urgent need to reformulate questions of policy intervention in a way that can enable Kosovo* to tackle this realm. Taking fully into consideration ILO Recommendation 204, the aim of this report is therefore to investigate the main characteristics and determinants of the undeclared economy and to provide appropriate and efficiently integrated policy frameworks and the associated policy guidelines to introduce incentives to enable the transition from the undeclared to the declared economy and reduce undeclared work. To achieve this, the objectives of this report are to:

- Identify the extent and character of the undeclared economy in Kosovo*;
- Identify the main incentives and drivers of the undeclared economy in Kosovo*;
- Review the legal, policy or strategic frameworks to inform the design and implementation of laws and regulations, policies and other measures aiming to facilitate the transition to the formal economy;
- Identify priority measures and sequencing to facilitating the transition from the undeclared to the declared economy;
- Enable the identification of possible and feasible pilot programmes to evaluate the initiatives to support the transition from the undeclared to the declared economy; and
- Provide a set of policy recommendations.

On the one hand, therefore, this report provides support to the Kosovo* Government and social partners in tackling the undeclared economy by identifying the causes, circumstances and forms



of undeclared work in Kosovo*. This has been here achieved through a multi-stakeholder diagnostic of the situation involving the meetings listed in Annex A, along with a desk-based review of the current situation. On the other hand, the information generated has been used to formulate a comprehensive policy action plan, with a view to enabling the transformation of undeclared work into declared work. The program is set out to facilitate the transition from the undeclared to the declared economy in Kosovo* and provides an integrated regulatory and policy framework based on a combination of deterrence, preventive and curative policies, and is based on good practice being developed elsewhere in the European Union's European Platform Tackling Undeclared Work and beyond, including ILO recommendation 204 (ILO, 2015b). As part of this, some pilot activities are recommended to enable the resultant integrated policy framework to be implemented and its impact evaluated in an evidence-based manner in terms of its effectiveness at tackling undeclared work.

Across the world, there is no official universal definition of the 'undeclared economy'. However, a useful working definition is provided by Schneider and Enste (2000, 79) who define it as all legal production and provision of goods and services that are deliberately concealed from public authorities for the following four reasons: (i) to avoid payment of income, value added or other taxes; (ii) to avoid payment of social security contributions; (iii) to avoid having to meet certain legal standards, such as minimum wages, maximum hours, safety standards, etc.; and (iv) to avoid compliance with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

The ILO (2015a: 6) Recommendation 204 similarly states that what it terms the informal economy (a) refers to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements; and (b) does not cover illicit activities, in particular the provision of services or the production, sale, possession or use of goods forbidden by law, including the illicit production and trafficking of drugs, the illicit manufacturing of and trafficking in firearms, trafficking in persons, and money laundering, as defined in the relevant international treaties.

Employees are therefore considered to have informal jobs if their employment relationship is, in law or in practice, not subject to national labour legislation, income taxation, social protection or entitlement to certain employment benefits (advance notice of dismissal, severance pay, paid annual or sick leave, etc.). The underpinning reasons may be the non-declaration of the jobs or the employees; casual jobs or jobs of a short duration; jobs with hours of work or wages below a specified threshold (e.g. for social security contributions); or lack of application of law and regulation in practice.

Employers and own-account workers are considered informal when their economic units belong to the informal sector. The informal sector is a subset of household unincorporated enterprises



(not constituted as separate legal entities independently of their owners)[‡] that produce for sale in the market, even if partly, and that do not have a complete set of accounts and/or are not registered under national legislation. Finally, all contributing family members are considered as informally employed. Economies use different operational criteria among those mentioned above to measure informal employment according to national context and circumstances.

As such, the only difference between undeclared and declared work in this report is that it is not declared to the authorities for tax, social security and labour law purposes when it should be. If other differences exist, it is not what we here term undeclared work (in line with the terminology used by the European Commission). For example, if the goods and services provided are illegal, it is part of the wider criminal economy, whilst if there is no monetary payment, it is part of the unpaid sphere.

2. The undeclared economy: an analytical and policy framework

2.1 Analytical Framework

Undeclared work by definition is not declared to the authorities. This makes it difficult to obtain reliable estimates of its magnitude and characteristics, with various methods used to estimate its size and characteristics. Evaluating the different measurement methods available, the European Commission (2007a: 4) state:

‘Undeclared work can be measured both directly and indirectly. Indirect methods are based on the comparison of macroeconomic aggregates (such as national accounts, electricity consumption, cash transactions). Indirect (especially monetary) methods often over-estimate the level of undeclared work and say little about its socio-economic characteristics. Direct methods, on the contrary, are based on statistical surveys and have advantages in terms of comparability and detail, but tend to under-report the extent of undeclared work.’

The resultant consensus has been to use indirect methods to measure the size of the undeclared economy and direct methods to identify its characteristics in terms of who engages in it, what they do and why, to inform policy development (Eurofound, 2013; Williams and Schneider, 2016). This will be the approach adopted in this report.

To identify the drivers of the undeclared economy is important because it is these that need to be tackled to transform undeclared work into declared work. Recently, significant advances have been made in understanding the determinants of undeclared work by adopting an institutional perspective which transcends the previous competing debates about the varying causes of undeclared work (Godfrey, 2015; Webb et al, 2009, 2013; Williams and Franic, 2016; Williams

[‡] ILO, Resolution concerning the measurement of employment in the informal sector, Fifteenth International Conference of Labour Statisticians (ICLS), Geneva, 1993.



and Horodnic, 2015a,b,c; Williams et al, 2015a). Institutions, or governance mechanisms, which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable, are seen to exist in every society (Baumol and Blinder, 2008; North, 1990; Scott, 1995). In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions which prescribe ‘citizen morality’ (i.e., socially shared rules, usually unwritten) (Helmke and Levitsky, 2004).

Undeclared work, from this institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. As Webb and Ireland (2015) outline, these formal institutional failings are of four types:

- (i) formal institutional voids, such as no social protection or a welfare ‘safety net’ which forces citizens into undeclared work to survive;
- (ii) formal institutional inefficiencies, or resource misallocations by formal institutions, such as when formal institutions seek to protect or maximize economic rents for elites, or when state capture occurs by such elites, resulting in the majority not receiving a fair share in return for their contributions, or suffering from overly burdensome taxes, registration and licensing regulations and costs;
- (iii) formal institutional uncertainty, such as when there is fear regarding the future of specific formal institutions, or when technology and socio-cultural change outpaces the ability of formal institutions to accommodate new domains of activity (e.g., ‘the sharing economy’), and/or
- (iv) formal institutional weaknesses and instability, manifested in their lack of capacity and capability to enforce legislation (Webb *et al.*, 2009) and/or there are continuous changes in the formal ‘rules of the game’ about what is acceptable, which leads citizens to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules.

Undeclared work arises, therefore, due to these failings of formal institutions producing a situation in which the formal ‘rules of the game’ (state morality) differ to what citizens view as socially acceptable (citizen morality). Indeed, the greater is the non-alignment of state morality and citizen morality, the greater is the prevalence of the undeclared economy.

Which specific formal institutional failings, therefore, result in the non-alignment of citizen morality with state morality, and thus the prevalence of undeclared work? Until now, there have been three competing theories which each identify different formal institutional failings as the cause of more extensive undeclared economies. Firstly, *modernization theory* has argued that undeclared work is rife in societies which are under-developed economically (i.e., with lower levels of GDP per capita) and where the formal institutions of governance are not modernised, displayed by the existence for example of higher levels of public sector corruption and lower qualities of governance. Secondly, ‘*state over-interference*’ theory has argued that undeclared work is a resistance practice voluntarily pursued and a rational economic response to high tax rates and too much state interference such as over-burdensome rules and regulations (e.g., Becker, 2004; De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Sauvy, 1984;



Small Business Council, 2004). Third and finally, ‘*state under-intervention*’ theory views undeclared work as a direct by-product of too little, rather than too much, state intervention in work and welfare arrangements. In this approach, undeclared work is viewed as an inherent and integral component of contemporary capitalism and a key facet of the sub-contracting, downsizing and outsourcing arrangements that are emerging in advanced capitalism and enable enterprises to achieve profit through flexible production and cost reduction (Meagher, 2010; Taiwo, 2013). Consequently, undeclared work is depicted as unregulated, insecure and low paid employment conducted out of necessity by marginalized populations excluded from the declared economy and conducted as a last resort when no other options are available to them (Ahmad, 2008; Castells and Portes, 1989). As such, undeclared work is seen to result from a lack of social protection for workers and the remedy is greater state intervention in work and welfare provision to protect workers from poverty (Davis, 2006; Gallin, 2001; Slavnic, 2010).

Reviewing the studies that evaluate these theories by examining the cross-national variations in these economic and social conditions, and cross-national variations in the size of the undeclared economy, the same findings continuously emerge. Whether one measures the size of the undeclared economy using Schneider’s MIMIC estimates (Williams, 2014d) or using direct surveys (Williams, 2014a,b,c, 2015a,b, 2016; Williams and Martinez-Perez, 2014) and whether one compares the 28 member states of the European Union (Williams, 2014c; 2016; Williams and Horodnic, 2016), post-socialist transition economies (Williams, 2014a, 2015b) or economies across the developing world (Williams, 2014b, 2015a,c,d), the finding is that there is no evidence to support the state over-interference thesis. Instead, the prevalence of the undeclared economy is positively associated with the tenets of the modernisation and state under-intervention theses. To tackle the undeclared economy, therefore, these multiple studies reveal a need to focus upon:

- Increasing GDP per capita;
- Improving the quality of governance and reducing corruption;
- Increasing expenditure on labour market interventions to help the most vulnerable groups;
- Increasing social expenditure, and
- Developing more effective social transfer systems so as to reduce the level of inequality and severe material deprivation, which includes improving the efficiency of collection.

Indeed, unless these formal institutional failings are tackled that result in an asymmetry between state morality and citizen morality, undeclared work will persist. For example, Williams and Horodnic (2016) examine the formal institutional failings that are associated with higher level of under-declared work (i.e., the illegal employer practice of under-reporting employees’ salaries) in the EU-28 using data from the 2013 Eurobarometer survey of 11,025 employees. Rather than an individual criminal act that increasing the risk of detection can tackle, they reveal that this is a symptom of systemic problems. They show that under-declared work is concentrated in economies with:

- lower levels of economic development and less modernised state bureaucracies;
- greater income inequality;
- higher rates of severe material deprivation;



- less effective redistribution via social transfers, and
 - lower levels of labour market interventions to protect vulnerable groups in the labour market.
- They also importantly reveal no significant association between increasing the perceived risk of detection and the likelihood of participating in under-declared work, when other variables are held constant. Under-declared work is nevertheless significantly associated with the non-alignment of state morality and citizen morality. To reduce under-declared work, therefore, the conventional approach of improving detection seems ineffective. Instead, if under-declared work is to be resolved, policy measures are required that tackle the formal institutional failings that lead to an asymmetry between the formal ‘rules of the game’ and citizen morality.

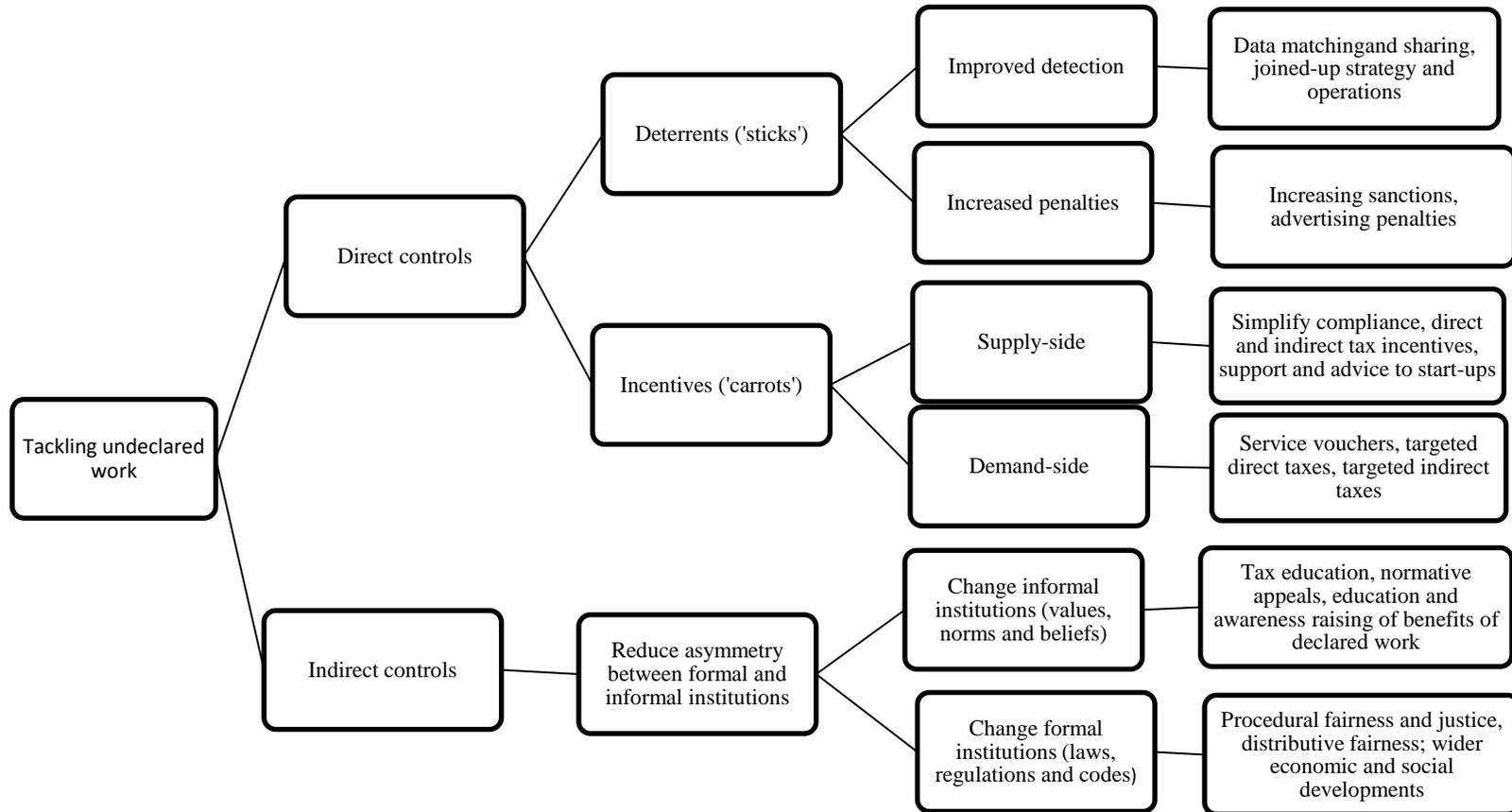
2.2 Policy approaches towards the undeclared economy

It is now widely accepted across the developed, transition and developing world, that the aim of governments is not to eradicate the undeclared economy, but to move undeclared work into the declared economy (Dekker *et al.*, 2010; Eurofound, 2013; European Commission, 2007a; ILO, 2015b; Small Business Council, 2004; Williams, 2014; Williams and Nadin, 2012a,b, 2013, 2014).

Figure 1 displays the full range of tools available for transforming undeclared work into declared work. On the one hand, there are direct tools. These transform undeclared into declared work by ensuring that benefits of operating in the declared economy outweigh the costs of working in the undeclared economy. This is accomplished either by using deterrence measures to increase the costs of non-compliance (‘sticks’) and/or by making the conduct of declared work more beneficial and easier (‘carrots’). On the other hand, there are indirect tools. These shift away from using ‘sticks’ and ‘carrots’, and instead focus on dealing with the formal institutional failings to repair the social contract between the state and its citizens in order to foster a high trust high commitment culture.



Figure 1: Policy approaches and measures for tackling undeclared work





Direct controls, therefore, seek to reduce the costs and increase the benefits of operating on a declared basis (OECD, 2008). Viewing the non-compliant as rational economic actors who engage in undeclared work when the pay-off is greater than the expected cost of detection and punishment, the objective is to change the cost/benefit ratio facing those participating or considering participation in undeclared work (e.g., Allingham and Sandmo, 1972; Hasseldine and Li, 1999; Richardson and Sawyer, 2001). This can be achieved in two ways:

- *Deterrence measures* seek to detect and punish non-compliant ('bad') behaviour (i.e., undeclared work). This is achieved by firstly, raising the perceived or actual likelihood of detection and/or secondly, increasing the penalties and sanctions for those caught. This 'negative reinforcement' approach thus seeks behaviour change by using 'sticks' to punish non-compliant ('bad') behaviour.
- *Incentive measures* seek to make it easier to undertake, and reward, compliant ('good') behaviour (i.e., declared work). To achieve this, one can use either:
 - Preventative measures to stop people moving into the undeclared economy in the first place (e.g., by simplifying compliance, using direct and indirect tax incentives to make it beneficial to operate on a declared basis, and providing support and advice about how to start-up legitimately); or
 - Curative measures to incentivise workers and businesses to make the transition to the declared realm. These can be either (a) supply-side incentives targeting businesses and workers in the undeclared economy or (b) demand-side incentives targeting their customers with rewards for using declared goods and services.

The problem with using these direct tools is that those operating on an undeclared basis are not always rational economic actors purely calculating the costs and benefits. They can be also social actors who engage in undeclared work because there is lack of alignment between their own morality and the laws and regulations, such as due to a lack of trust in the state and what it is seeking to achieve.

Indirect controls, therefore, seek to deal with the formal institutional failings and repair the social contract between the state and its citizens to create a high trust high commitment culture (Alm et al., 1995; Torgler, 2003; Wenzel, 2002). The intention is to seek a voluntary commitment to compliant behaviour rather than force citizens to comply using threats, harassment and/or incentives (Kirchler, 2007; Torgler, 2007, 2011). Undeclared work occurs where formal institutional failings lead to citizens' norms, values and beliefs differing to the laws and regulations, meaning that what formal institutions deem illegal activities are socially legitimate in the eyes of citizens. To tackle undeclared work therefore, there is a need to address the formal institutional failings and repair the social contract. To align citizen morality with state morality, one can either:

- *Change the informal institutions* - to change the norms, values and beliefs of citizens regarding the acceptability of undeclared work, so that these are in symmetry with the laws and regulations, one can use awareness raising campaigns and educational initiatives about the costs of undeclared work and benefits of declared work.
- *Change the formal institutions* – this is particularly important in societies in which there is a lack of trust in government, such as due to public sector corruption



(European Commission, 2014) or in societies where citizens do not believe that they receive back from government what they expect. This can involve either:

- Changes in the internal *processes* of the formal institutions to improve the perception amongst citizens that there is procedural and distributive fairness and justice, and/or
- Change in the *products* of formal institutions by pursuing wider economic and social developments (e.g., increased social expenditure levels, more effective social transfers).

The emerging evidence-base is that the ‘best practice’ when tackling undeclared work is to **combine direct and indirect tools** (Williams, 2014a; Williams and Renooy, 2013). For example, governments may pursue greater social expenditure to provide a welfare ‘safety net’ and culture changes in government departments towards a more customer-oriented approach, and introduce publicity campaigns to elicit greater commitment to compliance, but may also simplify regulatory compliance and introduce incentives (e.g., amnesties, tax deductions) to enable undeclared work to move into the declared realm. At the same time, and in relation to those failing to comply, they may also pursue improvements in the probability of detection and tougher sanctions for those subsequently caught. The debate therefore is not over whether it is best to use either indirect tools or direct tools. The emergent evidence-base is that both are required to effectively tackle undeclared work. Rather than debate is over how to combine and sequence the various direct and indirect measures. Two contrasting approaches exist for doing this:

- *Responsive regulation* - this envisages a regulatory pyramid, sequenced from the least intrusive indirect controls at the bottom and used first, to the most intrusive direct controls at the top. The idea is that an authority does not need in most cases to pursue the coercion option at the top of the pyramid to win compliance. Instead, it can start with the commitment measures at the bottom of the pyramid and if these fail to elicit behaviour change with some groups, then the level of intrusiveness escalates up the pyramid until it reaches the intervention that elicits the desired response. The outcome is recognition of a continuum of attitudes towards compliance and different policy responses that can be temporally sequenced starting with commitment measures, then incentives and only after these fail are sanctions used (Braithwaite, 2002, 2009). The Australian government for example has adopted this ‘responsive regulation’ approach. In the first instance, indirect controls facilitate voluntary self-regulated compliance, followed by persuasion and only then punitive measures to tackle non-compliance (Braithwaite, 2009; Job et al., 2007).
- *Slippery slope framework* - this argues that citizens abide by the law either because they fear detection and fines due to the power of authorities (**enforced compliance**) or because they feel a commitment to be honest because they have trust in the authorities (**voluntary cooperation**). When there is effective enforced compliance as well as high voluntary cooperation (i.e., both power and trust), undeclared work is absent. When there is ineffective enforced compliance and little voluntary cooperation, undeclared work is extensive (Alm and Torgler, 2011; Alm et al., 2012; Kastlunger et al., 2013; Khurana and Diwan, 2014; Kirchler et al., 2008; Kogler et al., 2015; Muehlbacher et al., 2011a,b; Prinz et al., 2013).



This recognition that both effective enforced compliance and high voluntary cooperation are essential for tackling undeclared work is now being seriously considered by authorities in various economies (OECD, 2013).

Indeed, the European Commission's European Platform Tackling Undeclared Work has referred to this slippery slope framework as a '**full policy operationalisation model**'. This is a model for implementing the holistic approach that combines the range of policy approaches and measures available (and uses all measures concurrently). This approach asserts that the most effective approach is to concurrently implement direct measures (e.g., workplace inspections) to enhance the power of authorities as well as indirect measures (e.g., awareness raising) to enhance trust in authorities (Williams, 2016). This approach is based on evidence that a high trust high power approach is the most effective in tackling undeclared work.

Indeed, it is this analytical framework and policy approach that is the basis for this report. With this analytical framework and policy approach in hand, attention now turns to an analysis of Kosovo* and what needs to be done.

3. Extent and nature of the undeclared economy in Kosovo*

3.1 Magnitude of the undeclared economy

Although undeclared work is considered a major concern in Kosovo*, there are no systematic estimates of the size of the undeclared economy. The National Strategy of Kosovo* for the Prevention of and Fight Against Undeclared Work, Money Laundering, Terrorist Financing and Financial Crimes 2014-2018, decomposes the undeclared economy into (i) the undeclared grey economy and (ii) the undeclared black economy. The *undeclared grey economy* consists of activities that are productive and legal but are deliberately concealed from the public authorities to avoid payment of taxes and/or social security contributions or complying with regulations. The income from the undeclared grey economy should be taxed. The *undeclared black economy* consists of the proceeds of crime. It includes those productive activities that generate goods and services prohibited by law or that are unlawful when carried out by unauthorized producers. This current report focuses upon what the strategy refers to as the undeclared grey economy and how it can be tackled. The strategy reports that the extent of undeclared economy in Kosovo* is estimated to be 26.67% – 34.75% of the GDP, in monetary value ranging between one million in 2008 and 1.7 billion Euros, in 2012. The Kosovo* Economic Reform Programme (ERP) 2018-2020, reports that the level of undeclared work in Kosovo* accounts for nearly two thirds of economies GDP (32%), a rate that is higher than other economies with the same level of economic development.

The most recent assessment on undeclared work was conducted in 2017, through an EU-funded project, "Further Support to Kosovo* Institutions in the Fight against Organized Crime, Corruption and Violent Extremism". The process was led by the Ministry of Finance and coordinated between other ministries, independent government agencies, and the Central Bank of Kosovo* among others⁴. This assessment, applies indirect macro methods, which in

⁴ Ministry of Justice; Ministry of Internal Affairs; Ministry of Trade and Industry; Ministry of Labour and Social Welfare; Kosovo* Police; Kosovo* Customs; Kosovo* Tax Administration; Kosovo* Prosecutorial Council;



this case consist of assessing the extent of the undeclared economy as a total household disposable income compared to formal (taxed or tax exempted) income. The same methodology was applied in previous extensive assessments financed by the EU in 2007 and 2014. Indirect methods consist mainly of macroeconomic approaches that quantify the extent of the undeclared economy based on macroeconomic data, indicators and tools. It is an extended version of “Household Consumption vs. Disposable Income Methodology”, and consists of assessing the extent of the undeclared economy as a total household disposable income compared to formal (taxed or tax exempted) income. The residual of total household income, which is not matched from any source of legal known income, unless resulting from miscalculations, is most likely an income generated by activities in the undeclared economy. As outlined in the report, the institutional units that are the focus of this assessment are households. Assessing the undeclared economy based on this approach is the equivalent of assessing the total tax gap (in other words, the difference between households’ or personal actual average and statutory tax rate) for both direct and indirect taxes through their respective effect on revenues’ (for direct taxes) or expenditures’ (for indirect taxes) side of household’s budgets. The employed methodology decomposes the shares of tax paid: a) on the income from labour b) on the income from capital (rent, interest, profit) and c) on the consumption. Findings from this assessment point to a reduction in the undeclared grey economy both in absolute terms and as a share of GDP value, which is related to an improvement in the effectiveness of tax administration practices, for both tax and custom authorities, during the period 2013-2015. According to this report, in 2015, the undeclared economy in Kosovo* accounted for 31.7% of GDP, a one percentage point drop from 2013 (European Union Office Prishtina, 2017). In absolute value, the undeclared economy was €1,594 million in 2013 and €1,368 million in 2015.

Adopting an employment perspective, more than 45 000 fulltime equivalent employees are estimated to be working in the undeclared economy. The estimation of personal income tax and corporate income tax gap are €60.1 million and €34.3 million respectively, whereas the VAT gap is estimated to be at a level of €12.4 million (European Union Office Prishtina, 2017). This study estimates that 33.2% of personal income for households is undeclared.

An alternative estimate of the undeclared economy is the World Bank Enterprise Survey estimates, based on a survey of a representative sample of 202 non-agricultural formal private enterprises, interviewed during January-November 2013, employing five or more employees. As Table 1 reveals, this survey of formal enterprises with five or more employees reveals that in 2013, 94.4% of these enterprises were registered when they started operations. This share is lower than the World Bank global region of Europe and Central Asia, but better than the global figure of 88.8%. However, those starting-up unregistered, on average, remained unregistered for 1.5 years, significantly higher when compared with the Europe and Central Asia (0.3 years) and World Bank global region (0.7 years). This tentatively intimates therefore that remaining unregistered is a problem in Kosovo*. However, this survey only interviews formal enterprises with five or more employees and there may be many more firms that started-up unregistered and remain unregistered. Tentative evidence that this might be the case is that in 2013, two thirds of surveyed formal enterprises in Kosovo* assert that

Kosovo* Central Bank; Kosovo* Supreme Court; Kosovo* Anti-Corruption Agency; Kosovo* Financial Intelligence Unit; Members of the Secretariat.

they compete against unregistered or informal firms, and 58.8% identify the practices of competitors in the undeclared economy as a major constraint. These percentages are much higher than in the Europe and Central Asia region in general, and the global figures, indicating that that a significant minority of formal enterprises compete against, and are constrained by, the operations of unregistered or informal enterprises.

Table 1: Prevalence of undeclared economy in Kosovo*, 2013

| | Percent of firms formally registered when they started operations in the economy | Number of years firm operated without formal registration | Percent of firms competing against unregistered or informal firms | Percent of firms identifying practices of competitors in the informal sector as a major constraint |
|------------------------|--|---|---|--|
| All economies globally | 88.8 | 0.7 | 54.2 | 28.2 |
| Europe & Central Asia | 98.0 | 0.3 | 38.1 | 19.5 |
| Kosovo* 2013 | 94.4 | 1.5 | 65.6 | 58.8 |

Source: World Bank Enterprise Survey 2013.

Referring to firm level data, a World Bank (2017) report states that in Kosovo*, the share of firms that are severely affected by the competition of informal firms is one of the largest in the world, high even among economies at the same level of development (cited source: Source: Winkler, Ajwad, and Vasquez, forthcoming, based on BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>, circa 2013, and World Development Indicators database.

Another survey undertaken by Rrinvest Institute in 2013 was conducted with a representative sample of 600 companies, with the sample selected from the Kosovo* Tax Administration (KTA) database. According to the results, business managers and owners believed that on average, businesses in their industry report about 65.6% of their sales, meaning 34.4% is evaded.

The Kosovo* LFS report does not include any data on the wider undeclared economy. . However, the LFS data does show that about 22 percent of Kosovo*'s wage workers are in unregistered employment without a formal written contract or terms of employment (see Table 2). Comparable estimates from the 2010 Life in Transition Survey (LiTS) on the level of unregistered employment show that Kosovo* has one of the highest rates of unregistered employment among all the economies surveyed in the ECA (World Bank, 2017).



Analysing the level of unregistered employment in more detail, the LFS data reveals that from 2012-2015, on average, 16% of employees were without a contract, whilst this share increased to 26.3% in 2016 and was recorded at 21.5% in 2017. According to LFS data, working without a contract is more prevalent among men (24.4% compared to 18.8% for women) and youth (46.2% as opposed to 21.5% of those aged 15-64), whilst by sector, unregistered employment is more present in construction and the agriculture sector. For illustration, the Kosovo* agriculture census of 2014 revealed that the workforce in the agricultural sector amounted to 362,700 individuals⁵, whilst the LFS in the same year depicted only 8,600 persons engaged in the sector (7,500 men and 1,100 women).

The Labour Force Survey also provides annual data on vulnerable employment, composed of unpaid family work and self-employed without employees, which can also serve as a proxy indicator for undeclared self-employment. Data outlined in Table 2 reveal that about 23% of those in employment in Kosovo* are in vulnerable employment. A distinct feature of vulnerable employment in Kosovo* is that unpaid family work constitutes one third of vulnerable employment, which is significantly higher than the corresponding average value for the EU28 (10.2%) and new member states (13.9%).⁶ A household survey commissioned by the Millennium Challenge Corporation (MCC) with 8,500 households in Kosovo*, meanwhile, found that in 2017, vulnerable employment was 30.1%, higher than the 23% found in the LFS survey. Whatever the exact figure, the suggestion is that being an undeclared worker in Kosovo* is not a voluntary choice, but rather a ‘survival strategy’ in the absence of formal sector opportunities (Krstić and Gashi, 2016). This also highlights that different policy approaches need to be considered, when opting to incentivise formalisation and tackle undeclared work in Kosovo*.

Table 2: Vulnerable employment, 2012-2017

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| Vulnerable employment (000’s) | 51 | 80.7 | 81.0 | 67.7 | 76.0 | 82.4 |
| Share of vulnerable employment in total employment (%) | 16.8 | 23.6 | 24.9 | 22.8 | 22.9 | 23.1 |
| Employed without contracts (%) | 16.6 | 18.0 | 15.5 | 15.5 | 26.3 | 21.5 |

Source: ASK, 2018.

Using 2012 LFS data, a World Bank report of 2017 (Cojojaru, 2017) applied a wider definition of informality, which included all workers in small firms, unpaid family workers, and self-employed people in either small firms or nonprofessional occupations. By this much wider definition of informality, about 35% of workers are informal in Kosovo*; more than half of workers in the formal sector are public sector employees; and more than 40% work in large firms. Of a higher prevalence were found to be young men with low educational attainment and living in rural areas.

⁵ KAS, 2015, Agriculture Census 2014 – Final results: <http://ask.rks-gov.net/media/1374/rezultatet-perfundimtare.pdf>

⁶ According to the Key Indicators of the Labour Market 9th Edition (indicator KILM 3 for 2014). Unweighted average, Malta is not included (software downloaded from <http://kilm.ilo.org/2015/install/>).



A Riinvest survey of 2013, found that managers and owners of surveyed enterprises believe that businesses in their respective industries, on average, declare 63% of their employees, meaning that on average 37% of the total labour force is not registered. This is most prevalent in agriculture with 70% of labour not registered, manufacturing with 46% and human health and social work with 39% (pp.22). Since the survey assesses the share of employees reported to the tax authorities in legally-operating businesses, this is an under-estimate. The survey does not capture such employment in unregistered enterprises.

Using data from the Riinvest survey in 2011, the 2012 Human Development Report (UNDP, 2013) reports that around 30 to 40% of the Kosovo* labour market is undeclared (measured as percentage of labour which is employed informally within a sector). The study stresses out that despite subsidies from government and international organizations operating in Kosovo* pushed firms in agriculture to register their workers, yet this sector is characterized with high rate of labour informality. The prevalence of high labour informality explains the small number of agriculture businesses in Kosovo*, despite the fact that about two thirds of population reside in rural areas.

A significantly higher magnitude on undeclared work has been reported in a recent study published by SELDI (2016). The survey covered 1,000 individuals and employment in the undeclared economy (as a percentage of total non-agricultural employment) includes all jobs in unregistered and/or small-scale private, unincorporated enterprises that produce goods or services meant for sale or barter. Self-employed street vendors, taxi drivers and home-based workers are all considered enterprises, regardless of the size of their operation. SELDI thus employs a broader definition of the undeclared economy: a person is considered as being engaged in the undeclared economy if they participate in at least one of six practices: no written contract with the employer at the main job; actual remuneration received in the previous month was higher than the one written in the contract with the main employer, based on a verbal agreement; no social security is paid on the main job; the base for the social security paid is the minimum wage, even if the actual salary is higher; the base for the social security paid is the amount written in the contract and not the actual received, which is higher; and there is no health insurance on the main job. According to this broader definition, undeclared work in Kosovo* is estimated to be 81% of all employment. This, however, is an overestimate due to the fact that Kosovo* does not have mandatory health and social insurance. This is confirmed also by a further disaggregation of this figure, which reveals that 40% of the undeclared workers are without contract, 87% do not have health insurance and 47% do not have social insurance.

With regards to envelope wages, the only available proxy is provided by the SELDI report (2016), which found that on average, 22.6% of wage earners with contracts receive higher salaries (not bonuses) than those written in contracts. This is a figure for those who in their main job receive envelope wages.

As outlined above, one of the major challenges in analysing the nature of the undeclared economy in Kosovo* is that there are very few sources of data. Indeed, one of the few additional data sources is inspections conducted by the Kosovo* Tax Administration and Labour Inspectorate. Data from Tax Administration of Kosovo*, show that in period 2015-



2017, collected €42, €49 and €52 million (KTA, 2018). On the other hand, in 2016 and 2017, the Labour Inspectorate conducted 7,285 and 8,128 inspections and found 1,340 and 1,750 persons engaged in undeclared work respectively (Labour Inspectorate, 2017 and 2018a). Given the higher prevalence of undeclared work in the construction sector, the Labour Inspectorate, during peak months in 2017 undertook 1,147 inspections, during which 245 informally employed were found (Labour Inspectorate, 2018b). This, however, cannot be taken as a measure of the size of the undeclared economy since the inspections are not conducted on a random selection of businesses.

3.2 Characteristics of the undeclared economy

The undeclared economy includes both wholly undeclared work and under-declared work. *Undeclared work* refers to work entirely undeclared to the state for taxation, social insurance and/or labour law purposes. This includes unregistered employees without a contract who work for a business, for a household, as family members, private tutors, or as farm workers. Besides undeclared wage work, there is also undeclared own-account work conducted on a self-employed basis where all or some of their transactions are not declared. *Under-declared work*, meanwhile, here refers to the illegal employer practice of salary under-reporting, including the practice of declared employers paying declared employees two salaries: (a) an official salary declared for tax and labour law purposes, and (b) an additional undeclared remuneration received ‘under the table’ or by ‘envelope’.

What are the characteristics, therefore, of the undeclared economy? WBES data reveal that the prevalence and impacts of the undeclared sector varies by firm size. Data outlined in Table 3 reveal that small formal businesses (5-19 employees) were more likely to have started-up unregistered than businesses with 20-99 employees. According to survey data, all enterprises with 100 and more employees were formally registered when they started operations in the economy. Moreover, smaller firms starting-up unregistered remain longer as unregistered, with an average duration of 2.4 years, compared to firms with 20-99 employees that remain unregistered for a quarter of a year. This tentatively suggests that starting-up unregistered reduces the future growth of businesses once they formalise and that the longer they remain unregistered, the greater is their future growth reduced. This provides a clear rationale for encouraging businesses to undergo the transition from the undeclared to the declared economy as quickly as possible and preferably, to start-up on a legitimate basis at the commencement of operations.

Findings show that 73.3% of small businesses (5-19 employees) compete against unregistered or informal firms, compared to 56.7% of medium and 49.2% of larger ones (200 and more employees). A somewhat similar share of small and medium-sized enterprises (29.6% and 26.7%) stated that they identify the practices of competitors in the undeclared sector as a major constraint, rather than smaller businesses, compared with 22.7% of larger ones.

Table 3: Prevalence of undeclared economy in Kosovo*, 2013, by firm size

| | Europe and Central | All economies globally |
|---------|--------------------|------------------------|
| Kosovo* | | |



| | | Asia | |
|---|-------------|-------------|-------------|
| Percent of firms formally registered when they started operations in the economy | 94.4 | 97.8 | 89 |
| 5-19 employees | 91.5 | 97.6 | 87.6 |
| 20-99 employees | 97.9 | 97.9 | 91 |
| 100+ employees | 100.0 | 99.3 | 93.1 |
| Number of years firm operated without formal registration | 1.5 | 0.3 | 0.7 |
| 5-19 employees | 2.4 | 0.3 | 0.7 |
| 20-99 employees | 0.3 | 0.4 | 0.7 |
| 100+ employees | 0.0 | 0.7 | 0.9 |
| Percent of firms competing against unregistered or informal firms | 65.6 | 40.3 | 53.9 |
| 5-19 employees | 73.3 | 41.3 | 55.8 |
| 20-99 employees | 56.7 | 41.0 | 52.1 |
| 100+ employees | 49.2 | 31.2 | 45 |
| Percent of firms identifying practices of competitors in the informal sector as a major constraint | 58.8 | 20.6 | 28.2 |
| 5-19 employees | 62.2 | 21.2 | 29.6 |
| 20-99 employees | 52.6 | 21.5 | 26.7 |
| 100+ employees | 61.8 | 15.2 | 22.7 |

Source: World Bank Enterprise Survey 2013.

A similar pattern was also observed by the Riinvest survey in 2013, which found a strong negative correlation between alleged tax evasion and company size. The results show that the large companies tend to evade less; while smaller firms are more prone to evasive behaviour.

According to WBES, starting-up unregistered is only present among manufacturing sector enterprises (Table 4), with an average duration of 3.3 years being unregistered. Manufacturing business are also more likely to state that they compete against unregistered or informal firms than service sector businesses (66.2% compared with 65.0%). When broken down by sub-sector, retail services are similarly likely to report competing against unregistered firms. However, service firms more commonly state that the practices of competitors in the undeclared sector are a major constraint (63.0%) compared with manufacturing sector businesses (53.9%).

WBES results show that undeclared economy is more pronounced among enterprises with male top managers: in 2013, all enterprises with women as top managers, were formally registered when established, as opposed to 94% of enterprises with male top managers. Nearly three quarters of enterprises with women as top managers reported that they compete against unregistered or informal firms, compared to two thirds of enterprises with male top managers.

Table 4: Prevalence of undeclared economy in Kosovo*, 2013, by sector

| | Kosovo* | Europe and Central Asia | All economies globally |
|---|----------------|--------------------------------|-------------------------------|
| Percent of firms formally registered when they started operations in the economy | 94.4 | 97.8 | 89 |
| Manufacturing all | 87.4 | 97.3 | 87.6 |
| Services all | 100 | 98.1 | 89.5 |
| Retail | 100 | | |
| Other services | 100 | | |
| Number of years firm operated without formal registration | 1.5 | 0.3 | 0.7 |
| Manufacturing all | 3.3 | 0.6 | 0.9 |
| Services all | 0 | 0.2 | 0.6 |
| Retail | 0 | | |
| Other services | 0 | | |
| Percent of firms competing against unregistered or informal firms | 65.6 | 40.3 | 53.9 |
| Manufacturing all | 66.2 | 40.7 | 53.1 |
| Services all | 65.0 | 40.2 | 54.1 |
| Retail | 66.2 | | |
| Other services | 64.6 | | |
| Percent of firms identifying practices of competitors in the informal sector as a major constraint | 58.8 | 20.6 | 28.2 |
| Manufacturing all | 53.9 | 20.2 | 28.4 |
| Services all | 63.0 | 21 | 28.1 |
| Retail | 62.4 | | |
| Other services | 63.2 | | |

Source: World Bank Enterprise Survey 2013.

Interesting findings were found by the Riinvest survey in 2013, identifying the construction sector among the most compliant sector, followed by education and arts, entertainment and recreation. Findings revealed that the most evasive sectors in Kosovo* are accommodation and food services, manufacturing and agriculture, with the explanation that these sectors involve higher cash transactions and/or are less observable industries, making them more likely to engage in evasive behaviour, (Riinvest, 2013).

Using data from the 2013 Riinvest survey, empirical investigation on determinants of tax evasion by businesses was conducted. The finding is that tax compliance is significantly correlated with traditional deterrence policy measures, as well as with institutional factors such as tax morale, trust and cost of compliance. A significant effect on the tax reporting rate for two of the three “usual suspects” in tax evasion analysis is identified, namely the tax rate

and audit rate. However, no significant effect of fine rate is found on tax compliance, indicating that the level of fines does not influence tax non-compliance. The results reveal a positive association between the tax rate and tax evasion, and a negative and statistically significant relationship between audit rates and tax evasion, implying that tax evasion will decline if tax inspections increase. It was also found that there is a strong, negative and statistically significant relationship between tax morale and tax evasion. Moreover, the relationship between taxpayers and government, captured by trust in government, appears to be statistically significant, i.e. the greater the trust in government, the lower the tax evasion and the larger the amount of time dealing with paperwork and other compliance requirements, the less likely the firm is to comply. Finally, the evidence also suggests that tax evasion falls as the level of education increases.

4. Barriers to formalisation in Kosovo*: drivers of the undeclared economy

As the analytical framework in Section 2.1 highlighted, undeclared work arises when the failings and imperfections of formal institutions result in an asymmetry between state morality (the laws and regulations) and citizen morality (citizens' norms, values and beliefs regarding the acceptability of these laws and regulations).

Governance indicators have improved, but Kosovo* ranks lower in most categories compared with neighbouring economies, particularly in terms of political stability and rule of law (Cojojaru, 2017). In Figure 6 an indication is provided of the degree to which state morality and citizen morality does not appear to be aligned in Kosovo* by examining the proportion of people who have trust in the government. The confidence in the state and the functioning of state institutions has been undermined among Kosovars by perceptions of widespread corruption, unresolved governance issues, and the fragile rule of law.

A further measure of the quality of governance is the measure of **government effectiveness**. Table 3 captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Estimate gives the economy's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

The Rule of Law Index assesses the extent which economies adhere to the rule of law in practice by examining eight factors, namely constraints on government powers, absence of corruption, open government, fundamental rights, order and security, regulatory enforcement, civil justice and criminal justice. Estimate gives the economy's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

Worldwide Governance Indicators reveal some improvements across several dimensions such as government effectiveness and rule of law between 2010 and 2015 (Table 6). After a decline from 2003 to 2008, control of corruption composite experienced a slight deterioration in 2013, then in 2015, overpassed the 2008 value. Despite, the improved performance, there is still a significant governance gap remains relative to regional neighbors improvements.

Table 5: World Governance Indicators: Government effectiveness, Rule of Law and Control of corruption, 2003–13

| | Minimum governance, -2.5 to +2.5 | |
|---------------------------------|----------------------------------|----------------|
| Government effectiveness | SEE | Kosovo* |
| 2003 | -0.58 | |
| 2008 | -0.28 | -0.50 |
| 2013 | -0.20 | -0.41 |
| 2015 | -0.09 | -0.42 |
| Rule of law | | |
| 2003 | -0.75 | -1.06 |
| 2008 | -0.44 | -0.60 |
| 2013 | -0.31 | -0.57 |
| 2015 | -0.23 | -0.47 |
| Control of corruption | | |
| 2003 | -0.59 | -0.81 |
| 2008 | -0.36 | -0.59 |
| 2013 | -0.35 | -0.64 |
| 2015 | -0.30 | -0.52 |

Source: World Bank, 2017 (Data of WGI (Worldwide Governance Indicators) (database), World Bank, Washington, DC, <http://info.worldbank.org/governance/wgi/index.aspx#home>)

A recent World Bank report (2017), highlights that although Kosovo*'s legislation, regulation, and institutions generally adhere to EU standards, the main drawback remains on inadequate development and performance of governance institutions, raising the costs and risks associated with doing business, hence encourage the offering, giving, receiving, and soliciting of bribes.

The social acceptability of engaging in undeclared work is an important determinant for the prevalence and intensity of this phenomenon. A study commissioned by Riinvest in 2013, to depict tax morale, employed a standard technique, of asking respondents whether or not they justify – on a scale from 1 to 10 – the level of tax evasion in Kosovo*. Findings revealed that 56% of respondents stated that they do not justify tax evasion, while 9% state that they very often justify tax evasion and 16% stating that they often justify tax evasion. These results, with tax evasion justification, Kosovo* is ranked close to India and Brazil (Riinvest, 2013).



As theoretically expected, empirical investigation found a strong, negative and statistically significant relationship between tax morale and tax evasion.

Which specific formal institutional failings, in consequence, result in this non-alignment of citizen morality with state morality (i.e., low tax morality), and thus the prevalence of undeclared work? As Section 2.1 revealed, a wealth of cross-national studies reveal that the failings and imperfections in the formal institutions which result in an asymmetry between state morality and citizen morality, and thus the prevalence of undeclared work, are:

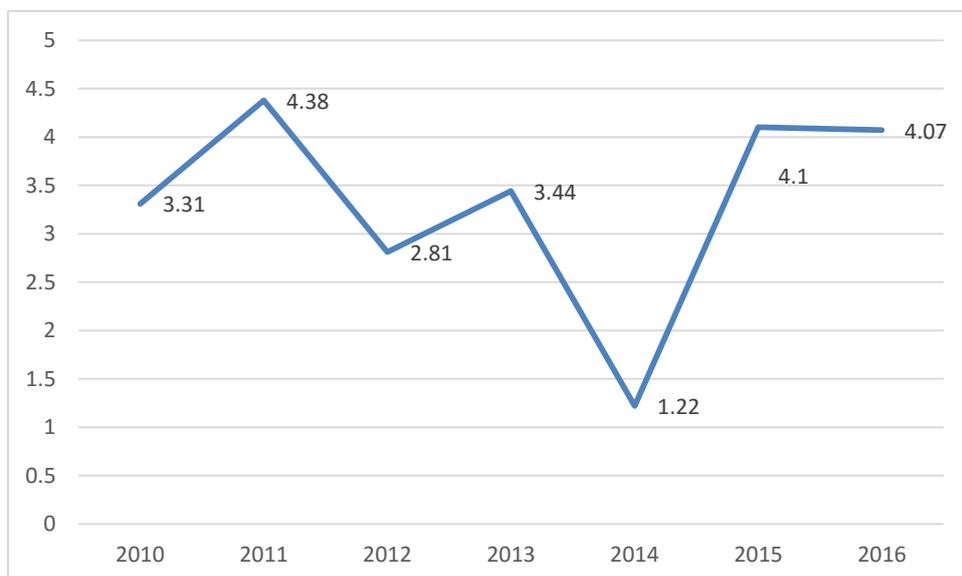
- lower GDP per capita;
- higher corruption and lower quality of governance;
- lower expenditure on labour market interventions to help the most vulnerable groups;
- lower levels of social expenditure, and
- social transfer systems that are less effective at reducing the level of inequality and severe material deprivation, which includes improving the efficiency of collection.

Therefore, we evaluate the direction of change in each of these in Kosovo* to evaluate where macro-level intervention is required in order to stem the growth of the Kosovo* undeclared economy.

Growth is a very important driver of formalization. Indeed, sustained economic growth results in more predictable labour markets, thus favouring an increase in long-term contracts. In this context, formalization becomes more feasible (Collings KOSOVO* report). Nevertheless, growth will not by itself solve the challenge of mass undeclared work. The problem of undeclared work is grounded in the inability of growth patterns to create sufficient declared jobs to absorb all those who want to work (either new entrants or those trapped in the undeclared economy). Structural transformation leading to a reduction in undeclared non-wage earners and increasing declared wage earners, and to up-scaling economic units and increasing their productivity, are crucial conditions for transition from the undeclared to the declared economy.

Kosovo* has experienced a steady positive growth (Figure 2), but this has not translated into robust employment creation, and labour market indicators are among the worst – in the region and in the world (Cojojaru, 2017).

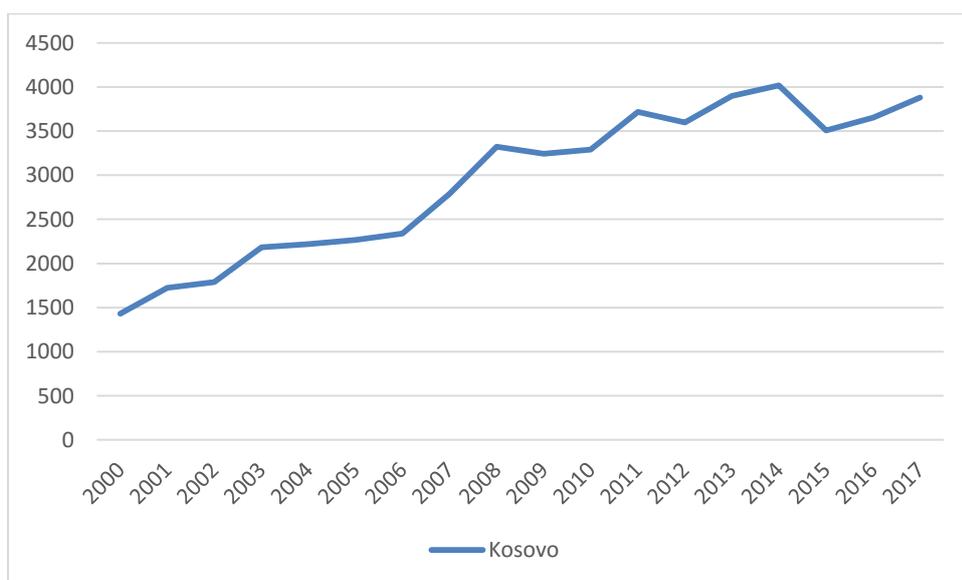
Figure 2: GDP growth rate: 2010–2016



Wiiw: 2018, Western Balkans Labour Markets Trends, Source: SEE Jobs Gateway, based on data provided by national statistical offices and Eurostat.

Figure 3 examines the trends in GDP per capita (in current euros) in Kosovo*, which in the literature has been widely identified as strongly correlated with the size of the undeclared economy, i.e. the lower the GDP per capita, the larger the undeclared economy (ILO, 2013; Williams 2014a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016). Data show that GDP per capital in Kosovo* was, on average, steadily increased, though subject to a decline in 2010, 2012 and 2015.

Figure 3: GDP per capita, USD current prices



Source: IMF: <http://www.imf.org/external/datamapper/NGDPDPC@WEO/UVK/EURO/EU>



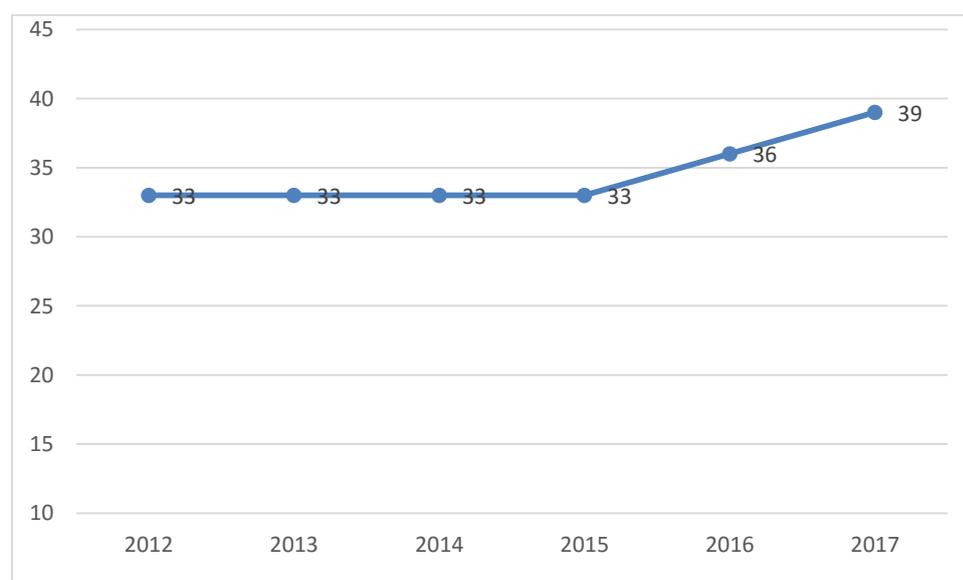
It is also the case that cross-national studies reveal that the greater the level of public sector corruption and the lower the quality of governance, the more extensive is the undeclared economy. The Life in Transition Survey 2016 finds that people who live in economies with more effective governments are less likely to experience corruption.

In Kosovo*, according to Transparency International’s Corruption Perceptions Index (CPI), there is a relatively higher level of perceived public sector corruption than in other EU member states. Thus, policies aiming at the reduction of the undeclared economy in Kosovo* should primarily focus on the fight against corruption and on the improvement of the quality of governance, mainly by reducing the unnecessary state interventions, by abolishing the clientelistic relations of politicians with the electorate and by combating the persistent institutional weaknesses that provide fertile ground for rent seeking behaviour on behalf of politicians and public employees. In this context, the effective reduction of the undeclared economy in the long-run is mainly a social issue, namely an issue of social development.

Bitzenis et al (2016) similarly argue that improving the quality of governance and reducing corruption are key means of reducing the undeclared economy. One reason this is the case is because many exit the declared economy due to the level of public sector corruption, since it increases the cost of doing business and operating undeclared is a means of escaping from having to make such bribe payments.

Transparency International’s Corruption Perceptions Index (CPI) measures the perceived level of public sector corruption in 180 economies. The index, which ranks 180 economies and territories by their perceived levels of public sector corruption according to experts and businesspeople, uses a scale of 0 to 100, where 0 is highly corrupt and 100 is very clean. As Figure 4 reveals, there is evidence that the perception of public sector corruption in Kosovo* has declined over the past three years. However, Kosovo*, still remains ranked at 85 out of 176 economies surveyed.

Figure 4: Corruption Perception Index (CPI), 2012-2017



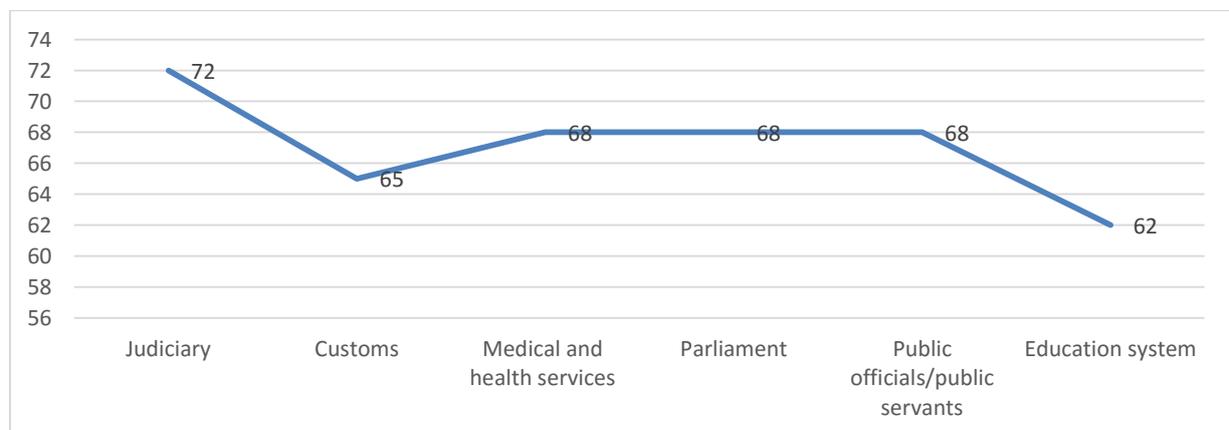


Source: Corruption Perception Index (Transparency International): https://www.transparency.org/news/feature/corruption_perceptions_index_2017

A further indicator of corruption is the perception of the **control of corruption**. This captures the perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. The estimate gives the economy's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. As data presented in Table 4 outline, there is some downwards trends from 2008-2015, but still higher than the one observed in SEE economies. If the control of corruption continues to improve, then the prevalence of the undeclared economy is expected to decline.

Findings from 2017 Balkan Barometer, reveal that a large share of respondents report corruption across the institutional landscape: 72% of individuals agree that judiciary is corrupt; 68% responded that medical and health services, parliament and public officials/public servants are corrupt and 65% and 62% of individuals perceive that education system is corrupt (Figure 5). Therefore, although the corruption indicator is improving, further reductions in public sector corruption and the quality of governance are required if the prevalence of undeclared work is to be tackled.

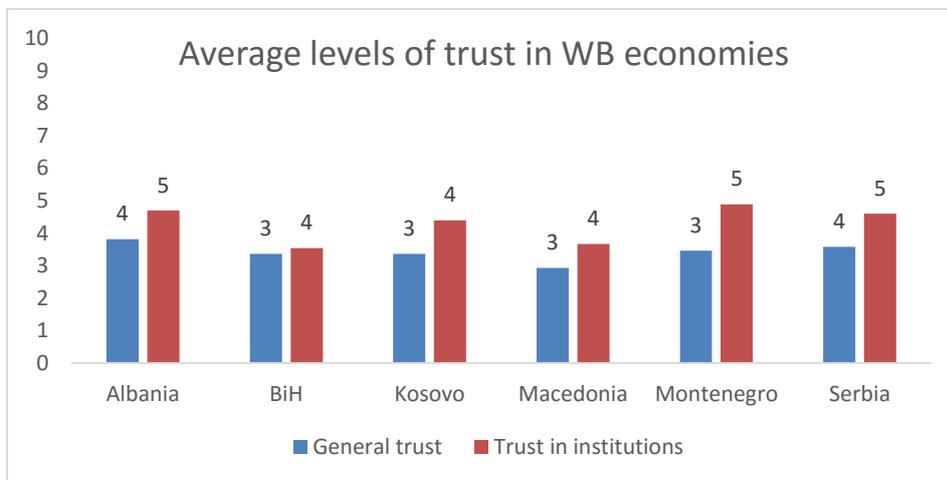
Figure 5: Corruption perception across different institutions in Kosovo*, 2017



Source: Balkan Barometer, 2017.

Lack of trust is also depicted by a recent survey conducted by INFORM in 2017 (Figure 6). In a range from 1 (no trust) to 10 (complete trust); Kosovo* was found to stand at index of 4, meaning that there is a low trust in institutions but also that within people (1-you need to be careful when dealing with people and 10 most people can be trusted).

Figure 6: General trust and trust in institutions



Source: INFORM, 2017. This project has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 693537.

Many stakeholders interviewed argued that the high tax rates are to blame for the level of undeclared work in Kosovo*. However, a multitude of studies reveal that there is little, if any, evidence that higher tax rates are significantly correlated with higher levels of undeclared work (Friedmann et al., 2000; Ihrig and Moe, 2000; Kuehn, 2007; Schneider, 2002; Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Martinez-Perez, 2014; Williams and Horodnic, 2016). For example, Vanderseyen et al (2013) in the European Commission's annual *Economic and Social Developments in Europe 2013*, examined the relationship between undeclared work and various tax rate variables, namely the implicit tax rate on labour, the share of labour wages in total taxes, and the tax wedge on labour. They find no statistically significant correlation between the prevalence of undeclared work and tax rates. In Kosovo*, the tax regime has one of the lowest rates in the region: with corporate income tax rate at 10% and the highest VAT rate of 18% and is characterised with the tax-GDP ratio of only 22.6% (World Bank, 2017), but still, the prevalence of tax evasion is very high. The proposals were, hence, on reducing costs (reporting costs, bureaucratic costs or even treatment costs); simplifying laws related to reimbursable taxes, such as Value Added Tax—because if the amount of time required for VAT reimbursement is sufficient to discourage taxpayers' compliant behaviour, then regardless of the tax rate (low or high) evasive behaviour becomes highly likely (Riinvest, 2013).

Tax reductions in Kosovo*, therefore, are not the way forward. Instead, the situation is more complex. On the one hand, in societies where citizen morality and state morality are aligned, tax rates can be high since citizens realise that taxes are the price they pay for a civilised society. Tax rates, therefore, are not the problem. It is the lack of trust in the state and belief that they receive appropriate public goods and services for the taxes they pay. Indeed, this was recognised by stakeholders during interviews with them. There was recognition for example that citizen morality and state morality are not aligned, not least due to a lack of trust in the state apparatus, and that this results in it being difficult for citizens to accept high tax rates due to the inadequate public goods and welfare services received in return. There is no evidence, therefore, that reducing tax rates reduces the undeclared economy. Instead, the focus needs to be on: (1) improving the ability to sustain higher tax rates by aligning state

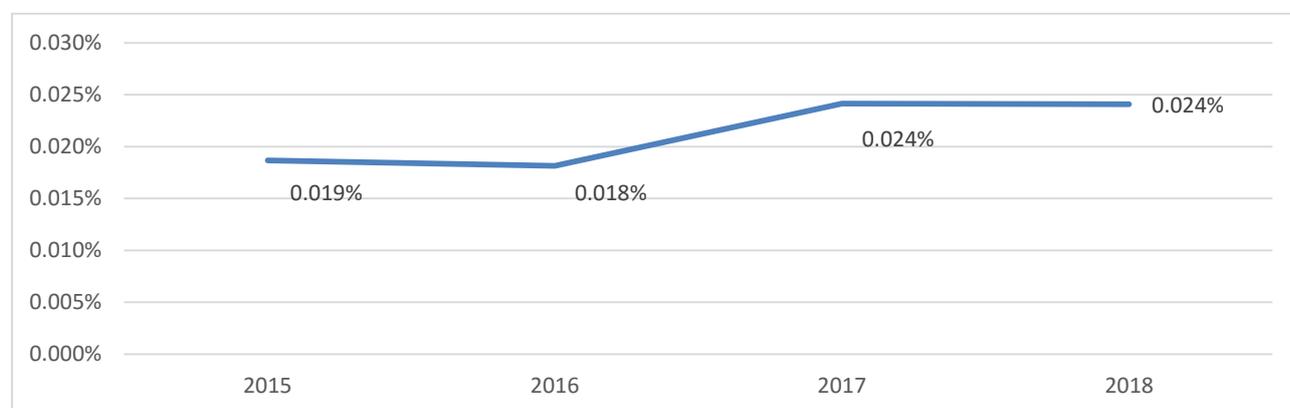


morality and citizen morality, not least by improving perceptions of distributive fairness (i.e., that people receive a fair and equitable return in terms of public goods and services for the taxes they pay), and (2) significantly improving tax collection.

There is also no evidence that reducing state intervention in the labour market reduces the size of the undeclared economy. Instead, quite the opposite is the case. Undeclared work is lower in economies where a larger proportion of GDP is spent by governments on interventions in the labour market targeted at groups with difficulties, such as the unemployed, people in jobs but at risk of involuntary job loss, and inactive persons currently not part of the labour force but who would like a job and are disadvantaged in some manner (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016). As Figure 7 reveals, Kosovo* has indeed increased the proportion of GDP spent on such labour market interventions, which is a positive step to facilitate reductions in the level of undeclared work, although this level of expenditure has reduced in recent years. Maintaining expenditure levels on active labour market policies targeted at vulnerable groups is therefore necessary if undeclared work is to be tackled.

Kosovo* spends an extremely small budget on Active Labour Market Measures (ALMM): in 2017, the overall spending on ALMPs in Kosovo* was about EUR 1.8 million, accounting for only 0.02% of GDP (Figure 7). This spending is extremely low to support about 101,773 unemployed persons. Due to limited budget, in 2017, only 10% of registered unemployed benefited from ALMMs, majority trained at Vocational Training Centres and very few benefiting from other ALMMs.

Figure 7: Government expenditures on Active Labour Market Measures



Source: Data of spending on ALMM collected from Employment Agency, data on GDP from Economic Reform Program 2018-2020.

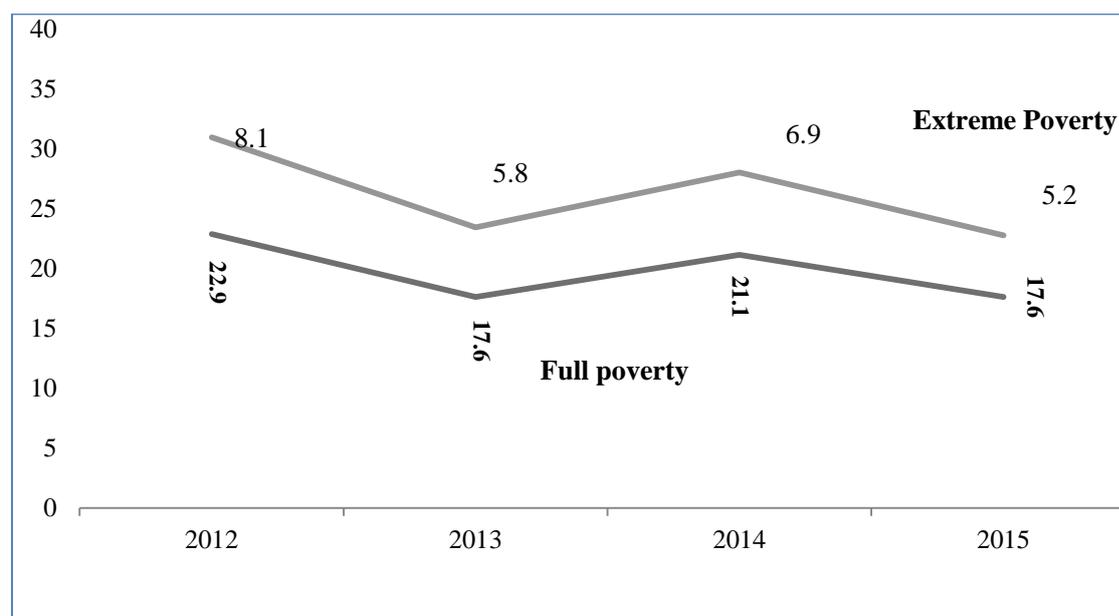
Ministry of Labour and Social Welfare, has developed a Sectoral Strategy 2018-2022 and Action Plan specifically targeting youth unemployment in Kosovo* for period 2018-2020. These two policy documents envisage increasing the coverage and efficiency of active labour market programs, strengthening integration of target groups to labour market for ensuring inclusive employment. Full implementation of these two documents, would facilitate integration to the labour market is therefore an important prerequisite for tackling the undeclared economy.

It has also been widely shown that the greater the level of expenditure on social protection as a proportion of GDP, the less prevalent is undeclared work (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016). As Figure 10 reveals, as a share of GDP, expenditures on social protection have been slightly increased. In 2017, and social protection constitutes 22% of the total budget.

The concern for the poor people is also captured through 2016 Life in Transition survey, whereby nearly one third of respondents stated that the main priority for extra government spending in Kosovo* should be in assisting the poor (30 per cent), the highest of all economies covered by the LiTS .

Poverty is also related to the undeclared economy. Most participants in the undeclared economy are driven out of necessity into this sphere as a means of livelihood and as a last resort (ILO, 2016). When there is a high level of poverty, therefore, the finding is that the undeclared economy is more prevalent (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016). Although growth has been largely inclusive, Kosovo* is still one of the poorest economies in Europe, and GDP per capita is only about 11 percent of the EU average (World Bank, 2017). According to latest poverty estimates, in Kosovo*, in 2015, 17.6% (1.82 Euros per adult equivalent) of Kosovo*'s population lived below the poverty line, with 5.2% (1.30 Euros per adult equivalent) of the population living below the extreme poverty line (Figure6). Across the period 2012-2015, the poverty rate fell by about 5.3 percentage points from 2012 to 2013; it increased from 2013 to 2014 by 3.5 percentage points and then it reverted to the 2013 rate of 17.6 - a decline of 3.5 percentage points from 2014. Poverty rates in all four years are higher in rural areas (Figure 8).

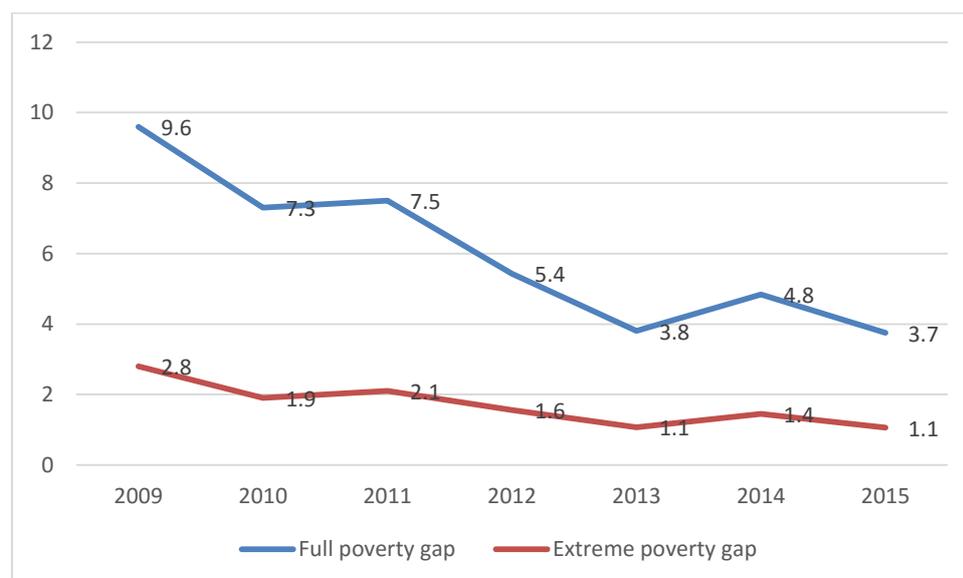
Figure 8: Absolute and extreme poverty, 2012-2015



Source: KAS, 2017.

The poverty gap measures the depth of poverty. It takes into account both the percentage of the population below the poverty line as well as the size of the gap between the poverty line and the average consumption of those below the poverty line. The poverty gap declined from 2009 to 2015, (Figure 9), with exception of year 2014, when an increase was observed.

Figure 9: Poverty gap 2009-2015



Kosovo* Agency of Statistics, 2017.

According to 2016 findings from the Life in transition survey, conducted with 1,500 individuals, one third of households surveyed in Kosovo* believe that some improvement in their living standards occurred over the four years preceding the survey, the second highest value in South East Europe (SEE). As of 2016, 32% of respondents were satisfied with their financial situation, compared to 29% and 31% of those in SEE and the transition region.

Similar to financial satisfaction, the level of life satisfaction for Kosovan respondents in 2016 was comparable to the transition region average, as 43% of respondents report being satisfied with life. Younger cohorts and respondents in the upper income group turn out to be more satisfied than their older and poorer counterparts in the economy.

LiT II survey revealed that just above 40% of Kosovars, would not be able to afford 'unexpected expenses', which is higher than the Western Europe average.

Expanding the social protection programs targeted toward the bottom quintiles is hampered both by fiscal constraints and the vocal demands for expansion of non-targeted benefits (World Bank, 2017). The last resort social assistance program has also not contributed substantially to income growth among the bottom 40% (Cojojaru, 2017). The program is well targeted, that is, there is little leakage to higher-income groups, and 71 percent of the program benefits go to the poorest quintile (Cojojaru, 2017). However, two-thirds of households in the poorest quintile do not receive program benefits, in large part because of nonmonetary eligibility criteria.



Since the basic pension is already sufficient to bring pensioners to the poverty threshold and war-related benefits are, in many cases generous, these steps would do little to combat poverty (World Bank, 2017)).

Kosovo* does not operate an unemployment insurance scheme *per se*, although elements of means-tested, non-contributory assistance are included in the minimum income guarantee scheme. Therefore, there is no ‘safety net’. Hence, it is of little surprise that citizens turn to undeclared work as a last resort and survival practice (Williams et al., 2016). Putting in place a stronger ‘safety net’, therefore, and targeting social expenditure at groups likely to enter the undeclared economy, will be required to reduce the ready-supply of labour for the undeclared economy.

Similarly, the more the state is successful in using direct taxes to reduce the proportion of the population at risk of poverty, the less prevalent is undeclared work in economies. Examining the effectiveness of state redistribution via direct taxes, measured by the decrease in percentage points of poverty (defined as the proportion of the population with an income below 60% of the national median income) after social transfers, a statistically significant positive correlation is found (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016).

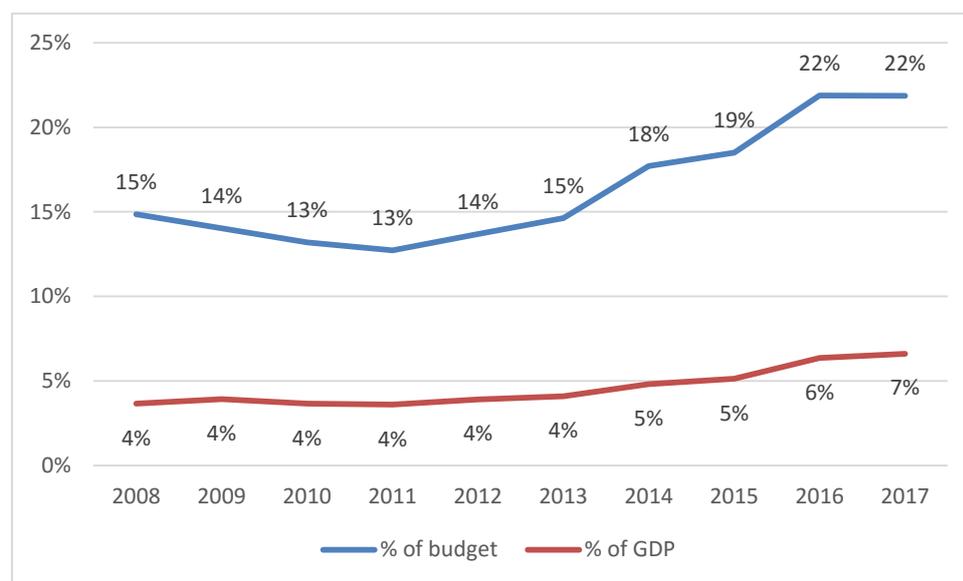
In Kosovo*, however, the effectiveness of social transfers in reducing poverty is low, with the main challenges being the insufficiency of social transfers in meeting the basic needs and limited coverage of poor families by the Social Assistance Scheme (IMF, 2016). While the targeting efficiency of the social assistance scheme is good, its coverage is poor, leaving many poor households unassisted. In 2011, 54% of total spending on social assistance went to the population in the bottom quintiles, compared with Eastern Europe and Central Asia’s average of 36 percent (and the Balkans’ average of 39 percent) and with relatively low leakage to the top quintile—only around 3 percent of social assistance spending (IMF, 2016). However, less than one-third of the poor population (living with less than the national poverty line of €1.72 a day) received the benefits—10 percentage points lower than the regional average (IMF, 2016).

Despite legislative provisions, the adjustments of social assistance benefits have been non-systematic. The Law on the Social Assistance Scheme states that the benefit level should be adjusted according to the consumer price index (prior to the 2012 legal amendments) and to the price of food basket (as a result of the 2012 legal amendments), but this has only been undertaken on an ad hoc basis, in 2003, 2019, 2015 and a recent one in 2018.

In 2017, social protection constituted 22% of budget and 7% of GDP (Figure 10), characterised by a rapid expansion of social assistance in recent years, now high by regional standards, has skewed towards categorical benefits (World Bank, 2017). Currently, Kosovo* has 12 different pension schemes (pension on police forces, law on education etc), fully funded from the state budget (Kllokoqi, 2018), accounting for nearly one fifth of the Kosovo* budget. Pension and social assistance as a share of current expenditure increased from 21.5% in 2010 to 36.5% in 2016, and social assistance spending is now above the Western Balkans average (IMF, 2018). Another observation noted by IMF (2018) is that the composition of benefits over time has shifted away from poverty and inequality-focused benefits towards

war-related benefits, namely, in 2010 social assistance accounted for 17% of social protection whilst it only represents 8% in 2017.

Figure 10: Social protection as share of budget and GDP, 2008-2017



Source: ASK, 2018: http://askdata.rks-gov.net/PXWeb/pxweb/en/askdata/askdata__07%20National%20and%20government%20accounts__Government%20accounts__Annual%20government%20accounts/gdp01.px/table/tableViewLayout1/?rxid=99910021-b40f-4bda-81bc-83877a4631d5

While the benefit level slightly increased, the number of beneficiaries and total social assistance spending declined due to stricter eligibility criteria and tighter enforcement in recent years. The IMF affirms that the removal of families from social assistance, once a family member is employed, pushes many individuals to work in the undeclared economy. The amendments to the Law on the Social Assistance Scheme of 2012, especially the selection criteria in Category II, have affected the number of beneficiaries falling sharply, despite the parameters of poverty and unemployment showing no notable improvement. While the benefit level slightly increased in 2015, the number of beneficiaries and total social assistance spending declined due to stricter eligibility criteria and tighter enforcement in recent years (IMF, 2016). As a result, the number of Social Assistance beneficiaries has declined markedly, from 36,129 families (2010) to 25,943 in 2015 (IMF, 2016). As a share of total social protection spending, spending on the social assistance scheme fell significantly from 17% in 2010 to 8% in 2015.

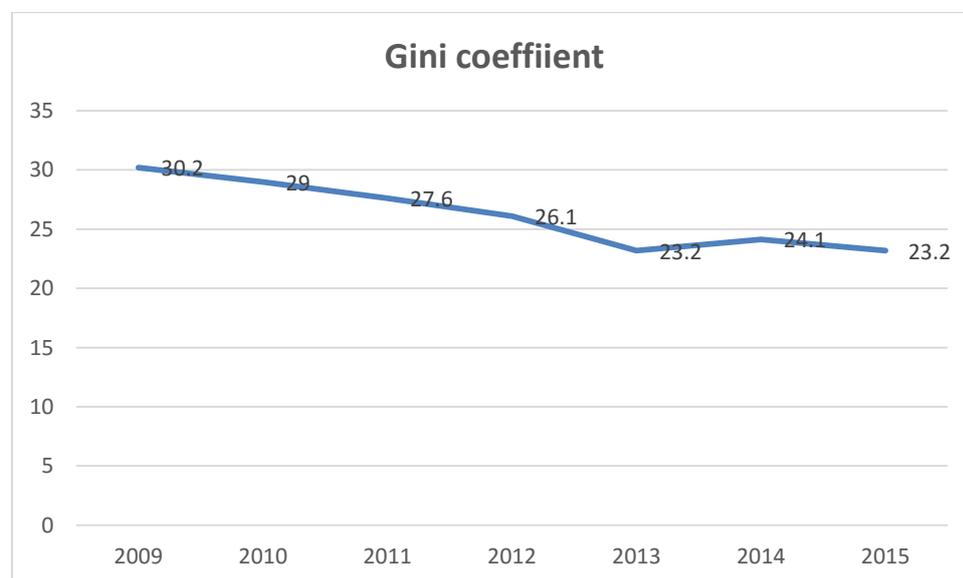
The criterion of at least one 5-year-old child for the same category of beneficiaries is a problem in covering poor households, taking into account the fact that the financial situation of households is aggravated by the child's starting education. Applying a mixed method approach, Roelen and Gassmann (2011) found that the social assistance scheme in Kosovo*



is highly efficient but excludes many poor children. If undeclared work is to be tackled, therefore, there needs to be a marked increase in the efficiency of the social transfer system in reducing poverty. Figure 8, reveals that poverty rate in Kosovo* stood at 17.6% (1.82 Euros per adult equivalent) whilst 5.2% of people were living under extreme poverty conditions (with less than 1.30 Euros for adult equivalent). Poverty and distributional gains are constrained by high unemployment (31 percent in 2017) and low participation (57 percent inactive); both indicators are worse among youth and women.

Studies also reveal a strong positive relationship between the level of equality in societies and the prevalence of undeclared work; the greater the income inequality, the more prevalent is the undeclared economy (Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Martinez-Perez, 2014; Williams and Horodnic, 2016). The Gini coefficient is the most widely used summary statistic of inequality. A Gini coefficient equal to one (100%) means that the total consumption belongs to one person whereas as it approaches zero it means that the consumption is equally shared among people, i.e., consumption levels are equal across the population. Data in Figure 11 show that inequality, in Kosovo*, has declined over time. It is evident that over a three-year period, urban inequality remained higher than that observed in rural areas. The decrease in inequality between 2010 and 2011 occurred because of a decline in consumption among the top half of the distribution, while consumption among the poorer half remained more or less constant.

Figure 11: Gini coefficient, 2009-2015



Source: Kosovo* Agency of Statistics, poverty estimates, different years.

In sum, to tackle the undeclared economy in Kosovo*, it is not simply a case of pursuing enforced compliance/direct controls (using deterrents and incentives) and voluntary cooperation/indirect controls (using awareness raising campaigns about the unacceptability of undeclared work and reforms to the processes of formal institutions). Although these are necessary, they are insufficient. There is also a need to change the macro-level economic and social conditions which result in the prevalence of the undeclared economy. These include:



- Redressing the falls in GDP per capita;
- Improving governance and reducing public sector corruption;
- Maintaining and improving the levels of expenditure on labour market interventions to help the most vulnerable groups;
- Persisting with increasing social expenditure, but coupling this with developing far more effective social transfer systems that reduce the widening levels of income inequality and ever increasing levels of severe material deprivation in Greek society.

Given this identification of the drivers of the undeclared economy, attention now turns to the organisation of the fight against undeclared work in Kosovo* and an evaluation of the policy approach and measures being pursued.

5. Organisation of the fight against undeclared work in Kosovo*: institutional framework

5.1 Responsibilities of government ministries

The aim of this section is to describe the organisation of the fight against undeclared work in Kosovo* and examine ways in which the institutional framework can be improved. Table 12 provides a conceptual framework for evaluating the current organisational approach of the Kosovo* government. At the top of this spectrum are fully joined-up forms of government where one agency/department is responsible. Moving down the spectrum, there are then a range of cross-government departmental co-operations ranging from initiatives where the co-operating government departments have common shared targets to achieve at the level of strategy, operations or data matching (and which relate to the whole undeclared economy or specific sectors, occupations and so forth). Following this, there are then cross-government departmental co-operations where the departments involved have separate targets to achieve and which again can be applied at the level of strategy, operations or data matching. Finally, and at the bottom of the spectrum, are completely fragmented forms of government in the form of a departmental ‘silos’ approach.⁷

Figure 12: A hierarchy of joined-up government

| | | | | |
|------------------------|---------------|----------|--------|---|
| Single compliance unit | Whole economy | informal | Common | Strategy, operations and data matching |
| | Segment | | Common | Strategy, operations &/or data matching |
| Cross-Departmental | Whole/segment | | Shared | Strategy |
| | Whole/segment | | Shared | Operations |

⁷ This table only considers joined-up government, not joined-up ‘governance’, which includes tripartite social dialogue.



| | | | |
|-------------------------|---------------|----------|-------------------------|
| Cooperation | Whole/segment | Shared | Data matching & sharing |
| | Whole/segment | Separate | Strategy |
| | Whole/segment | Separate | Operations |
| | Whole/segment | Separate | Data matching & sharing |
| Departmental 'silos' | Segments | Separate | Strategy |
| | | | Operations |
| | | | Data matching |

Source: derived from Dekker et al (2010)

So far, Kosovo* has developed three Strategic documents on tackling undeclared work, namely, the Governmental Program and Action Plan for the Prevention of Undeclared Economy in Kosovo* 2008 - 2009; Government Program and Action Plan to Fight the Undeclared Economy in Kosovo* 2010 - 2012; and the National Strategy of the Kosovo* for the Prevention of and Fight against Undeclared Economy, Money Laundering, Terrorist Financing and Financial Crimes 2014-2018. The latter was developed based on a National Risk Assessment of 2013, an assessment led by the Ministry of Finance. The Ministry of Finance, chaired the Governmental Working Group, Secretariat and Technical Working Group for developing the Strategy. One of the goals of the Strategy was to reduce the extent of undeclared work by 5%, in period 2014 - 2018. Consequently, the value of the declared economy subjected to tax and customs procedures would increase by at least €52 billion by the end of 2018. This goal was to be achieved through: awareness raising on impacts and on the prevention of undeclared work and financial crimes; strengthening the prevention and fight against undeclared work by enhancing transparency, accountability, good governance and societal partnership; and strengthening the capacity of the relevant institutions; strengthening the prevention and fight against undeclared work. The Government of Kosovo*, specifically the Minister of Finance, has recently committed to update the existing Strategy, to set up a better monitoring and implementing mechanism that would contribute to closing the tax gap.

In Kosovo*, a departmental 'silos' approach is currently adopted. Ministries involved in the fight against undeclared work largely work separately, with each responsible for their own segment of the undeclared economy, namely:

- The Ministry of Labour and Social Welfare for labour law violations; and
- The Ministry of Finance for tax non-compliance.

Ministry of Labour and Social Welfare (MLSW)

The main competencies of the Ministry of Labour and Social Welfare are in developing labour and social welfare policies; supporting and promoting non-discriminatory labour relations and employment; monitoring employment and social welfare and proposing measures to increase employment and adequate passive measures to meet social assistance needs for citizens in need; setting standards for occupational safety and protection at work and supervise their implementation; managing and supervising public administrative institutions of labour and social welfare; promoting and encouraging social dialogue between the social partners (trade unions, unions, employers organizations and Government); and



administering and supporting the development of a social insurance system, including pensions and unemployment benefits.

The Ministry is responsible for drafting policies on employment relationships, safety and health at work; in cooperation with the Labour Inspectorate, is responsible for drafting the Development Program of Labour Inspectorate; and the Minister approves the Annual Work Plan of the Labour Inspectorate, the Development Program and monitors their implementation.

Executive Body of Labour Inspectorate

Labour Inspectorate, is an independent body, functioning under the MLSW, in charge of overseeing the implementation of Law no. 03 / L-212 of Labour, Law no. 04 / L-161 on Safety and Health at Work, but also other laws related to labour. Duties and responsibilities of the Labour Inspectorate are defined in the Law on Labour Inspectorate, 2002/9, supplemented and amended by Law No. 02 / L-133. Recently, in June 2018, the government has approved the new Law on Labour Inspectorate. The law authorizes the labour inspectors to oversee the enforceability of legislation to natural and legal persons, domestic and foreign, private and public, who exercise profit or non-profit activities in Kosovo*.

The Inspectorate operates with 49 inspectors (including 7 heads of regional coordination divisions, who are not engaged in inspections) grouped by regional centres, 18 in Prishtina, 7 in Gjilan, 7 in Peja, 6 in Ferizaj, 4 in Prizren, 4 in Mitrovica and 3 in Gjakova. The Inspectorate operates with limited technical capacities, having access to only 12 vehicles in 2016. In 2017, with 42 inspectors (plus 7 coordinators, whose main task is not inspecting workplaces), the Inspectorate in total, conducted 8,128 inspections, which according to the Labour Inspectorate and trade union representative, is a high number per inspector. However, the representative of the MLSW, stated that considering ILO standards, the number of businesses per inspector in Kosovo*, is quite similar to the set standard. However, the Ministry has set a priority to increase the number of inspectors (up to 65 as recommended by the European Commission), mainly through internal staff of the Ministry.

The Information Management System at the Labour Inspectorate is being developed, supported by the European Union. The system, aims to automate the work of inspectors through the use of tablets (Demi, 2017). This would facilitate easier and faster exchange of information with KTA and Trust Fund and enable monitoring of the work of field inspectors (Demi, 2017).

Currently, as emphasised in the Economic reform programme 2018-2020, there is a strong need to establish a coordination mechanism between inspection bodies. This would contribute to better alignment of procedures and would increase effectiveness of the oversight system. This would be done through the establishment of an information exchange system between inspectorates; amendment of horizontal legislation by allowing and regulating the inspection reform; approval of the organizational structure that implements the new organizational concept of inspections; and capacity building, which involves training of inspectors and other relevant officials, for the full implementation of the new concept.

The limited capacities of labour inspectorate are explicitly emphasised as a barrier to combating undeclared work, in the Sectoral Strategy and Action Plan 2018-2022, of the



Ministry of Labour and Social Welfare. Therefore, the Action Plan envisages activities to increase the number of inspectors but also enhance their human capacities. Additionally, the improving of mechanisms and coordination of institutional activities, engagement of stakeholders and wider public in addressing undeclared work, and exchange of data with relevant institutions and social partners, are considered of central importance for addressing undeclared work.

Strategic Development Plan of the Labour Inspectorate 2017-2021 includes four main strategic objectives:

1. Effective implementation of workers' rights;
2. Capacity building of human resources of Inspectorate;
3. Enhancing communication with employees, employers and general public;
4. Advancing cooperation with relevant institutions (mainly for joint inspections, no data sharing plans), towards reducing undeclared work.

Specifically, the Plan opts for reducing undeclared work by 5% every year, through an increased number of inspections and enhancement of monitoring of the work conducted by inspectors. It is important to emphasise that the key performance indicators are to reduce undeclared work, but the Labour Inspectorate does not have any indicators that seek to prevent undeclared work.

In Kosovo*, there is no health or social insurance, so the vast majority of employees do not have health insurance, except when obtained voluntarily through insurance agencies. The Law on Health Insurance, which entered into force on 1 January 2015, has not yet begun to be implemented. According to the Administrative Instruction for the collection of premiums, every employee is obliged to share 3.5% of his/her salary for health insurance, and the employer complements this amount by 3.5% of the employee's salary level. At the end of 2016, it was decided that the collection of premiums will begin on 1 January 2017, to be postponed for 1 July 2017 but not expected to commence before the second half of 2018 (DEMI, 2017).

A European Commission funded project, starting from July 2018, will support capacity building of the labour inspectorate and facilitate in raising awareness among the general public. The aim is to improve labour inspection practices, in order to ensure efficient and effective controls of working conditions. The project will undertake an assessment of effectiveness of different policy measures to tackle undeclared work through developing regulations about fines; improvement of techniques of inspection; development of inspection guidelines for the implementation of newly elaborated laws and sub-laws; training of inspectors; and by facilitating the coordination of inspections and exchange of data with other institutions-concluding an inter-institutional agreement with key institutions, including Kosovo* Police, Kosovo* Tax Administration, Kosovo* Pensions Savings Trust, and Agency for Business Registration. Within the course of the project, a public awareness strategy of the Labour Inspectorate will be developed, to be implemented jointly with the Ministry of Labour and Social Welfare and Social Partners. It will indicatively encompass: marketing strategy and brand identity of the campaign; videos, animation; radio and TV interviews and announcements; leaflets and posters; social media campaign; and public debates with relevant stakeholders, etc.



National Council for Safety and Health at Work is a body engaged in the development of national policies in the field of safety and health at work. The Council was established by the Government of Kosovo* in 2016. The Council is mandated to systematically monitor the state of health and safety at work, perform analysis and to provide recommendations for furthering health and safety at work. Capacity building remains a challenge, though progress has been attained. The training program has been developed and 15 persons from institutions, the private sector, employers and employees' organizations, have been selected to be trained and certified as trainers in the field of safety and health at work (Demi, 2017).

Partial implementation of the Law on Safety and Health at Work contributes to implementation of minimum standards for the protection of employees in the workplace. Kosovo* has still not developed the provision regarding occupational accidents and occupational diseases. Lack of this insurance results in negative consequences on the health of the employee in cases of injuries at work (Sectoral Strategy 2018-2022).

Since 2017, public employment services and Active Labour Market Measures are offered by the **Employment Agency** (EARK), an Agency that operates under the MLSW. Law No. 04/L-205 on the Employment Agency regulates the establishment, organization, functions, duties, responsibilities and funding of the Employment Agency of Kosovo*. As defined by the Law, the Employment Agency is the public provider of services in the labour market, which aims at the management of the labour market and the implementation of employment and mechanisms in regional/local level: 32 Employment Offices (EO); 8 Vocational Training Centres (VTC). EOs register and profile the unemployed (and other job seekers⁸) and provide counselling and mediation in regular employment or access to Active Labour Market Measures (ALMM) such as wage subsidies, internships, etc.), while VTCs provide vocational training and retraining⁹ through modular short-term training¹⁰. Low coverage of the unemployed by ALMMs is considered as a pressing challenge for the Agency.

The Employment Offices are in charge of issuing a statement/declaration of unemployment for applicants and recipients of Social Assistance Scheme Category¹¹. Unemployed persons are obliged to appear at EOs, regularly every three months and respond to every call from EOs. Through Employment Management Information System (EMIS), EOs have access to the database of Social Assistance (Category II) beneficiaries, maintained at the Centers for Social Work. PES removes unemployed persons from the records of unemployed in case: a) they do not appear in PES without a reason in two rows over six (6) months; b) if they reject

⁸ According to the Law No. 04/L083, jobseekers are all job seekers including full-time or part-time employees and persons temporarily suspended from work.

⁹ According to LAW no. 04/L-205 on the Employment Agency, Vocational Training and Retraining includes all activities aimed at providing practical knowledge and skills for the efficient realization of activities within a profession or a group of professions

¹⁰ According to Law no. 04 / L-205 on the Employment Agency of Kosovo* (adopted in 2014), the EARA will be responsible for the implementation of policies in the field of employment, including the implementation of ALMM; labour market analyses; organization of information campaigns; gathering and providing information on the labour market, providing counselling and training services to the unemployed; contracting private accredited vocational training providers; and other services.

¹¹ Family with one member capable of work and registered with the Employment Office, with at least one child less than 5 years old or taking permanent care of an orphan less than 15 years old with all other members dependant

a proposal for employment offered by PES and, c) if they reject training offered from the PES. The EMIS system is also integrated to the Tax Administration of Kosovo* database, enabling the EO to check the employment status of jobseekers. This in turn, ensures that only unemployed persons are assisted through active labour market measures. However, given the high prevalence of undeclared work in Kosovo*, the aim is not assured in practice.

Ministry of Finance

Pursuant to Annex 2 of the Regulation of the Government of Kosovo*, no. 02/2011 on areas of administrative responsibilities of the Office of the Prime Minister and Ministers, the Ministry of Finance has the following responsibilities: to coordinate the development and ensure the realisation of a balanced annual budget for the public administration; to ensure that all income and other sources of funding from public administration institutions, including voluntary contributions, are registered according to budget rules; to ensure the implementation of the tax and customs legislation of Kosovo*; to oversee the public administration instructions concerning their implementation of the rules and procedures in force regarding public expenditure, including public procurement without prejudice to competencies of the Office of General Auditor; to support anti-fraud and anticorruption activities in public administration institutions, and raise awareness against fraud in general; to ensure the adoption and implementation of accounting standards in public and private sector in accordance with relevant international accounting standards; to ensure the establishment of a legal infrastructure for developing the private sector of Kosovo*; and to ensure the macroeconomic stability of the economy through the development of sustainable economic policies.

Tax Administration of Kosovo* (KTA)

KTA was organized on January 17, 2000 under the guidance and administration of the United Nations Mission in Kosovo* (UNMIK). On February 2003, the authority for tax administration was transferred from the UNMIK to the Ministry of Economy and Finance (now the Ministry of Finance). The Tax Administration is an Executive Agency and functions with full operational independence within the Ministry of Finance.

Tax Administration of Kosovo* (KTA), as an enforcement agency with full autonomy, is responsible to administer the implementation of any tax type applicable by tax legislation of Kosovo*. The mission of KTA is to enhance voluntary compliance in line with tax legislation in force, and to provide professional, transparent and effective services to taxpayers.

In 2017, the total budget of KTA was nearly €8.9 million, of which 78% were for wages and salaries (KTA, 2018). It employs 781 employees, of which 326 are inspectors. Recently, 30 new inspectors were recruited, but given the workload, it is envisaged that 50 more inspectors are needed.

KTA is responsible to collect the following government central taxes:

- Value Added Tax (VAT) on domestic supplies;
- Personal Income Tax;



- Corporate Income Tax;
- Withholding Tax;
- Pension Contributions;
- Issuance of licenses for Game of Chance.

Relevant laws and administrative instruction in force are shown below.

| No. | Name of the law | No. of the law | No. of the Administrative Instruction |
|-----|--|---|---------------------------------------|
| 1 | Law on Tax Administration and Procedures | No.03/L222 No.04/L-102 No.04/L-223 | No.03/2016 No. 15/2000 |
| 2 | Law on Value Added Tax | No.05/L-037 | No.03/2015 No.06/2016 |
| 3 | Law on Persona Income Tax-PIT | No.05/L-028 | No.01/2016 |
| 4 | Law on Corporate Income Tax-CIT | No.05/L-029 | No.02/2016 |
| 5 | Law on Pension Contribution-PC | No.04/L-168 No.04/L-101 No.05/L-116 | |
| 6 | Law on Game of Chance | No.04/L-080 | No.03/2013 |

Key performance indicators of KTA are made explicit in the Annual Plan for Risk Treatment. Indicators are measurable and defined as an outcome, such as increasing declaration, and increasing the installation of cash registers (KTA, 2018b). For the year 2018, KTA has set out five key objectives: human capacity development; improving key tax processes; reduction of undeclared work; advancement of IT; ensuring an effective organisational structure (KTA, 2018a).

Kosovo* Customs

Customs Service of UNMIK was established in August 1999 by the pillar of the European Union, to ensure the application of fair and uniform customs regulations and other provisions applicable to goods, which are subject to customs supervision. On December 2008, Customs Service UNMIK Customs became Kosovo* Customs. The new Customs Code was adopted on 11 November 2008 by the Kosovo* Assembly. The Customs Code is in full compliance with legal standards of the European Union and among others has as its objective the economic development of Kosovo*.

Aside from customs duties, Kosovo* Customs collects also VAT and tax on excise. Moreover, the collection of revenues, Kosovo* Customs protects society from smuggling of drugs and other prohibited goods by the prejudicial effect of economic crime and evasion in revenue. Kosovo* Customs has developed on the basis of EU standards and is funded entirely from Kosovo* Consolidated Budget and currently has about 591 employees. The mission of



the Customs is to contribute to economic issues, through collection of customs duties: such as customs duty, value added tax; excise for the Kosovo* Consolidated Budget, and control import and export, defend the economy; protection of trademarks and others. Another aim of the Kosovo* Customs is to contribute to security, through fighting illegal activities, increased security presence at border crossings through; fighting border crime; fighting drug trafficking, etc., and protection of population and environment, prevention of smuggling weapons and explosive substances. In Kosovo*, indirect tax revenues account for 84% of tax revenues, mainly collected at the border through VAT, excise, and customs duties, collected by Kosovo* Customs.

Role of other Ministries

Beyond the Ministry of Labour and Social and Welfare, and Ministry of Finance, a range of additional Ministries have responsibility for tackling various aspects of the undeclared economy. These include:

- ✓ **Ministry of Agricultural, Forestry and Rural Development**, which has an interest in the undeclared economy in the agricultural and forestry sector.
- ✓ **Ministry of Economic Development**, which has an interest in the undeclared economy in the energy, water, mining, telecommunication and ICT sector.
- ✓ **Ministry of Trade and Industry**, which has a particular interest in the undeclared economy in the trade, tourism and industry.
- ✓ Ministry of Innovation and Entrepreneurship.
- ✓ **Ministry of Culture and Sports**, again with a minor interest in the undeclared economy in the cultural and sports sectors.
- ✓ **Ministry of Innovation and Entrepreneurship**, with a particular interest in the undeclared economy among newly established enterprises and innovative firms.

5.2 The role of social partners

Social dialogue and partnership is crucial in strengthening the social protection of population, improving the quality of employment, ensuring decent work and improving the quality of labour force. In this respect, strengthening the social protection of the population, as one of the main objectives, will always be in the spotlight. For these purposes, the the 2018-2022 Sectoral Strategy and Action Plan, has defined a specific objective of *developing and strengthening the social dialogue, in particular, with employers and employees' organisations.*

The key social partners are:

- The Union of Independent Trade Unions of Kosovo*-BSPK; an
- Kosovo* Chamber of Commerce, established by Law No. 2004 /7

The Union of Independent Trade Unions of Kosovo*, is the only one trade union confederation in Kosovo* (Union of Independent Trade Unions of Kosovo*-BSPK), established in 1990, with 18 regional trade unions. The Union in the only employee organization represented in the Socio-Economic Council, and it is affiliated to the International Trade Union Confederation (ITUC) and is an observer at European Trade Union



Confederation (ETUC). The Confederation is composed of 16 other federations, representing workers from different sectors, such as the education sector, health, Kosovo* Police, mining, and energy sector.

A study by Shaipi (2016) emphasises that trade union organizational structures are outdated, which together with ineffective leadership, is the primary cause behind their inability to effectively represent their constituencies. Whilst the trade union coverage of workers in the public sector is relatively good, the private sector, though accounting for the majority of the employed in Kosovo*, do not have direct representation in social dialogue (Shaipi, 2016).

Kosovo* Chamber of Commerce (KCC) is a professional organization founded in 1962 by the Assembly of Kosovo*. KCC is an independent professional organization, apolitical and non-profitable. KCC serves the Kosovo* economy, and is a constructive partner of the Kosovo* state institutions, a partner in social dialogue and promoter of economic development and macroeconomic policies. Membership at the KCC is voluntary.

Bodies of Social Dialogue

The Kosovo* Socio Economic Council (SEC) was established in 2011, by Law No.04/L – 008, and is the national level tripartite body, composed of government, employers' and employees' representatives. As defined by the Law, the role of the Council is to conduct consultations and providing advice to competent bodies, in the area of labour and employment issues, social welfare and other issues related to economic policies in Kosovo*. The Council has established its own bodies such as: the professional committees of ESC; ad-hoc negotiating groups and the secretariat of ESC.

The main achievement by ESC, is considered to be the General Collective Agreement. This agreement, signed in 2014, entered into force from 1 January 2015, with a duration of up to three years. The agreement aims to address issues related to working relationships, schedules and vacations, compensation and employee information. However, at the beginning of 2015, the agreement was suspended by the Minister of the MLSW after complaints that the Agreement is in contradiction with the Law on Labour, as it foresees its implementation also from those who are not signatories to the agreement (Sectoral Strategy 2018-2020).

The work of ESC has been criticized for several years in the European Commission reports for Kosovo*. Workers' unions are divided, while employers' organizations are minimally represented (Sectoral Strategy 2018-2022). The effectiveness of the Council seems to be limited, stemming from a lack of decision-making on certain issues, lack of proper evidence-based analysis and due to the established bodies (excluding the secretariat) are passive. To improve the effectiveness of the Council, the Sectoral Strategy 2018-2022 considers it necessary to strengthen the structures of the Council.

Currently, the MLSW is in the process of drafting a new law, which aims to improve the representation criteria within the ESC to enable more inclusive representation by employees and employers' organizations, as well as to provide greater financial independence, access to finance, and empowerment of the secretariat of this institution. The new Law is also foreseen to transpose EU Directives, especially those for the establishment of the Employment

Committee (2000/98/ EC) and the Directive on the Establishment of the Tripartite Social Summit (2003/174/EC) (Sectoral Strategy 2018-2022).

To collate views on undeclared work from employer and employee representative organizations, interviews were conducted with Kosovo* Economic Chamber and Union of Independent Trade Unions of Kosovo*.

Main findings collected from the Kosovo* Chamber of Commerce (KCC) are the following:

Businesses in Kosovo* operate in unfair conditions. This is depicted with the Bottleneck survey, conducted by Kosovo* Chamber of Commerce since 2014. Findings from 2017 survey (conducted between January 8 and January 26, 2018) show that the most common barrier to businesses is the unfair competition by the undeclared grey economy-reported by 61% of interviewed businesses (Kosovo* Chamber of Commerce, 2018). This finding is significantly higher than that from previous years.

Undeclared work remains prevalent, mostly in the construction and service sector. It was emphasised that small suppliers at the bottom of the value chain, are most exposed to the undeclared economy. Although a large share of enterprises have cash registers, their usage is limited.

There is no fairness in the inspection system, particularly with businesses in North Kosovo* freed from inspections. Based on information collated from the Chamber, Kosovo* Tax Administration usually operate/inspects the same businesses, while other firms are nearly never visited. One important observation made by the representative of KCC is that many tax inspectors operate accounting service businesses, supporting businesses in book-keeping, which are ‘never’ inspected. This conflict of interest, was noted to be an important contributing factor to a perceived unfairness of the system and also discouraging firms to operate fully in the declared economy.

There is no monitoring body to oversee the work of institutions in charge of detecting undeclared work (namely to oversee the KTA and Labour Inspectorate) and institutions where business could lodge complaints about these enforcement authorities. This is a serious concern, given the weak efficiency of the justice system in Kosovo*.

Although the Kosovo* Tax system seeks to improve voluntary declaration, institutions have been mainly oriented towards detection rather than preventive or supportive measures for formalisation. The government should introduce ‘white lists’ as a rewarding approach for formal employers. There is a need to intensify and widen awareness raising campaigns, to educate people for paying taxes, but also to inform them about consequences to the society when avoiding taxes and working undeclared.

Similar views have been expressed in February of 2018, in a roundtable organised by the American Chamber of Commerce in Kosovo* on ‘Fighting informality: Steps so far and the road ahead’. It was emphasised that besides its direct impact on collecting revenues for the economy’s budget, undeclared work increases unfair competition, hampering legitimate companies that are regular taxpayers. The proposal was that there is a need to increase the



human capacities to combat undeclared work and advance fair competition between operators..

Workers' organizations also emphasized a number of concerns:

- According to BSPK estimates, the rate of undeclared work is 50%, the most prevalent being in the construction sector and trade sector;
- There is lack of willingness from the government to tackle undeclared work, since some government officials own businesses, hence it goes against their interest to fight undeclared work. Despite the consistent call to the government to increase the human and technical capacities of the Inspectorate, no progress has been attained. Their common response was a lack of budget, whilst today the Kosovo* government operates with above 70 deputy ministers, a budget that is considerably higher than the need for employing additional inspectors;
- Concerns have also been raised in relation to selective inspections, whereby inspectors are not sent for visits at certain businesses that are politically affiliated or related to the government officials;
- Size of penalties is not uniform and fair, since it is up to the inspectors' judgement to set a fine. Moreover, according to the BSPK, once the fine is paid, there is no follow up and enforcement for registering undeclared workers, captured by inspectors;
- There is no proper approach in detecting undeclared work. If willing, government can easily conduct simple analysis and detect undeclared work. For example, recently, BSPK found a company in the construction sector, with a €7 million turnover in a 3-year period, and with only four workers. This simple analysis leads to a clear assessment of a company operating with a large number of undeclared workers;
- Currently, there is no 'black list' or any kind of punishment for companies that operate in the undeclared economy. You find cases, when in the government buildings, there are cleaning staff employed by a subcontracting company, that pays them below the minimum wage; the government is informed but takes no action;
- BSPK does organise awareness raising campaigns but there is a greater need to inform the public on the costs attached to undeclared work.

The main message was that due to the interests of individuals, government is not willing and interested to combat undeclared work. Kosovo* is a small economy, it is very easy to collate information on the prevalence and also extent of undeclared work, but steps need to be taken.

5.3 Towards a joined-up strategic approach

As shown, there is a relatively limited level of coordination across government to tackle undeclared work. Therefore, consideration needs to be attributed to enhancing the joined-up strategic approach where common shared targets are set at the level of strategy and operations. There is also a need to consider how governance is joined-up, such as the extent to which employer representatives (chambers and associations), trade unions, private and voluntary sector organizations, as well as local government, are involved as partners at every level in this joined-up governance.

6. Current policy approach and measures: an evaluation

To evaluate the current policy approach and measures adopted in Kosovo*, both desk-based research was conducted as well as meetings with relevant stakeholders in June 2018 in Kosovo* (see Appendix A for a list of the organisations with whom meetings were held). Table 7 summarises the current policy measures used in Kosovo* and compares this with the range of policy measures pursued in the European Economic Area (EEA) as reported by Dekker et al (2010). This reveals that Kosovo* focuses upon using deterrence measures to combat undeclared work. Only a very narrow range of incentive measures are currently being used in Kosovo*, in contrast to EEA economies that are changing the ‘benefits’ side of the equation by adopting measures to make it easier and more beneficial to operate in the declared economy. Moreover, although in some EEA economies there is a shift from purely the ‘direct controls’ (enforced compliance) approach which changes the cost/benefit ratio confronting suppliers and purchasers and towards an ‘indirect controls’ (voluntary cooperation) approach that seeks to engender a commitment to operating on a declared basis, this is largely absent in Kosovo*.

Table 6: Policy measures used in Kosovo* and 31 other European economies to tackle undeclared work

| | Use in Kosovo* | % of EEA nations | % of EEA stakeholders stating measure is: | | |
|---|----------------|------------------|---|---------|-------------|
| | | | Effective | Neutral | Ineffective |
| Policy | | | | | |
| DIRECT CONTROLS | | | | | |
| Deterrence | | | | | |
| <i>Penalties:</i> | | 93 | 50 | 45 | 5 |
| Administrative sanctions for purchasers/companies | √ | 87 | 46 | 49 | 6 |
| Administrative sanctions for suppliers/employees | | 83 | 41 | 59 | 0 |
| Penal sanctions for purchasers/companies | √ | 74 | 59 | 33 | 8 |
| Penal sanctions for suppliers/employees | | 52 | 53 | 42 | 5 |
| <i>Measures to improve detection:</i> | | 100 | 64 | 34 | 2 |
| Data matching and sharing | √ | 83 | 72 | 25 | 2 |



| | | | | | |
|---|-----|-----|----|----|----|
| Workplace inspections | √ | 100 | 75 | 17 | 8 |
| Registration of workers prior to starting work or on first day of work | | 74 | 74 | 23 | 3 |
| Coordinating strategy across government | | 57 | 56 | 44 | 0 |
| Certification of business, certifying payments of social contribution and taxes | | 65 | 62 | 33 | 5 |
| Use of peer-to-peer surveillance (e.g. telephone hotlines) | | 39 | 20 | 80 | 0 |
| Coordination of operations across government | | 61 | 64 | 36 | 0 |
| Coordination of data sharing across government | √ | 65 | 82 | 19 | 0 |
| Mandatory ID in the workplace | | 65 | 70 | 30 | 0 |
| Enabling compliance: | | | | | |
| <i>Preventative measures:</i> | | 90 | 45 | 43 | 12 |
| Reduce regulations | | 48 | 56 | 38 | 6 |
| Simplify compliance procedures | | 87 | 62 | 38 | 0 |
| Technological innovations (e.g. certified cash registers) | √ | 43 | 73 | 27 | 0 |
| New categories of work (e.g., for small or mini-jobs) | | 35 | 59 | 33 | 8 |
| Direct tax incentives (e.g., exemptions, deductions) | | 61 | 57 | 33 | 10 |
| Social security incentives | | 35 | 62 | 15 | 23 |
| Ease transition from unemployment into self-employment | | 65 | 29 | 63 | 8 |
| Ease transition from employment into self-employment | | 44 | 15 | 77 | 8 |
| Changing minimum wage upwards | | 48 | 24 | 59 | 18 |
| Changing minimum wage downwards | | 9 | 0 | 50 | 50 |
| Training & support to business start-ups | | 61 | 50 | 46 | 4 |
| Micro-finance to business start-ups | √ | 52 | 48 | 52 | 0 |
| Advice on how to formalise | | 61 | 33 | 67 | 0 |
| Connecting pension schemes to formal labour | ??? | 61 | 47 | 41 | 12 |



| | | | | | |
|--|---|-----------|-----------|-----------|----------|
| Introducing supply chain responsibility | | 17 | 78 | 0 | 22 |
| Restricting free movement of (foreign) workers | | 43 | 29 | 53 | 18 |
| <i>Curative measures:</i> | | 64 | 61 | 35 | 4 |
| <i>Stimulate purchasers to buy declared:</i> | | | | | |
| Service vouchers | | 26 | 58 | 42 | 0 |
| Targeted direct tax incentives | | 61 | 65 | 29 | 6 |
| Targeted indirect taxes | | 17 | 63 | 25 | 13 |
| <i>Stimulate suppliers to formalise:</i> | | | | | |
| Society-wide amnesties | √ | 9 | 10 | 0 | 0 |
| Individual-level amnesties for voluntary disclosure | | 17 | 75 | 25 | 0 |
| Formalisation advice to business | | 30 | 44 | 56 | 0 |
| Formalisation support services to businesses | √ | 30 | 57 | 29 | 14 |
| Targeted VAT reductions | | 17 | 43 | 43 | 14 |
| Free record-keeping software to businesses | | 13 | 50 | 50 | 0 |
| Fact sheets on record-keeping | | 22 | 57 | 43 | 0 |
| Free advice/training on record-keeping | √ | 22 | 57 | 43 | 0 |
| Gradual formalisation schemes | | 13 | 67 | 33 | 0 |
| INDIRECT CONTROLS: | | 69 | 44 | 52 | 4 |
| Change values, norms & beliefs | √ | | | | |
| Campaigns to inform undeclared workers of risks and costs of working undeclared | | 61 | 64 | 36 | 0 |
| Campaigns to inform undeclared workers of benefits of formalising their work | √ | 57 | 43 | 47 | 10 |
| Campaigns to inform users of undeclared work of the risks and costs | √ | 61 | 50 | 40 | 10 |
| Campaigns to inform users of undeclared work of the benefits of declared work | √ | 52 | 35 | 59 | 6 |
| Use of normative appeals to people to declare their | | 52 | 33 | 67 | 0 |



| | | | | | |
|--|---|----|----|----|----|
| activities | | | | | |
| Measures to improve tax/social security/labour law knowledge | | 65 | 50 | 50 | 0 |
| Campaigns to encourage a culture of commitment to declaration | √ | 39 | 29 | 64 | 7 |
| Reform formal institutions | | | | | |
| Measures to change perceived fairness of the system | | 26 | 25 | 75 | 0 |
| Measures to improve procedural justice of the system (i.e., degree to which people believe government has treated them in a respectful, impartial and responsible manner) | | 17 | 60 | 40 | 0 |
| Adoption of commitment rather than compliance approach (e.g., ‘responsive regulation’) | | 30 | 50 | 40 | 10 |

Source: Williams and Demetriades, 2016

6.1 Direct controls: deterrence measures

Citizens abide by the law either (1) because they fear detection and fines due to the power of authorities (enforced compliance) or (2) because they feel a commitment to be honest and have trust in the authorities (voluntary cooperation). In Kosovo*, much of the emphasis until now has been on pursuing enforced compliance, not voluntary cooperation. Moreover, enforced compliance has been largely sought not by providing incentives to operate in the declared economy but by increasing the perceived and/or actual costs of working in the undeclared economy. The size of fines is defined by Administrative Instruction No. 07/2012, approved in 2012-and no change has been undertaken since then. Although, the government and relevant institutions have repeatedly declared their commitment to fighting undeclared work, based on interviews conducted for this study, there is no increase in the perceived and/or actual risk of detection.

6.1.1 Penalties and sanctions

Findings from Riinvest survey (2013) revealed that there is a relatively low level of “fear of being caught”, as only 37% of enterprises claimed that there is high or very high chance of getting caught evading taxes. This lack of fear is an important determinant on general evasive behaviour, as 63% of respondents believe that they can easily get away if they decide to cheat. According to this survey, 42% of the respondents consider the fine level to be high, or too high. As defined by Administrative Instruction (AI) No. 07/2012 for determination of Fines and Specific Amounts for Violation of the Provisions of Labour Law, the fine for every single employee without a contract, ranges between €100-7,000 (Article 7 of this AI). The representative of the MLSW claimed that the Labour Law which is currently under revision,



will specifically determine the fine size for each type of violation, which will insure uniform and fair application of fines, rather than leaving it to the discretion of the labour inspector. It is important to note that in majority of cases, when violations are observed, the labour inspectorate issues a note for compliance, providing an opportunity to correct the violation. In cases where the employer does not take actions, then the labour inspectorate will issue a fine. In case of repetition of the violation, the labour inspector has to impose a fine up to a maximum amount of €10,000 (the rate defined by Article 92 of the Labour Law).

For non-compliance with taxes, Kosovo* Tax Administration applies fines and penalties. These are regulated by Administrative Instruction 04/L-223 Law on amending and supplementing the Law no. 03-L-222 on tax administration and procedures, as amended and supplemented by law no.04-L-102. During 2017, KTA conducted 37,240 visits, whereby 6,434 mandatory fines were issued and 368 fines for goods with irregularities with place of origin. An important development at the KTA is the establishment of an Office for Fines and Administrative Penalties, which removes determination of fines and penalties from the discretion of inspectors.

Even if the claim of the business that the penalties are too harsh stand, reducing penalties would negate the power of authorities and thus the ability of the state to pursue enforced compliance. Accordingly, rather than reduce penalties and thus the power of authorities, what is perhaps instead required is to increase the perceived risk of detection, which is significantly correlated with the likelihood of participation in undeclared work. Finally, more emphasis needs to be given to improving trust in authorities and therefore voluntary compliance. With regards to undeclared work, once such cases are found, the employee is directly registered at KTA, whilst the employer is sent a fine for the violation.

6.1.2 Detection measures

Until now in Kosovo*, the majority of measures pursued to tackle undeclared work have been focused on improving the risk of detection. Enforced compliance has been sought, therefore, not by providing incentives to operate in the declared economy, but by increasing the perceived and actual risks of detection, to increase the perceived and actual costs of working in the undeclared economy.

The ERP 2018-2020, considers a need for a general reform of inspection, requiring amendments to the legislative framework, modifying the framework of functional organization, and capacity building. More specifically, it stipulates the need to adopt a harmonized law on inspections which will lay the foundations for a risk-based approach to inspections; evaluation of existing inspections, followed by eliminating unnecessary or merging of inspection activities; establishment of a coordination mechanism between inspection bodies for better alignment of procedures and a more effective oversight system, including the establishment of an information exchange system between inspectorates; amendment of horizontal legislation by allowing and regulating the inspection reform; approval of the organizational structure that implements the new organizational concept of inspections; capacity building, which involves training of inspectors and other relevant officials, for the full implementation of the new concept. These measures are expected to improve competitiveness by reducing the oversight burden and uncertainty for businesses. A



more effective inspection system will contribute to a reduction of undeclared work by favouring compliant businesses and focusing on high-risk activities and operators.

Data matching and sharing

One of the key initiatives in recent years has been the improvement of the risk of detection of non-compliance through better data mining, matching and sharing. It is now increasingly possible to crosscheck and monitor information over time through integrated databases. De Wispelaere and Pacolet (2017) provide useful definitions of these processes:

- Data sharing - The process of making data available to other users.
- Data matching - the large-scale comparison of records or files collected or held for different purposes, with a view to identifying matters of interest. By data matching two or more sets of collected data are compared (comparison of records).
- Data mining - A set of automated techniques used to extract buried or previously unknown pieces of information from large databases.

As the IMF (2013: 23-26) state specifically in relation to tax non-compliance, the low probability of detection is exasperated by the historical tendency for audits to firstly, focus on non-filers and non-active companies, with minimal prospects of collecting additional assessed taxes, leaving high-risk cases unlikely to be audited; and secondly, the limited probability of detecting undeclared tax liability when an audit is carried out, due to limited use of third party information to detect inconsistencies between declared and actual wealth and income, and lack of access to bank account information. Audits focus on bookkeeping formalities rather than assessment of tax liabilities, reducing auditor productivity.

The Employment Agency has access to the Tax Administration database, which enables it to check the employment status of unemployed persons and those that participate in the ALMMs. Integration was operational also with the social assistance database, to ensure that ALMM beneficiaries do not remain in the social assistance scheme, while in placement.

The Labour Inspectorate lacks a database and operates data in EXCEL format. The process of developing a software data set has been initiated but with slow progress. The aim of the database is to enable data entry and analysis in real time. Labour Inspectors would conduct their inspections with tablets that would be automatically connected to data stored in the database, and available for any analysis during an inspection visit.

Kosovo* Tax Administration (KTA) shares data with Kosovo* Customs, Treasury, Agency for Business Registration, and Agency for Civil Registration. Occasionally, as needed, data are exchanged with the Labour Inspectorate. KTA operates a solid IT system but needs to advance it, in order to integrate different tools into a single system. This is of great importance for determining the risky businesses and targeting inspections.

Coordination of data sharing across government

Currently there is no database sharing data between the Labour Inspectorate and the Tax Administration or other institutions. To make progress, therefore, one option is for a decision to be made on which system is to be primarily used to collate data to detect instances of undeclared work. During the interview with Labour Inspectorate it was emphasised that



sharing data with the Tax Administration would greatly facilitate the work and increase the efficiency of the Labour Inspectorate. For example, prior to inspections, a labour inspector would collect information on number of employees for which the enterprise is paying tax contributions, and upon inspection would compare this with number of employees found at the visiting enterprise.

Another more integrated and comprehensive approach is to create one specialist unit that gathers information and conducts data mining investigations into undeclared work. This unit would produce reports on the undeclared economy and investigate using data mining specific organizations and persons suspected of engaging in undeclared work at the request of other organizations, such as the Labour Inspectorate and Ministry of Finance. This unit would have the power to obtain information from the authority that requests the compliance report. The unit would not charge for the preparation of compliance reports and would be entitled to obtain the necessary information free of charge. A compliance report can be used only for the requested purpose, although it can be used as basis for another report requested by the same authority on the same subject (see Box 1).

The MLSW recognises the relevance of data sharing, therefore there are plans to integrate databases of the Labour Inspectorate with the Tax Administration and Pension Fund. It is important to note that Kosovo* does not operate an employment register, which for some time has been demanded as necessary by the MLSW.

Box 1 Joining-up data mining

Initiative: Grey Economy Information Unit (*Harmaan talouden selvitysyksikkö*), Finland

Aim: To join-up the previously fragmented function of data-mining.

Description: In Finland, data mining is the responsibility of the Grey Economy Information Unit (*Harmaan talouden selvitysyksikkö*). Established on 1 January 2011, this specialist unit within the tax administration (in the Ministry of Finance) gathers information and conducts investigations into undeclared work. This unit produces reports on the undeclared economy and investigates specific organizations and persons suspected of engaging in undeclared work at the request of other organizations, such as the police, customs bureau and Finnish Centre for Pensions as well as authorities dealing with work safety, debt recovery and bankruptcies. The unit has the power to obtain information from the authority that requests the compliance report. A compliance investigation can also be a general phenomenon report. The unit does not charge for the preparation of compliance reports and is entitled to obtain the necessary information free of charge. A compliance report can be used only for the requested purpose, although it can be used as basis for another report requested by the same authority on the same subject. The Grey Economy Information Unit is authorised to keep a database within the meaning of the Data Protection Directive (95/46/EC, 1995), containing information necessary for the preparation of reports. The data controller is the tax administration.

Evaluation: Its budget in 2011, the unit's first year, was €1.6 million and €1.9 million in 2012. Some 20 persons are employed. After a year and a half of operation, the unit completed over 40 information gathering and dissemination tasks. It also produced



approximately 11,000 compliance reports to other authorities (this mandate started in July 2011). During 2011, 732 tax audits were conducted on information provided, resulting in €42 million of undeclared wages and €65 million in undeclared sales being recovered (Virtanen, 2013).

Targeting of workplace inspections

The Labour Inspectorate conducts four types of inspections: a) regular inspections based on the previous plan; b) extraordinary inspections, occurring on an ad-hoc basis; and inspections with the requests of parties; c) inspections with other institutions; and d) re-inspections. During the interview with the representative of the Labour Inspectorate it was stated that in most of the cases, inspections at the workplace are done without a prior notice. The representative of the Labour Inspectorate stated that one year, they did send notice letters and according to him, there is nothing wrong with this approach (the representative of the trade union strongly criticised this approach, claiming this will lead to few detections and formalisations). The statement was that the aim of the labour inspectorate is to increase formalisation, and notice letters might produce this result, i.e. knowing that they will be visited, enterprises will register their employees.

There is no sampling technique employed for selecting enterprises for inspections, but all enterprises that meet criteria as per risk assessment findings are to be visited. For example, last year, higher education providers were defined as one of the target sectors for inspections, which implied that labour inspectors had to inspect every single higher education institution, in their set geographic area.

As outlined during the interview, depending on the results from inspections but also secondary data, the Labour Inspectorate conducts a risk assessment (not available for public), which guides them to sectors and type of firms (size-class) with a greater risk to employing undeclared workers. However, a greater emphasis so far has been attributed to the intensity of the undeclared work rather than the incidence, i.e. inspections were oriented towards larger firms, with potentially larger number of undeclared workers, rather than towards micro firms which are more prone to undeclared work, but with smaller number of such workers. This is confirmed, by the fact, that for example in 2018, in total Labour Inspectorate visited 5,769 businesses (8,128 - 2,359 revisits) which employed 38,787 employees. This coverage of employees is an important success to the Labour Inspectorate. Whilst, this approach might lead to a higher number of formalisation cases due to detection, the impact on increasing the perceived risk of detection is expected to be lower. Therefore, the Inspectorate should evaluate and consider applying random sampling techniques. So far, the Labour Inspectorate has not undertaken any evaluation which measures the impact of the employed approaches in detecting undeclared work and formalisation.

The new Law on Labour Inspectorate introduces an Article on a Risk based Approach (Article 17), stipulating that based on the risk level of the work at the employer, the Labour Inspectorate shall divide employers and activities into three risk groups: high, medium and low. However, the reference data to conduct this division is envisaged to be done based only



on analysis of the official reports of Labour Inspectors, which does not promote data sharing and analysis from relevant analysis. The risk will be determined by considering the level of impact, the consequences due to inconsistency, and the probability of inconsistency.

Although the Law on the Labour Inspectorate regulates that the Minister monitors implementation of Annual Work Plans of the Labour Inspectorate, it remains unclear who monitors the work of Labour Inspectorate. This aspect has not been addressed in the new Law on Labour Inspectorate. Moreover, it was emphasised that the transparency of work conducted by the Labour Inspectorate needs to improve. It is not known what is the rate of incidence and intensity of inspections performed by labour inspectors. The representative of the MLSW, strongly emphasised the need to publish the Labour Inspectorate annual reports, and conform to requirements/guidelines set by the ILO R081-Labour Inspection Recommendation, 1947, (No. 81). As per this recommendation, the published annual reports on the work of inspection services should, in so far as possible, supply the following detailed information:

(a) a list of the laws and regulations bearing on the work of the inspection system not mentioned in previous reports;

(b) particulars of the staff of the labour inspection system, including: the aggregate number of inspectors; the numbers of inspectors of different categories; the number of women inspectors; and particulars of the geographical distribution of inspection services;

- (c) statistics of workplaces liable to inspection and of the number of persons therein employed, including: the number of workplaces liable to inspection; the average number of persons employed in such workplaces during the year; particulars of the classification of persons employed under the following headings: men, women, young persons, and children;
- (d) statistics of inspection visits, including: the number of workplaces visited; the number of inspection visits made, classified according to whether they were made by day or by night; the number of persons employed in the workplaces visited; the number of workplaces visited more than once during the year;
- (e) statistics of violations and penalties, including: the number of infringements reported to the competent authorities; particulars of the classification of such infringements according to the legal provisions to which they relate; the number of convictions; particulars of the nature of the penalties imposed by the competent authorities in the various cases (fines, imprisonment, etc.);
- (f) statistics of industrial accidents, including the number of industrial accidents notified and particulars of the classification of such accidents: by industry and occupation; according to cause; according to whether fatal or non-fatal;
- (g) statistics of occupational diseases, including: the number of cases of occupational disease notified; particulars of the classification of such cases according to industry and occupation; particulars of the classification of such cases according to their cause or character, such as the nature of the disease, poisonous substance or unhealthy process to which the disease is due.



During the interview with the representative of the Ministry of Labour and Social Welfare, it was strongly emphasised that targeting methodology should be improved. The current approach of focusing on specific sectors will not result in increasing the perception of an increased detection risk, hence will not produce results, across all sectors.

Further improvements in workplace inspections could be achieved. It is not only the number of labour inspectors that hinders the effectiveness of workplace inspections but also the quality of the information systems for data mining to identify targets for inspections. There is currently not only a lack of necessary resources, but also the tools, procedures and coordination with other relevant authorities to prevent, identify and remedy suspected cases of labour law violation.

The lack of **training of inspectors** is considered as a challenge in the Sectoral Strategy 2018-2020. The Labour Inspectorate operates with 61 employees, out of which 49 are inspectors (7 out of which are coordinators and inspections are not their primary job). The total annual budget of the Labour Inspectorate is €621,000, from which €500,000 are for wages and salaries. The strategy envisages the need to train inspectors. Moreover, the planning and practice of inspection visits should be reassessed to ensure that adequate attention is paid to the incidence of undeclared work, even in situations where a visit's primary objective is not to detect undeclared activities. Better targeting inspections in the labour inspectorate would considerably improve the detection of undeclared work.

The ERP 2018-2020 envisages a specific measure for tackling undeclared work, stipulating the need for a general inspection reform through intensification of coordination of procedures, information exchange and using a risk-based approach. This in turn, is expected to increase the efficiency of inspections, reducing the burden on businesses from too frequent, uncoordinated and unnecessary inspections.

The newly approved Law on Labour Inspectorates includes a new clause, whereby labour inspectors are required to complete the national professional exam for labour inspectors (article 10, point 2.2.). The program, terms and criteria, the manner and procedure for completing the national professional exam, are defined by regulations proposed by the Ministry and approved by the Government. However, given that this program has not been developed, it is not known what aspects it will cover.

In addition, there is an under-emphasis put on the educational or promotional function of labour inspectorates to increase awareness among businesses and workers about the rules on undeclared work and how such situations can be avoided or regularized. Instead, they are largely viewed as enforcers handing out fines and penalties. The overall balance between preventive and enforcing services is not systematic or based on strategic objectives, even though such a balance is important for promoting a culture of compliance. A greater focus upon the **preventative role** of the labour inspectorate (and tax administration) rather than the enforcement role, would therefore be a useful development. This could include the development of educational materials on the benefits of declared work, a FAQ section on their websites and a more customer-friendly approach, all of which would facilitate the further development of their more facilitative preventative role.



A better balance between reactive and proactive inspection visits is also required. In a economy characterized by SMEs and micro enterprises (91% micro and 7.7% with up to 99 employees: World Bank 2017), the number of labour inspection visits per inspector could be much higher with better planning and with a more adequate composition of the inspection teams, taking into account the economic sectors and local realities. A modern system of management combining strategic objectives, target setting and performance appraisal is not in place in the labour or tax inspectorate.

The KTA performs targeting for inspections, in accordance with risk assessment, at the sector and firm level. There are predefined indicators, which are used when setting the risk level for sectors and firms, such as turnover, losses, amount of tax paid, crediting, etc. In the 2018 Annual Work Plan, risk assessment has determined that 20% of controls and visits are to be performed in the construction sector, 20% in wholesale and retail trade, 15% in manufacturing, 5% in real estate, 10% in accommodation and gastronomy, 10% in services, and 15% other sectors. By size class, 5% of controls and visits are planned to take place at micro enterprises, 10% at small, 35% at medium sized and 50% at large enterprises. By type, 25% of controls are planned to be monthly, 45% yearly and 30% long duration controls. As informed from the key informant of the KTA, for this assignment, about 70% of inspections are determined from the head office of KTA and 30% are done, to respond to initiatives from other institutions (Kosovo* Police, Courts and other parties). For planned visits, prior to visits, KTA sends an information letter to the business, indicating documentation and information that needs to be prepared in advance. KTA inspectors conduct also ad-hoc visits and also perform observations.

Both the Labour Inspectorate and Tax Administration operate a call centre, available for reporting cases of undeclared work, violations and asking for support and guidance. During 2017, the Tax Administration received 8,249 calls, mainly requesting support and guidance (information on taxes, business registration and deregistration, debt, fiscal cash registers, etc.).

Law No.05/L-043 Law on Public Debt Forgiveness has the purpose of public debt forgiveness, as well as establishing criteria and procedures for the forgiveness of these debts, owed by natural and legal persons for the period until December 31 2008. According to Article 4, entities benefiting from Debt Forgiveness are all persons who have outstanding obligations towards the State Institutions and Public Enterprises, provided that the same carry out full payment of obligations for the period from 1 January 2009 until 31 December 2014. If so, such persons in addition to total debt forgiveness for the period until 31 December 2008, will also benefit remission of fines, penalties, interest and any other obligation arising from failure to timely pay the debt principal for the period January 1 2009 until December 31, 2014; or shall conclude agreements with the State Institution or Public Enterprise for payment of debts by instalments for the period 1 January 2009 to 31 December 2014. Where agreement is reached, then such persons, in addition to entire debt forgiveness for the period until 31 December 2008, will also benefit remission of penalties for the period 1 January 2009 to 31 December 2014. Under this paragraph debt payment must be carried out within two years for legal persons from the date of entering into the agreement; and within three years by natural persons, from the date of entering into the agreement. The European Union Office report (2017) highlights that this tax amnesty has had a positive effect on tax revenues.



The representative of the KTA highlighted that whilst at the individual level, the amnesty has been discussed as being unfair, it has been beneficial by bringing into the system a sizable number of enterprises, who were most likely working undeclared, having the status of a debtor at KTA accounts.

Coordination of inspections

The World Bank (2017) emphasises that although the tax burden in Kosovo* is low, firms face costly regulatory burdens, particularly in the form of an inefficient and extensive inspection system. These inefficiencies derive also due to: uncoordinated visits of different inspectorates; insufficient risk-focus – many businesses get inspected despite a low or moderate risk level (90% according to 2013 BEEPS data); inconsistency, poor coordination and incoherence among inspection agencies; and a focus on finding violations rather than improving compliance and outcomes.

The Labour Inspectorate conducts inspections at the workplace separately and jointly with other institutions, mainly with the Kosovo* Police and Kosovo* Tax Administration. Initiative on joint inspections comes from any institutions that assesses a need for such an action. For example, in cases when the Police has information of an illegal person working at an enterprise in Kosovo*, it will invite the Labour Inspectorate, as it implies that the person is also working without a work permit.

In 2015, the Minister of Finance of Kosovo* took a decision to merge the Kosovo* Customs and Tax Administration. A concept paper entitled Preliminary Plan on the Establishment of a Revenue Agency was prepared, indicating the Ministry's commitment to effective revenue collection and service to taxpayers. The Plan outlines five reasons for the merger: improving services, reducing the tax gap (assessed as one-third of GDP), increasing efficiency, enhancing autonomy, and facilitating accession to the EU. The draft law for the Agency has been prepared, passed to the government, but so far, no concrete progress has been attained.

Increasing the potential of detection does not always have to lie with state authorities. Social partners can also play a central role. Some 17% of European economies have introduced supply chain responsibility to tackle the undeclared economy. In those economies which have done so, 78% of stakeholders view this as an effective policy instrument and the remaining 22% as ineffective. To see how this operates in practice, a case study is provided of the implementation of supply chain responsibility in Finland (see Box 2). Based on findings, this approach is not implemented in Kosovo*.

Box 2 Introducing supply chain responsibility

Initiative: Contractor's Obligations and Liability Act, Finland

Aim: To reduce the presence of undeclared work in supply chains.

Description: The 2006 Contractor's Obligations and Liability When Work Is Contracted Out Act requires that the party responsible for a construction project obtains necessary guarantees that subcontractors fulfil their various obligations. The law has been in effect since 2007, but obligations in construction sector expanded in 2012. The 2006 legislation originally exempted established subcontracting relationships from a background check, but this hampered the enforcement of the legislation. These have now been included, as has accident

insurance been included on the list of items that now needs checking. The objective of the original legislation as well as the 2012 amendments has been to combat the undeclared economy and promote fair competition between companies, particularly in the construction sector. Long subcontracting chains lead to situations where work is carried out without withholding employee taxes, making VAT payments, making pension payments, or observing conditions laid out in collective bargaining agreements. The legislation placed the responsibility on the users (which tend to be larger businesses) of subcontractors and temporary work agencies that these subcontractors and employment agencies meet their obligations. Contracting parties are required to ask for and obtain documents that verify certain registrations and payment of taxes as well as a reference to applicable collective bargaining agreements or corresponding conditions. Depending on the results of the background check, contracting may be subject to a penalty. The contracting party must inform its employee representatives of subcontracting or the use of employment agency workers. The act is limited to work taking place on the premises or site of the contracting party by employees of a subcontractor or an employment agency.

Evaluation: An early evaluation of the measure found that the law and its contents were known, although this questionnaire-based evaluation also revealed some companies were unaware of them (predominantly small companies). There was more uncertainty of the law's applicability in different sectors and situations, but most respondents regarded it as useful in raising the issue of employer obligations in contracting decisions so as to avoid undeclared work occurring. One problem identified by the respondents of the early evaluation was the additional work required by contracting companies. So too was getting the required information on foreign companies identified as a problem, the penalties were viewed as too low for some situations and the omission of accident insurance from the documents to be requested was considered a problem. This feedback was taken into account in the 2012 amendments. This set the penalties higher at between €16 000 and €50 000 depending on the size of the contract, included accident insurance on the list of documents to be collected, and dropped existing business relationships from exemption because of the prior difficulties of verifying this. In 2010, there were 872 investigations by the authorities (50% in the construction sector). In total, 2541 contracts were examined and half found to contain violations. By March 2011, penalties totalling €302 500 had been imposed based on the 2010 investigations (Alvesalo and Hakamo, 2009; Työ-ja elinkeinoministeriö, 2011).

6.2 Direct controls: supply-side incentives

All the measures so far reviewed are deterrents which seek to increase the costs of operating undeclared work by increasing the penalties or risks of detection. Another way of changing the cost-benefit ratio confronting those considering participation in undeclared work is to provide incentives for, or increase the benefits of, declared work. These measures can be either supply-side incentives or benefits that encourage people to engage in declared rather than undeclared work, or demand-side incentives that reduce the purchase of undeclared goods and services by providing rewards for purchasing on a declared basis. In this subsection, the focus is upon supply-side incentives.



Every end year, Chambers of Commerce together with the Tax Administration of Kosovo* and Kosovo* Customs organise the taxpayer of the year ceremony, announcing the biggest and most regular taxpayers. This activity aims to publicly recognize companies considered as the biggest contributors to the state budget, as well as raise awareness of the business community about their duties towards the economy.

A ‘white’ registry of consistent business could be established, which would provide an incentive for businesses to operate legitimately. One way forward in this regard is to introduce business certification schemes and payment certification of tax contributions to create a ‘white list’ of compliant businesses, which a business needs to be listed on in order to tender for public procurement contracts (see Box 3). Application of a ‘white registry’ was highly recommended by an employer representative. KTA, defines types of tax payers into 3 categories (A, B and C): those belonging to category A having access to faster services (for example they get reimbursed for VAT within 7 days).

Box 3 Business certification schemes

Initiative: Certification scheme for cleaning companies, Norway

Aim: To reduce the use of undeclared workers in cleaning businesses.

Description: In Norway, the Confederation of Norwegian Enterprise (*Næringslivets Hovedorganisasjon*, NHO) developed a voluntary certification scheme for cleaning businesses known as ‘clean development’ (*Ren utvikling*). All participating cleaning businesses had to provide documentation that their accounts and tax records were in order. User companies were then provided with a list of service providers in the cleaning industry whose activities are in order in relation to the existing rules and standards on tax as well as the working environment and workers’ rights.

Evaluation: In 2008, however, there were just 27 certified businesses, which was a tiny fraction of all businesses in the cleaning industry (Sissel et al., 2011). In 2012 therefore, the certification scheme was made compulsory for Norwegian cleaning companies (*Godkjenningsordningen for renholdsbedrifter*) and it was made illegal to purchase cleaning services from companies not approved by the labour inspectorate. This scheme ensures that any approved business has documented that it meets the requirements for residence permits for all employees and the registration and reporting obligations on public registers for all employees. The companies also need to document that they fulfil important requirements related to health and safety, and that all employees carry identity cards that they receive from the labour inspectorate. A central register lists the approved companies that customers can use. In 2012, the government allocated 20 million NOK (€2.69m) to implement this approval scheme (Sissel et al., 2011).

Literature suggests that another supply-side incentive is to **simplify compliance**. Simplifying compliance is not the same as de-regulation. However, during interviews with institutions and stakeholders, it was stated that Kosovo* operates with simple regulation and procedures for labour registration and operates simple tax procedures. Labour inspectors continuously provide advice to enterprises and employees with regards to the compliance with labour laws.



Another perhaps preferable option is to simplify the regulatory compliance framework itself. An example would be to simplify tax administration for small businesses (e.g., the number of tax forms and returns, pursuing an integrated approach to audit with a single visit to inspect records rather than separate inspections) and improving support and education to help firms comply. Simplifying regulatory compliance however, need not solely concern relatively minor administrative changes such as simplifying the number of procedures and forms. Measures might also include fundamental changes. This has already occurred for employees with the ‘pre-filling’ of tax returns. On pay-as-you-earn accounts, this information is inserted, as is bank interest inserted on all accounts and from next year, so too will be dividends. Lease property revenue is not yet included. A similar simplification has not yet occurred for the self-employed and small businesses. One example would be introducing a ‘standard deduction’ for the self-employed (see Box 4).

Box 4. Measures to simplify compliance.

Initiative: A ‘standard deduction’ for the self-employed

Aim: To facilitate a higher level of tax compliance by simplifying the compliance system so that it is easy to understand and use, with few loopholes.

Description: In many economies, the self-employed have to complete detailed (often self-assessed) tax returns that require a great deal of time and effort, as well as psychological stress. Indeed, all income has to be recorded, receipts kept for all expenditures and detailed calculations made for all tax deductible items, so that net profit can be calculated. A major change proposed by Elffers and Helsing (1997) is to introduce one overall standard deduction to replace the current complex process (see also Slemrod and Yitzhaki, 1994). This would not be simply a fixed deduction on specific standard tax-deductible items but an overall standard deduction that the self-employed person would deduct from their income to take account of the expenses. This could be either a fixed amount or a percentage of gross income. If implemented, it would eradicate the whole process of deductible items, the keeping and logging of receipts from expenditures and significantly decrease the complexity of the tax system. The usual argument against such a measure is either that it will not work or that it is unfair towards those taxpayers who really do have high costs. The latter could be overcome by allowing taxpayers not wishing to opt for the overall standard deduction to retain the right to continue with the current process if they so wish.

Evaluation: The advantage for the taxpayer of applying this overall deduction, which has operated in the US federal income tax system for many years, is that: this is a safe and certain option; it saves time and trouble; there is no need to pay for a tax advisor; and it reduces uncertainty. The higher the standard deduction, the greater is the chance that they will use this system rather than seek to specify all tax deductible items. Indeed, the fact that this is an attractive option for taxpayers is its take-up in economies where introduced. Gross (1990) reports that in the US in 1990, 71% of taxpayers opted for the standard deduction, in the form of a fixed amount. For tax authorities meanwhile, from the revenue-to-costs viewpoint, it is wholly ineffective to check deductible items claimed on each self-assessment form; it is a matter of small sums of money, which takes tax officials much time to check, let alone discuss and correct. If there were fewer claims with deductible items, this would make an enormous difference to the workload of tax offices. It would

also release time either to check those specifying deductible items in more depth or for shifting resources towards enabling compliance rather than detecting non-compliance.

Various options exist for implementing this overall standard deduction. One option is to start by applying it to those filing self-employment tax returns. To estimate the effects on revenue collected under a standard deduction system, three variables require consideration. Firstly, there are the revenues lost or gained by introducing the standard deduction. Secondly, there is the number of taxpayers opting for the overall standard deduction, and third and finally, there is the reduction of work involved for the tax administration. The level of this standard deduction, either a fixed amount or percentage of gross income, so that it is revenue-neutral, could be calculated by auditing existing tax returns across various industries and occupations for the mean or median deductions claimed. It could then be either universally applied (which would be simplest for the tax filer) or applied in the first instance only to those sectors and/or occupations where the shadow economy is rife.

One feasible option is to use **reverse charges for VAT** whereby the buyer, not seller, must file and pay the VAT. Until now, reverse VAT charges have been introduced in several European economies in the construction industry (see Box 5). This also started to be applied in Kosovo* in 2017 in the construction sector (in line with note 1.4.1 and 1.4.2 of Article 52 of VAT tax Law No. 05/L-037, namely 1.4.1. the supply of construction work, including repair, cleaning, maintenance, alteration and demolition services in relation to immovable property; 1.4.2. the supply if staff engaged in activities covered by sub-paragraph 1.4.1 of this paragraph). As reported by the KTA representative, this is an important measure to reduce undeclared work in the construction sector. For 2018, KTA opts to increase by 15% the number of businesses applying the reverse charges of VAT. This is planned to be achieved through, information, education, control and risk module.

Box 5 Reverse VAT charges

Initiative: Reverse charges in the construction industry, Sweden

Aim: To tackle VAT fraud and undeclared work in the construction industry

Description: To tackle VAT fraud and undeclared work in the construction industry, the Swedish government introduced a law on reverse charges for VAT effective from 1 July 2007. A reverse charge means that the buyer, not the seller, must file and pay the VAT. A company selling construction services more than on a temporary basis must pay VAT for its sub-contractors. If the purchaser is not a construction company, the vendor shall add VAT to the invoice. If the purchaser is a construction company, the vendor shall not add VAT to the invoice. Instead, the purchaser will be responsible for reporting the output VAT. Reverse VAT liability does not apply to sales which consist solely of materials.

Evaluation: According to a survey by the Swedish Tax Agency (2011), around 39% of the surveyed companies believed that the reverse charge reduced undeclared work in the construction sector. The Swedish Tax Agency does not find support for this argument when investigating a possible increase in reported payroll taxes. However, it does not preclude that the measure may have affected the prevalence of the undeclared economy concluding that the reverse charge has had positive effects in terms of increased reporting

of output tax in the construction sector at SEK 700 million (€82.3 million) in 2008 (Swedish Tax Agency, 2011).

Initiative: Reverse VAT in the construction industry, Finland

Aim: To tackle VAT fraud and undeclared work in the construction industry

Description: In April 2011, Finland similarly introduced reverse VAT where VAT is paid by the buyer (main contractor) rather than seller (subcontractors). This was deemed effective because the tax liability does not as easily disappear into the subcontracting chain and the main contractors tend to be large, established and reputable companies. Subcontractors do not charge VAT to the main responsible party. If there is a chain of subcontracting, as is typical, all invoicing excludes VAT, which is only disbursed at the top of the chain. The reverse system only applies to construction services, not materials, and private individuals as buyers are excluded.

Evaluation: The tax administration estimated that during the first three years the reverse system would annually require 60 work-years to implement, followed by 30 work-years in each subsequent year. In the legislative proposal, the increase in VAT revenue was estimated at €80-120 million. The disbursement of VAT has been shifting towards the main contractors as intended. Information from a few tax audits based on it have been analysed and reported. They have uncovered both honest mistakes and suspicious activity. There are no reports however, of suspected appearances of ‘front’ organizations as fraudulent main contractors.

To make it easier to work on a declared basis, another approach is to introduce new categories of declared work to allow economic activity currently conducted as undeclared work, often out of necessity due to the compliance regulations involved, to move into the declared realm. Overall, one-third of the European economies surveyed in 2010 had introduced such measures. Of those adopting this measure, 59% viewed it as effective, 33% as neither effective nor ineffective, and just 8% as ineffective (Dekker et al., 2010). Here therefore, and to see how new categories of declared work can be introduced to make it easier to move work currently conducted out of necessity in the undeclared economy into the declared realm, an example is taken from Hungary where the Simplified Employment Act has made it easier for people to undertake small jobs in the declared economy which would have been impossible beforehand and would be necessary have been undertaken on an undeclared basis, such as doing a small computer repair job for an acquaintance (see Box 6).

Box 6 New forms of declared work

Initiative: Simplified Employment Act (Egyszerűsített foglalkoztatási törvény) 2010, Hungary

Aim: To bring small mini-jobs into the declared economy that would otherwise be conducted on an undeclared basis

Description: In 2010, the Hungarian government introduced the Simplified Employment Act to make seasonal and temporary employment easier to conduct on a declared basis. Before this Act, it was necessary to complete in duplicate an official attendance sheet with 18 pieces

of information for every single seasonal worker. This Act frees both the employee and employer of such administrative burdens, and enables the mutually agreed simplified work contract to be notified either by: a simple Text Message (SMS) or electronically via the Client Gate System after they are registered and in the system. It distinguishes two categories of simplified employment: seasonal agricultural work, including seasonal tourism services, and other casual/temporary work (i.e., domestic work). In the first case the employer has to pay taxes of HUF 500 (€1.75), in the second case HUF 1000 (€3.50), on a daily basis. All obligations are fulfilled by entering two codes into the Text Message or into the Client Gate System.

Evaluation: According to data from the Hungarian National Tax and Customs Administration, between April and May 2010, 505,621 simplified employment cases were registered at the tax authority, of which 417 937 entries were for ad hoc/casual employment, 15,877 for seasonal agricultural employment, 6393 tourism employment, 761 at non-profit organizations, and 10,326 in plant cultivation. Of these jobs, 499,987 lasted less than five days and 2,169 longer than five days. By July 2011, there were 512,000 temporary or seasonal jobs registered as simplified employment from 370,000 employers. Between 1 August 2010 and 31 December 2011, around 12.5 million working days were registered across these 17 months and HUF 8 billion (€28 million) flowed into the state's treasury (Rindt and Krén, 2013).

Another supply-side incentive is to use **direct tax incentives** to prevent citizens and businesses entering the undeclared economy. Although many of the policy initiatives discussed until now have been government-led initiatives, there are many opportunities for both employer and employee representative organizations to develop social security measures to tackle the undeclared economy, as a Romanian measure displays. This seeks to provide social protection for workers so that they do not need to turn to the undeclared economy and at the same time, provides rewards for those workers who operate on a declared basis to make work in the declared economy pay relative to work in the undeclared economy (see Box 7). Given the lack of unemployment benefit in Kosovo*, this could well be applicable and transferable to the Kosovo* context, once health insurance starts being implemented.

Box 7 Social security incentives

Initiative: Builders Social House, Romania

Aim: To introduce incentives to workers to operate in the declared rather than undeclared economy by providing them with social security during the off-season.

Description: In Romania, 'The Construction Sector Social Agreement for 2007-2009' (*Acordul Social Sectorial Pentru Construcții 2007-2009*) estimates that some one-third of the active workforce operates in the undeclared economy and highlights the importance of tackling this sphere. The Builders Social House (*Casa Socială a Constructorilor, CSC*) is one prominent initiative used to enable this work to take place in the declared rather than undeclared economy. The CSC was established in 1998 as a privately run welfare organization, to which the representative trade unions and employer organizations in the construction and building materials sector contribute in equal measure. It provides welfare



payments during the cold season (1 November - 31 March), when the construction sector slumbers, to workers in registered declared employment and in doing so, provides an incentive for workers to be in the declared economy rather than working in the undeclared economy in the construction and building materials sector. CSC members are construction companies and manufacturers of building materials. Entitlement to welfare payments during these winter months is only available to declared employees, that is, those with employment contracts recorded with the local labour inspectorates, and whose social security contributions due by both the employer and employee have been paid. Corporate contributors pay 1.5% of their turnover into the CSC scheme, and employees contribute 1% of their gross base salary.

Evaluation: In 2008, CSC had 573 member organizations accounting for 40% of all declared employment in the construction and building materials industries. During the 2007-8 winter period, 102,387 declared workers benefited from this scheme as recipients of welfare payments (Eurofound, 2013). This is potentially transferable both to other economic sectors where work is largely seasonal, such as agriculture and forestry, and other economies. Importantly moreover, it shows what can be achieved by employer and employee representative organizations working together, and without reliance on governments, so far as implementing policy measures to tackle the undeclared economy is concerned.

A further supply-side incentive to encourage declared work is the provision of **support and advice on formalisation** both by government and by social partners. Currently, no such initiative exists in Kosovo*. The advice would also focus more upon providing formalisation advice to current businesses that operate on a partially undeclared basis about how they can put their affairs in order. A broader initiative might also include the use of ‘role models’ organised by for example chambers of commerce. The use of non-governmental bodies to provide this advice is important so that there is greater willingness and less fear from businesses of approaching them for such advice.

Overall, in Kosovo*, there is little support at present given to businesses to facilitate their formalisation. There is no free provision of record-keeping software to businesses, no fact sheets on record-keeping. The only exception is the Kosovo* Tax Administration, providing free advice or training on record-keeping.

6.3 Direct controls: demand-side incentives

Besides providing supply-side incentives to operate in the declared economy, recent years have witnessed the expansion of demand-side incentives to encourage the purchase of declared goods and services. One option is to give straightforward income tax relief, claimed on tax returns, to customers using declared labour to do specific tasks (e.g., roof maintenance, outside painting, domestic cleaning) commonly conducted in the undeclared economy, so that the wage costs of employing workers on a declared basis become equivalent or better than the wage costs of employing somebody on an undeclared basis (see Box 8).

So far, only a narrow range of incentive measures has been used. In 2015, the Ministry of Finance approved an Administrative Instruction MF-No. 01/2015 on the Use of Fiscal

Electronic Devices and Systems, with a specific article (No. 26) on *Incentives and motivation for taking fiscal receipts*. With this initiative, customers collect fiscal receipts and take them to the authorities to have a portion of VAT reimbursed. The primary aim was to increase awareness about the importance of fiscal compliance, and secondly to encourage consumers to put pressure on businesses to issue fiscal receipts. In the period 2015-2017, in total, €13 million were reimbursed to consumers- €1.25 million in 2015; €14.3 million in 2016 and €13 million in 2017 (KTA, 2018). This activity is ongoing, but now transformed into a 'lottery' model. According to the KTA representative, this initiative proved successful, with tangible impacts on tax revenues.

Box 9 Tackling the demand-side: the use of tax deductions

Initiative: Tax deductions for household work, Sweden

Aim: To use direct tax incentives to bring domestic services provided in the undeclared economy into the declared realm

Description: Since 8 December 2008, Swedish citizens have been able to apply for a tax deduction amounting to 50% of the labour cost for the renovation, conversion and extension of homes (ROT), and also for household services (RUT), including cleaning, laundry, basic gardening and babysitting. The maximum annual tax deduction that can be applied for is SEK 50 000 (€6000) for each individual. In the government bill from 2007 where the RUT deduction was proposed, the measure was estimated to cost SEK1.3 billion per year (€155 million). The ROT-deduction was in the spring budget bill in 2009 and was calculated to cost SEK 13.5 billion per year (€416 million) (Swedish Tax Agency, 2011). As of 1 July 2009, companies performing household services charge the customer the costs of materials and half the labour costs, including VAT. The company performing the work then requests the outstanding sum from the Swedish Tax Agency. As a result, the customers only pay half of the labour cost at the point of purchase of the service.

Evaluation: Comparing data from 2005 and 2011, the Swedish Tax Agency (2011) display that undeclared work has decreased by about 10% within the categories of jobs covered by the ROT and RUT-deduction. In the autumn of 2011, the Swedish Federation of Business Owners (*Företagarna*) conducted a survey of 2447 construction companies. The results show that nearly 90% felt that the ROT-deduction had a positive impact on reducing undeclared work in the sector compared with 78% in 2009. In 2010, 1.1 million people bought household services with a tax deduction (RUT and ROT) and the Swedish Tax Agency paid out SEK 1.4 billion (€166 million) in RUT deductions and SEK 13.5 billion (€1.6 billion) in ROT-deductions. This means that around 7.6 million hours of cleaning and household (ROT) services and 53 million hours of renovation work (ROT) were performed using these schemes (Brunk, 2013c).

Initiative: Home-job plan, home-job tax deduction, Denmark

Aim: To use direct tax incentives to bring domestic services provided in the undeclared economy into the declared realm

Description: Since 1 June 2011 until the end of 2013, it has been possible for each member of the household over 18 years of age to deduct from their taxes up to DKK 15 000 (€2000) the costs of employing craftspeople and domestic helpers under a pilot project called 'Home-Job Plan' (*Bolig-Jobplan*). The major difference compared with the Swedish



scheme therefore, is that whilst Sweden has a maximum tax deduction of €6600, the cap is €2000 in Denmark. The activities covered include cleaning, indoor-outdoor maintenance of the house, gardening and babysitting. The cost to the government is estimated to be DKK 1 billion (€134 million) in 2011 and around DKK 1.75 billion (€234 million) in 2012 and 2013. The expenses and the company involved is informed digitally by the buyer of the services to the tax authorities in a special template, who then deduct 15% of the amount in the yearly tax or fiscal income. The action involved for the buyer of these services resembles an ordinary payment transfer, and the system does the rest.

Evaluation: Relative to expectations, the pilot project has so far been a success. Some 270 000 people used the deduction in 2011 and most of the work involved home improvement, maintenance and repair. They have on average reported deductions of DKK 9800 (€1315) per person. In total, the deductions reported constitute DKK 2.7 billion (€362 million). The tax value of those deductions is around DKK 900 million (€121 million) (Jørgensen, 2013).

In the ATK annual report 2017, the total number of businesses equipped with fiscal cash registers by 31.12.2017 is 27,703. Only in 2017, 1,986 new businesses have been equipped with fiscal cash registers, and 646 fiscal cash registers have been installed in the businesses involved in the sale of oil derivatives. As reported by the representative of the Tax Administration, cash registers operate in businesses that account for 90% of total tax collected. However, the main challenge remains in formalising micro and family owned businesses.

Further measures that could be adopted include the compulsory installation of POS terminals, the imposition of fines in case that a digital payment is refused, incentives to the consumers that have justifiably reported a digital payment refusal and incentives to very small enterprises, such as a subsidy for the installation of POS terminals with a corresponding reduction of the bank fees and the possibility to participate in a lottery. One advantage of the KTA, as reported by the KTA representative, is that as POS terminals are placed at all KTA premises, no cash payments can be made.

Box 10. Service vouchers in Belgium

Aim: To transform undeclared work into declared work; to create new jobs for low-skilled;

Description: In **Belgium**, service vouchers were introduced in 2004, and are used to pay for everyday personal services. Each voucher costs €9.00. An individual can buy 500 vouchers each year or 1000 vouchers for each family (although single parents or mothers returning to work with young children can buy more). Each year, Sodexo (the contractor delivering the scheme) sends users a tax certificate that they can use to claim a 30% tax deduction on the cost of their vouchers. Low income users who do not pay taxes enjoy this benefit through a reimbursable tax credit.

Every voucher pays for an hour of work from certified companies that hire unemployed people to do this work. At first, the company can hire the unemployed person on a part-time temporary contract. After three months of fixed-term employment, the company has to offer the worker a permanent employment contract for at least half-time employment if the person was previously registered as unemployed.

The company then assigns them to offer services to users, but the users are solely clients, not their employers. For every voucher a company receives they could claim a payment equalling €22.04 in 2013. This amount is made up of the price paid by the user (€8.50 or €9.00) and a subsidy from the regions (€13.54 or €12.54). The value of the tax deduction varies from one region to another. In Wallonia, the deduction amounts to 0.90 euro for each voucher, in Flanders and Brussels region the deduction goes up to 30% of the value of the voucher but is limited to €1,400 per person per year.

An employee of a certified company could carry out the following activities: in-house cleaning and ironing; preparing meals; external ironing services; transport for disabled person; and a shopping service. The customer pays using the vouchers. The total cost of the service voucher scheme to the government in 2011 was some €500m. Per employee net costs amounted to €3,520 in 2011 (€2,793 in 2010) (Gerard et al., 2012).

Evaluation: In 2016, there were some 3,500 companies active in the system (Willems, 2018) and some 130,000 workers, or circa 100,000 full-time equivalent workers, employed in the system (Willems, 2016). A significant share of these workers (35%) were unemployed before entering the system. It has been estimated that only around 5% of these jobs existed before (substitution of regular labour through the service voucher system). In 2016, 11% of Belgians used service vouchers (some 1 million households) who bought 129 million vouchers from Sodexo.

6.4 Indirect controls

Until now, all the measures proposed have been direct controls which seek to change the cost/benefit ratio confronting businesses and citizens when considering participation in undeclared work either by increasing the costs of undeclared work or the benefits of declared work. As shown in section 2.2 however, business and citizens are not always simply rational economic actors. They are also often social actors who do not comply because they either lack trust in the state, or do not understand or believe in what the state is seeking to achieve (i.e. they lack ‘vertical’ trust), or they believe that many others are operating undeclared so see no reason that they should operate on a declared basis (i.e., they lack ‘horizontal’ trust).

To tackle undeclared work, the root causes that lead to the values, norms and beliefs of citizens not being aligned with the laws and regulations, needs to be tackled. This is what indirect controls seek to achieve by dealing with the formal institutional imperfections and failures that lead to the decision to engage in the undeclared economy. Until now, Kosovo* has paid little if any attention to such indirect controls as a means of tackling the undeclared economy. No strategy has been developed to foster trust in government and to align the norms, values and beliefs of citizens regarding compliance with the codified laws and regulations. Two sets of initiatives are required to achieve this. Firstly, initiatives can be pursued to alter the norms, values and beliefs of citizens so that they align with the laws and regulations and secondly, and in order for this to be achieved, it is also necessary to deal with



the formal institutional failings and imperfections so as to foster greater self-compliance in the population.

6.4.1 Altering informal institutions: awareness raising campaigns

The Labour Inspectorate and Kosovo* Tax Administration on a regular basis organise awareness raising campaigns. The Labour Inspectorate, in 2018, has organised two campaigns, through media, brochures, and direct contacts to outreach different target groups. However, it was highlighted that more activities are deemed necessary to inform the public on the costs of working undeclared and the benefits of declared work.

The Tax Administration operates a Taxpayers Education and Service (TESD), which is in charge of development and management of policies and strategies for the provision of services in the most qualitative, timely and accurate manner to taxpayers, including the direct provision of services to taxpayers through the Taxpayer Service Centre. The aim of this department is also to facilitate coordination and cooperation with Government Institutions: Kosovo* Business Registration Agency (KBRA - MTI) in view of taxpayer registration, Kosovo* Agency of Statistics (KAS) in order to coordinate activities for National Business Accounts, The Kosovo* Pension Savings Trust (KPST) in compliance with the obligations on Pension Contributions, as well as cooperation with the media and institutions (Associations, Chambers of Commerce) representing taxpayers in view of better communication with taxpayers. This department, on regular basis, delivers seminars and trainings, presentations, various events for certain tax issues. Requests submitted by the taxpayers, received in physical and electronic form, are treated with special commitment, thus responding to taxpayers in accordance with the Tax Legislation. The KTA operating a voluntary tax declaration, organises many activities to educate the population on the contribution of taxes to socio-economic development (activities in schools; universities; media awareness campaigns; etc.).

Many citizens do not fully understand why they pay their taxes and/or what these taxes are used for by governments; they do not fully make the connection between the public goods and services they receive (e.g., hospitals, schools, transport infrastructure) and the taxes they pay. Until now, governments have generally undertaken very little marketing to help citizens make this connection. However, if the norms, values and beliefs of many in the population are to become better aligned with the codified laws and regulations of formal institutions and voluntary cooperation is to ensue, educating citizens about this is important. The advantage of pursuing voluntary cooperation, rather than enforced compliance, is that this is potentially a far cheaper, more effective and sustainable means of tackling violations of tax, social security and labour law related to undeclared work than having an army of inspectors to police non-compliant behaviour and using incentives to effectively ‘bribe’ the population to operate on a declared basis.



To achieve such voluntary cooperation, two broad forms of education are required. On the one hand, and to prevent unintentional non-compliance, citizens need to be educated and informed about what the current system requires of them. On the other hand, and more broadly, citizens need to be educated about the benefits and value of paying tax and being compliant with labour law and social insurance regulations, by educating them about the benefits of paying taxes and social insurance contributions, and complying with labour law, to develop their intrinsic motivation to do so and facilitate greater self-regulation.

The first type of education requires the provision of easily understood information regarding their responsibilities with regard to the tax, social security and labour law. A significant portion of non-compliance is unintentional, arising from both the complexity of the compliance system as well as a lack of knowledge, misunderstanding and ambiguous interpretation of tax and labour law (Hasseldine and Li, 1999; Natrah, 2013). In consequence, one way forward is to provide greater information to citizens (Internal Revenue Service, 2007; Vossler et al., 2011). At present, few if any initiatives in this regard have been pursued in Greece. Besides simplifying compliance, a frequently asked questions (FAQ) section on ministerial websites might be helpful.

The second and perhaps more important type of education is that which seeks to educate citizens about the benefits and value of being compliant with labour, tax and social insurance regulations. One potential and partial remedy, therefore, is to educate citizens about the activities on which their taxes are spent, and the value of pensions and abiding by labour law. If citizens are informed and knowledgeable about the current and potential public goods and services which they are receiving for their money, and the value of having a pension, they may be more willing to pay their taxes and social contributions (Bird et al., 2006; Saeed and Shah, 2011). One direct way of doing this, as occurred in 2009 in Greece, and is continuously applied in the United Kingdom, is to provide information to tax payers regarding where their taxes are being spent and how much they are contributing to which activities of government. This set out what portion of their taxes is spent on which public goods and services. Another simple way of doing this is to display signs such as ‘your taxes are paying for this’ on public construction projects (e.g., new roads), on ambulances, in doctor’s waiting rooms, in hospitals and schools, which convey a clear message to the public that the taxes they pay are being used to provide these public goods and services.

In Canada for example, the Tax System Learning Unit provides information about the tax system as well as how the government spends the tax dollars collected. This Unit until now has targeted junior and high school students to educate citizens before they start participating in the tax system. While the initiative has enjoyed success in getting participation from education institutions, its impact on compliance has not been measured, since there is no mechanism to track the compliance behaviour of those taking the modules against a control group who have not. Austria has adopted a similar initiative targeted at schools whereby tax



officials provide training on future responsibilities for compliance, as have the Internal Revenue Service in the USA (Internal Revenue Service, 2007).

Although information and advice is provided by telephone, email or during inspection visits, and material is published, no concerted awareness raising campaign has been launched about the costs of undeclared work and benefits of declared work. It is more information on *obligations* that is provided by the tax, labour and social security bodies. An awareness raising campaign, meanwhile, can either: inform those working in the undeclared economy of the costs and risks of doing so; inform potential users of undeclared labour of the risks and costs; inform those working in the undeclared economy of the benefits of being legitimate, and/or inform potential users of undeclared labour of the benefits of formal labour.

There is tentative evidence that emphasising the benefits of working declared rather than the costs and risks of engaging in undeclared labour is more effective. As Thurman et al. (1984) explain, publicising the adverse consequences of engaging in undeclared labour is ineffective because those working in the undeclared economy tend to neutralise their guilt, such as by seeing themselves as small players with little impact compared with the big players. If an awareness-raising campaign does decide to focus upon the costs of undeclared work, therefore, then it will need to ensure that these rationalisations are not available to participants in the undeclared economy, such as by advertising the average level of non-compliance so that people will not view their own activity as ‘minor’ compared with others.

For a campaign to be effective however, it has to use tailored advertisements that will need to vary in form and content depending on the audience targeted. The language, media used, word style and slogans that will be effective for one population group such as younger people, will not be for another group such as the elderly. Similarly, effective media for one target group, such as newspaper adverts for older people, will not be for the internet-oriented younger generation. As shown in other realms of advertising, harnessing the power of celebrities can also be effective in influencing the target audience. If celebrities and/or opinion leaders are used by administrations, then as Lessing and Park (1978) identify, it is necessary to differentiate three types of campaign. These are firstly, information campaigns where citizens lacking knowledge refer to opinion leaders for information, such as highly respected economic experts via television commercials, talk shows and newspaper articles, secondly, utilitarian campaigns when citizens are motivated by hearing about others rewarded or punished, such as when names are published of those who pay taxes and do not and, third and finally, value-expressive campaigns when citizens are encouraged to associate themselves with positive role models, such as by publicising the tax payments of famous television and movie stars, athletes, scientists, politicians and business tycoons, holding them up as role models for the law-abiding citizen to follow.

Moreover, it does not always have to be governments leading such awareness raising campaigns. It can also be social partners such as employer or employee representative



organizations either independently or in cooperation with the state. In Sweden for example, employers have led campaigns to tackle the undeclared economy and undeclared labour in both the construction industry and the taxi-driving sector. The Bulgarian Industrial Association, meanwhile, has run an ‘In the Light’ (www.nasvetlo.net) campaign since 2007 and sought to encourage greater awareness of the negative implications of the undeclared economy and undeclared labour, whilst in Canada, a national awareness advertising campaign, ‘Get it in Writing’, to inform purchasers of undeclared labour of the risks involved in dealing with home repair and maintenance contractors has been developed in partnership between the tax administration and the Canadian Home Builders’ Association.

6.4.2 Reforming formal institutions

There is little point in seeking to change norms, values and beliefs, however, unless one addresses the formal institutional failings that cause the non-alignment of citizen morality with state morality, and thus the prevalence of undeclared work. As Matsaganis et al (2012) assert for example, there is a tension between the conflicting goals of achieving fiscal savings in the short run and modernizing public administration over the longer run, and that there is a need to opt for lasting solutions which ensure that economies such as Kosovo* can function as a modern state. To tackle these formal institutional failings so that citizens become more committed to being compliant, therefore, two broad approaches are required. On the one hand, the processes of formal institutions need to be changed. On the other hand, the products of formal institutions need to be addressed. These related to tackling formal institutional voids (e.g., a lack of welfare protection). Here, each is considered in turn, starting with the processes of formal institutions.

Changing the processes of formal institutions addresses two key types of formal institutional failure. On the one hand, changing the processes of formal institutions tackles formal institutional inefficiencies, or resource misallocations by formal institutions, such as when formal institutions seek to protect or maximize economic rents for elites, or when state capture occurs by such elites, resulting in the majority not receiving a fair share in return for their contributions, or suffering from overly burdensome taxes, registration and licensing regulations and costs. On the other hand, changing the processes of formal institutions tackles formal institutional weaknesses and instability, manifested in their lack of capacity and capability to enforce legislation and/or there are continuous changes in the formal ‘rules of the game’ about what is acceptable, which leads citizens to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules. These malfunctions lead to a non-alignment between state morality and citizen morality. To change this, processes need to be altered to ensure that there is procedural justice, procedural fairness and distributive fairness. This net result will be a shift in public institutions away from a ‘cops and robbers’ approach and towards a more customer-friendly orientation. Each is here considered in turn.



6.4.2.1 Modernising governance

Citizens often do not adhere to the formal rules, and there is thus a breakdown in the social contract between government and its citizens, due to a low level of trust in government. A modernisation of governance is thus one way forward. To address what are perceived as formal institutional resource misallocations and inefficiencies, at least three institutional reforms are required:

- **Procedural justice** must be improved, which here refers to the authorities treating citizens in a respectful, impartial and responsible manner and thus shifting away from a ‘cops and robbers’ approach and towards a service-oriented approach;
- **Procedural fairness** must be enhanced, which refers to citizens believing that they pay their fair share compared with others; and
- **Redistributive justice** needs improving, which relates to whether citizens believe that they receive the goods and services they deserve given the taxes they pay.

In the 2017 Annual Platform Survey of European Union economies, 48% of Member States responding asserted that they had taken measures to improve the degree to which customers of enforcement agencies believe they have been treated in a respectful, impartial and responsible manner. All Nordic nations had pursued this policy approach, but only 57% of West European, 33% of East-Central European and just 25% of Southern European Member States responding.

Improving procedural justice

Procedural justice refers to whether citizens view the government as dealing with them in a respectful, impartial and responsible manner (Murphy, 2005). If citizens view government institutions as treating them in a poor manner, the evidence is that they are more likely to engage in non-compliant behaviour (Murphy *et al.*, 2009). Leventhal (1980) thus proposed the following six rules for how governments should interact with citizens to improve the perceived level of procedural justice:

- The consistency rule - procedures should be consistently applied across all people and over time; nobody should be more favoured, or disadvantaged compared with others;
- Bias suppression rule - egoistic intentions and prejudice on the part of the decision-makers must be avoided;
- Accuracy rule - all relevant sources of information should be exhausted, in order that decisions are based on well-founded evidence and information;
- Correctability rule - the possibility that decisions made can be adjusted or revised in the light of evidence;
- Representativeness rule - the interests and opinions of all stakeholders and individuals involved should be considered; and
- Ethicality rule - procedures should be in accord with the prevailing moral and ethical values.



Others additionally consider the importance of interpersonal interactions. Compliance rates are significantly higher when people are treated politely, with respect and dignity, are given a say, and have genuine respect shown for their rights and social status (Gangl *et al.*, 2013).

However, if they believe that they are being treated unfairly or unreasonably, such as by inspectors showing disrespect for them, or they believe that taxes are collected and being used to support the interests of powerful private interests who have captured the state, this results in a lack of trust and lower compliance rates (Murphy, 2008).

There is thus a need for enforcement authorities to treat citizens with respect and dignity. The overarching goal is to improve the trust and confidence of citizens in public administrations.

Improving procedural fairness

Procedural fairness refers to whether citizens feel that they are being treated in a fair manner relative to others and that they pay their fair share compared with others. Those who perceive that they receive procedurally fair treatment are more likely to trust the authorities and to adhere to the formal rules (Murphy, 2005). The fairness of the tax system is one of the most important determinants of whether they do so (Molero and Pujol, 2012).

Conversely, if they perceive that they are not receiving fair treatment, non-compliance increases (Bird *et al.*, 2006). As Molero and Pujol (2012) find, where there is grievance either in absolute terms (e.g., they feel taxes are too high or public money wasted) or grievances in relative terms (e.g., there is a lack of horizontal trust and a belief that others are cheating), non-compliance is the outcome. Indeed, they justify their non-compliance using their perceptions of the activities of others. If undeclared work is viewed as widespread, this justifies their non-compliant behaviour. This has important implications. If governments publicise that undeclared work is rife, they create the conditions for widespread grievance and thus even wider participation in undeclared work by those who might not otherwise have done so.

Improving redistributive justice

Redistributive justice refers to whether the population believe they receive the goods and services deserved given the taxes that they pay (Richardson and Sawyer, 2001). Taxes are the price the population pays for the public goods and services that government provide. The question is whether the price corresponds to the perceived value of these goods and services (i.e., whether it is 'just'). The less the tax system is seen as just, the more likely they will be to operate undeclared and to break the social contract with the state. To improve compliance therefore, the compliance system must be just. Governments thus need to educate the population about where their taxes are spent and why social security and labour laws prevail. When they do not know, or do not fully understand what public goods and services are provided with their taxes, compliance is lower. In recent years therefore, many governments have begun to pursue education and awareness raising initiatives.

6.4.2.1 Changing the structural conditions



It is not purely changes in the processes of formal institutions which are required to increase voluntary compliance. The broader work and welfare regimes influence the size of the undeclared economy in a economy. Larger undeclared economies are associated with lower levels of GDP per capita, a low quality of bureaucracy and higher levels of perceived public sector corruption, lower levels of expenditure on social protection, less effective social transfer systems and greater inequality and deprivation. Tackling the undeclared economy, therefore, is not solely about changing the penalties and risks of detection, or providing incentives to work in the declared economy. It also requires changes in the macro-level economic and social conditions, if it is to be reduced. Unless this is achieved, there will continue to be an asymmetry between the informal and formal institutions in a economy and undeclared work will remain rife.

7. Policy recommendations and sequencing

Until recently, governments have largely sought to tackle undeclared work by seeking to repress this sphere. Today however, most governments are no longer seeking to eradicate the undeclared economy. Rather, there has been growing recognition across governments that they are seeking to move the undeclared economy into the declared economy (Dekker *et al.*, 2010; Eurofound, 2013; European Commission, 2007a, ILO, 2015; Small Business Council, 2004, Williams, 2006a; Williams and Nadin, 2012a,b, 2013, 2014). The rationale for this shift is several-fold.

For governments, the benefits of moving undeclared work into the declared economy are that it improves the level of public revenue, thus enabling governments to pursue higher expenditure on social integration and mobility projects (Williams and Windebank, 1998). It also enables the creation of more declared jobs and facilitates a joining-up of policy towards the undeclared economy with the policy approaches towards entrepreneurship and social inclusion (Dekker *et al.*, 2010; European Commission, 2007a). Given that a large proportion of undeclared work is self-employment and undeclared work, seeking to eradicate the undeclared economy would result in one hand of government repressing precisely the entrepreneurship and enterprise culture that with other hands they are seeking to foster. Similarly, given that much work in the undeclared economy is composed of paid favours between close social relations conducted for redistributive rationales and to help out others, repressing the undeclared economy would also result in one hand of government eradicating precisely the active citizenship that other hands of government wish to nurture. Seeking to harness endeavour in the undeclared economy by facilitating its transfer into the declared economy, rather than seeking to eradicate it, these contradictions are overcome. There is a joining-up of government policy towards the undeclared economy and policy towards entrepreneurship and active citizenship. It is beneficial not only to governments however, to move the undeclared economy into the declared economy.



For legitimate businesses, it prevents unfair competition and enables the business community to pursue a ‘high road’ rather than ‘low road’ approach by shifting towards greater regulatory standards on working conditions such as health and safety and labour standards (Williams and Windebank, 1998). For undeclared workers meanwhile, the key benefits are that they can achieve the same levels of legal protection as declared workers (ILO, 2015b). For customers, furthermore, the advantages of legitimising the undeclared economy are that such customers benefit from legal recourse if a poor job is done, have access to insurance cover, enjoy guarantees with regard to the work conducted, and have more certainty that health and safety regulations are being followed (Williams and Martinez, 2014c). Across most governments therefore, the aim now is less to stamp out the undeclared economy and more to move the undeclared economy into the declared realm. How, therefore, can this be achieved?

The recommendations for tackling undeclared work is an integrated holistic approach based on a diagnostic of the current character of the undeclared economy in Kosovo* which tackles this by utilising the full range of direct and indirect controls by concurrently pursuing both enforced compliance and voluntary cooperation. In Table 7 and in the second report setting out the recommendations for tackling undeclared work in Kosovo*, the policy measures that are required in Kosovo* to achieve this are outlined.



Table 7: Recommendations

| Recommendation | Goal | Implementation | Responsible Institutions | Outcomes | Indicators of achievement | Start date & duration |
|---|---|---|--|---|--|-----------------------|
| STRATEGIC MANAGEMENT INITIATIVES | | | | | | |
| 1. A holistic integrated strategic approach towards tackling undeclared work. | To enhance the effectiveness and efficiency of the fight against undeclared work by improving coordination across enforcement authorities at the level of strategy, operations and data mining, sharing and analysis. | Establish a coordinating body to take responsibility for joining-up the strategies, operations and data mining, sharing and analysis of all state agencies and social partners involved in the fight against undeclared work. | Cross-government, including Ministry of Labour and Social Welfare, Labour Inspectorate, Ministry of Finance, Tax Administration, Ministry of Trade and Industry, Ministry of Innovation and Entrepreneurship, Employment Agency, Ministry of Culture, Youth and Sports, , and Border Police, plus social partners. | A coordinated national approach towards undeclared work on the level of strategy, operations and data mining, sharing and analysis. | <ul style="list-style-type: none"> • Production of shared cross-cutting strategic objectives and key performance indicators (KPIs) across bodies responsible for tackling undeclared work, in addition to the existing agency-level strategic objectives and KPIs. • Greater proportion of operations and inspections conducted on joint/shared basis. • Implement a joined-up strategic plan on data mining, | Q1 2019 (ongoing) |



This project is funded by the EU

| Recommendation | Goal | Implementation | Responsible Institutions | Outcomes | Indicators of achievement | Start date & duration |
|--|--|--|--|---|---|-----------------------|
| | | | | | sharing and analysis to tackle undeclared work | |
| 2. Modernise the Labour Inspectorate's and Tax Administration's strategic objectives and KPIs in relation to undeclared work | Broaden the responsibilities of the Labour Inspectorate and Tax Administration to include a preventative approach towards undeclared work. | Include as a strategic objective of the LI and TA to 'transform undeclared work into declared work'. | Labour Inspectorate and Tax Administration | Adopt additional KPIs associated with transforming undeclared work into declared work, and preventative measures, which are related to: <ul style="list-style-type: none"> ○ the number of start-up businesses offered advice and/or support on how to operate legitimately, the success of which is measured by the level of customer satisfaction" (grouped by the type of support and advice provided, with the first year used to produce a baseline figure for future years); | <ul style="list-style-type: none"> • The number of start-up businesses offered advice and/or support by the LI and TA on how to operate legitimately; • The number of existing businesses offered formalisation advice and/or support by the LI and TA. | Q1 2019 (6 months) |



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| | | | | <ul style="list-style-type: none"> ○ the number of existing businesses offered formalisation advice and/or support, the success of which is measured by the level of customer satisfaction” (grouped by the type of support and advice provided, with the first year used to produce a baseline figure for future years). ○ x% of legitimized labour relations resulting from the total number of controlled labour relations (with the first year used to establish a baseline figure) <p>These objectives should</p> | | |



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| | | | | be SMART (Specific, Measurable, Achievable, Relevant & Time-bound). | | |
| 3. Improvements in performance measurement | To improve the management-by-objectives approach within the enforcement agencies responsible for tackling undeclared work | <ul style="list-style-type: none"> • Systems should be put in place to share whether the enforcement agency achieves its KPIs in a fixed and easily understood format. Different channels should be used to communicate the results of its performance (e.g., reports and face-to-face information) for different audiences (e.g., staff, the public). • This should be followed up by a cascaded system of top-down and bottom-up dialogues. In doing so, all relevant members of staff and stakeholders are involved, and the main characteristics of these dialogues are: respect and fairness, open dialogue, empowerment, reward and recognition. Decisions taken in the dialogue are implemented, monitored, assessed and (if necessary) revised. • Implementing a system of | Labour Inspectorate, Tax Administration | <ul style="list-style-type: none"> • Better communication of performance both internally within the enforcement agency and to wider stakeholders. • Greater dialogue on the KPIs and management-by-objectives • Evaluation of staff satisfaction integrated into the management process to improve human resource management within the enforcement agencies. | <ul style="list-style-type: none"> • Provision of reports and face-to-face information on performance results. • Evidence of top-down and bottom-up dialogues with staff. • Evidence that decisions taken in the dialogue are implemented, monitored and assessed. <p>Conducting of staff satisfaction survey which evaluates effectiveness of the performance measurement system and dialogue, and displays actions are</p> | Q1 2019 (ongoing) |



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| | | financial appreciation; 1.500 Kuna for every executed proposal of a staff member. <ul style="list-style-type: none"> This should be coupled with a staff satisfaction survey conducted on a regular annual or bi-annual basis, with evaluation and feedback mechanisms of actions taken | | | taken in response to feedback received. | |
| POLICY MEASURES TO DETER UNDECLARED WORK | | | | | | |
| 4. Widening the spread of fines | <ul style="list-style-type: none"> To allow proportionate treatment of cases of different seriousness | <ul style="list-style-type: none"> to widen the spread of fines giving enforcement bodies a broader width of penalties <u>or</u> to make the system of fines less rigid to allow more flexibility and proportionality within the sanction system | Ministry of Labour and Social Welfare | <ul style="list-style-type: none"> Makes sanction system more proportionate; offences of the same seriousness are punished with the comparable sanctions; increases the predictability of the system thus having a better deterrent effect | <ul style="list-style-type: none"> Improved rate of proportionality of decisions by courts. | Q2 2019 |
| 5. Register of employers fined for undeclared work | <ul style="list-style-type: none"> To allow the labour evaluative, | <ul style="list-style-type: none"> To create a public register and to develop criteria for listing offenders To list offenders for a certain period of time | Labour Inspectorate | <ul style="list-style-type: none"> Increases the deterring impact and gives persons, employees and companies the opportunity to decide | <ul style="list-style-type: none"> Usage of register for due diligence purposes by public. | Q2 2019 |



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| | state bodies, employees, and companies to check whether an employer was penalised for undeclared work | <ul style="list-style-type: none"> To consider other implications resulting from listing on the register | | whether they want to do business with persons or companies listed on the register. | | |
| 6. Improve the effectiveness of electronic systems for data mining, data sharing and data analysis. | <ul style="list-style-type: none"> To improve the perceived and actual risk of detection of businesses engaged in undeclared work | <ul style="list-style-type: none"> Akin to proposals on health and safety data, a single centralised database should be created where requests for information on individual businesses or sectors can be sent. A first step is visit to the Grey Economy Information Unit in Finland to gather information on how it works. A plan can then be prepared on the organisation of how such a unit would operate in Kosovo* | MLSW, Ministry of Finance, Employment Agency | <ul style="list-style-type: none"> Join-up the various data-sets and enable more effective data mining, sharing and analysis across government Inspectors will receive better information to plan more effective inspections Inspectors will be able to develop segmentation strategies that focus | <ul style="list-style-type: none"> Improved rate of detection of undeclared work | Q2 2019 (ongoing) |



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| | | | | resources where the risks are the greatest. | | |
| 7. Normative notification letters (using data mining) | To improve the perceived and actual risk of detection of businesses engaged in under-declared employment | Databases should be used to detect businesses perceived to be potentially engaging under-declared workers by identifying ‘outliers’ who have below average wage rates for their sector or size, or occupations employed. These ‘outliers’ should be sent friendly normative notification letters so as to ‘nudge’ them towards legitimacy. The selection of suitable cases should be done by executive personnel and be supported by selection guidelines. This should be initially implemented as a pilot study in a particular sector, industry or locality, and various kinds of notification letter should be used to evaluate which types work and which do not. | Labour Inspectorate and Tax Administration | Businesses paying ‘envelope wages’ will be encouraged to put their affairs in order in a cost-effective manner. Widens tax base | Proportion of businesses contacted that improved their compliance and reported increased wage levels. | Q3 2018 (4 months for pilot study & evaluative) |
| 8. Targeting and planning inspections | To improve the perceived and actual risk of detection of | <ul style="list-style-type: none"> Develop a points-based system for assessing the validity of reported violations, and whether an inspection should take place, supported by data mining. | Labour Inspectorate and Tax Administration | <ul style="list-style-type: none"> Improved rate of detection of labour law violations, tax non-compliance and social insurance fraud. | <ul style="list-style-type: none"> To increase by x% p.a., the number of inspections which are targeted inspections and to | Q3 2018 (ongoing) |



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| | businesses engaged in undeclared work | <ul style="list-style-type: none"> Use the inspectors' time freed from following-up on reported violations by developing a strategic targeted approach towards inspections based on those sectors and business types in which undeclared work is more prevalent. Coordinate inspections between various enforcement authorities targeted at the same business, which would increase impact, and be more business-friendly. | | <ul style="list-style-type: none"> Set a target of conducting x% of inspections based on a more strategic and targeted approach. Set a target of conducting x% of inspections as joint inspections with other inspectorates | <p>decrease the overall percentage of inspections which are responses to reports of violations.</p> <ul style="list-style-type: none"> x% of inspections to be conducted as joint inspections. | |
| 9. Introduce supply chain responsibility in public works contracts | To improve the perceived and actual risk of detection of businesses engaged in undeclared work | <ul style="list-style-type: none"> Introduce into public works contracts awarded a clause in the contract certifying that the winning firm undertakes not to engage any undeclared workers and will put in place measures to ensure that any sub-contractors engaged will not employ undeclared workers. Pilot study within a selected Ministry in relation to public contracts within a relatively well-defined sector in which undeclared work is considered prevalent | Selected Ministry | <ul style="list-style-type: none"> If main contractors are found by the state inspectorates to have engaged undeclared workers in their supply chain, then a ban on bidding for public works contracts could be imposed for a specified period, and they would be removed from the 'white list' (see below). Reduces opportunities | Pilot study introduces this clause into public works contracts and inspections are used to reveal if it is effective in preventing undeclared work in the supply chain. | Q3 2018 (12 months for pilot study and evaluative) |



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| | | | | <p>for undeclared work.</p> <ul style="list-style-type: none"> • Shifts detection of undeclared work beyond solely a state responsibility by involving private businesses in the active detection of undeclared work. | | |
| INCENTIVES TO FORMALIZE: SUPPLY-SIDE POLICY MEASURES | | | | | | |
| 10. 'White list' of legitimate employers (not 'black list') for public procurement contracts | To provide supply-side incentives to engage in undeclared work | <p>All firms who wish to tender for public contracts would have to obtain a 'Clearance Certificate'. This certification could be kept simple and refer to the absence of wage, tax and social insurance arrears, and sanctions imposed in recent years.</p> <p>Pilot study in a selected Ministry in relation to public procurement in a specific industrial sector where undeclared work is prevalent</p> | Selected Ministry | Provides an incentive and positive benefit of being compliant by rewarding those who are compliant with access to public contracts. | Reduction in number of businesses excluded from receiving a 'clearance certificate' | Q3 2019 12 months for pilot study & evaluative) |
| 11. Formalisation and advice to | Make it easier and/or incentivise, established businesses to | <ul style="list-style-type: none"> • Provision of advice and business support to self-employed people and micro-enterprises wishing to undergo | Ministry of Finance, Ministry of Innovation and Entrepreneurship, jointly with employer | <ul style="list-style-type: none"> • Provides an incentive and positive benefit of operating in formal sector. Incentives are provided to facilitate | <ul style="list-style-type: none"> • To increase the share of self-employed and micro-enterprises operating in the | Q2 2019 (ongoing) |



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| business es | operate on a declared basis by offering bespoke formalization support and advice | <p>a transition to formalisation</p> <ul style="list-style-type: none"> Besides advice and support, incentives could be provided, for example promotional aid, training, trade fairs, and facilitation in internationalization of their markets. | associations | entrepreneurs to compete on grounds other than labour cost. | formal economy | |
| INCENTIVES TO FORMALIZE: DEMAND-SIDE POLICY MEASURES | | | | | | |
| 12. Decrease incentives to use cash and increase incentives to use electronic payments to reduce undeclared work | Incentivise consumers to purchase declared goods and services | <ul style="list-style-type: none"> To discourage the use of cash and incentivise an increase in electronic payments, so as to reduce the opportunities for undeclared work, Kosovo* should: (1) implement a lower ceiling on cash transactions, (2) consider discouraging easy access to cash, (3) make point-of-sale (POS) terminals available across all sectors, including the mandatory acceptance of digital payments, with a subsidy for the installation of POS terminals in enterprises with an annual turnover of less than €X operating in sectors with intermediate or high risk of undeclared | <p>Banks Financial institutions All government departments Social partners</p> | <ul style="list-style-type: none"> Tax revenues increase with the growth of the use of payment cards. It is estimated that a discount of X% for customers of the transaction value for digital payments through POS terminals (payment cards and e-money) for the purchase of goods and services, would yield a X% net increase in budget revenues. Subsequently, as the electronic payment | Decreased use of cash and increased use of electronic payments. | Q3 2019 (ongoing) |



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| | | <p>transactions, (4) central and regional governments to shift more fully towards electronic payments, especially with regard to pension payments, and (5) provide incentives for using cards at the point-of-sale. This might involve:</p> <ul style="list-style-type: none"> • A discount of X% for customers of the transaction value for digital payments through POS terminals (payment cards and e-money) for the purchase of goods and services, or • A refund of X% discount for suppliers taking electronic payments through POS terminals for the purchase of goods and services. | | <p>targets are met, and the use of digital payments consolidates as part of the consumer habits, incentives can be gradually withdrawn, resulting in an increase in the fiscal benefit.</p> | | |
| <p>13. Introduce a tax rebate incentive scheme for home owners to receive a rebate of tax when they employ (i)</p> | <p>Incentivise consumers to use declared goods and services</p> | <p>A pilot study should be undertaken in a particular region for a limited range of activities, to be evaluated after 24 months</p> | <p>Ministry of Finance Tax Administration</p> | <ul style="list-style-type: none"> • Offers an incentive to citizens to employ declared workers and raises awareness of the negative effects of employing undeclared workers. • It has a two-fold benefit in increasing | <p>Survey of pilot study to evaluate whether purchasers would have used undeclared work previously to get the work done</p> | <p>Q3 2019 (24 months for pilot study & evaluat</p> |



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| domestic workers, and (ii) registered building contractors or registered tradespeople who provide house repair and renovation services. | | | | income possibilities for registered builders and trades persons and it raises the quality of housing repair and maintenance. | | ive) |
| 14. Service Vouchers for households | To encourage individuals/households to purchase services on a declared rather than undeclared basis. | Provision of service vouchers, a means of payment, subsidised by government, to be used by private users/households to pay an employee for conducting tasks for cleaning, repair, baby sitting. Pilot initiatives should be used in particular localities, or for specific tasks/sectors where undeclared work is prevalent, and ex-ante and ex-post evaluations should be conducted. | Ministry of Finance Tax Administration | <ul style="list-style-type: none"> • Offers an incentive to citizens to employ declared workers • Incentivises working in declared sector as it allows them to gain access to pension benefits, sickness benefits, maternity leave and health benefits (when starts being introduced in Kosovo*). | <ul style="list-style-type: none"> • Number of households purchasing services such as cleaning, baby sitting, etc. The extent to which the service voucher scheme reduces undeclared work/transforms undeclared work into declared work. | Q3 2019 (ongoing) |



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| | | | | | Number of active and employed persons increases (particularly among women) | |
| CHANGING CITIZENS VALUES, NORMS AND BELIEFS | | | | | | |
| 15.Launch of a Public Awareness Campaign on the a) Benefits of Declared Work b) Costs and risks related to undeclared work | Change values, norms and beliefs regarding the benefits of declared work and costs of undeclared work | <ul style="list-style-type: none"> • Target younger people who are more likely to view undeclared work as socially acceptable, as well as perhaps professional groups such as doctors, lawyers and accountants. The media used and messages need to be tailored to these selected groups. • MLSW/LI website use - landing page as part of ministry's website • Materials uploaded to the MLSW/LI website • Materials uploaded to the Social media (FB, YouTube, etc.) • Ensure full awareness about the MLSW/LI competencies vis-a-vis detection of undeclared work and related consequences on | Ministry of Labour and Social Welfare, Labour Inspectorate, other line-ministries (Ministry of Finance/Tax Administration/Customs; Ministry of Innovation and Entrepreneurship, etc.). Selected journalists dealing with social matters with focus on social fairness | <ul style="list-style-type: none"> • Reducing the tolerance of undeclared work will result in lower levels of undeclared work. • The percentage of citizens engaged in undeclared work will fall. • There will be an increase in the number of reports to of non-compliance to inspectorates. • It will widen the tax base • More transparency | <ul style="list-style-type: none"> • Decrease in number of reports of non-compliance to inspectorates • Reduction in tolerance of undeclared work • Decrease in undeclared work | Q1 2019 (at least two times a year) |



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| | | individuals | | | | |
| 16. Educating citizens about the tax system and tax morality | Change values, norms and beliefs regarding the benefits of declared work and costs of undeclared work | <ul style="list-style-type: none"> Send an annual letter to all tax payers which sets out what portion of their taxes is spent on which public goods and services. Introduce signs such as ‘your taxes are paying for this’ on public construction projects (e.g., new roads), on ambulances, in doctor’s waiting rooms, in hospitals and schools. This conveys a clear message to the public that their taxes are being used to pay for these public goods and services. | Ministry of Labour and Social Welfare, Ministry of Finance/Tax Administration/Customs; Ministry of Innovation and Entrepreneurship; Ministry of Trade and Industry in close cooperation with Trade Unions and business chambers and associations | Improved citizens understanding about the relationship between paying taxes and the public goods and services received. | <ul style="list-style-type: none"> Resultant reduction in undeclared work Greater awareness that taxes pay for public goods and services. | Q3 2019 (ongoing) |
| 17. Educate schoolchildren and university students of the benefits of declared work | Change values, norms and beliefs regarding the benefits of declared work and costs of undeclared work | <ul style="list-style-type: none"> Introduce in the civic education curriculum lessons on why people pay tax, the benefits of social insurance and declared work, and the costs of undeclared work. Introduce a national Undeclared Work-week, addressing school children and explaining the benefits of compliance and the costs of being non-compliant. Involve sportspeople, singers or actors in order to have ‘celebrity endorsement’ for a large social | Ministry of Education, Science and Technology, Municipalities, in close cooperation with Labour and Social Welfare, Ministry of Finance/Tax Administration/Customs; Ministry of Innovation and Entrepreneurship; | <ul style="list-style-type: none"> Improved understanding of children and students about the benefits of paying taxes and social insurance, and working declared. Resultant peer pressure on parents from children will reduce undeclared work. | Greater awareness of benefits of declared work and costs of undeclared work among younger people | Q2 2019 (at least once a year) |



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| | | media campaign addressed to young people on the benefits of declared work. | Ministry of Trade and Industry in close cooperation with Trade Unions and business chambers and associations. | | | |
| 18. National competition on why pay your taxes/why work declared | Change values, norms and beliefs regarding the benefits of declared work and costs of undeclared work | <ul style="list-style-type: none"> Use a celebrity role model (for example from sports) to make a social media video on 'why pay your taxes' or 'why reject envelope wages' or 'why work declared' so as to use appropriate role models for the target group for celebrity endorsement. This video will be used to launch a competition for people to make their own video on the subject of 'why pay your taxes'. A prize fund of €20,000 (for 1st, 2nd, 3rd place etc) would be awarded for the best social media (e.g., youtube) video on this subject of 'why pay your taxes'/'why reject envelope wages'/'why work declared'. An additional option is to integrate this competition with the above recommendation to | Ministry of Labour and Social Welfare, Ministry of Finance/Tax Administration/Customs; Ministry of Innovation and Entrepreneurship; Ministry of Trade and Industry in close cooperation with Trade Unions and business chambers and associations. | <ul style="list-style-type: none"> Encourages self-reflection by a wide segment of the target population (e.g., young people) to consider the advantages of paying taxes and disadvantages of failing to do so. Rather than preach messages, it encourages self-reflection and self-education. | Reduced tolerance of participation in undeclared work by the target group. | Q3 2018 |



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| | | <p>introduce this issue in the civic education curriculum. If this is done, schoolchildren can produce such videos in their civic education classes.</p> <ul style="list-style-type: none"> • The sequencing of such a competition with other policy measures below is important. It should be run following, rather than prior to, public institutional reforms to be effective. | | | | |
| REFORMING FORMAL INSTITUTIONS | | | | | | |
| 19. Training of inspectors | Produce more effective trained labour inspectors | <ul style="list-style-type: none"> • There is currently limited official training of labour inspectors on tackling undeclared work. • The LI should make use of the ILO toolkit for the training of labour inspectors in tackling undeclared work. | Labour Inspectorate ILO trainers | <ul style="list-style-type: none"> • Improved efficiency and effectiveness of inspectors in tackling the undeclared economy. • Capacity-building of the inspectorate. • Facilitates organisational culture change towards a more customer-friendly approach. • Monitor via annual staff satisfaction | <ul style="list-style-type: none"> • Improvements in productivity of staff in achieving KPIs | Q1 2019 |



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| | | | | survey | | |
| 20.Modernisation of management processes in bodies responsible for tackling undeclared work | To improve the internal process of the formal institutions involved in transforming undeclared work into declared work | The Labour Inspectorate should request its Minister to write formally to the Regional Cooperation Council requesting a Mutual Assistance Project. This will entail a three-day visit from experts from other economies to help the LI think through the establishment of modern management practices via the review of various performance enablers. The outcome will be a set of recommendations for improving these performance enablers. | LI, Regional Cooperation Council | Improvement in the management and effectiveness of the LI | Mutual Assistance Project (MAP) visit by the RCC and a set of recommendations for improving performance enablers. | Q1 2019 (9 months duration including visit & follow-up visit) |
| IMPROVING THE INVOLVEMENT OF SOCIAL PARTNERS | | | | | | |
| 21.Introduce employer-led voluntary supply chain responsibility initiative | Greater involvement of social partners in the fight against undeclared work | <ul style="list-style-type: none"> In this voluntary employer-led initiative, firms in the supply-chain could be requested to show those higher in the supply chain that they comply with tax and social security obligations through external auditors and/or refer to the absence of wage, tax and social insurance arrears, and | Kosovo* Chamber of Commerce Corporate Social Responsibility Network in Kosovo* | <ul style="list-style-type: none"> Increases detection of undeclared work by involving social partners in its detection. Reduces opportunities for undeclared work. Provides a clear 'demonstration effect' | Successful implementation among a selection of larger employers in Kosovo* | Q2 2019 |



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| | | <p>sanctions imposed in recent years.</p> <ul style="list-style-type: none"> • This might be conducted as a pilot initiative by 10-15 larger employers under the auspices of their Corporate Social Responsibility (CSR) strategy. | | <p>to smaller firms that larger employers take compliance seriously and that they need to similarly do so.</p> <ul style="list-style-type: none"> • Shifts detection of undeclared work beyond solely a state responsibility by involving private businesses in the active detection of undeclared work. | | |
| 22.Provision of one-to-one formalisation advice and support | Greater involvement of social partners in the fight against undeclared work | <ul style="list-style-type: none"> • Use local role models/mentors by developing a ‘buddy system’ whereby legitimate entrepreneurs buddy with younger nascent entrepreneurs to help them legitimise, and provide support and advice on legitimate business development. • Technical assistance could be sought to secure EU funds for this awareness raising initiative. | Kosovo* Chamber of Commerce | <ul style="list-style-type: none"> • Enables business start-ups to do so legitimately • Enables business operating on a partially undeclared basis to receive advice on how they can put their affairs in order. | Successful implementation of mentoring system for younger nascent entrepreneurs | Q3 2019 (ongoing) |
| 23.Awareness raising campaign among | Greater involvement of social partners in | <ul style="list-style-type: none"> • Roadshow via regional branches of Kosovo* Chamber of Commerce • Ensure establishment of strong | Kosovo* Chamber of Commerce American Chamber | <ul style="list-style-type: none"> • Reducing the tolerance of undeclared work will result in lower levels | • Implementation of Roadshow via regional branches of Kosovo* | Q4 2019 |



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| business community of the benefits of declared work | the fight against undeclared work | network for cooperation, exchange of information, full awareness about the MLSW/LI competencies vis-a-vis detection of undeclared work and necessity of increase of social fairness. Support material/presentations for these road shows could be provided by the Tax Administration and/or Labour Inspectorate | of Commerce, Women for Women Association, Sectoral Associations in close cooperation with Ministry of Labour and Social Welfare, Labour Inspectorate, Employment Agency (EARK) other line-ministries (Ministry of Finance/Tax Administration/Customs; Ministry of Innovation and Entrepreneurship, Ministry of Trade and Industry, etc.) | of undeclared work. <ul style="list-style-type: none"> • The percentage engaged in undeclared work will fall. • There will be an increase in the number of reports to inspectorates. • It will widen the tax base • Increase in transparency | chamber of Commerce <ul style="list-style-type: none"> • Number of meetings held and number of participants attending | |

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ANNEX: KEY STAKEHOLDERS CONSULTED

| Name and surname | Institution | Position |
|----------------------------|---|--|
| Mr. Berat Rukiqi | Kosovo* Chamber of Commerce | Senior advisor |
| Mr. Jusuf Azemi | The Union of Independent Trade Unions of Kosova (BSPK) | Head of Trade Union for private Sector |
| Mrs. Leunora Ahmeti Zylfaj | Ministry of Labour and Social Welfare | Head of Division for Work Relations, Social Dialogue, Safety and Health at Work/Department for Labour and Employment |
| Mr. Nahit Sharku | Kosovo* Tax Administration | Deputy General Director |
| Mr. Valon Leci | Labour Inspectorate/Ministry of labour and Social Welfare | Director of Department for Finance and General Services |