

## **Employment and Social Affairs Platform**

# **Policy Brief**

**on**

## **Undeclared work in The Former Yugoslav Republic of Macedonia**

**-evidence and policy recommendations-**

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### **List of abbreviations**

**AIS** - Albanian Institute of Statistics

**GDP** - Gross Domestic Product

**KPIs** - Key performance Indicators

**LFS** - Labour Force Survey

**SSO** - State Statistical Office

**VAT** - Value Added Tax

**WB** - Western Balkans

# 1. Introduction

Undeclared work – work that in itself is legal but not declared to the authorities for tax, social security and/or labour law purposes – plays an important role in all economies in the Western Balkans. This challenge has been recognized both in the national Economic Reform Programmes<sup>1</sup>, prepared annually by the Western Balkan economies as part of their economic governance dialogue with the EU, and the EU strategic documents related to the enlargement process<sup>23</sup>.

In this context, under its Employment and Social Affairs Platform project and in close coordination with Ministries of Labour and Social Affairs, the Regional Cooperation Council (RCC) has commissioned diagnostic reports for each Western Balkan economy, which review and assess in-depth direct and indirect policy approaches with regard to undeclared work and provide rapid appraisal of applicability and transferability of EU policies to the WB6 economies. The insights in these reports will be further discussed in national and regional fora and will provide the trigger for future collaboration and mutual learning in tackling informal employment.

Inspired by the successful experience of the European Platform Tackling Undeclared Work, this work will support the establishment of a WB6 Network for Tackling Undeclared Work, with the immediate objective of enhancing cooperation on tackling undeclared work using a holistic and integrated approach, that joins up on the level of both strategy and operations the policy fields of labour, tax and social security law, and involving social partners.

This policy brief draws on the diagnostic report for the Former Yugoslav Republic of Macedonia and aims to provide information related to the current size, character and drivers of the informal economy in the Former Yugoslav Republic of Macedonia, a summary of policy measures employed so far by the government and outline some key indicative recommendations for policy makers and other stakeholders to better address informal economy.

The aim of this policy brief is to provide information on the extent and nature of undeclared economy in The Former Yugoslav Republic of Macedonia, to discuss policy approaches implemented so far and outline some indicative recommendations for policymakers.

## 2. Evidence and analysis

### 2.1 Informal economy

The reduction of the undeclared economy<sup>4</sup> is a key step in the process of establishment of a predictable and stable business environment, equal opportunities and healthy competition.

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<sup>1</sup> [https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance\\_en](https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance_en)

<sup>2</sup> The communication of the European Commission on a credible enlargement perspective for and enhanced EU engagement with the Western Balkans, 2018 recognizes that economic development in the region is hampered by an entrenched grey economy.

<sup>3</sup> In its Communication on EU Enlargement Policy, the European Commission emphasized that all Western Balkan economies face high unemployment rates and persistently high levels of informal economy (European Commission, 2018)

<sup>4</sup> A widely accepted definition for undeclared work across the European Union is that it covers 'productive activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems between Member States.

Formalization of the undeclared economy can increase the fairness of the taxation system, improve the mutual confidence among the economic actors, the state and the citizens, and increase the tax morale. In addition, it will increase the tax revenues, hence enabling the state and its institutions to provide better quality services and greater social security for the citizens. Facilitating the transition to formality is especially important for the citizens belonging to the most vulnerable categories, which do not have access to social security and employment related benefits, protection of rights and possibilities for career advancement.

There is a large discrepancy in different measures of the undeclared economy. The results from the direct and indirect measures of informality show that the informal economy is in a range of 17-40% of GDP. For instance, Schneider *et al.* (2010)<sup>5</sup>, who provide calculations for the grey economy for 169 economies, estimated the size of the shadow economy in The Former Yugoslav Republic of Macedonia at 35% in 2007. According to this data, the grey economy in The Former Yugoslav Republic of Macedonia is lower than the average in the countries of Europe and Central Asia. On the other hand, Dybka *et al.* (2017)<sup>6</sup> estimate the size of the shadow economy in The Former Yugoslav Republic of Macedonia in 2015 to range between 8.2% and 17.2% of GDP<sup>7</sup>, depending on the method used. Moreover, they show that the undeclared economy decreased since 2007-2008 and conclude that The Former Yugoslav Republic of Macedonia is one of the few economies where the official GDP adjustments for the unrecorded economy are greater than the (estimated) actual shadow economy.

The State Statistical Office (SSO) implements an adjustment to the official Gross Domestic Product (GDP) to cover for the non-observed economy. The adjustments for the non-observed economy have been decreasing from 20.1% in 2008 to 17.2% in 2014 (the last available data).

## 2.2 Undeclared work

**Data from the Labour Force Survey (LFS) of the SSO for the period 2008-2016 indicate the share of unregistered employment in total employment in the country has decreased 28.6% (2008) to 18.1% (2017) (see**

Table 1).

**Table 1. Unregistered employment, figures and trends (population aged 15+)**

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total number of employed	609,000	629,900	637,800	645,100	650,500	678,800	690,188	705,991	723,550	740,648

<sup>5</sup> Schneider, F., A. Buehn and C.E. Montenegro (2010), New Estimates for the Shadow Economies all over the World. *International Economic Journal*, 24(3): 443-461.

<sup>6</sup> Dybka, P., M. Kowalczyk, B. Olesinski, M. Rozkrut and A. Torój (2017), Currency demand and MIMIC models: towards a structured hybrid model-based estimation of the shadow economy size. *SGH KAE Working Papers Series*, No. 2017/030 September 2017.

<sup>7</sup> The estimates presented in their study show shadow economy as % of GDP, where GDP is a sum of the official GDP plus the estimated shadow GDP. On the other hand, most other calculations show undeclared economy as a % of official GDP (or employment).

Total number of informally employed	174,025	169,916	166,814	160,957	146,295	152,805	155,993	140,642	133,777	134,285
Informal employment rate*	28.0%	27.0%	26.0%	25.0%	22.0%	22.0%	22.0%	19.9%	18.5%	18.1%

Source: SSO, Labour Force Survey, different years.

\* The share of unregistered employment in the total employment, defined as workers without formal employment contracts (in registered and non-registered businesses).

Males are more likely to work unregistered compared with females: 20.5% of men in employment compared with 15.4% of women. Undeclared work is highest for the population aged 65+ (who are mainly retired people) and for young persons aged 15-24 (35%). According to the LFS data for 2014, unregistered employment was mainly prevalent in manufacturing (19.3% of total unregistered employment), agriculture (18.5%), trade 13.5% and construction (7%). However, in some of these sectors the prevalence of undeclared work is very high whereas in others it is low (i.e. we need to take into account their respective shares in overall employment). For instance, although manufacturing has a large share in unregistered employment, a small fraction of manufacturing workers is undeclared (4.7%). On the other hand, as much as 64% of the agricultural workers are undeclared.<sup>8</sup> Workers employed in elementary occupations, plant and machine operators and crafts and related workers were most represented among unregistered workers in 2014. In addition, 62% of the workers with elementary occupation were non-registered.

In addition to engaging unregistered workers, without a formal contract, another significant form of informality is the envelope wages or hidden wages. Although it is known that this phenomenon is present, the estimates of its size vary from 8-50%. Most studies find that envelope wages are mainly occurring for low wage workers, further increasing their social vulnerability.

## 2.3 Policy approaches

The policy towards undeclared work in The Former Yugoslav Republic of Macedonia has been mainly based on a repressive approach which is based on a premise that people engage in undeclared work only if the costs of doing so exceed the benefits. The policy measures heavily focused upon a direct controls approach based on deterring engagement in undeclared work by increasing the penalties and risks of detection and were mainly implemented through annual action plans for reduction of the informal economy. The State Labour Inspectorate (under the Ministry of Labour and Social Policy) and the Public Revenue Office (of the Ministry of Finance) were the main institutions engaged in detecting and penalizing the undeclared work and tax evasion. Some general business environment reforms, though, have reduced the costs and increased the benefits of formality (such as **improvement of the tax administration and reduction of tax rates, general decrease of the administrative burden on firms**, etc.), potentially leading to a reduction of informality.

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<sup>8</sup> These data are from LFS but are not regularly published by the SSO. They are though reported in the study of Spitznagel et al. (2016), Annex A5, for year 2014. *Spitznagel, E., Fieldhouse, G., Kearney, B., Gilberg, R., Karchicka-Vasilevska, R. and Georgiev, I. (2016) Report on the Survey on Undeclared Work in Macedonia. Report from a Project "Support to the Fight Against Undeclared Work", funded by the European Union.*

From an institutional viewpoint, there is no single agency or government institution in The Former Yugoslav Republic of Macedonia for tackling informality. Until recently, the situation in terms of the institutional framework was a “departments silos” approach. Although some cooperation existed at the level of operations, and to some extent for data exchange, there were no common databases and/or shared key performance targets and goals. Instead, the departments involved in the fight against undeclared work largely worked separately, with each responsible for their own segment of the undeclared economy. Cooperation increased in 2014, with the adoption of the Law for Prohibition and Prevention of Unregistered Activities, whose implementation requires joined-up approaches between several inspection bodies. Another positive step in this direction has been the establishment of the Inspection Council in 2014 as a coordinating body for all inspection bodies.

A comparative assessment of the policy measures in the economy with those of the EU Member States shows a **narrow range of incentive measures** used in The Former Yugoslav Republic of Macedonia, in contrast to EU countries which focus on changing the ‘benefits’ side of the equation by adopting measures to make it easier and more beneficial to operate in the declared economy. Such approach reflects the **focus upon reducing undeclared work rather than transforming undeclared work into declared one**. Hence, there is a need for a large switch of the government approach from deterrence and penalties towards stimulative measures for purchasers and suppliers of undeclared work to formalize, as well as towards actions that change the values, beliefs and norms of the citizens.

In 2018, the Government adopted the **first Strategy for the Formalization of the Informal Economy**, supported by the International Labour Organization (ILO). The Strategy is a first attempt of the Government to **shift the focus of its actions from reduction of undeclared work to formalization and from deterrence (punishments and detection measures) to measures for enabling compliance**. Currently, the Government (i.e. the working group established for preparation of the Strategy) is developing the action plan for implementation of the Strategy. The strategy also aims to **enhance the coordination and cooperation between the different state agencies**. However, the success of this new approach will depend on the capacity of the newly established Coordinative body (and the Ministry of Labour and Social Policy) to bring together and to coordinate the involved stakeholders, but also on whether the other institutions will prioritize undeclared work over (or at the same level) as their other regular activities.

### 3. Policy implications and recommendations

The most important step in the efforts to address undeclared work is to identify its drivers. 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. The analysis, based on the institutional framework, has shown the importance of the following factors (institutional failings) as drivers of informality in The Former Yugoslav Republic of Macedonia:

- Relatively low level of living standard (measured by GDP per capita);
- Low social protection of workers, and small expenditures on labour market interventions to help the most vulnerable groups;
- Social transfer system is not effective at reducing the level of inequality and severe material deprivation, which includes improving the efficiency of collection;

- Inadequate provision of public services and low quality of those public services (such as education, health, etc.);
- Lack of capacity of formal institutions for enforcement of the legislation and fair treatment of the citizens and companies;
- Low tax morale and high tolerance of informality, which are related to the lack of trust in the government and state institutions;
- High corruption and lower quality of governance.

Based on a multi-stakeholder diagnostic of the causes, circumstances and forms of undeclared work in The Former Yugoslav Republic of Macedonia, and the experience of the EU Member States, we recommend a coordinated and evidence-based approach based on a package of policies that involve: more effective deterrence measures; simplifying compliance to help individuals operate on a declared basis; the provision of various incentives to businesses to operate on a declared basis, 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 on a declared basis.

Within this approach, there are a range of measures that all institutions involved in tackling the undeclared economy should implement. These policy measures that cross-cut all ministries include:

- **Strategic management initiatives:** Implement a holistic integrated strategic approach towards tackling undeclared work; modernise the strategic objectives and KPIs of the main inspection bodies in relation to undeclared work;
- **Policy measures to deter undeclared work:** Improve the legal framework by introducing a definition of undeclared work; set up an Undeclared Economy Information Unit; make greater use of normative notification letters; introduce risk-based approaches in targeting and planning inspections;
- **Supply side measures** such as introducing a ‘white list’ of legitimate employers for public procurement contracts; introducing a system of ID cards for all workers in the construction industry; reversing VAT scheme in the construction industry; removing the barriers to formality by simplifying compliance on tax, labour and social security law, especially among micro and small firms; providing free record-keeping software to businesses and improve the provision of formalisation advice;
- **Demand side policy measures** such as increasing incentives to use electronic payments to reduce undeclared work; introducing a tax rebate incentive scheme for small scale home repairs; using service vouchers in sectors where undeclared work is rife;
- **Reforming formal institutions** through strengthening the human resources of State Labour Inspectorate, training of labour inspectors and reorganization of the Inspectorate;
- **Changing citizens’ values, norms and beliefs**, through for instance public awareness campaigns on the benefits of declared work;
- **Improving the involvement of social partners**, such as through the introduction of an employer-led voluntary supply chain responsibility initiative.

While some of these measures apply only to certain institutions, some of them involve many government institutions and social partners and hence there is a need for large coordination.

#### 4. Research parameters

This brief draws from the undeclared work diagnostic report and action plan for The Former Yugoslav Republic of Macedonia prepared as part of a regional exercise by a team of experts



for the RCC. The methodology includes a review of existing surveys on undeclared work, a desk-based survey of policy measures initiatives to explore the policy instruments used by the government, social partners and employers' organizations, and in-depth interviews with representatives of Tax Administration, Labour Inspectorate, and economic experts.

## References

- Mojsoska Blazeovski, N. and Williams, C.C. (2018) Diagnostic Report on Undeclared Work in the former Yugoslav Republic of Macedonia, Regional Cooperation Council, Sarajevo.
- Mojsoska Blazeovski, N. and Williams, C.C. (2018) Strategy and Action Plan for Tackling Undeclared Work in the former Yugoslav Republic of Macedonia, Regional Cooperation Council, Sarajevo.