

# MONITORING REPORT

## MONITORING THE HIDDEN ECONOMY IN MACEDONIA: TRENDS AND POLICY OPTIONS



CENTER FOR  
THE STUDY OF  
DEMOCRACY



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Monitoring the Hidden Economy in Macedonia: Trends and Policy Options

**Project name: Promoting Good Governance and Economic Rights through Empowering Macedonian Civil Society to Monitor and Tackle the Hidden Economy in Macedonia**

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# Monitoring the Hidden Economy in Macedonia: Trends and Policy Options

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## List of Abbreviations

EU	European Union
FP	Financial Police
GoM	Government of Macedonia
IC	Inspection Council
ILO	International Labour Office
IMF	International Monetary Fund
MLSP	Ministry of Labour and Social Policy
NBRM	National Bank of the Republic of Macedonia
PRO	The Public Revenue Office
SLI	State Labour Inspectorate
SMI	State Market Inspectorate
SSO	State Statistical Office
WB	World Bank

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“Monitoring the Hidden Economy in Macedonia: Trends and Policy Options”

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## Executive Summary

Macedonia features in many discussions as a country with high hidden economy. The European Commission has repeatedly voiced its concerns in its regular country reports about the size and proliferation of hidden economy practices. Hidden employment or undeclared work in Macedonia is of particular concern to the authorities, provided the very high and stubborn levels of official unemployment and low employment levels. However, most studies and research on the matter involve a high level of ambiguity, as they refer to specific narrow outcomes of the hidden economy, usually towards a specific point in time, with dynamics being difficult to trace. The current report proposes a methodology that would allow the **tracing of the dynamics of the hidden economy and its components (e.g. hidden turnover, hidden employment, etc.) over time**. This would make possible for the Macedonian government and its European partners **to follow the impact and assess the effectiveness of their policies** for tackling the hidden economy.

Estimates suggest that the **hidden economy** size in Macedonia **ranges from 24% to 47% of its GDP** according to different measurement methods. But even the most conservative results suggest that it represents a serious socio-economic problem for the country. In times when countries are struggling with post-crisis austerity measures, finding ways to increase government revenues very often leads them to the issue of hidden economy as a potential source of income and a target for new social measures. However, the recent experience in Greece and elsewhere in Southern and Eastern Europe shows that **short term measures for tackling the hidden economy are unlikely to produce tangible results**. This calls for developing a concerted **public-private platform for designing long-term measures** for tackling hidden economy issues and for tracking progress continuously over time.

The current report indicates that the percentage of hidden salaries remains the most acute concern, with the **employment income of some 40% of Macedonian employees being at least partially undeclared**. Moreover, **7% of all Macedonian employees work without a contract**, and are not being paid any social security contributions whatsoever. The interviewed business representatives confirmed wide scale violations of the *Labour Code*. Over half of those respondents claimed that signing contracts with 'hidden clauses' (not accounting for the full remuneration paid out) were commonplace in their sector. Moreover, **large-scale tax evasion seems to continue to pose a serious problem** for the Macedonian economy and social system as the government tries to adjust them in order to be compatible with the principles of the market economy without imposing too extensive erosion of the social fabric and the existing social benefits.

**The most important aggravating factor related to the hidden economy in Macedonia is the decreasing, yet still high unemployment rate (27.3% as of Q1 2015)**. The extremely high rate of long-term unemployment (around 80% of the unemployed) in the country suggests

that a large share of the jobless have to engage in some kind of hidden activity in order to achieve at least a basic level of subsistence. These undeclared workers are most likely to engage in industries and services where transactions are customarily performed with cash in hand payments, including a variety of handicraft services, the green bazaars, etc. The very high share of this subsistence sector of the hidden economy makes it even more difficult for the government to target other forms of undeclared employment, without infringing on the human rights of the former group. Another **strong factor fuelling the hidden economy** seems to be the **contraband and smuggling of goods across borders**, as evident from the mirror statistics accounting. The latter suggests that more than a third of imports are particular trade partners are unaccounted for. More worryingly, research suggests that companies, which have close relations and protection from political and party circles, perform a sizable share of this hidden import.

Official government data demonstrates that **tax compliance of both households and businesses has progressively improved over the past decade**. Still, the CRPM/CSD hidden economy surveys indicate that a third of the interviewed business representatives confirm that, manipulating VAT and other accounting tricks in order to avoid paying taxes are common in Macedonia, on different scales, in their sectors. What is more, taxes are largely avoided by the poorest members of the society, which makes the underprivileged especially vulnerable as they may find themselves being criminally prosecuted for unpaid taxes or charged with paying large penalties. On the other hand, **VAT returns are provided back to companies with significant time lags and represent additional burden for companies** which are part of the formal economy. The issuance of cash register receipts also remains an issue, as **only less than a half of the respondents claimed that they always received receipts** when buying groceries. The situation is similar with the purchase of services.

Persistence of the high share of hidden economy in the Macedonian GDP threatens to heighten social tensions and to create an environment where corruption and other illicit or semi-legal business activities can thrive. In addition, **tax avoidance is especially widespread among the poorest members of the society**, which makes the underprivileged especially vulnerable as they may find themselves being criminally prosecuted for unpaid taxes or charged with paying large penalties. Therefore, it is imperative that the Government of Macedonia continues to pay extensive attention to the resolution of this issue and that it coordinates its activities with the business, the civil society organizations, and other social stakeholders.

In accordance with the initiatives launched by the EU-28 countries in the aftermath of the economic crisis of 2008, the Macedonian government has adopted several measures in order to curb the share of the hidden economy in the country's GDP. These measures take lead from both neo-liberal and social-democratic recipes. For instance, **the government has introduced a flat-income tax rate and adopted laws to simplify businesses' start-up procedures, established a progressive reductions framework for social security contributions**, but it has also brought in progressive minimum wage and subsidies for self-

employers. Furthermore, the government has recently introduced several **public awareness campaigns in order to counter the hidden economy**. Despite some recent measures towards enabling formalization of labour and businesses, **the focus remains predominantly on repressive and punitive measures** which limit the scope and effectiveness of the public policies targeting hidden economic activities.

These newly introduced laws and initiatives have contributed to the decrease of the share of the hidden economy in total GDP, and have also simplified and eased the process of formalization of labour. Notably, the **tax revenues from pension and disability and from healthcare contributions in Macedonia have increased** recently despite decreasing tax rates. Furthermore, half of the interviewed business executives agreed that the current tax system was good and stimulating for the growth of their companies, indicating that the tax simplification reforms and its 'regulative guillotine' were a step in the right direction. To ensure the sustainability of these trends, the government would be advised to introduce regular monitoring and evaluation of the weight of the work of the regulatory agencies on business and household motivations, e.g. how taxes are actually collected and penalties enforced by the tax authorities. Particular attention is warranted towards the work of the customs agency. **Labour inspectorates should be encouraged to make a difference between subsistence and motivational hiding of employment** and act accordingly, balancing law enforcement, incentives, and education.

**The economic growth in 2015 and 2016 will likely reduce the unemployment rate**, which coupled with regulatory reforms targeted at labour policy, taxation, and inspections will affect the extent of hidden economy and, consequently, the risk of poverty and social exclusion that undeclared workers would be subject to. However, the Macedonian government needs to work further on **increasing the institutional capacity of regulatory agencies** to tackle hidden economy activities, and to **improve the overall quality of public goods, including rule of law and good governance**. The latter might be problematic as according to the IMF World Economic Outlook, April 2015 data **general government revenue has been declining since 2000, and has fallen firmly below 30% of GDP after 2011**, which limits the government's capacity to underpin public goods provision with financial means. As expenditures have not fallen as fast as revenues, general government gross debt has increased since 2008, which is likely to squeeze even further the government's room for manoeuvre in the future. Therefore, the Macedonian government needs to resort to smart hidden economy policies, drawing in civil society and business, as well as media partners, and embarking on bold reforms to improve dramatically the efficiency of public goods delivery.

Despite the fact that there is a consensus and often pressure from EU (through the EU Progress reports) for the Macedonian government to proactively fight hidden economy and increase the efficiency of coordination between law enforcement bodies, such policies should be implemented with due care. Various parts of the hidden economy are an essential part of the Macedonian developing economy (i.e. handicraft and subsistence economy,

private lessons of school-teachers, construction works, car repair services, etc.), and as such the government should look into ways to curtail it and limit its negative effects in the long-run, but preserving the source of employment and income, and entrepreneurial activity, which they are in the short run. **The government should aim to tackle black and grey economy harsher, starting with big law-breakers, and leave for longer-term measures and for economic growth to tackle the subsistence (informal) economy, and micro businesses.** Finding the right balance is a delicate and difficult task for the Macedonian government and its partners to perform. Legalization strategies might have a direct positive effect in terms of eliminating non-compliance and tax evasion, but might also scale-down the markets due to increased transaction/compliance costs or provide unjust preference to market players, who are insiders in the law-enforcement circles. So, at the end of the day the social and monetary cost of a programme that reduces the hidden economy in a specific niche might be higher than the cost and negative consequences of the hidden economy itself. The scale of hidden economy indicates **deficiencies in the interaction between public and private stakeholders, ranging from over-regulation, lack of fiscal and tax discipline of enterprises, or complicated business registration mechanisms, to ineffective inspection authorities, and inefficient judicial system.**

While it is evident that the measures the government has adopted recently in order to tackle the hidden economy have had some beneficial effect, this analysis suggests that a multilevel approach should be adopted in order to tackle the negative side effects of undeclared labour even more efficiently. Systematic efforts to utilize the official and unofficial flows of remittances for formalisation of the economy should be part of this multilevel approach. **Improved data sharing and coordination between different governmental bodies and also the civil society organizations are imperative to successfully combating the negative consequences posed by undeclared labour and all facets of the hidden economy.** Working to establish partnership relations with businesses and the citizens would be of particular importance for sustaining successful effects from hidden economy policies. It would also be very important that the government addresses more comprehensively the repeated concerns of the European Commission voiced in its progress reports of the lack of proper formal evaluation of undertaken measures, the continuing coordination issues between different law enforcement agencies, e.g. tax, labour, and customs, the understaffing, and underfunding of labour inspectorates, etc.

**The civil society organizations in Macedonia should also increase their capacity to play a more active role in monitoring, and tackling the hidden economy issues through follow-up and promotion of best practices in the area.** Better results and performance based evaluations of existing policies and further expert research in this area is also necessary in order for short and long-term effects to take place. Taking novel steps and enhancing already established good European practices that improve the general macroeconomic situation of the Republic of Macedonia is and will be the most efficient strategy to curb the hidden economy issue.

## 1. Introduction

Hidden economy is one of many terms referring both in academic and policy discourse to economic activity, which is divergent from the established official rules and procedures for goods and services production, delivery and accounting for. Often adjectives such as “shadow”, “underground”, “informal”, “undeclared”, “grey”, “black”, and “unobserved” are interchangeably used with “hidden” to describe the same phenomenon, the choice of words dependent on various factors often not linked to the etymological meaning. This report uses the term “hidden” economy vis-à-vis other terms for three major reasons: a) it includes a wider spectrum of economic activities – i.e. black/grey markets, informal sector (subsistence production), etc., which better encompass the diversity of reality in countries from South East Europe; b) it employs the Hidden Economy Indexes (population and business) and existing know-how of the Center for the Study of Democracy (CSD) studying the hidden economy in Bulgaria, a country with similar economic characteristics to Macedonia; and c) not to confuse the readers and differentiate from other approaches used to study the phenomenon such as the one used by national statistical institutes, which estimate the “non-observed” economy in GDP through the systems of national accounts.

Undeclared work, tax, health and social security evasion, and fraud, and related corruption (to prevent their detection and punishment) are among the main and most malign manifestations of the hidden economy in all countries. The on-going Eurozone and Greek debt crisis has amplified governments’ interest to tackle the hidden economy and reduce these manifestations. Macedonia and other Western Balkan countries, which have suffered from very high levels of unemployment and poverty, have been particularly affected by these events, with job creation and policies targeting unemployment and fiscal revenues being a major concern and a focal point of governments throughout the region, including in Macedonia. **Low growth prospects in the EU**, the difficult geo-political situation in relation to EU – Russia relations, and the continuing slump in Greece, have been **limiting Macedonia’s opportunities for growth**. Still the prospects for 2015, according to the World Bank and IMF forecasts, are for annual growth of around 3% GDP (2.7% as of Q4 2014). The estimates of the National Bank of the Republic of Macedonia are even higher with forecasted 4% growth rate for 2015 and 2016 (Kadievaska-Vojnovik, 2014), which provide good background for tackling the hidden economy issues. Yet, the prolonged political crisis in Macedonia paralyzed institutions, blocked hidden economy policy plans, and might result in significantly lower growth rate by the end of 2015 and in 2016.

While hidden economy yields various consequences (including sometimes positive in short or mid-term) and its ripples spread across many different social strata, **it always has a particularly negative long-term impact on the societies’ most vulnerable and marginalized groups**. This impact develops further into a vicious cycle, a culture of informality, of ever-increasing lack of trust in the administrative and tax system, insufficient financing of public

goods and services – health, education and security, social exclusion and ghettoization, corruption and inequality. Often seen as an unfortunate side effect of today's economy, "informal economy had become a permanent, but subordinate and dependent, feature of capitalist development (Portes, Castells and Benton 1989),"<sup>1</sup> while producing different scales of hidden economic activity in different societies. In effect, large scaled hidden economic activities undermine the basic values on which democratic societies are built, hence deepening another phenomenon, namely inequality. **"On average, compared to formal workers, informal workers have lower earnings and face higher risks, are less likely to enjoy economic opportunities and legal protections, and are less able to exercise economic rights and collective voice."**<sup>2</sup> If the state does not legitimately restore trust and compliance, often organized crime takes full control and replaces the state in most of its functions, with the respective deviations in their provision. However, an approach encompassing mostly punitive and repressive measures, which apply equally to all economic entities irrespective of their size, turnover etc. will only exacerbate the problem further and make any preventative measures (outreach, enhancing commitment, education) obsolete.

As an EU candidate country, Macedonia must tackle comprehensively the hidden economy and ensure that its policies and measures follow EU's best practices, while at the same time exploring innovative solutions that suit the local context. Accordingly, the Hidden Economy Index (HE index) presented in this report serves as a valuable instrument to assist the creation and monitoring of implementation of appropriate evidence-based policies and measures to tackle the hidden economy. This Hidden Economy Monitoring Report provides a comprehensive analysis of the present status of the hidden economy in Macedonia based on the findings of a Background Analysis about the causes and consequences of hidden economic activities and the Hidden Economy Indexes for population and businesses in Macedonia. Due to the lack of multiannual data for the indexes, the report juxtaposes them with the index value for Bulgaria for 2013, to ensure comparable values. The report aims at aiding policy-makers and stakeholders in Macedonia find viable solutions to the hidden economy issues, with a particular hindsight at the position and rights of the most vulnerable social groups in the Macedonian society. The report's deliberations and findings are based on a variety of sources, including desktop research, original survey data from households and businesses, policy briefs and media notes developed in line with stakeholder workshops, including civil society, media, relevant government institutions, etc. In addition the report has benefited from insights from consultations with stakeholders in forming the **Hidden Economy Task Force on Hidden Economy in Macedonia, which might serve as a viable public-private policy forum on finding solutions and evaluation of policy options in the future.**

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<sup>1</sup> Chen, Martha, Alter (2012). *The Informal Economy: Definitions, Theories and Policies*. Retrieved online on 07.03.13 from: [http://wiego.org/sites/wiego.org/files/publications/files/Chen\\_WIEGO\\_WP1.pdf](http://wiego.org/sites/wiego.org/files/publications/files/Chen_WIEGO_WP1.pdf)

<sup>2</sup> ILO (2013). *Labour inspections and undeclared work in the eu*. Retrieved from: [http://www.ilo.org/wcmsp5/groups/public/---ed\\_dialogue/---lab\\_admin/documents/publication/wcms\\_220021.pdf](http://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---lab_admin/documents/publication/wcms_220021.pdf)



## 2. The Hidden Economy: Overview of Concepts, Definitions and Measurement

The concept of 'hidden economy' is not new to the Macedonian public and academic sphere, although the term itself has not been used to date. The most widely used term is 'grey' or 'informal' economy, used by the state institutions in the strategic documents (Action Plans), the media, and most of the academia. It is defined as 'economic activities which are legal, but are (intentionally) unregistered and not recorded for tax purposes.'<sup>3</sup> Yet, many business-led international usage of "grey" economy refers to the situation and markets, where products are being imported legally and sold by paying all due taxes to the government, but outside and in violation of product manufacturer's distribution channels (for more information see Sugden, 2009). With the gradual improvement of intellectual property rights system in Macedonia it is expected that "grey" would be much more used to denote such "parallel" imports and merchandise unofficially.

At the same time, informal economy seems to innovate constantly by adding new forms of informality, which gradually institutionalize and turn into new formal businesses. The current hype of "sharing economy" is in the middle of such processes for companies like Uber, Airbnb, HomeJoy, Snapcar, and TaskRabbit. Critics say that they simply provide technology and face-saving for informal workers. In the past governments decided to legitimize a lot of informal workers by asking them to pay a simple patent tax. In reality nobody knew the actual volume of economic activities and thus they remain somewhat hidden and only estimated, but to an extent accounted to the GDP. An example of emerging new form of informal economy activity is playing games that can earn virtual money (e.g. Bitcoins<sup>4</sup>), which in turn could be exchanged to virtual products or services, which cost to other players real money. Some governments already started to tax such earnings or at least the backward exchange of virtual money to cash (in case the player made a profit). So, we are tempted to leave informal economy for reference to economic activities outside the common formal organizational boundaries and existing sectors/markets.

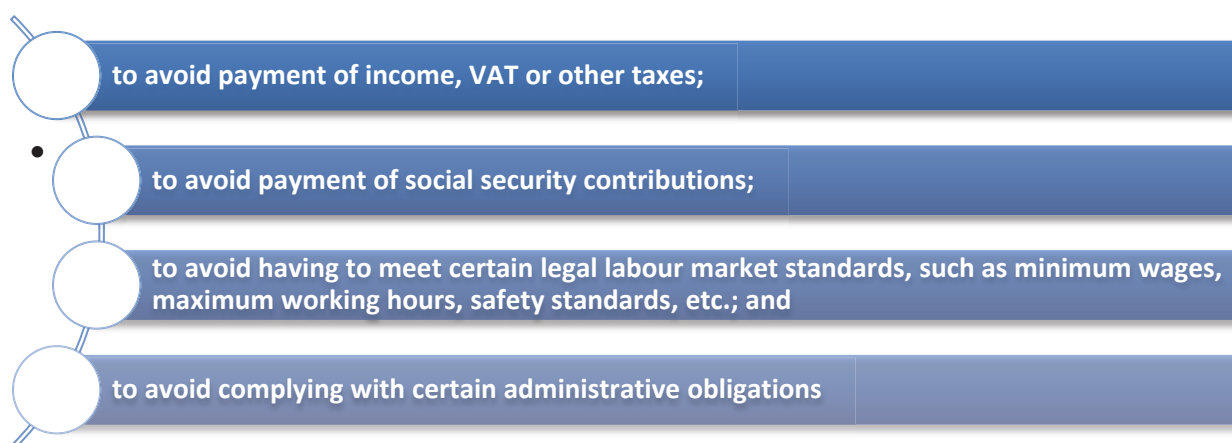
Overall, a wide variety of terms and definitions have been put forward by economists and policy makers throughout the relevant literature depending on the institutional perspective they have. The socio-economic phenomenon has been given a wide array of labels, including informal, unofficial, unregistered, irregular, shadow, hidden, underground, black, illegal, illicit, deviant, grey, parallel, unobserved, unrecorded, undeclared, non-compliant economy, with an even wider reference within each language. While all terms and definitions touch upon similar or the same general matter of un-recorded economic activities, they each differ slightly depending on their purpose and form. For example the European Commission focuses more on undeclared work, which is defined as **"any paid activities that are lawful as**

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<sup>3</sup> Grey Economy Action Plan 2014, MLSP, 2013

<sup>4</sup> Check what Bitcoins are at: <https://bitcoin.org/en/>

regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States.”<sup>5</sup> This definition covers diverse activities while excluding criminal activities. The World Bank’s model of informality<sup>6</sup> identifies the causes and composition of the hidden economy. Some of the field’s main authors, such as Schneider and Williams (2013), state that the shadow economy: “includes all market-based production of legal goods and services that are deliberately concealed from public authorities for the following reasons:



Source - Schneider, Friedrich; Williams, Colin “The Shadow Economy,” The institute of Economic Affairs 2013, pp 23-27, Retrieved on 01.06.2014 from: <http://www.iea.org.uk/sites/default/files/publications/files/IEA%20Shadow%20Economy%20web%20rev%207.6.13.pdf>

Feige (1979), who was among the first to academically study the issue, talks about the underground and irregular economy. Different schools of thought recommend different methods - direct and indirect for measuring the hidden economy. The most prominently used are listed in Table 1.

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

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

In the case of estimating the hidden economy worldwide and in Macedonia, there is a prevalence of **indirect methods**. Most researchers and institutions have been focusing their attention to the two-sector dynamic general equilibrium model<sup>7</sup>, Electricity Consumption

<sup>5</sup> European Commission Communication COM(2007) 628 final. Retrieved from: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0628:FIN:EN:PDF>

<sup>6</sup> Chen, M., A., *The Informal Economy: Definitions, Theories and Policies* (2012). Retrieved online on 07.03.13 from: [http://wiego.org/sites/wiego.org/files/publications/files/Chen\\_WIEGO\\_WP1.pdf](http://wiego.org/sites/wiego.org/files/publications/files/Chen_WIEGO_WP1.pdf)

<sup>7</sup> Elgin, C. and Öztunali, O. (2012) *Shadow Economies around the World: Model Based Estimates*. Istanbul: Bogazici University, Department of Economics.



Method (ECM)<sup>8</sup>, Multiple Indicators – Multiple Causes (MIMIC)<sup>9,10</sup>, and the supply-demand method of using adjustments of national GDP for non-exhaustiveness as a measure for estimating the non-observed economy (NOE)<sup>11</sup>. **Direct methods**, on the other hand, have been represented by intermittent country-level direct population surveys<sup>12</sup>, enterprise surveys<sup>13</sup>, and the Labour Force Survey<sup>14</sup>. Although generally academic researchers tend to favour indirect methods and heavily criticize direct methods, the think tanks and policy makers tend to prefer direct methods as they provide more timely information, which seems more accurate than projections for current year based on delayed data from several years ago. Direct methods, although subject to a lot of debates if respondents provide reliable and valid data and what characteristics of this complex social phenomenon should be measured, have indispensable strength – they could quickly provide sound empirical evidence if a particular reform adds up to hindering the hidden economy.

Participation in the hidden economy has somewhat different motivation, rationale and patterns depending on whether we consider businesses (even unregistered) or individuals (employees). Morris and Polese (2015) provide various country case studies of why firms and people enter, stay or exit hidden economy. Fajnzylber and Maloney (2007) provide arguments why in certain cases firms have higher productivity when working in the shadows and that in order to move them out of there the policy response should be sequenced to provide for higher productivity in the formal economy. **Firms usually have stronger bargaining power vis-à-vis workers and they dictate the decisions and undeclared or hidden work is linked with hidden revenues in order to guarantee unreported cash to pay the salaries.** However, in particular periods combination of exogenous factors (i.e. change in legislation or pressure by inspection authorities) with endogenous ones (workers prefer lower official net wage as this would allow them to take (higher) credit/mortgage). These factors lead to decreasing the levels of hidden labour in Bulgaria just after the accession to EU. However, in certain cases hidden labour is not just exit from the formal market, but rather exclusion (Perry, 2007) and result of social embeddedness (White, 1992). So, policy makers need to have indicators, which could account for the perspective – if it is individual or business and partially to detect the rationale for engaging with different hidden economic activities This is achieved in the current report through implementing two indexes of the hidden economy – based on the business perspective (for index structure see Box 1) and based on the citizens' perspective (for index structure see Box 2), which are employed in the current report.

<sup>8</sup> Garvanlieva, V., Andonov, V., Nikolov, M. (2012) *Shadow Economy in Macedonia*. Skopje: Center for Economic Analyses

<sup>9</sup> Ibid,

<sup>10</sup> Schneider, F., Buehn, A. and Montenegro, C. (2010) *Shadow Economies All over the World. New Estimates for 162 Countries from 1999 to 2007. Policy Research Working Paper 5356*. Washington D.C.: World Bank Group.

<sup>11</sup> SSO

<sup>12</sup> Stankovic, M. and Stankovic, B. (2012). *Social and economic aspects of the shadow economy in the Republic of Macedonia: A study*. Social Science Research Network [Online]. Available from: <http://ssrn.com/abstract=2162922> (Accessed 30 June 2014).

<sup>13</sup> World Bank. (2014) *Enterprise Survey 2013. Country Profile Macedonia*. Washington D.C.: World Bank Group.

<sup>14</sup> State Statistical Office (SSO)

Box 1 - Structure of the Hidden Economy Index (business).

1. **Size of the hidden economy** – this index summarizes subjective perceptions of business owners and executives of the scope of the hidden economy in the country as a whole, and within their sector of economic activity. It includes two sub-indices:
  - 1.1.subjective assessment of the share of the hidden economy in the country as a whole;
  - 1.2.subjective assessment of the share of the hidden economy within their sector of economic activity.
2. **Hidden labour relations** – reflects the practice of employing workers without formal contracts, or under contracts which do not reflect actual remuneration. It has two sub-indices:
  - 2.1.the share of employees without a contract in the respective sector;
  - 2.2.the share of the employees under contracts with “hidden clauses” in the respective sector (envelope wages).
3. **Hidden turnover** – captures the extent to which different ways for hiding turnover are prevalent in the respective sector of economic activity. The index includes the following sub-indices:
  - 3.1 not issuing of receipts for certain sales in the respective sector;
  - 3.2 reporting lower than the actual revenues in the respective sector;
  - 3.3 reporting lower than the actual profit in the respective sector;
  - 3.4 illegal import/export in the respective sector.
4. **Hidden re-distribution** – covers the businesses’ practice of hiding/not paying taxes, duties, and/or excises, as well as VAT fraud using accounting tricks. It is comprised of the following two indices:
  - a. hiding/not paying taxes, duties, and excises in the respective sector;
  - b. VAT fraud in the respective sector.

Source - Center for the Study of Democracy (CSD)

Box 2 - Structure of the Hidden Economy Index (population).

1. **Hidden employment** – this index summarizes employment victimization in terms of major ways to hide taxes and social and health security at the expense of both the state and the worker. It includes three sub-indices (undeclared work, hidden social security and hidden health security):
  - 1.1. Undeclared work places
    - 1.1.1. Share of employed without formal contracts
    - 1.1.2. Share of employed with hidden clauses
  - 1.2. Hidden social security
    - 1.2.1. Share of employed without social insurance
    - 1.2.2. Share of employed with partially hidden social insurance
  - 1.3. Hidden health security
    - 1.3.1. Share of employed without health insurance
    - 1.3.2. Share of employed with partially hidden health insurance
2. **Hidden turnover** – captures the extent to which documents and fiscal receipts are not being issued on purchase. The index includes the following sub-indices:
  - 2.1 frequency of not issuing of tax receipts for certain larger sales;
  - 2.2 frequency of not issuing of tax receipts for certain services
  - 2.3 average-weighted frequency of not issuing fiscal receipts for purchasing certain groups of goods from retail shops.

Source - Center for the Study of Democracy (CSD)

### 3. The Hidden Economy in Macedonia in Context

During the past 24 years, the Macedonian economy experienced a strong but often chaotic development of SMEs, which led to the adoption of a variety of new, often confronting and vague, measures and policies, especially in terms of laws that govern the economy. The law enforcement and judiciary are key factors to effective functioning of the market economy. Slow justice and family or political linkages of top law enforcement officers with top businessmen created circles of untouchables over the years. Citizens distrusting the government and its social services and earning wages which were insufficient to accumulate substantial savings, preferred to receive informal payments instead saving on social and health insurance payments. All these factors, coupled with normal business drive to minimize cost of doing business gave rise to the hidden economy in the country. The hidden economy in Macedonia has been further augmented after the 2007 global economic crisis as citizens have been spiralled into a tight squeeze of finances. Subsequently, Macedonia has experienced lower per capita foreign direct investment compared to other countries in the region, lowered credit availability, and a large trade deficit; therefore, people have been incited to migrate to the hidden economy in order to sustain their incomes, resulting in pressure on the unemployment rate<sup>15</sup>.

Depending on the method applied, the hidden economy in Macedonia varies from 24% of GDP by using the ECM method (Electricity Consumption Method) (CEA, 2012), through 30% of GDP according to the Ministry of Economy (using LFS estimates presented by Novkovska, 2013<sup>16</sup>), to a staggering hidden economy estimate of 46.9% as a

**“The biggest problem when reporting about the hidden economy is the inability to obtain official statistics and data regarding this problem. Also, only a small portion of the affected (institutions, employers, workers) are willing to openly discuss this topic. Usually, the answers we get from the state institutions are too general and can be rarely used as a reliable indicator of the real situation.”**

share of GDP by using the MIMIC method (Multiple Indicator Multiple Causes), (CEA, 2011). Using ECM method the Centre of Economic Activity (CEA) assesses that there are around 70,000 people actually working but registered as unemployed in Macedonia. The first and foremost reason for using ECM is because electricity consumption in a country is generally assumed to be proportional to total economic activity. This means that the growth of total electricity consumption is an indicator for growth of overall (official and unofficial) GDP. As a result, changes in the electricity consumption which do not correlate to changes in the total

<sup>15</sup> Nikolov et al. 2012, *Shadow Economy in Macedonia*, Centre for Economic Analysis (CEA)

[http://www.cea.org.mk/documents/studij/CEA%20SHADOW%20ECONOMY%20IN%20MACEDONIA%20FINAL\\_4.pdf](http://www.cea.org.mk/documents/studij/CEA%20SHADOW%20ECONOMY%20IN%20MACEDONIA%20FINAL_4.pdf)

<sup>16</sup> Novkovska, B. (2008) Measuring Non-standard and Informal Employment in the Republic of Macedonia. Paper presented at the workshop *Measurement Informal Employment in Developed Countries WIEGO*, Kennedy School of Government, Harvard University, 31 October – 1 November 2008. Retrieved from:

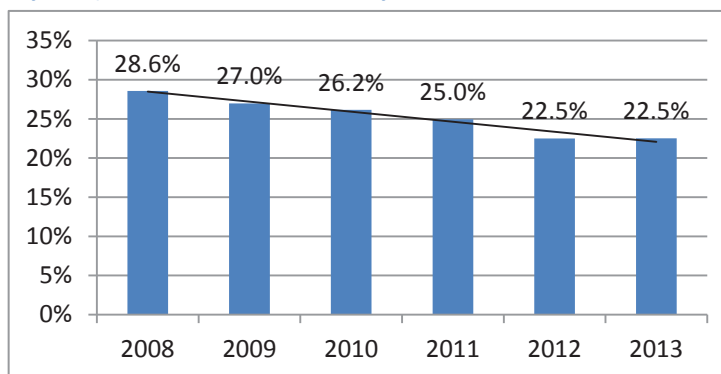
[http://wiego.org/sites/wiego.org/files/publications/files/Novkovska\\_Measuring\\_informal\\_empl\\_Macedonia.pdf](http://wiego.org/sites/wiego.org/files/publications/files/Novkovska_Measuring_informal_empl_Macedonia.pdf)

economic activity of the country signify a proportional change in the size of the hidden economy within the total economic activity. Yet, the method might have structural deficiencies, as it does not account for energy efficiency rates and developments over the years, neither effectively distinguishes by different energy intensity of sectors and households and businesses.

Taking aside the discrepancy between the results produced by these methods they all show that the share of hidden economy is substantial and systemic and that it should be simultaneously tackled and monitored. **A striking majority of 73.9% of firms report that they compete against unregistered economic entities (and hence all employed in them would contribute to the hidden labour) and 54.9% report that the informal sector competitors represent a major constraint on the growth of their business (World Bank, 2000).** The unregistered economy, which is operating completely outside of the books signals complete distrust in formal institutions and provides examples where Coasian firms' and markets' boundaries blur to be distinguishable only to long-term insiders in the absence of any state. From a policy perspective it is priority to first incorporate businesses, have labour contracts registered and then consider incentives for higher tax compliance.

Participation in hidden economy has somewhat different motivation, rationale and patterns depending if we consider businesses (even unregistered) or individuals (employees). Morris and Polese (2015) provide various country case studies of why firms and people enter, stay or exit hidden economy. Fajnzylber and Maloney (2007) provide arguments why in certain cases firms have higher productivity when working in the shadows and that in order to move them out of there the policy response should be sequenced to provide for higher productivity in the formal economy. Firms usually have stronger bargaining power vis-à-vis workers and they dictate the decisions and undeclared or hidden work is linked with hidden revenues in order to guarantee unreported cash to pay the salaries. However, in particular periods combination of exogenous factors (i.e. change in legislation or pressure by inspection authorities) with endogenous ones (workers prefer lower official net wage as this would allow them to take (higher) credit/mortgage. These factors lead to decreasing the levels of hidden labour in Bulgaria just after the accession to EU. However, in certain cases hidden labour is not just exit from the formal market, but rather exclusion (Perry, 2007) and result of social embeddedness (White, 1992). So, policy makers need to have indicators, which could account for the perspective – if it is individual or business and partially to detect rationale for engaging with different hidden economic activities. This is achieved through implementing two indexes of hidden economy –

Figure 1 - Observed informal employment (as % of total employment y-o-y basis) Source: Labour Force Survey 2013, State Statistical Office

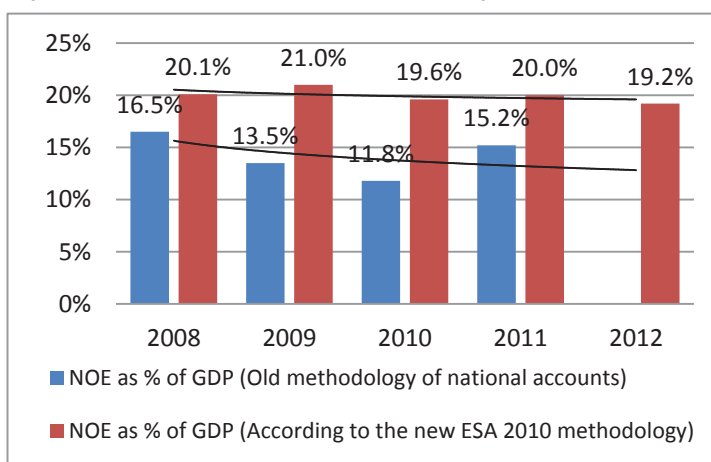


based on the business perspective (for index structure see Box 1) and based on the citizens' perspective (for index structure see Box 2).

As research (AT Kearney, 2014) has shown a strong correlation between the country's tax rate and its scale of hidden economy, the Government of Macedonia in 2007 and 2008 decided to adopt a flat tax rate system, where personal income taxes were lowered to 12% in 2007 and further down to 10% in 2008 across the board for all income groups. Even though the hidden economy as a share in GDP, as assessed by most academic research, remains high, there are assessment, such as that of Garvanlieva et al (2012) that the effects of this particular measure have been: improved tax discipline, increased simplicity of the tax system, and better business environment, increased attractiveness for FDIs, increased contributions to the budget, and overall downward pressure on the hidden economic activities. The downside though can be the longer-term erosion of government's tax receipts. Data has shown that the total government revenues as a share of GDP have continuously declined in Macedonia since 2002, which cripples the authorities' long-term capacity to deliver public services effectively. This is particularly likely to emerge in periods of prolonged growth stagnation.

According to the Labour Force Survey 2013 conducted by the SSO, the hidden employment as a percentage of the total employment as of 2013 stood at 22.5% (Figure 1). SSO uses hidden employment to encompass all undeclared employees (those without social and legal protection coverage), regardless if they work in: regular firms, un-registered or un-incorporated entities, own-account enterprises or in the household sector. The hidden

Figure 2 - Non observed economy (NOE) in Macedonia 2008-2012, as % adjustment of annual GDP. Source: SSO GDP Reports



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

employment steadily decreases over the past few years, an indication of labour crossover towards formalization of employment. Given the recent economic crisis and its prolonged impact, fears over an increase in undeclared economy emerged. However other estimates confirm that "the current economic crisis has not reversed the previous trend of an on-going incremental decline in the size of the undeclared economy as a proportion of GDP" (Williams and Renoy, 2013).

The SSO has also detected a decrease in Non-Observed Economy (NOE). However by using the new ESA 2010 methodology of national accounts **NOE shows a flatter trend line that remained around 20% of GDP** throughout the period 2008-2012. NOE refers to all productive activities that cannot be enveloped by the by the basic data sources which are

utilized for assembling national accounts. These activities include: underground, informal (including activities performed by households aimed at their own final use) illegal, and other activities which are omitted due to deficiencies within the basic data collection. The non-observed economy (NOE) is probably the closest term to the hidden economy compared to all others, however the national statistical offices are usually pressed to under-estimate it due to different reasons: **first**, politically if the estimates are large enough the opposition would criticize the government for not effectively managing the tax authority, **second**, for EU member states higher non-observed economy will mean higher payments to the EU budget, **and third**, the probability that the citizens would not believe the higher growth rate that a higher non-observed economy entails.

In accordance with the data provided by the NBRM the average participation of cash in the money mass of the country in the period of 2001-2010 was set at a staggering 44%. According to NBRM, in 2012, 79% of the value of total transactions performed with payment cards were attributed to cash withdrawals from ATMs<sup>17</sup>. **Cash provides anonymity during payment transactions and cannot be tracked thus becoming a powerful tool and stimulator of hidden economy.** Prevalence of cash on the other hand, due to lack of judicial protection of business entities, avoidance of obligations among economic entities, and inefficient reimbursement mechanisms, conditions the companies to demand and fulfil payments by using cash<sup>18</sup> (Nenovski, 2012).

The World Bank (Hudson et al., 2012) estimates that Macedonia's informal competition in the hidden economy is nearly 20% more than the average in Southeast Europe. The report suggested that hiding is inversely related to regional inspections and bank credit. Other factors, besides inspections and bank credit, such as the exogenous factors as increases in political instability, logistical problems and problems related to obtaining various permits, all tend to increase the problems caused to the hiding firms. Yet, not all hiding firms are equal, as Yalamov (2012) shows for Bulgaria - endogenous firms to political circles actually are more often (successfully) hiding and circumventing regulations. Not-connected firms will pay bribes in order to get things done, which are taken for granted by the connected firms. There are no reasons to doubt that Macedonian politically connected firms would differ from this pattern. **The large share of hidden import for Macedonia (between 20 to 33% of import from important trade partners) suggests strong capturing of the Customs Administration Agency in the interest of politically linked importers.** They in turn finance political parties/patrons re-election; however this is usually cheaper than the bribes paid by not-connected firms.

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<sup>17</sup> [http://www.nbrm.mk/WBStorage/Files/WebBuilder\\_Prezentacija\\_Strategija\\_PS\\_2013\\_2017.pdf](http://www.nbrm.mk/WBStorage/Files/WebBuilder_Prezentacija_Strategija_PS_2013_2017.pdf), p.20

<sup>18</sup> Nenovski, Tome; (2012) "The Grey Economy in Macedonia: Macroeconomic Aspects, Implications and Possible Problem Solutions", (20 Journal of Sustainable Development, Vol. 5, Issue 10, March 2014. Retrieved from: <http://www.fbe.edu.mk/JoSDv10.pdf>



Table 2 - Comparing measures of the hidden economy

Country	Informal:		Characteristics	Informal:	
	Competition %	Impact Average		Competition %	Impact Average
Albania	48.7	2.06	Young	41.9	1.57
Bosnia & Herzegovina	48.8	1.35	Not Young	45.4	1.57
Bulgaria	48.7	1.67	Small	50.8	1.69
Croatia	40.0	1.48	Medium	42.8	1.60
Fyr Macedonia	69.6	2.08	Large	39.0	1.35
Hungary	51.6	1.45	Foreign	36.0	1.17
Kosovo	63.2	1.55	Group	43.4	1.37
Moldova	37.5	1.69	Rural	45.4	1.54
Montenegro	32.7	0.95	Town	44.8	1.57
Romania	34.3	1.40	Large Town/City	45.0	1.61
Serbia	53.6	1.61	High exports	26.6	1.06
Slovak Republic	37.4	1.29	Medium exports	41.9	1.45
Slovenia	24.2	1.06	Low exports	47.6	1.65
Ukraine	41.5	1.78	All firms	45.1	1.57

Source: World Bank (2012) *Evaluating the Impact of the Informal Economy on Businesses in South East Europe* <http://opus.bath.ac.uk/31397/> Date accessed 29 June 2015.

Looking at a wider regional context estimations indicate that the shadow economy in Macedonia is the highest in the region. Schneider et al (2010) argue that with regards to Eastern European and Central Asian (mostly former transition) countries ‘the size of government and the fiscal freedom variable (both capturing the overall state burden), are highly statistically significant causes’ for the shadow economy rate, as well as the inflation rate, the growth rate of the total labour force and the growth of GDP per capita. However, the economic freedom was found to be negatively correlated with the shadow economy rate in these countries. Finally, analysis indicates that ‘a reduction of the regulatory burden and improvement of business/economic freedom in transition and OECD countries leads to a much higher reduction of the shadow economy than it would in developing countries’.<sup>19</sup>

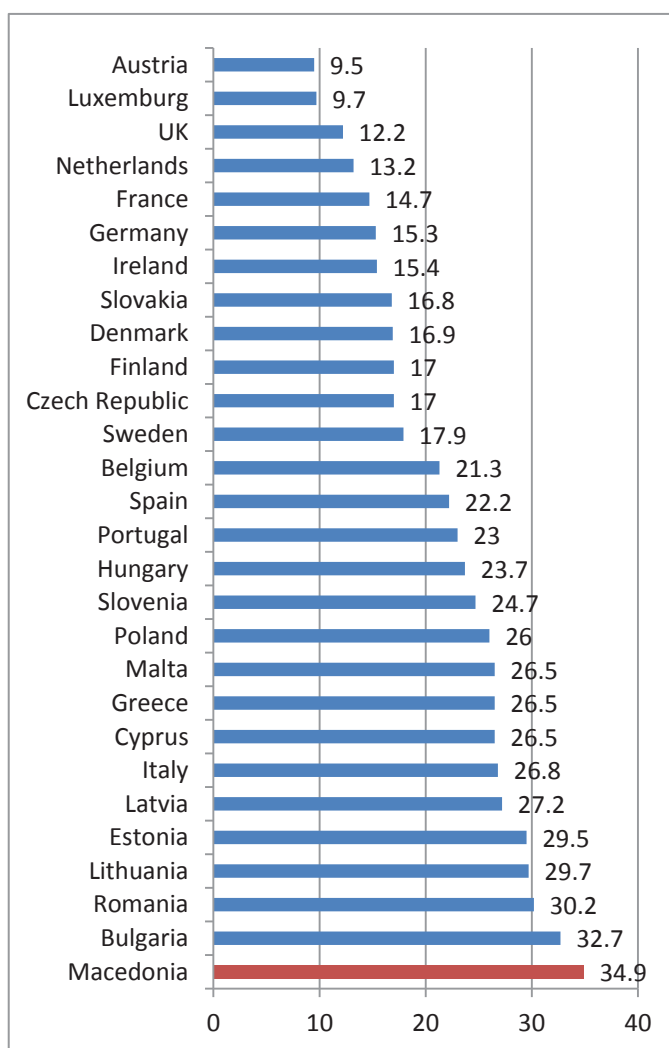
The Eurofound (2013) analysis notes that Schneider’s method provides only ‘relative values, with the help of the currency demand approach for a few countries (Austria, Germany, Poland and Switzerland)’, which have been then calibrated into absolute ones.<sup>20</sup> However, they use Schneider’s data to compare the undeclared economy for Macedonia in with its EU-27 counterparts. Data indicate that Macedonia lags behind all EU-27 countries, although Bulgaria and Romania are very close.

<sup>19</sup> Schneider, F., Buehn, A. and Montenegro, C. (2010) *Shadow Economies All over the World. New Estimates for 162 Countries from 1999 to 2007. Policy Research Working Paper 5356*. Washington D.C.: World Bank Group.

<sup>20</sup> Eurofound (2013), *Tackling Undeclared Work in FYR Macedonia*

As Macedonia looks to integrate with its European neighbours, ‘the informal economy is a very important challenge’, according to the European Commission, which has a candidate status for Macedonia<sup>21</sup>. Tackling the informal economy is a key priority in order for Macedonia to make steps towards accession as the existence of a considerable informal sector leads to major distortions in the economy<sup>22</sup>, and in turn could be used to fuel political instability in favour of different political options.

Figure 3 - Size of undeclared economy, as a % of GDP  
Source: Schneider, (2011); according to Eurofound, 2013



<sup>21</sup> EU Inside, 2014, <http://www.euinside.eu/en/news/western-balkan-countries-suffer-high-unemployment-lack-of-reforms> Date accessed 30 June 2015.

<sup>22</sup> European Commission, 2006, *Country profile: Macedonia* [http://ec.europa.eu/enlargement/candidate-countries/the\\_Former\\_Yugoslav\\_Republic\\_of\\_Macedonia/economic\\_profile\\_en.htm](http://ec.europa.eu/enlargement/candidate-countries/the_Former_Yugoslav_Republic_of_Macedonia/economic_profile_en.htm) Date accessed 1 July 2015.

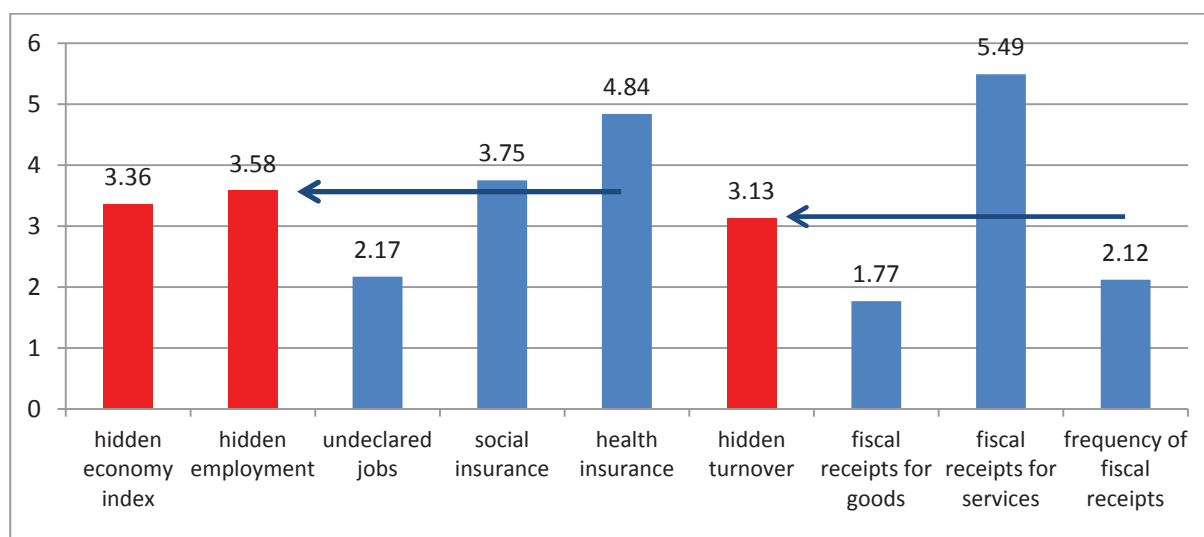


#### 4. The Hidden Economy Surveys and Indexes: Results for Macedonia

Based on the comparison of the Hidden Economy Indexes' value for the population and the business, citizens assess the prevalence of hidden economy (index of 3.36) higher than the business owners and managers (index of 2.73). This was also the case in Bulgaria in 2003 and 2009 as well, which were two of the most beneficial years for the economy of that country for the first decade of the century. **The greatest contribution to that difference comes from hiding in the service economy and from not paying in full health insurance contributions.** Citizens are aware and accept the widespread hidden economy as inevitable part of everyday life; they appreciate its negative impact to the local economy and that it spurs unfair competition. **They also consider bribing as a generally tolerated behaviour, and that it is one of the factors for the prevalence of hidden economy.**

As expected, businesses' perceptions of the hidden economy levels in Macedonia vary significantly when they refer to their own sector and on the national level. Firms give lower estimates on hidden economic activities within their own sector compared to the national level. The sub-index for the size of the hidden economy based on assessments of the national economy ( $i=3.98$ ) is more than 1 full index point higher than the assessments based on individual branch (sector of economic activity), indicating closer assessments between the sector and economy as a whole, as compared to Bulgarian indexes (where the discrepancy is higher or close to 2 index points). While the sub-indexes for hidden labour assessed by business are very close to each other, **the citizens' sub-indexes exhibit a strong discrepancy between health security avoidance and undeclared jobs, with the former being the most avoided obligation.**

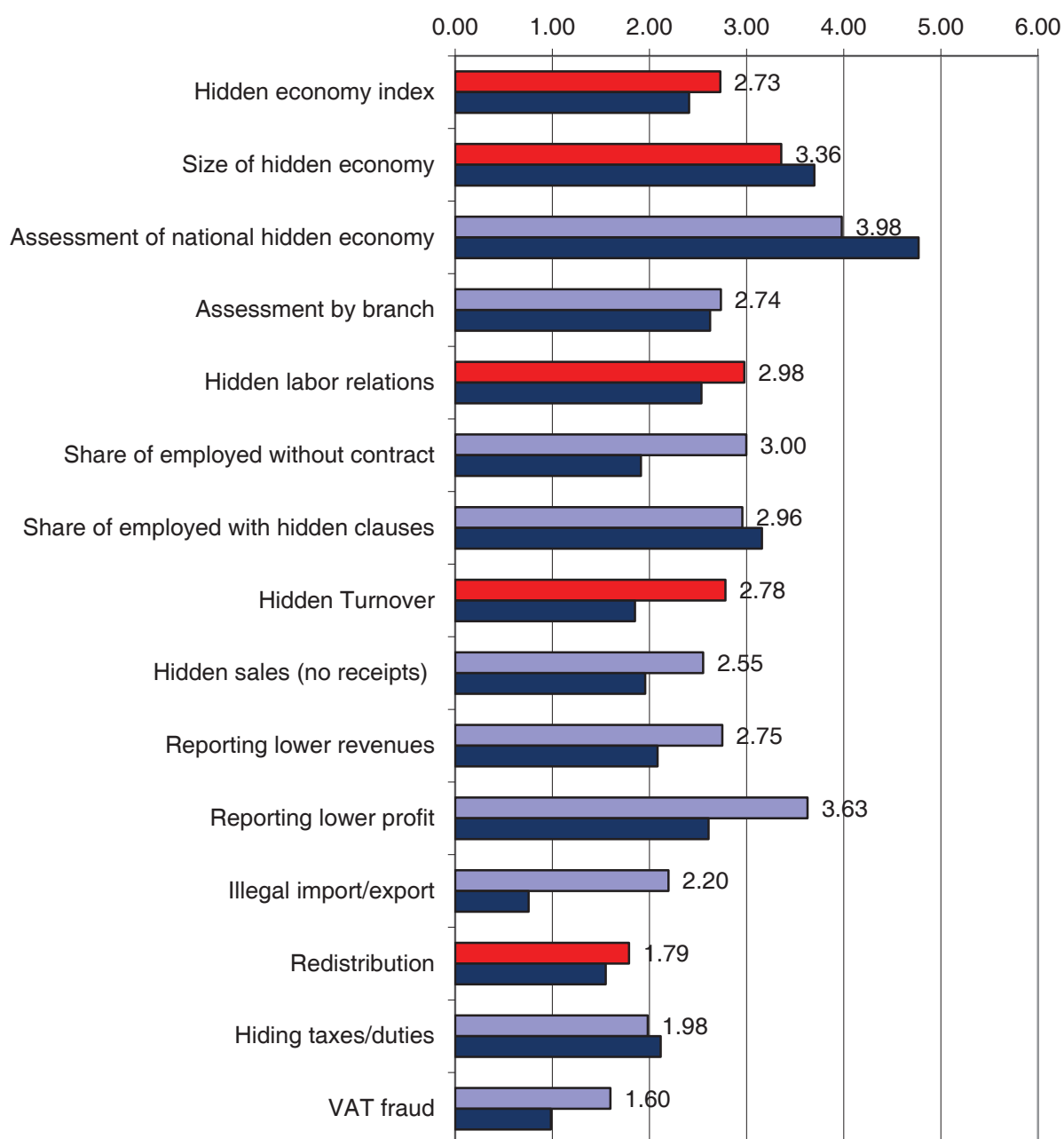
Figure 4 - Hidden economy index and sub-indexes (population)  
Source: National representative population & business survey, October, CRPM 2014



Note - The red bars refer to the index and two of its sub-indexes. The blue bars refer to sub-sub-indexes.

In both cases - business and citizens, the hidden labour sub-index is higher than the total index, indicating that the undeclared labour is considered the most serious hidden economy factor in the country. In addition, the situation seems worse in the eyes of the population, vis-à-vis business owners and managers. This comes as a no surprise since people usually tend to perceive themselves as victims or losers from the lack of social protection, while many businesses see hidden employment as a way of reducing labour costs.

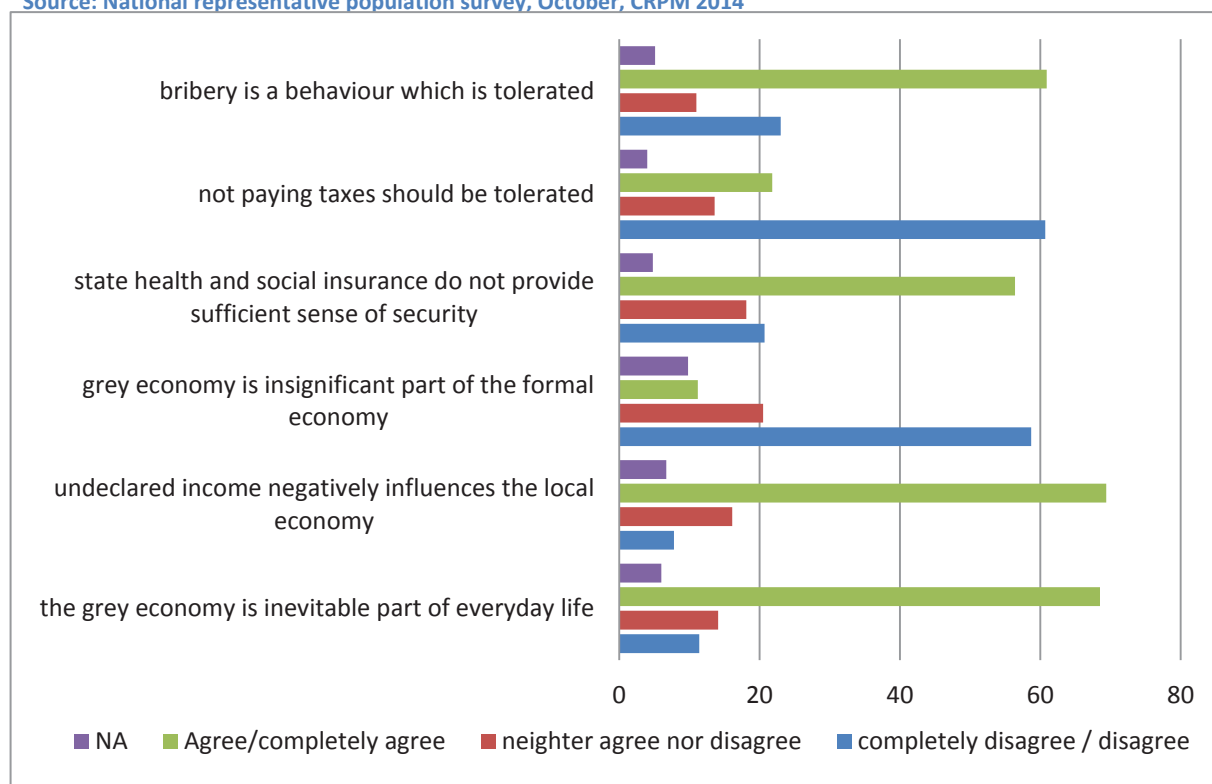
Figure 5 - Hidden economy index composition in comparative perspective with Bulgaria (business).  
Source: CRPM and CSD



Note: Dark-blue bars refer to Bulgaria, October 2013

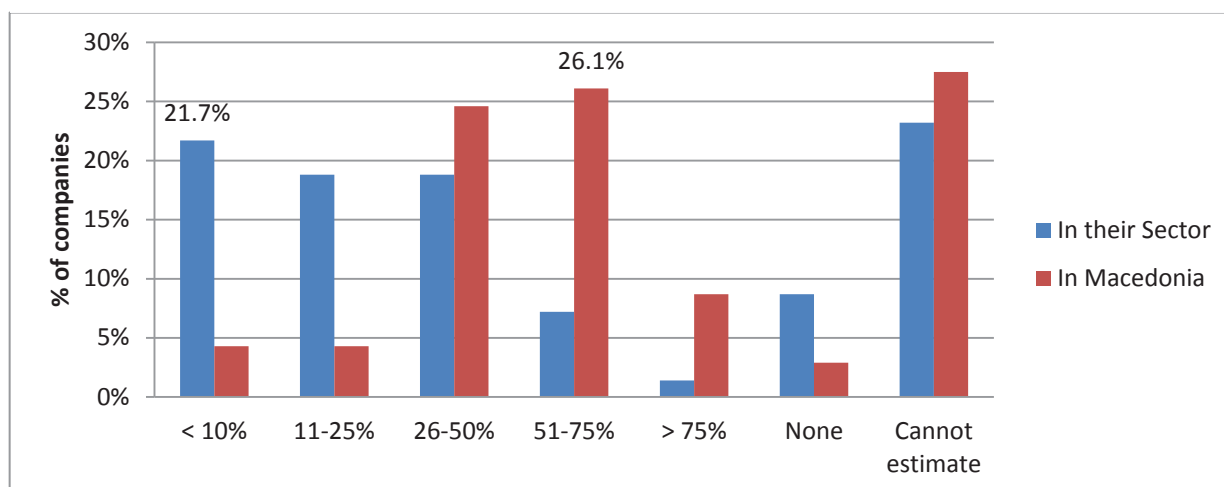
Figure 6 - Level of agreement of citizens with issues related to hidden economy (population).

Source: National representative population survey, October, CRPM 2014



While the majority of respondents (more than 60%) believe that not paying taxes should not be tolerated, still every fourth, a comparatively high share of the population, considers it should be tolerated. This opinion is related to the **belief that the grey economy is an inevitable part of everyday life (68.5% of the population)** and to the fact that majority of respondents consider the state health and social insurance as not providing sufficient sense of security (56.4% of the population). **Hence people consider the act of contributing to these funds through tax coercion as unjust.**

Figure 7 - Estimates of respondents about the size of the hidden economy on the level of their respective business sector and the national level (business). (Q. C13\_A). Source: National representative survey, October, CRPM 2014 (business).



The introduction of the 10% flat rate for the income tax in 2008 coincided for Macedonia and Bulgaria. But the respective reduction in hidden employment could be attributed to the

flat rate only in Macedonia. For Bulgaria the respective reduction in overall hidden economy was rather achieved through the introduction of a mandatory registration of labour contracts in the National Social Security Institute since the beginning of 2003 and the setting of minimal social security thresholds, which reduced tax evasion (Nonchev et. al., 2011).

## 5. Hidden Employment

The structural unemployment from the transition period after the 1990s and the long-term unemployment steadily of about 80% of unemployed, continues to be a problem for citizens and policy makers. As of 2014, the unemployment rate has decreased to 27.6% (265,370 people), with a tendency to decrease further, yet citizens (57% of them) believe this is the major problem Macedonia faces these days. The low income and, related to that, poverty come at around 40%.

Despite a significant decline (from 36.0% in 2004 – Figure 8), unemployment, especially at this scale, represents one of the most significant factors in generating hidden economic activities – people are desperate to get a job, no matter what contract and if at all there will be contract. **Only 2.7% of respondents explicitly stated that hidden economy is a problem. While all state unemployment as the biggest**

**problem**, logically, the unemployed and those coming from poorer families are primarily concerned with unemployment, while the employed, on the other hand, complain on low income and people with relative high income are concerned with political instability, ethnic problems and corruption. Even within the context of the economic crisis of 2008, the unemployment rate has decreased by 6.2% in the years since, showing an increased capacity of the Macedonian economy to absorb new workers and consequently offer better conditions for crossing over from the informal to the formal economy.

Despite the numerous strategies of lowering the unemployment rate, the total long-term unemployment each year since 1996 remains above 80% (83%, 2013 est. – Figure 9). Similarly, youth unemployment (ages 15-24) remains high, at 50.4% of total unemployment in 2014, with a tendency to decrease further. According to the latest data from the SSO, the youth unemployment in Q1 of 2015 dipped below 50% of total unemployment for the first time in 17

Figure 8 - Unemployment rate in Macedonia (in %). Source: SSO

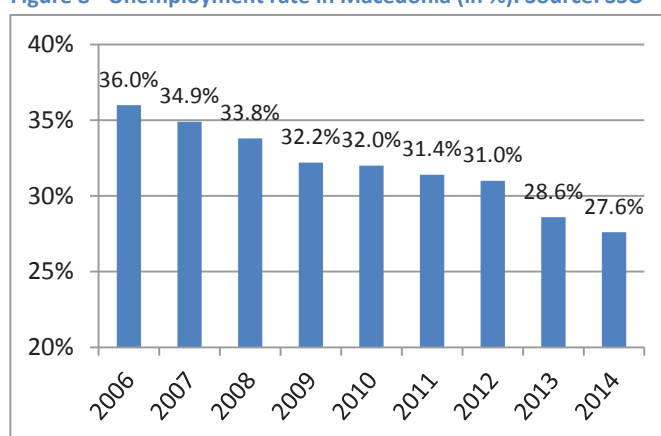
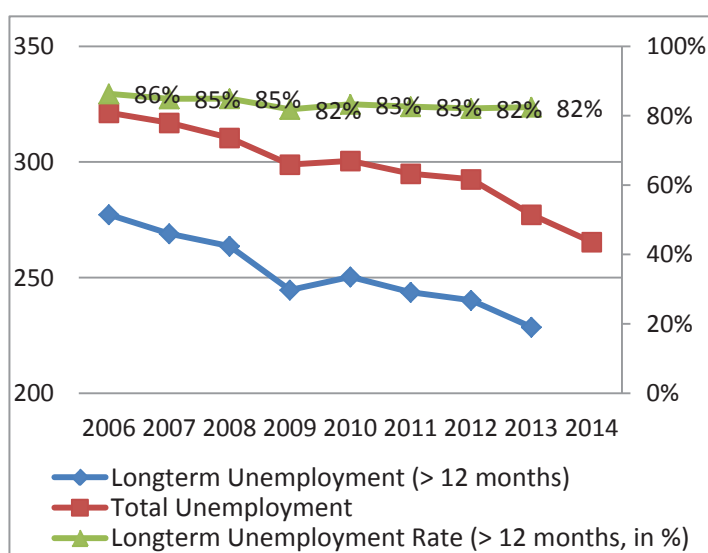


Figure 9 - Structure of unemployment. Right axis (%) for long-term unemployment rate. Source: SSO

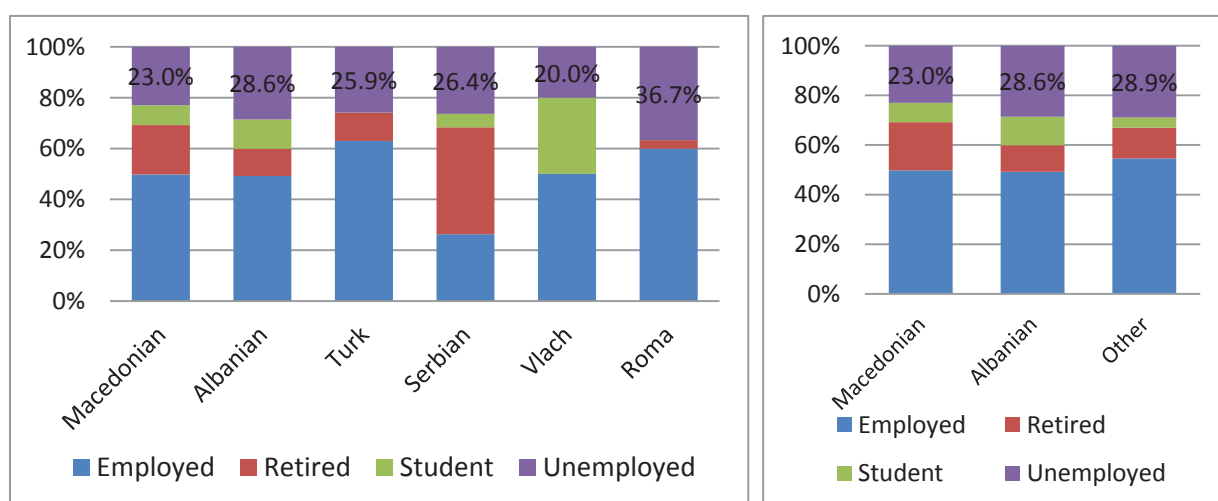


years.<sup>23</sup> In contrast, total seasonally adjusted unemployment rate, long-term unemployment (as % of total unemployment) and youth unemployment in EU28 countries in 2014 was 11.5% (Q3), 48.7% (Q1), and 21.6% (Q3) respectively.<sup>24</sup>

In Q3 2015, there were several measures designed by the Employment Agency of Macedonia in cooperation with the Ministry of Labour and Social Policy (MLSP) targeted at tackling the high rates of long-term and youth unemployment by offering special benefits for businesses that will employ from within these categories of workers. However, it is too early to estimate how well the program is doing or the interest of businesses to employ such type of labour.

Figure 10 – Economic activity by ethnic structure (population).

Source: Population survey CRPM 2014 (1116 respondents)



The CRPM survey supplements the SSO lack of data on ethnicity in relation to unemployment by providing empirical assessment of ethnic vulnerabilities in the Macedonian labour supply. Analysing the structure of the unemployed according to ethnic background (see Figure 10) one can observe higher unemployment rates (28.6%) and students (11.5%) among the ethnic Albanians than Macedonians (23% and 7.8% respectively) whereas close to half of both communities stated that they were employed at the time of the survey. These figures are not far from the rates indicated in the SSO statistics on the national unemployment rate (27.3%). **The ethnic Turks seem to carry the highest levels of employment (63%) and the Roma the highest rates of unemployment (36%).** However, it is difficult to produce substantiated arguments for the rest of the ethnic groups due to their smaller sample frequency.

In a situation where there is high unemployment rate, any job position is welcomed regardless of the working environment and respect of labour rights. Hence, workers tend to accept various labour arrangements in short-run that go against their interest, at least in the long run, such as working without a job contract or with a contract with ‘hidden clauses’.

<sup>23</sup> State Statistical Office (SSO), Press release on Macedonian labor market (09.06.2015). Retrieved from: <http://www.stat.gov.mk/PrikaziSooptenie.aspx?id=98&rbr=1710>

<sup>24</sup> Eurostat News Release, 01.07.2014, Euro Indicators October 2014. Retrieved from: <http://ec.europa.eu/eurostat/documents/2995521/6033691/3-31102014-BP-EN.PDF/fb5a7034-d11b-498c-b997-43a691c85c8f>

While the lack of contracts was rarely noted in the population survey regarding the primary occupation, it was rather common in relation to secondary occupation. Hidden clauses contracts, on the other hand, were more prominent when referring to second jobs.

Nearly half of all survey respondents (48%) indicated they were employed with a primary occupation. The vast majority of them (84%) have a written job contract with the employer, while **6.6% reported they work without a contract** and 9% are self-employed. Typically, **those working without a contract are employed in the private sector**<sup>25</sup>. Those who have an additional paid job besides their primary occupation represent 11.8% of the population and out them **7.9% confirmed that they work without a contract** and 1.5% are self-employed. In contrast, the latest 2013 figures about Bulgaria for example show that 4% with primary employment and 32.2% with secondary employment work without a contract (see Table 2).

Table 3 - CSD survey data (2003-2013) about hidden economy trends in Bulgaria (In %), (population).

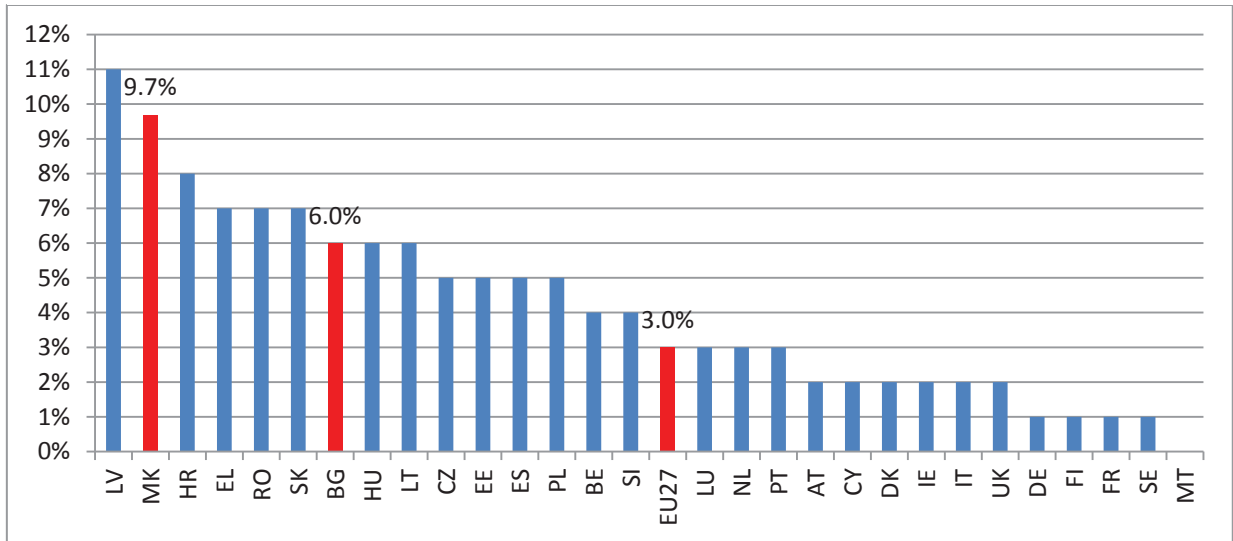
	2003	2004	2008	2009	2010	2012	2013
Without labour contract - <b>primary</b> employment	6.0	5.9	5.6	5.9	3.4	3.0	4.0
Without labour contract - <b>secondary</b> employment	77.4	59.1	51.5	51.0	38.1	29.0	32.2

Additionally, more than half of the interviewed employers (all from the private sector) for the business survey confirmed that in the sector they operate, there are employees working without a contract, though the estimated percentage differs widely, ranging from 5% to 50% of the employees. While one-third responded that this happens all the time or in most cases, 30% claimed it happens sometimes, while one-quarter that this does not happen in their sector. **In general, it is obvious that this practice is not unusual among companies, although its scope is difficult to determine (also because the business sample does not include unregistered businesses).**

<sup>25</sup> Sometimes employed in the public sector work in the shadows, because it is formally forbidden to have a second job – policemen, teachers, etc.

As ‘envelope payments’ represent another characteristic of hidden labour, respondents of the population survey were also asked whether during the past month they have received part of the salary on their banking account. Substantial **9.7%** would have received ‘envelope

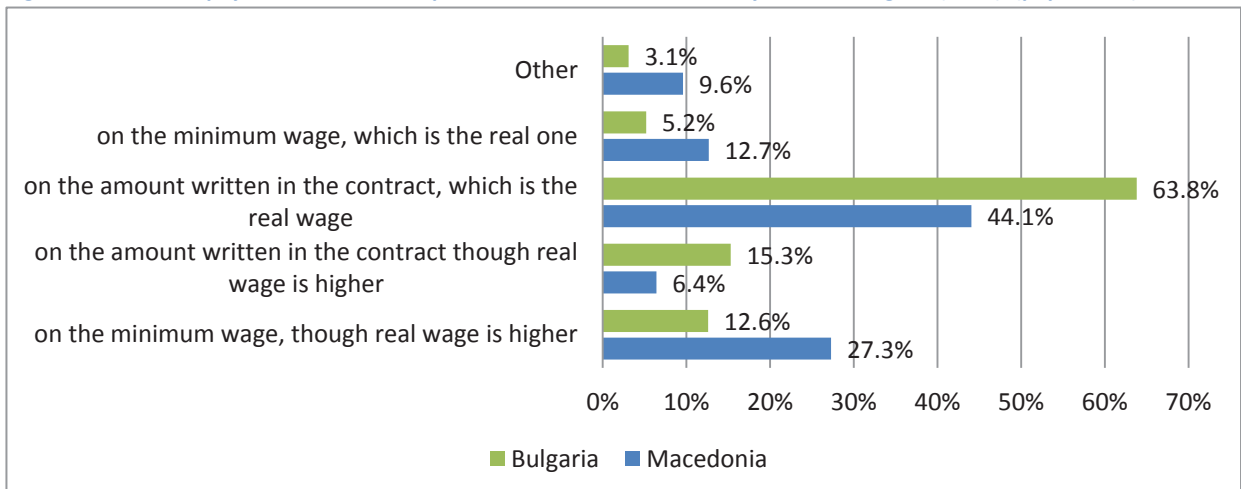
Figure 11 - Employees who received all or part of their wages in cash in the past 12 months in 2013 for EU27, and past 1 month in 2014 for MK (population). Source CRPM/CSD Survey 2014 and Eurofound 2013 survey [http://www.eurofound.europa.eu/sites/default/files/ef\\_files/ewco/surveyreports/EU1404011D/EU1404011D.pdf](http://www.eurofound.europa.eu/sites/default/files/ef_files/ewco/surveyreports/EU1404011D/EU1404011D.pdf)



payment’, yet the reported amounts varied greatly, ranging from 500 to 25.000 MKD (from 10€ to 400€), with the majority receiving 2.000-6.000 MKD in cash (from 30€ to 100€). Contrasting these numbers with the average net salary in Macedonia (21.217<sup>26</sup> MKD or 345€), the conclusion is that the majority of ‘envelope payments’ range from **9.4% to substantial 28.3% of the Macedonian net average salary.**

Furthermore, comparing to envelope wages of other countries in the EU<sup>27</sup> (Figure 11) Macedonia with its 9.7% of the population receiving all or part of their pay as an envelope wage is the second worst performing EU country, and has three times higher rate of the EU-27 average (3%). **Even when compared with countries from the region (Croatia, Romania, and Bulgaria), Macedonia still has a substantially higher rate of persons with envelope payments.**

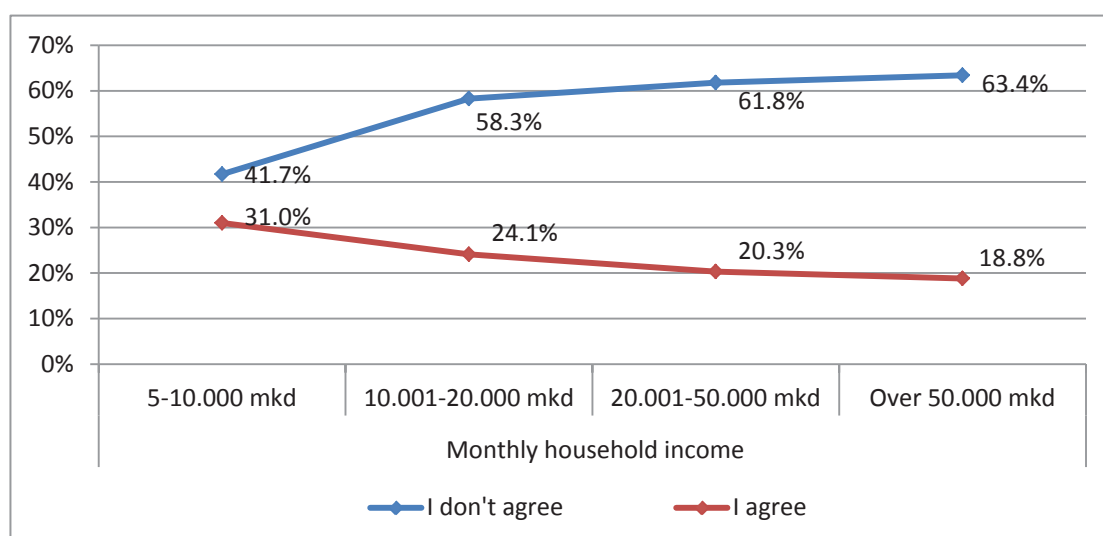
Figure 12 - Basis for payment of the social/pension insurance vs. CSD survey data for Bulgaria (2013), (population)





As these figures seem overly underestimated even for EU countries and especially countries with large immigrant employment (often partially or entirely hidden) as France, Germany and UK or seem not to account for tips at all (and tips might be substantial part of the wages in certain sectors). Bearing in mind the sensitivity of the issue, another formulation was used as a control question, i.e.: ‘What is the basis for your social/pension insurance payments?’ responses indicated a much more concerning trend. Specifically,

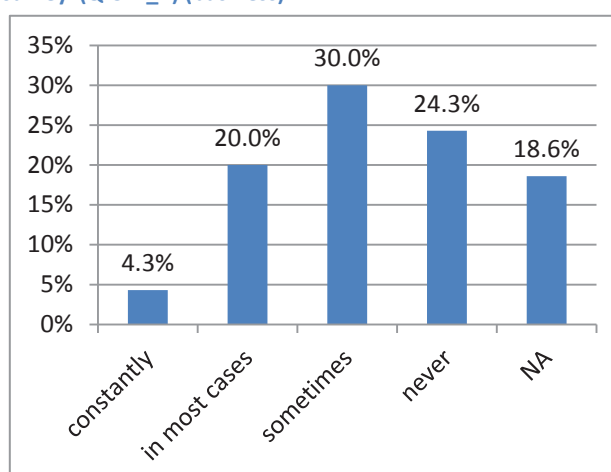
**Figure 14 – (Dis)agreement with the statement ‘I would rather be an undeclared worker with a higher wage, than a declared one with a lower wage’ and monthly family income (population). FX rate 1 EUR = 61.5 MKD**  
 Source: National Population Field Survey, conducted during 10/2014 with a representative sample size: 1116 respondents.



**27.3% reported to have their social/pension insurance paid at the minimum wage level (which in 2014 was 8.800 MKD or 143€), although their actual wage is higher, and 6.4% on the basis of the sum included in the job contract, although their actual wage is higher** (see Figure 12). Considering that the sum on which social security contributions are paid should correspond to the sum transferred to a certain bank account, it is assumed that the remaining of the salary has been paid in cash or through a temporary service contract. **This indicates that the proportion of employees receiving envelope payments, including the additional temporary service contracts as an instrument of avoiding social security contributions, is about one-third of the employed population.**

The rather concerning indicator on incomplete social security payments, combined with the notion that 7% of respondents (almost exclusively from the private sector) reported that their pension insurance is not being paid at all, indicates that **the salary of about 40% of employees with a primary employment is partially or completely hidden/undeclared.** Interestingly, even half of respondents who declared

**Figure 13 - Signing of contracts with 'hidden clauses', business survey (Q.C12\_B) (business)**



themselves as self-employed do not pay their social insurance contributions based on the actual wage received. The reasons could be based on the notion that social insurance contributions are too high, which is shared among 40% of company representatives surveyed.

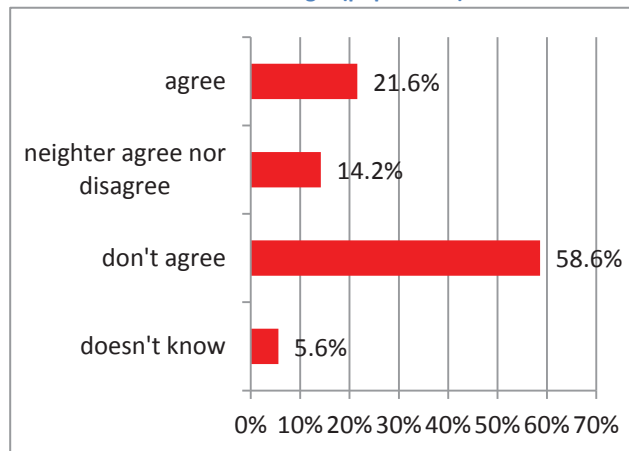
The practice of **signing contracts with 'hidden clauses'** was also confirmed by company representatives, half of which noted that it happens in their sector and **encompasses from 5% to 50% of employees**, depending on individual observations. Overall, more than half of employers responded it happens in most of the cases or sometimes, a fact indicating the issue is quite prevalent among Macedonian companies.

Whatever the motivation for such decisions, the reason for this situation does not only lay within employers, but also employees. Assessing their level of agreement with different statements related to the hidden economy, it is evident that the current level of satisfaction with the wage for many workers is much more important than the long-term security implied with the social insurance. Specifically, **21.6% responded that they would rather be an undeclared worker with a higher wage** (see Figure 15).

Specifically, **21.6% responded that they would rather be an undeclared worker with a higher wage** (see Figure 15).

This opinion, however, appears to be related to the financial situation of the individual/family. Individuals assessing themselves as poor were more likely to prefer a higher wage than a socially secured lower wage, compared to the ones assessed as being in the middle or rich. Observed through the family income lenses, respondents with a monthly income of 5.000-10.000 MKD were more likely to accept undeclared work than

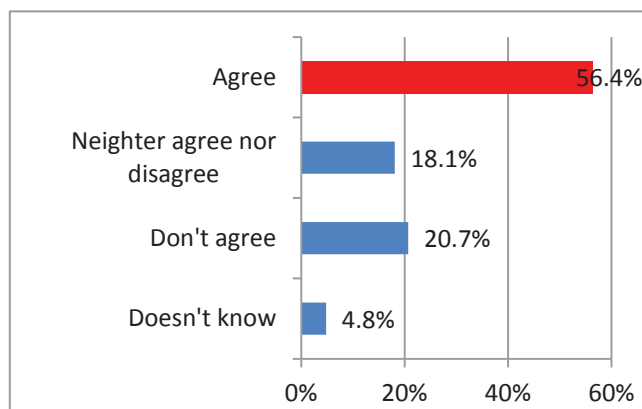
Figure 15 - Level of agreement with the statement 'I would rather be an undeclared worker with a higher wage, than a declared one with a lower wage' (population).



Source: National population field survey, conducted during 10/2014 with a representative sample size: 1116 respondents

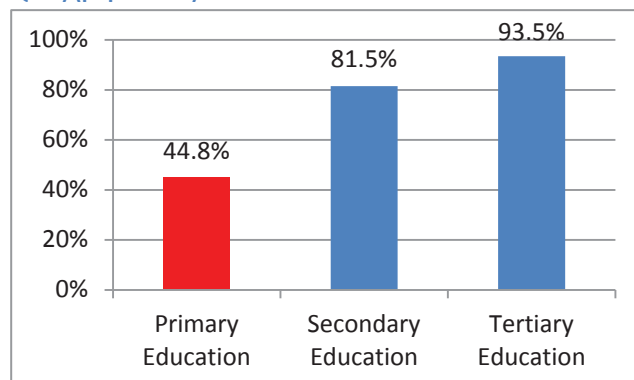
Overall, more than half of employers responded it happens in most of the cases or sometimes, a fact indicating the issue is quite prevalent among Macedonian companies.

Figure 16 - Level of agreement with the statement 'State health and pension insurance do not provide sufficient sense of security' (population)



Source: National population field survey, conducted during 10/2014 with a representative sample size: 1116 respondents

Figure 17 – Percentage of population with written contract for primary job according to educational attainment % (Q.3 vs. Q.D3) (population)



those with income over 20.000 MKD (Figure 13). This goes in favour of the argument that **the problem of undeclared work is in great deal related to the high poverty levels and is actually a coping mechanism used by individuals when trying to make ends meet with the finances they have.** Nevertheless, this type of opinion and consequent behaviour **enhances the risk of economically disadvantaged groups to become even more at risk when in need of social security net.**

Additional explanation for accepting undeclared work might be the fact that the **state-level security schemes are perceived by the majority of the population as not providing sufficient sense of security** (Figure 16). Hence, they would prefer a temporary security which comes with a higher wage, rather than a diffident assurance of a longer term security grounded in the public security system. This once again confirms the importance of trust within institutions and the system in general, as a form of ‘psychological contract’ between the citizen and the state, important for the tax morale.

When it comes to **secondary / additional occupation** the situation is more concerning, bearing in mind that **in the vast majority of cases (80%) it is being performed without a contract.** In case of a contract, it is fixed term, authorship agreement or another temporary agreement. In line with this, social and health insurance are also not being paid in 80% of the cases and over 50% of respondents do not report and/or pay personal income tax for their additional activity.

The data shows no gender difference in relation to attainment of an official (**written contract for the primary job**), in which case 82.4% of employed men and 86.2% of employed women stated that they attained a written contract. The same applies to age differences (86.1% age 18-34; 81.5% age 35-54; 90.3% age 55+). However, there are noticeable differences with regards to educational attainment levels where 44.8% of employees with

Figure 18 - Educational attainment according to ethnic background (population)

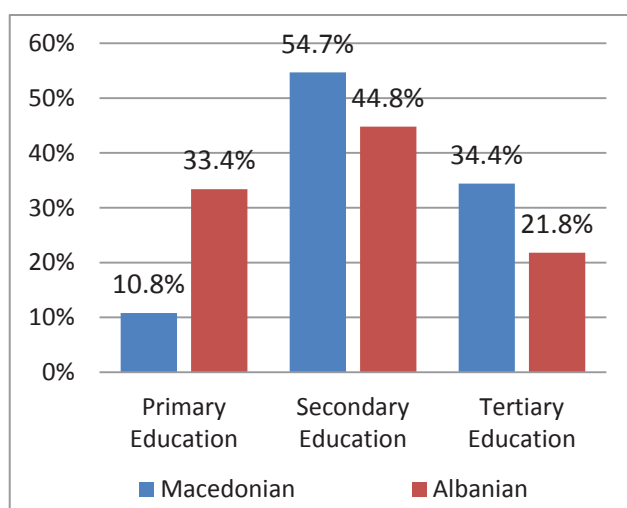
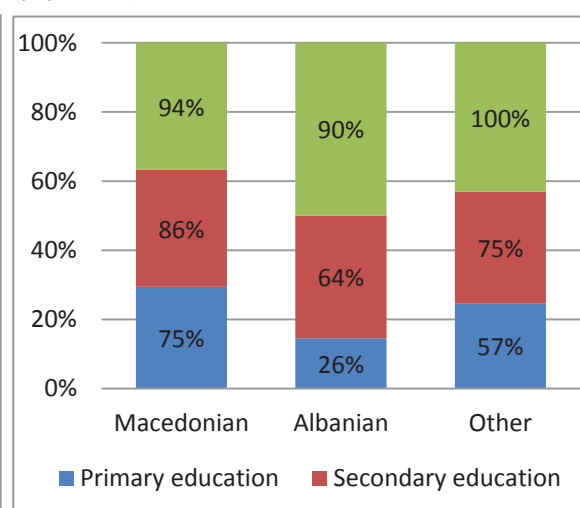


Figure 19 – Share of the population with written contracts according to educational attainment & ethnic background (population)



primary 81.5% of employees with secondary and 93.5% with tertiary education stated that they have acquired a written contract for their primary job (Figure 17). The data clearly

show, unsurprisingly, that **the probability of working under a written job contract increases with the level of educational attainment, and this is especially drastic when moving from primary to secondary education attainment.**

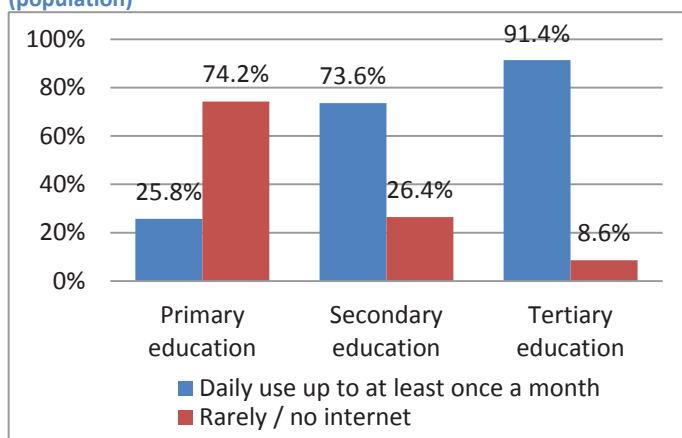
In accordance with the ethnic background of respondents, the data show that Albanians are less likely to work under a written job contract (71.7%) compared to Macedonians (88.9%). There is a strong indication that education might play a role in the distribution of written contracts acquirement which is evident by looking at the educational attainment according to ethnic background. Out of the one third of Albanians (33.4%) that have primary education, or less, only 26% have written contracts. **As shown above moving from primary to secondary education doubles the probability of having a written contract.** However, ethnic Albanians do not benefit to the same extent from this pattern and only 64% of workers with secondary education have written contracts compared to Macedonians (86%) and other ethnicities (75%)<sup>28</sup> with the same level of educational attainment.

The population is equally vulnerable in relation to envelope wages with no difference related to gender, age, ethnic and educational background. Concerning the anecdotal evidence of a practice of returning part of the salary to the employer after it has been formally paid out to the worker, it must be noted that the data is inconclusive.

Regarding the payment of social security contributions the data shows no age difference. However, gender difference is present with men being more likely to be the victims of non-payment by their employer, thus being more vulnerable, with 80.4% of men, and 89.6% of women claiming that their employers pay their social security contributions. **The differences with regards to education of the population are notable with the employer paying contributions for 42.3% of employees with primary, 83.3% with secondary school vs. 91.5% with tertiary education;** an indication which is quite close to the data concerning educational attainment vs. written contract attainment. The probability of having social insurance contributions paid increases with the educational attainment.

Similar to the distribution of written contract according to ethnic background, Albanians are less likely to have their social security contributions paid. **According to the data, the employer pays contributions for 74.8% of Albanians compared to 89% of Macedonians,** and as presented above, it is quite

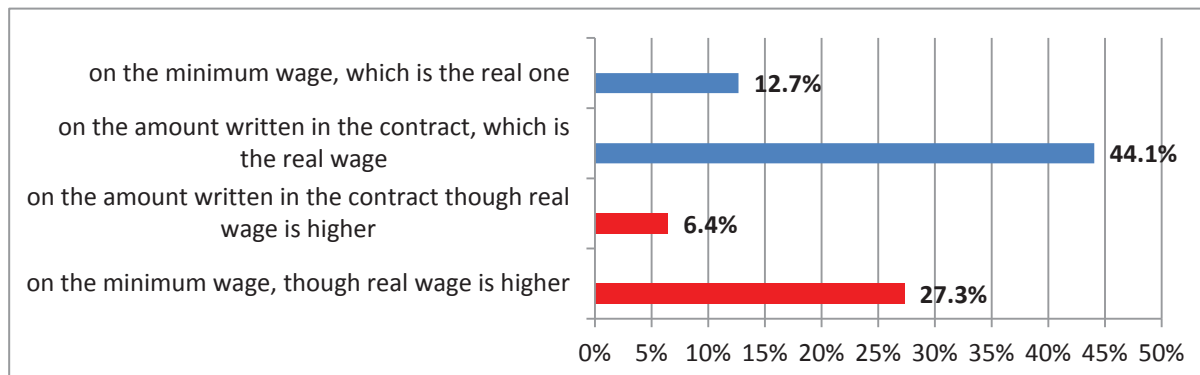
Figure 20 – Educational attainment of the sample vs. Internet usage (Q.D3 vs. Q.D18) Source: CRPM population survey 2014, (population)



<sup>28</sup> The Figure 19 shows for example that from all employed Macedonian respondents with primary education only 75% of that particular strata have written contacts, then 86% of the ones with secondary education and 94% of the ones with tertiary education.

likely that this is related to the level of education. The level of education can impact the way workers perceive their rights and obligations and the extent to which they are willing to fight in order to benefit from those rights.

**Figure 21 - What is the wage amount on which your social security contributions are being paid by your employer (Q.7A).**  
Source: CRPM population survey 2014 (population)



An additional amplifying effect can be the level of internet usage (internet penetration) of the population which according to the latest figures in 2014 in Macedonia was 68.3%<sup>29</sup>. Our data show significantly lower internet usage among those with primary education with 74.2% of them (Figure 20) having seldom access or no access at all. The internet is a medium that offers access to independent media and influential bloggers, public information, and more importantly, access to government e-services and online tools that can enhance workers' rights and individual freedoms (i.e. almost anonymous reporting on corruption and various forms of employers' non-compliance). **The lower usage rate among the less educated indicates that they are even more vulnerable to the negative effects of participating in the hidden economy. Significant government revenues are lost due to avoidance of social security contributions and the incentives are spread among the employee and employer and both parties benefit to a different extent depending on the mutual agreement.** As shown in Figure 12, one third (33.7%) of employees have their social security contributions calculated and paid on wage amounts which are lower than their actual wages. The data suggest that the population is equally vulnerable to this practice and now that there is no difference in vulnerability on the basis of age, education, and ethnic background.

Regarding the payment of health insurance contributions the data shows no age difference. However, similar to social security contributions, gender difference is once again present, with men being more likely to be the victims of non-payment by their employer with 79.9% men, and 88.2% women claiming that their employers pay their health insurance contributions. The differences with regards to education of the population are notable with the employer paying contributions for 42.3% of employees with primary, 82.8% with secondary school and 89.9% with tertiary education; an indication which is quite close to the data presented (in Figure 19) concerning educational attainment vs. written contract attainment. The probability of having health insurance contributions paid increases with the

<sup>29</sup> State Statistical Bureau, Q1 2014, retrieved from:  
<http://www.stat.gov.mk/PrikaziSoopstenie.aspx?id=77&rbr=1517>

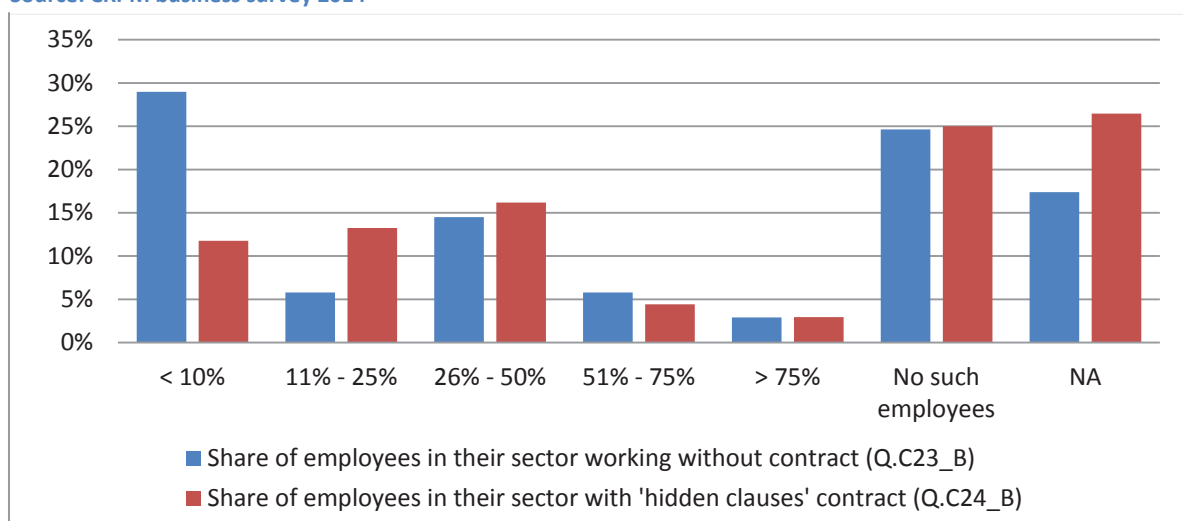
educational attainment just as it was the case with social security contribution payments. Looking at the ethnic background, it is indicative that Albanians are less likely to have health contributions paid compared to Macedonians. Employer pays contributions (71.8%) compared to Macedonians (88.6%).

As stated earlier in the text, the negative consequences of the hidden economy hardest hit the most vulnerable groups in the society (low income, low educated, long-term unemployed women etc.) and in the Macedonian case the ethnic background seems to exacerbate the problem even further given that income inequality is larger among ethnic Albanians.

Another interesting phenomenon, particular about the Macedonian labour market likely due to the high unemployment rate, is the corruptive practice of asking for bribes in order to secure a new job. According to CRPM/CSD survey data, **10.8% of the respondents confirmed that either bribe to be employed was asked directly from them or know somebody who was asked a bribe.** Only 6.7% of the respondents were willing to disclose the size of the bribes which ranged from 4.000 to 360.000 MKD (65 to 6.000 EUR) or a **maximum bribe of 17 Macedonian monthly average net wages.**

Share of the employees who work under no written contracts or hidden clauses contracts is substantial and only 25% of business representatives confirm that within their sector, in their view, there are no employees who are hired without a contract or with 'hidden clauses' contracts (see Figure 22).

Figure 22 - Share of employees with no contract or 'hidden clauses' contracts (Q.C23\_B & Q.C24\_B) (business)  
Source: CRPM business survey 2014



Macedonia, as most EU-28 countries, employs measures addressing hidden work which focus predominantly on repressive measures despite some recent measures towards enabling formalization of labour (self-employment program) and fostering commitment. However, as shown in the survey conducted by CRPM, the proportion of employees receiving 'envelope' payments, or payments through temporary service contracts, is about **one-third of the employed population.** Even if one takes into account only the data that the salary of **40% of employees with primary employment is partially or completely**



**undeclared** is an indication enough by itself that the space for improvement is vast and much more can be done. Improved data sharing and coordination among government bodies is of utmost importance in combating undeclared labour, together with an increase in the number of incentives for suppliers to join the declared economy and measures to increase public awareness on the risks and downsides of joining the hidden labour market.

The Ministry of Labour and Social Policy (MLSP) is the main body that regulates the activity

### Box 3 – Why supporting a Hidden Economy Task Force in Macedonia is necessary?

The activities of the Ministry of Labour and Social Policy (MLSP), as a national coordinator of the government's measures to tackle the hidden economy, would benefit greatly from the support and involvement from the business community and other stakeholders. **Even though some business associations are participating in the adoption of the action plan on the hidden economy and they are consulted in the process, many social partners perceive this partnership as an exclusive government initiative.** The due process of coordination of the action plan with stakeholders will be improved if the government displays more willingness to listen to the views and advice of the wider civil society which can enrich this social partnership. The Government, and specifically the Ministry of Labour and Social Policy (MLSP) and the Ministry of Economy, which also has jurisdiction of some aspects of tackling the hidden economy, should be fundamental to the expansion of communication between all stakeholders, such as local governments and NGOs. Apart from the Social and Economic Council where some of these organizations/institutions are members, no other forms of cooperation on common goals exist, which leads to diffusive and uncoordinated enactment in situations of advocating for or against certain policies. The current report advocates for the development of a Hidden Economy Task Force as a comprehensive solution to engaging the wider civil society policy community.

**The Task Force for tackling the hidden economy is an institutional mechanism for involving the CSOs, the business community and state actors in defining transparency and democratic accountability solutions.** The initiative is meant to be implemented by local applicants aided by the Centre for Research and Policy Making (CRPM). The Task Force aims at a participative approach by including a network of private sector CSOs such as unions, employer's associations, chambers and think tanks together with state institutions such as the Public Revenue Office, the inspectorates, the Financial Police, the Customs Office, The National Bank of Macedonia, and the Ministries of Economy, Finance and Labour & Social Policy.

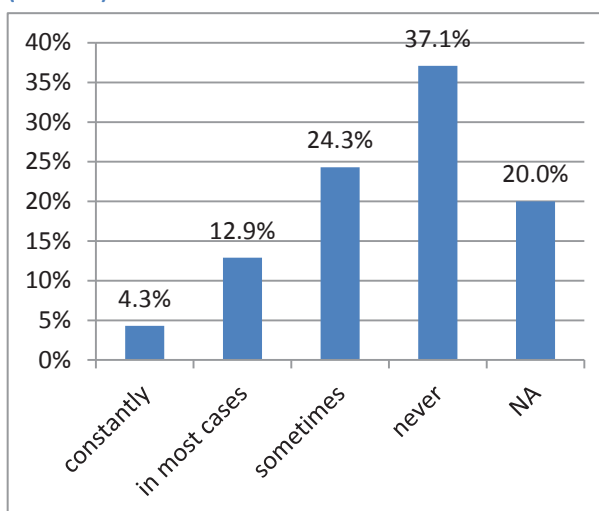
of all labour market institutions as well as constructing the main pillars around the social security contributions and related measures and implements and enforces those policies through the Employment Agency (EA), Pension and Disability Insurance Fund, Social

Assistance Agency<sup>30</sup> and State Labour Inspectorate (SLI).<sup>31</sup> Additionally, the MLSP is in charge of drafting and implementing the Action Plan for the reduction of the grey economy (Ministry of Economy, 2013; MLSP, 2014), which manages the related tasks among several government bodies.

Even though the Macedonian case shows a predominant focus on repressive and preventative measures, in the recent years a trend is evident towards adopting more curative measures and measures which foster commitment. The SLI is the main enforcement body of the labour legislation and thus is responsible for exercising control over undeclared work. A drop of 78% of detected undeclared workers in 2009 is one indication that increased control of the SLI led to positive results even though some of this decrease can be attributed to the general decrease of employment due to the economic crisis of 2008.<sup>32</sup> Additionally, the **number of detected undeclared workers continues to drop** while the incidence of inspections initiated by complaints reported through written requests, web tool and call centre continues to rise, representing 8.8% of the total inspections performed in 2012. The International Labour Organizations for the preceding years estimates that only 4% of the total inspections were initiated after a complaint has been filed.<sup>33</sup>

The available data does not allow for straightforward conclusions about the effectiveness of another government body that uses repressive and preventative measures, the State Market Inspectorate (SMI). However, its activity has increased over the years from 26,599 in 2011 to 40,582 in 2013. Additionally data on payment orders issued and penalty fines collected due to offences which are within the domain of the law on State Market Inspectorate<sup>34</sup> might give some insight. Collection rates of payment orders in 2011 were mere 4% while reaching 6% in Q3 2014. Collection rate of penalty fines ranged from 9% in 2013 to 14% of all issued penalty fines by Q3 2014.<sup>35</sup>

Figure 23 - Paying cash for large wholesale deals (Q.C12\_H) (business)



<sup>30</sup> Social Assistance Agency. Retrieved from: [http://www.mtsp.gov.mk/institucii-ns\\_article-zavod-za-socijalni-dejnosti.nspx](http://www.mtsp.gov.mk/institucii-ns_article-zavod-za-socijalni-dejnosti.nspx)

<sup>31</sup> While traditionally a body under the auspices of the MLSP, after forming the Inspection Council, the SLI is administratively part of this institution.

<sup>32</sup> Mojsoska-Blazevski, N. (2011) *Supporting strategies to recover from the crisis in south eastern Europe: Country Assessment Report: The former Yugoslav Republic of Macedonia*. Geneva: ILO. Retrieved on 10.05.2014 from: [http://www.ilo.org/wcmsp5/groups/public/@europe/@ro-geneva/@sro-budapest/documents/publication/wcms\\_167032.pdf](http://www.ilo.org/wcmsp5/groups/public/@europe/@ro-geneva/@sro-budapest/documents/publication/wcms_167032.pdf)

<sup>33</sup> International Labour Organisation (2011b) *Labour inspection country profile: The former Yugoslav Republic of Macedonia*. Geneva: ILO [Online]. Retrieved from: [http://www.ilo.org/labadmin/info/WCMS\\_114938/lang--en/index.htm](http://www.ilo.org/labadmin/info/WCMS_114938/lang--en/index.htm)

<sup>34</sup> Official Gazette of RM, Nr. 35/97, 23/99, 7/02, 20/02, 24/2007, 81/2007

<sup>35</sup> Mickovska R. A; Shurkov E. *Background Analysis on the Spread and Trends of the Hidden Economy in Macedonia* (CRPM/CSD 2014). Retrieved from: <http://www.crpm.org.mk/?p=13971> (p.55-56)



The Inspection Surveillance Council<sup>36</sup> (ISC) in 2014, which oversees and coordinates the activities among the 29 different state inspectorates, should be able to facilitate, within its jurisdiction, the GoM efforts to curb the already noted deficiencies within the inspectorates, namely: **a) insufficient joint inspections<sup>37</sup>, b) poor organization,<sup>38</sup> c) and insufficient data sharing and connectivity.<sup>39</sup>** Additionally, it will review the work of inspectorates where irregularities have been reported or detected, putting in place training programs, inspector certification, and in general will work towards increasing the efficiency of the inspectorates while decreasing costs.

Curative measures, on the other hand, are mainly implemented by the Employment Agency and coordinated by MLSP and usually targets the most vulnerable groups in terms of undeclared labour such as youth unemployment, long-term unemployment (more than 12 months), structural unemployment,

**“Definitely the fear not to lose ones’ job and the low level of awareness about the negative effects of the issue makes them reluctant to discuss the phenomenon in a situation when they are not sure whether they will get the proper protection from the state if they decide to share the problem with the public and to stand behind it with their name.”**

unemployed women, the Roma population etc. However, while some programs show positive results others clearly have limited outreach and effects. For example the program for **formalizing existing businesses<sup>40</sup> (currently part of the self-employment program), the regulation of seasonal employments and fostering formalization in the agricultural sector** show positive results. Anyway, the very important programs targeted at the most vulnerable groups of the Macedonian society show minor or limited results given the extent of the unemployment rate and its structure. Particularly, **subsidizing employment of users of social assistance** initiated only **60 employments in 2014** and **the activities for the integration of the Roma population into the formal economy<sup>41</sup>** initiated only 13 employments in 2013 out of 91 applicants which is a success rate of 14% for this specific program.

<sup>36</sup> Official Gazette of the Republic of Macedonia Nr. 50/2010, 147/2013, 41/2014

<sup>37</sup> Williams, C.C., Baric, M. and Renooy, P. (2013) *Tackling Undeclared Work in FYR Macedonia*. Dublin: Eurofound.

<sup>38</sup> International Labour Organization, (2011). Labour Inspection Country Profile: Macedonia. Retrieved from: [http://www.ilo.org/labadmin/info/WCMS\\_114938/lang-en/index.htm](http://www.ilo.org/labadmin/info/WCMS_114938/lang-en/index.htm)

<sup>39</sup> Ibid

<sup>40</sup> Presentation of Mladen Frckovski, MLSP advisor, at the conference on Countering Undeclared Labour, CRPM and CSD Workshop, 27 November, 2014, Skopje

<sup>41</sup> Analysis: *Between Implementation and Reality of the National Strategy for Roma Inclusion – Roma Decade 2005-2015*, Helsinki Committee of RM, 2014

## 6. Tax Compliance and Tax Avoidance

### 6.1 Businesses and Tax Compliance

The hidden economy index measures overall tax compliance by two sub-indexes – hidden turnover in different segments (imports, reporting lower revenues or reporting lower profit through reporting costs that should not decrease the profit before taxes) and redistribution (VAT fraud, not paying due customs duties or excise tax). Comparing indexes with Bulgaria (Figure 5) the major difference comes with respect to illegal trade across border. Despite the fact that among the 10 sub-indexes of hidden economy, the illegal imports/exports component is 2.2 and only third to last (with the lower sub-indexes directly linked to it – hiding excise and customs duties and VAT fraud), it signals a major dysfunction in the state and economy. **Hiding imports in whole, partially or miss-declaring the customs codes in order to save customs duties or VAT represents a significant factor fuelling the hidden economy.**

Figure 24 - Mirror statistics for the top 6 importers to Macedonia. Source: Comext database, 2015

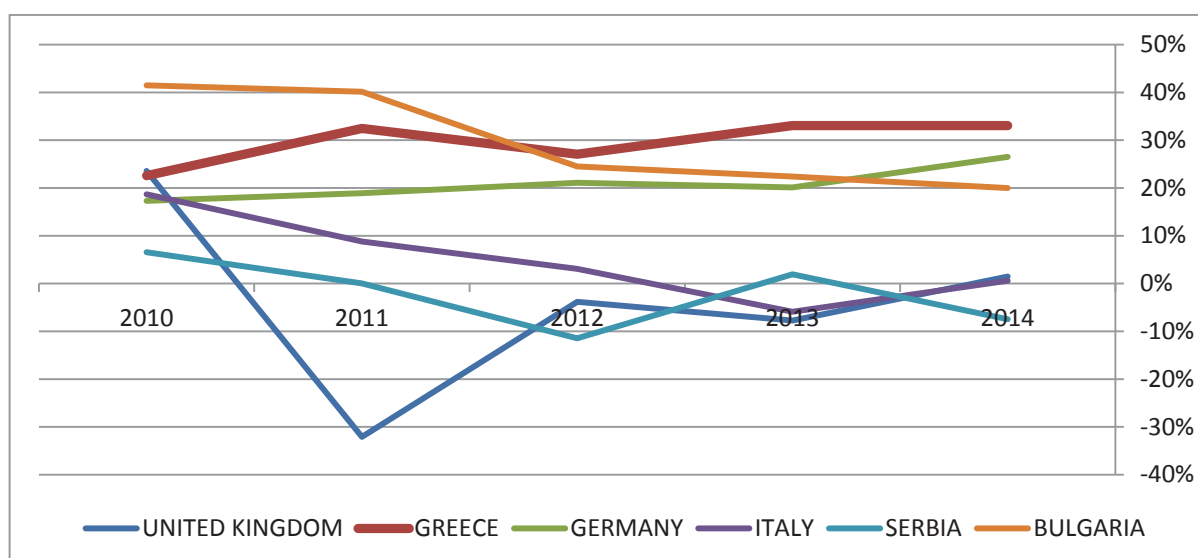


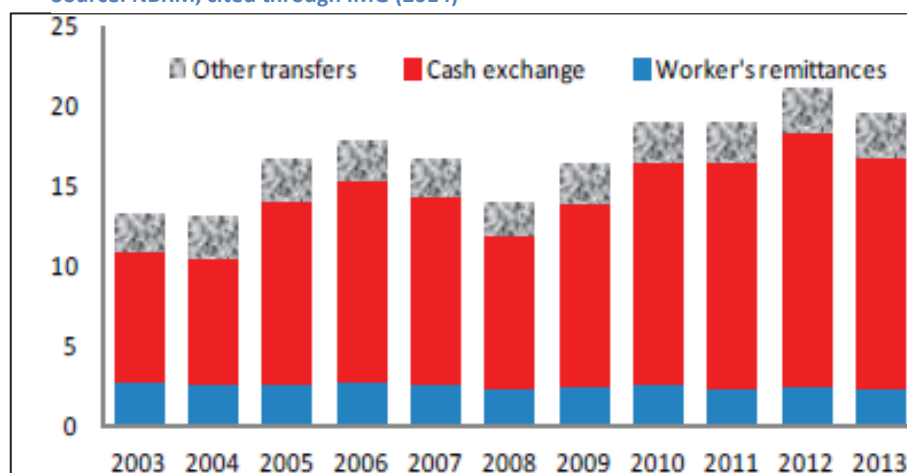
Figure 24 provides data for the discrepancies in reporting of imports by Macedonia and respective exports reported by the trade partners. Due to the fact that imports are usually reported on CIF valuation and exports on FOB (although this might not be true in case of trade within company groups/subsidiaries) imports are generally higher than exports. The CIF/FOB effect on mirror statistic is dependent on distance between partners; type of goods traded and so on, but nevertheless should be marginal. In the last 5 years imports from UK, Greece and Germany increased between 50% and 150%, while exports from the other countries were below 25% (as reported by the trade partner). Imports from Greece, Germany and Bulgaria account for a significant part of the hidden exports to Macedonia – about a third of imports from Greece and a quarter from Germany are hidden from the customs. Due to lack of data mirror statistics for important trade partners as China and Russia could not be provided, but it could be expected based on what we know about other

neighbouring countries that there is a significant hiding (including transfer pricing in the case of oil imports) occurs also for imports originating from these countries. The top 6 importers to Macedonia account for 50-55% of the total imports to Macedonia and hidden imports from Greece, Germany and Bulgaria account for 9% of total imports. If all imports are considered, the share of hiding can be estimated to be from 16% to 20%.

The hidden imports allow not only for companies to evade duties and taxes at the time of import, but also provide wider opportunities for the supply chain down to the client to under-report revenues, not declare salaries to employees and thus hide value added and hence VAT and profit tax. **Significant discrepancies exist in imports/exports of food/coffee/tea suggesting for easier hiding of economic activities in the area of retail, restaurants and related services.** As the green markets sell a lot of imported food along with domestic unregistered production, the nexus of hidden production-import-work-sale-purchase represent a significant part of the hidden economy in the country and accounts to a significant tax gap for Macedonia. **Perpetual VAT fraud coupled with a weak capacity of the judiciary and slow investigative procedures translates to lagging VAT return claims which in turn produces incentives for businesses to hide their economic activity.**<sup>42</sup>

As Macedonian economy and consumption is heavily dependent on remittances, large fraction of which is also hidden, the macroeconomic framework might not signal misbalances (between import, sales and income). The private transfers account to between 13% (in 2003) and 21 % (in 2012) of GDP (IMF, 2014). These private transfers help the large majority of Macedonians (unemployed and economic inactive people) to survive without official income.

Figure 25 - Private transfers (as percentage of GDP).  
Source: NBRM, cited through IMG (2014)



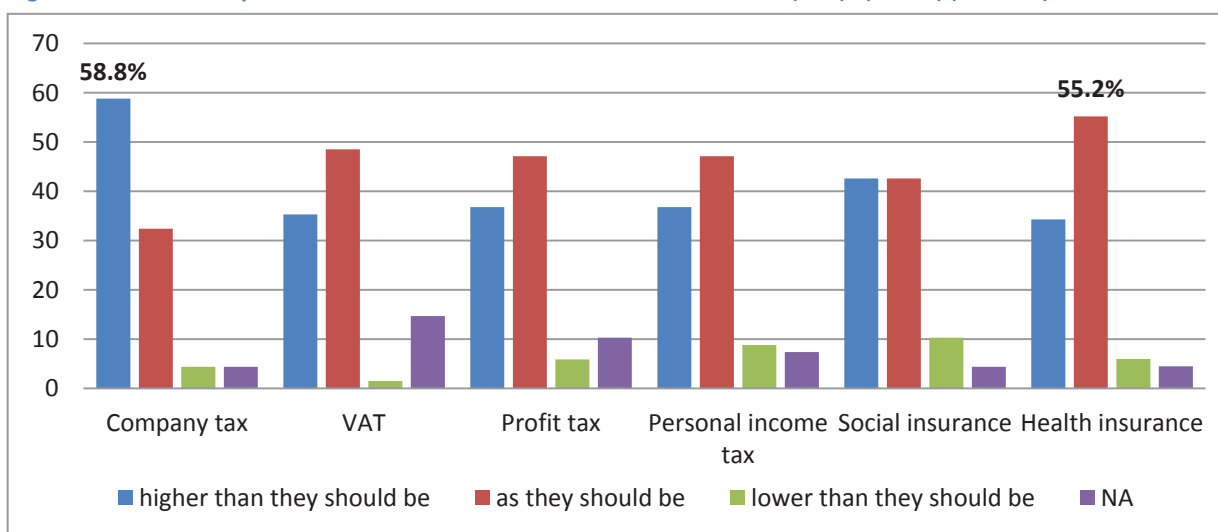
**Official remittances account to 2.5% of GDP but through the cash exchange another 14% of GDP of remittances come to Macedonia.** Of course part of these exchanges account for a business-like activity of individuals either completely unregistered or on the side of the official business. What part of remittances and private transfers to what part of hidden import corresponds is hard to determine or estimate, but case studies from neighbouring

<sup>42</sup> In-depth interview, May 2015, with the Business Confederation of Macedonia (BCM). <http://www.bcm.mk/>

countries such as Kosovo (Danielsson, 2015), Bulgaria and Southeast Europe (CSD, 2000, 2002, 2004) suggest that this is not an exception. The reason for that large amount of unofficial remittances lies in the fact that part of it also comes from hidden labour in Western Europe and thus senders prefer to stay under the radar anyway.

Tackling tax evasion and fraud, being just a part of the policies targeting hidden economic activities, is not just a way to increase government revenues, but also a way to increase the fairness of the tax system, and improve tax acceptance and trust among its citizens and businesses, promote human rights, and enable appropriate protection to the most vulnerable in the Macedonian society.

Figure 26 - How would you assess the amount of different taxes in Macedonia (in %)? (Q. C17) (business)

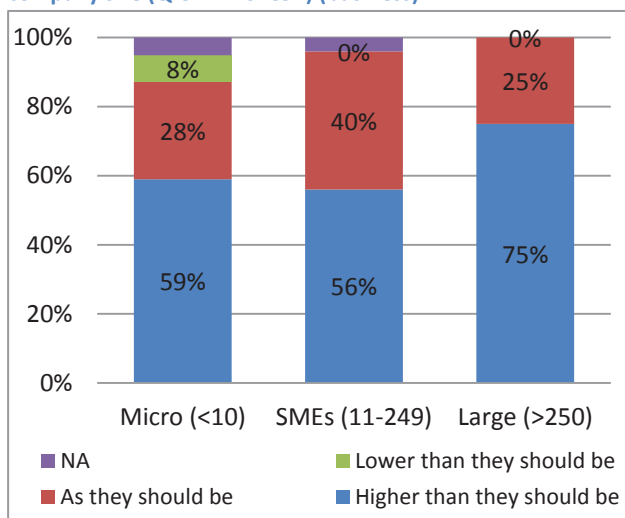


Tax compliance is an immanent part of every business venture, but taxes can often represent a burden for businesses and a reason to direct part of their actions into the informal sphere. This is why the opinion of businesses regarding the tax policies is especially important for developing policies which guarantee tax compliance.

Data reveal that **for the majority of businesses interviewed, the current tax system does not represent a problem for development of their business (42%), or represents an insignificant problem (23%),** regardless of the size of the company. The largest detected problem is the unfair competition, which is assessed as a big problem by 67% of businesses, especially the micro companies.

**In fact, half of interviewed businesses agreed that the tax system is good and simulative for the development of businesses,** specifically 17% completely agreed with this statement, while 33% partially agreed. On the other hand –

Figure 27 - How companies assess “Firmarina” according to company size (Q.C17A vs. C5B) (business)



21.4% partially disagreed with the statement and 15.7 completely disagreed. There are no differences regarding the company size.

Hence, there isn't a big disagreement concerning the size of different taxes. In fact, most interviewed businesses consider the current amount/size of taxes to be appropriate, less than half of businesses reported that they are higher than they should be, and small number consider them to be lower than they should (Figure 26). Contrary to what is expected, micro firms were more accepting of the existing taxes and believe they are appropriate size/amount compared to the small/medium and large companies who were more prone to consider them to be higher than they should.

The only tax that breaks the general prevailing pattern of tax acceptance 'as they should be' is the company tax (firmarina)<sup>43</sup>. Close to 60% of all companies agree that this tax, which is collected by the municipality, is higher than it should be and Figure 27 shows that there is no significant discrepancy on this perception if the company size is taken into account. Most often the respondents find the corporate tax (firmarina) was:

Figure 28 - Most important factors for the existence of hidden economy (Q. C14) (business)

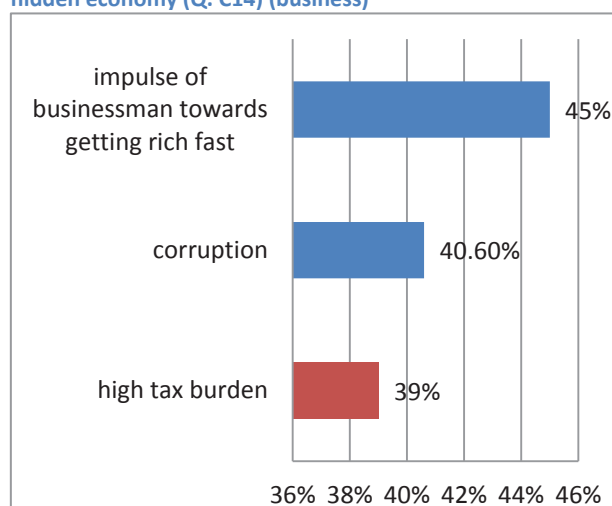
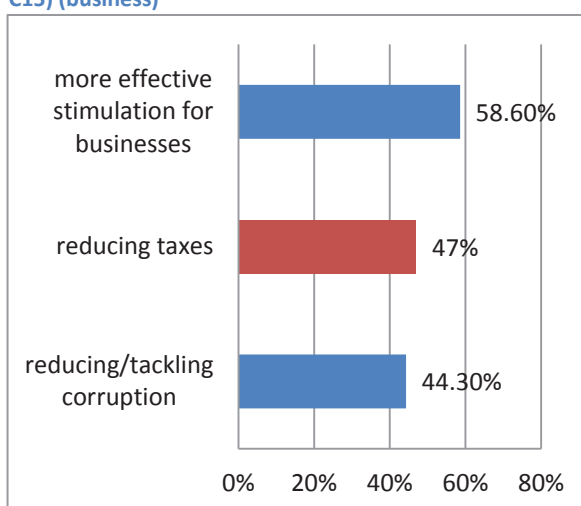


Figure 29 - Measures for reducing hidden economy (Q. C15) (business)



Source: Business survey of 70 companies, conducted during October 2014

- Confusing and unreasonable
- Lack of clear understanding what this tax covers and what is the company benefit from paying it
- Lack of proportionality of the tax according to company size. Instead the tax uses a flat rate per company branch/office (which is especially unjust to smaller companies).

Nevertheless, apart from the general satisfaction with the tax system in the country, **taxes are considered to play an important role in engaging with hidden economic activities.** Specifically, the 'high tax burden' is considered to be the third most important factor for the existence of hidden economy, selected by 39% of business representatives, after the 'impulse of businessmen towards getting rich fast' (45%) and 'corruption' (40.6%), (Figure

<sup>43</sup> Corporate tax (firmarina) should not be confused with corporate profit tax. It is a tax gathered and spent on the municipal level. It is a flat tax rate that each branch/office of the enterprise has to pay.

28). Consequently, the top three measures proposed for reducing hidden economy include – ‘introducing more effective stimulation for businesses’, selected by 58.6% of businesses; ‘reducing taxes’ (47%) and ‘reducing/tackling corruption’ (44.3%), (Figure 29).

Evidently, businesses are more inclined towards stimulative, rather than punitive measures, which is in contradiction with the main set of policies which the Government is implementing in order to tackle the hidden economy issues.

Figure 30 - How frequently companies tend to report smaller income than the real one? (Q. C12\_C) (business)

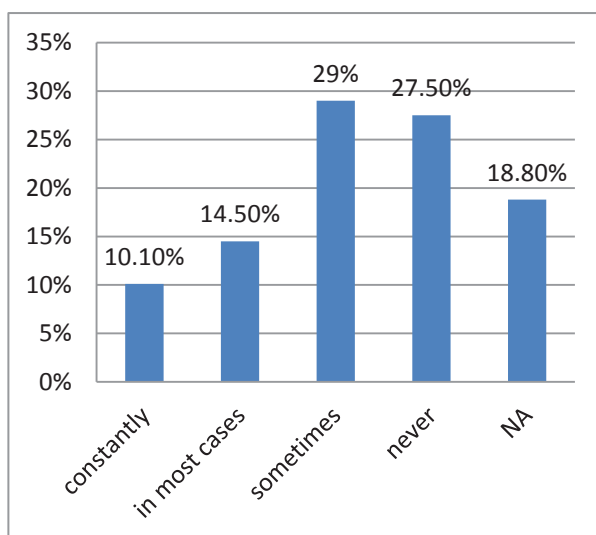
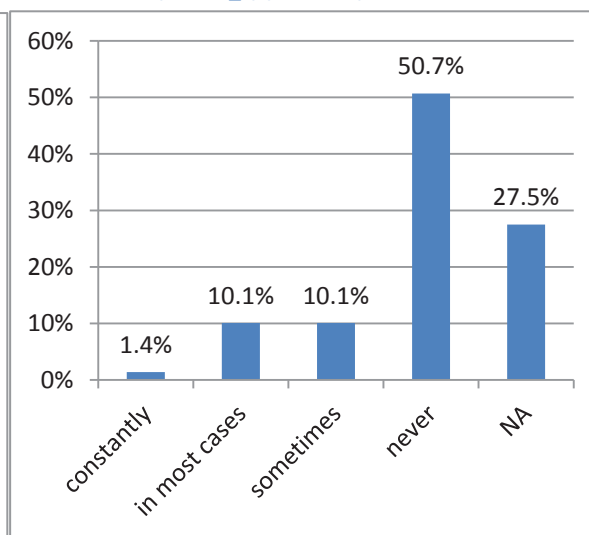


Figure 31 - How frequently companies tend to manipulate with the VAT? (Q. C12\_L) (business)



Various technologies of avoiding and/or manipulating tax reporting and compliance are utilized by companies. Specifically, somewhat more than half of companies confirm that there is a practice of reporting smaller incomes than the real ones among companies from their sector, with 10.1% claiming it happens all the time, 14.5% in most of the cases and 29% sometimes (Figure 30). In line with this, approximately same distribution of responses goes for reporting a lower turnover than the real one, with 5.9% of companies stating it happens all the time in their sector, 16.2%-in most of the cases and 32%-sometimes (Figure 32).

The population survey provides relative confirmation to these findings, visible through the data on provision of fiscal receipts. **Less than half (46.7%) of citizens reported to always receive receipts when buying food; every third citizen always receives receipts when buying clothes and shoes, alcohol and tobacco; and every fourth when buying books.** Although cases of never receiving fiscal receipts are rare (reported by less than 10% of respondents), the tendency of businesses to hide part of the profit/turnover is nevertheless evident.

However, when it comes to ‘manipulating with the VAT’ and ‘employing accounting tricks in order to pay lower taxes’, the options seem to be more limited and less than a third of interviewed businesses reported this happening in their sector.

Figure 32 - How frequently companies tend to report lower turnover than the real one (Q. C12\_G) (business)

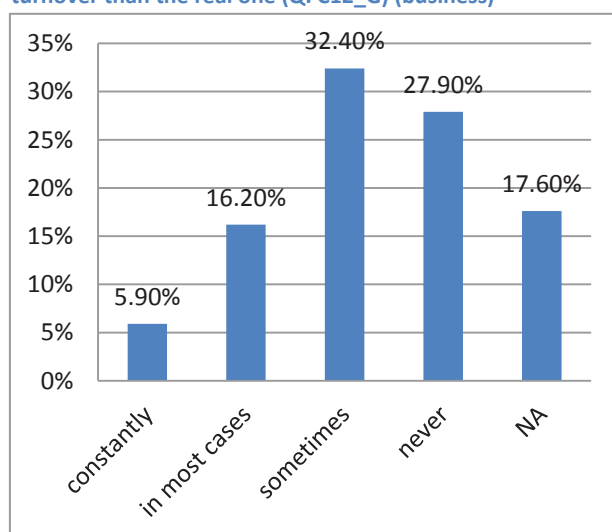
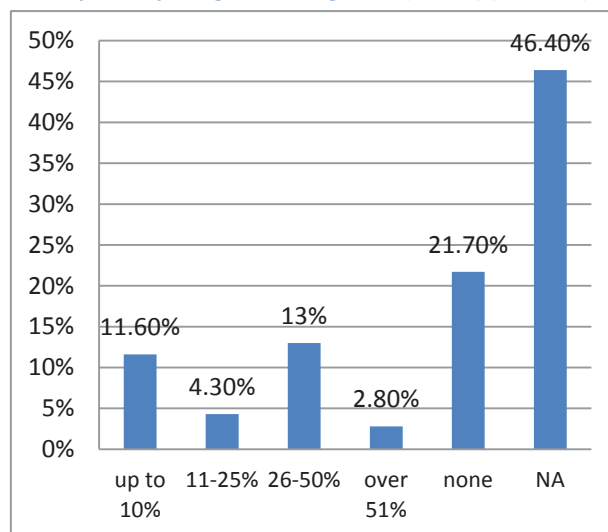


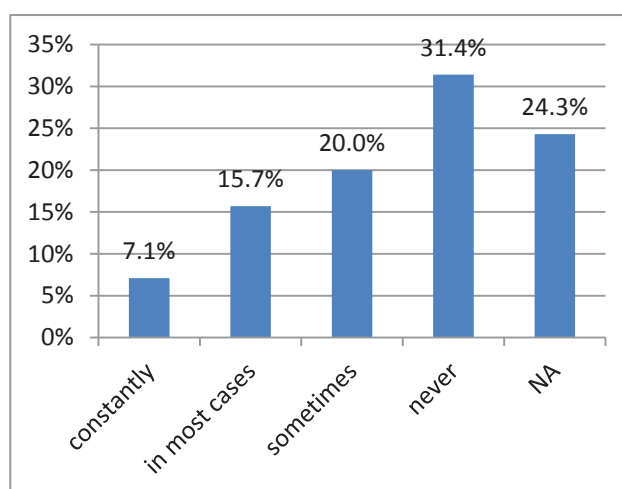
Figure 33 - Percentage of companies paying lower taxes than the required by using accounting tricks (Q. C25) (business)



**Enhanced implementation of punitive measures seem to have produced results to some extent**, bearing in mind that nearly half of the business representatives stated that they never avoid paying custom duties, taxes or excises. Therefore, the percentage of companies which avoid payment of taxes constantly (4.3%) or in most cases (8.6%) is rather small, while is somewhat higher among the companies the companies that sometimes (171%) evade paying taxes, custom duties and excises.

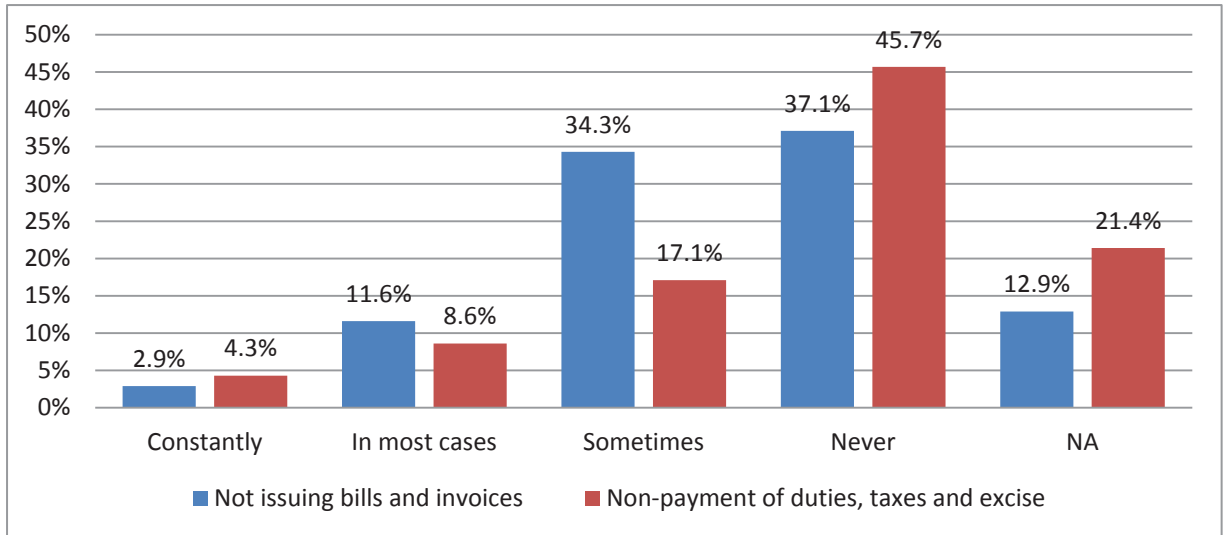
While there is still room for improvement, evidently the lack of issuing bills and invoices is not among the most serious factors which give rise to the hidden economy. Namely, most of the business representatives reported that they never (37%) avoid issuing bills and invoices or only sometimes (34%) avoid. Consequently, the percentage of companies which have established practice of not issuing bills and invoices is relatively small.

Figure 34 - 'How frequently bribing/taking bribes happens in your sector' (Q.C12\_E) (business)



The data on business representatives' perceptions on the activity of bribing in their respective sectors shows that a relatively high percentage of involvement in bribery activities which highlights the need for additional efforts in tackling anticorruption and the different elements of hidden economy. For instance, 43% of them have stated that, in one way or another, companies in their sector are involved in bribing activities. On the other hand, 31% of the company representatives have answered that bribing (offering or giving) never happens in their sector.

Figure 35 - Business representatives view on the involvement of companies in their sector in 'not issuing bills and invoices' (Q.C12\_F) and 'Non-payment of duties, taxes and excises' (Q.C12\_D) (business)



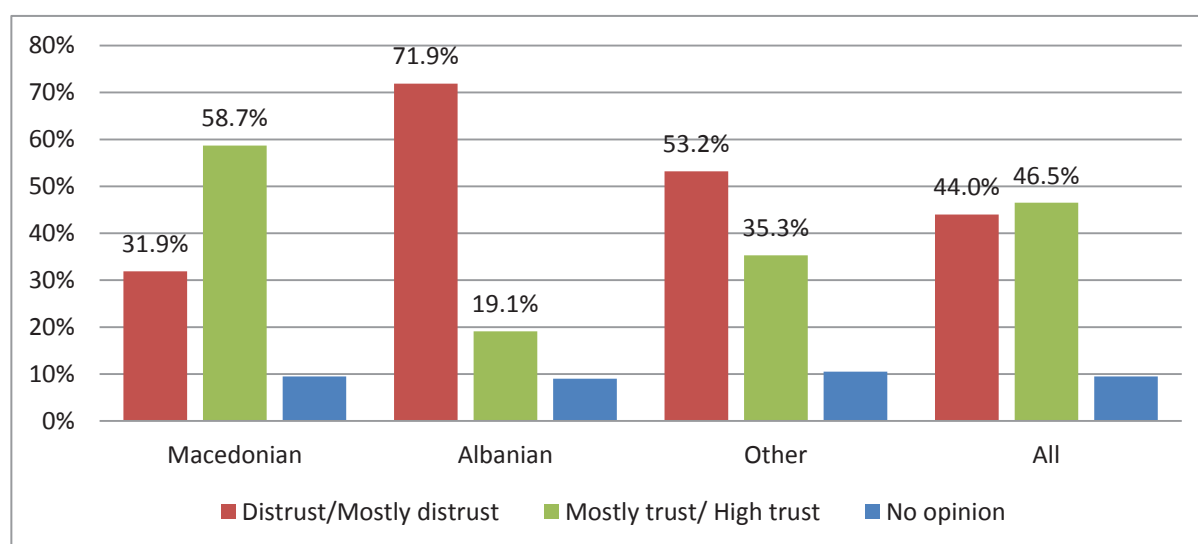


## 6.2 Citizens and Tax Compliance

The results of the October 2014 population survey suggest that tax compliance of respondents varies widely according to their monthly household income. Generally, they indicate that the lower the income, the less likely for an individual to pay their taxes. Furthermore, the ethnicity of citizens proved to be decisive for tax compliance, as Macedonians seem to have considerably higher tax compliance and awareness than the ethnic Albanian respondents. This is most likely related to lack of trust in the institutions as well as lack of visibility of the relation between paying taxes and the delivery of public goods and services. The data from the CRPM survey (Figure 36) points exactly to a significantly higher distrust/mostly distrust levels in institutions, the Government of Macedonia in particular, of ethnic Albanian respondents (71.9%) compared to the average (44%), as well as to Macedonians (31.9%) and other ethnic communities (53.2%). **Accordingly, at these levels of distrust, the lack of tax compliance and tax awareness among ethnic Albanians and other ethnic communities, even though it should not be tolerated, seems reasonable.**

Figure 36 - Level of trust in the GoM according to ethnic background (Q3 v. Q5.1), (population).

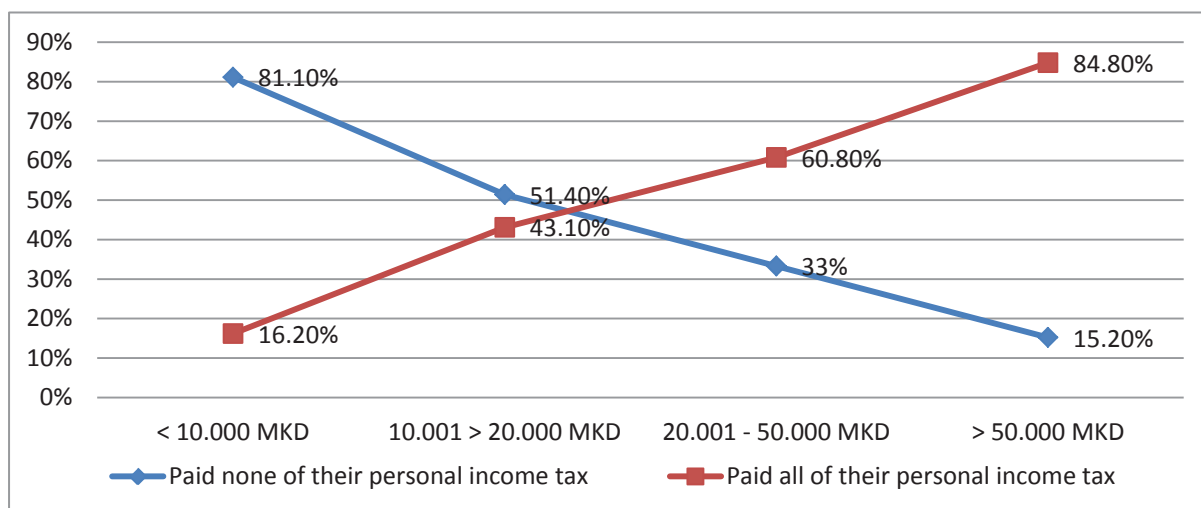
Source: CRPM field survey 2014, representative population sample of 1104 respondents



As the GoM dedicates more and more efforts towards the Partnership for Open Government, and increases the size and scope of its electronic services, the access to internet becomes of critical importance. Access to internet doesn't just mean access to services but also to information and resources that guards labour rights and personal freedoms. As it was shown earlier 74.2% of workers with primary education rarely have access to the internet or no access at all. Unfortunately, with unequal access to the internet it is likely that some vulnerable groups (low educated, long term unemployed, ethnic groups etc.) will have higher rates of distrust towards government institutions and eventually lower rates of tax compliance.

Awareness raising campaigns aim to increase trust and encourage overall compliance generally and the Government of Macedonia uses them seldom.<sup>44</sup> However, at these levels of institutional distrust an optimal outreach and results can only be achieved by **restructuring the awareness campaign to better fit the context of the groups that show**

Figure 37 - What part of the annual personal income tax citizens pay according to their monthly household income? (Q.D27\_B vs. Q.27\_B) (Population). FX rate 1 EUR = 61.5 MKD



**highest levels of distrust and lowest levels of tax compliance/awareness**, namely ethnic Albanians and other minorities.

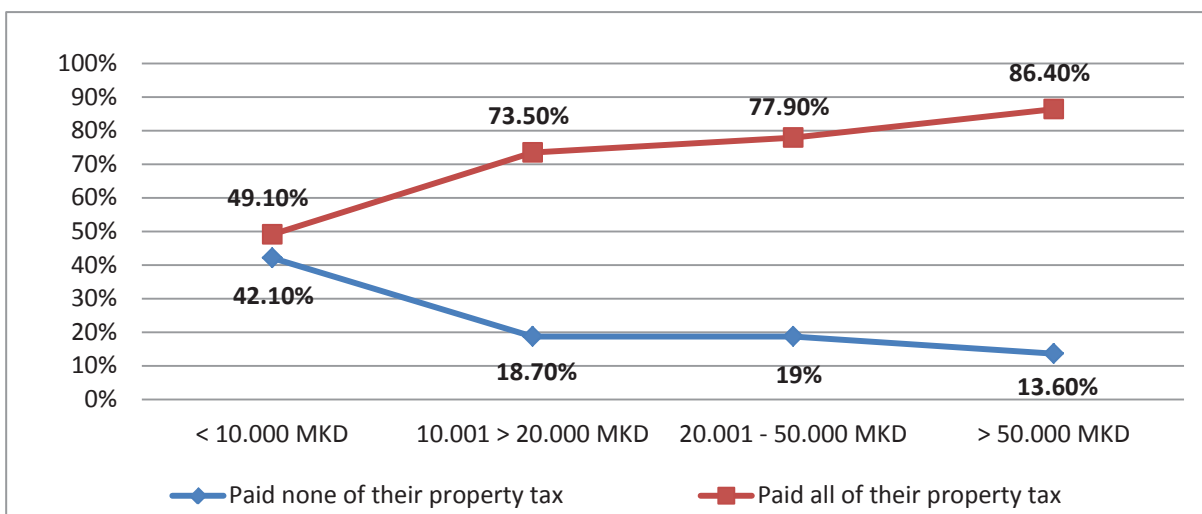
**Yet, the political parties do not explicit these aims within political campaigns and even more likely push for “learning helplessness” (White, 1992) to ease control over their constituents similar to the ethnic electoral control in Bulgaria.** Furthermore, ethnic political parties tend to be financed by groups and influential individuals who benefit by their replacement roles of formal institutions (i.e. private money lenders instead of banks, private security instead of police, political brokers who provide protection against state inspections, etc.) and businesses that get the ghetto-premium (higher profits due to less competition for in-group trade). These economic interests free-ride on the low enforcement capacity of the state and receive even higher premium than the state would have received if taxes are collected and more formal competition is in place.

As an additional argument, the amount of taxes currently imposed by the Government of Macedonia proved to be relatively unimportant for tax compliance, as relatively low percentage of respondents claimed that they didn't pay taxes because they would consider them too high. Hence, the question of trust to institutions (formal and informal) has significantly more power over the compliance decisions than the tax rates.

<sup>44</sup> CRPM/CSD (2014), *Background Analysis on the Spread and Trends of the Hidden Economy in Macedonia*. Available at: <http://www.crpm.org.mk/?p=13971> (p.63; Eng. version)

As Figure 37 indicates, the amount of family income is especially decisive in the case of personal income tax compliance. Whilst majority of those whose income exceeds 20.000 MKD reported that they have paid the whole amount of the personal income tax in the last month, staggering 81.1% of the poorest citizens with family income lower than 10.000 MKD a month claimed that they didn't pay this tax even partially<sup>45</sup>.

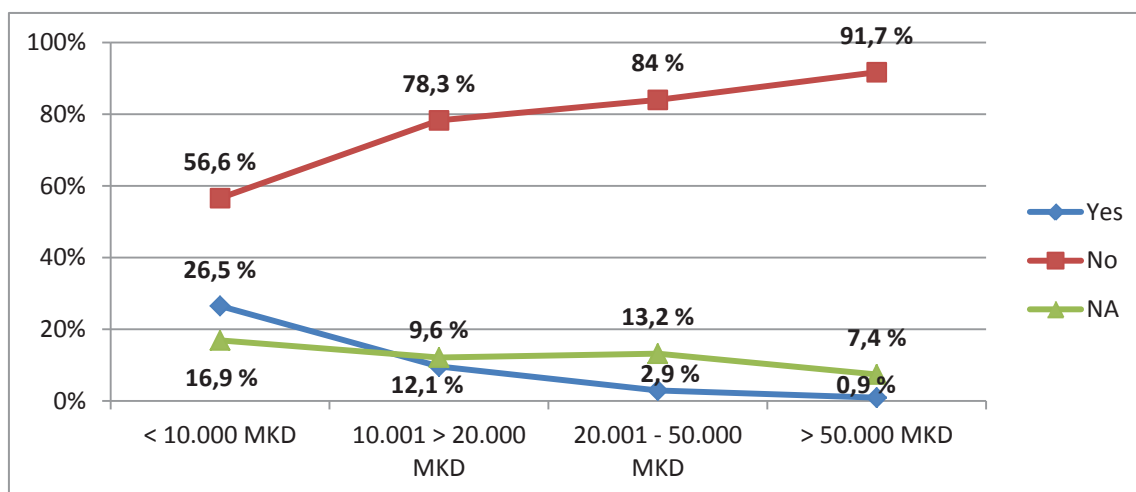
Figure 38 - What part of property tax citizens pay according to their monthly family income? (Q.D27\_B vs. Q.27B) (Population). FX rate 1 EUR = 61.5 MKD



The results of the survey suggest that the low-income families are especially vulnerable under the current system as they may find themselves being criminally prosecuted for unpaid taxes. Taxes therefore represent an additional burden for the already fragile situation of economically disadvantaged families, which is a problem that should be seriously tackled by the government.

As Figure 38 suggests, the taxpayers are more likely to pay the real estate/property tax than the personal income tax regardless to their monthly household income. Still, the displayed

Figure 39 - Do you agree with the following statement: 'I don't pay taxes, they are too high'? (D27\_B) (Population) FX rate 1 EUR = 61.5 MKD

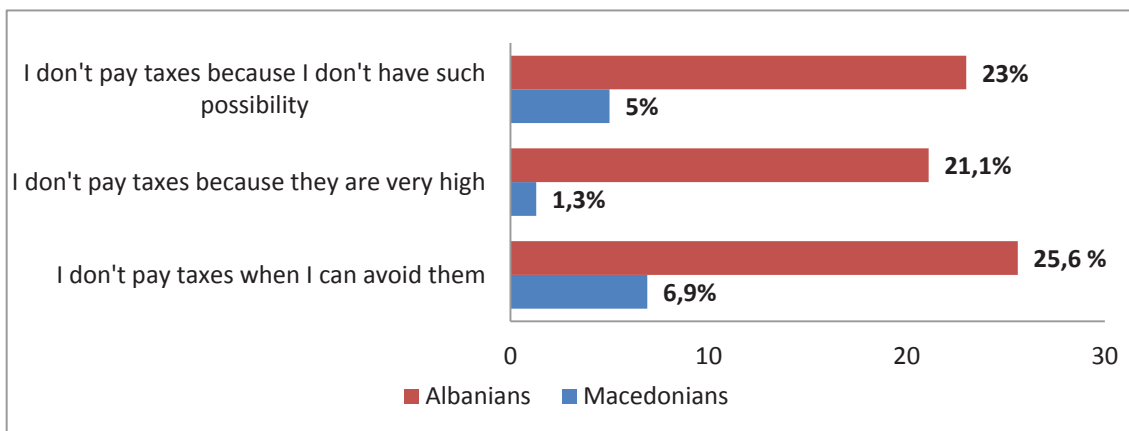


<sup>45</sup> Note: Respondents who reported they don't have such obligation and those who did not provide an answer are not included.

results confirm that the higher income households have higher tax morale than the poorer ones.

Despite the high percentage of lower income households who confessed of not paying taxes whatsoever, a relatively small share of the population admitted that they didn't pay taxes because they considered them too high. More than three quarters of households with a monthly income over 10.000 MKD expressed that they didn't agree with such statement and even among the households with the lowest incomes, only one quarter of the respondents agreed. Therefore, results displayed in Figure 39 suggest that the employment status and the level of household income are more decisive for tax compliance/morale than the current tax rates.

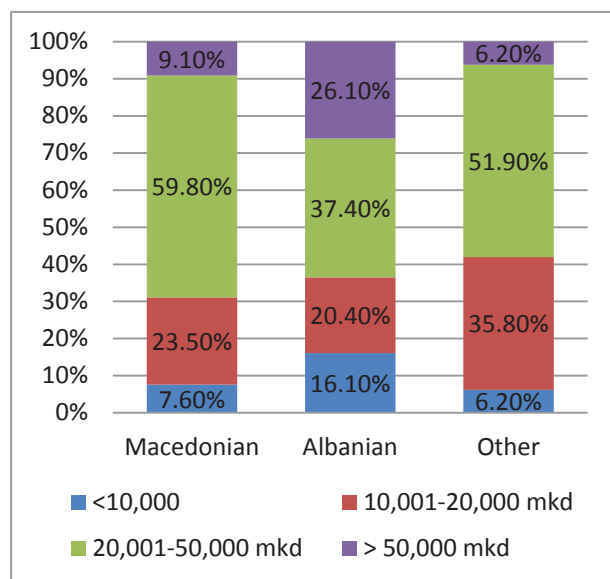
Figure 40 - What percentage of the population agrees with the following individual statements? (Population).



Apart from the family income, ethnicity of the individual citizens is decisive for tax compliance. Whilst “only” 11% of total ethnic Macedonian respondents of the survey confessed of not paying taxes, the same transgression was reported in the case of almost one third of the questioned Albanians. Furthermore, the Albanians were much more likely to admit that they didn't pay taxes if they could avoid them or to protest over the height of the taxes. What is more, a quarter of respondents from this minority claimed that they didn't pay “because they didn't have such possibility.”

**These numbers indicate a significantly lower tax compliance among the Albanians, which suggests lack of trust in the state institutions within this minority.** Therefore, measures to enhance social inclusion, good governance on the local level and general awareness about the tax obligations

Figure 41 – Household monthly income according to ethnic background (Q.D5 vs. D27\_B), (population). FX rate 1 EUR = 61.5 MKD



remain crucial to spur tax compliance. Nonetheless, it is important to note that the number of non-paying Albanians may be also dependent on the relatively worse economic situation of this community, as the previous parts suggest, is a crucial variable that determines the level of tax compliance. Furthermore, Figure 41 coupled with the fact that only 22% of Macedonian households have more than four members compared to 68% of Albanian and 41% of other households (i.e. smaller per capita income within the household due to bigger number of household members), **points to a larger economic vulnerability of all minorities (with exceptions), and thus larger susceptibility to mistrust in institutions, tax avoidance, and hidden economic activities.**

Macedonia, as a middle-income country, which is still reforming its tax authority, tax system and related measures against tax evasion and fraud, one can reasonably assume that Macedonia should expect at least a similar rate to GDP of tax evasion and fraud (7.9%) or at least 700 mln. EUR on an annual basis.<sup>46</sup> To put things in perspective, this estimate equals to 2 annual budgets (22 billion MKD per annum) of the National Health Insurance Fund of Macedonia

**Box 4 - Public Revenue Office (PRO). Source: In-depth interviews with the PRO**

**5 biggest problems PRO inspectors face while performing their duty:**

- Inability to establish contact with taxpayers due to inaccurate or old address data which makes it difficult to launch control. The PRO is forced to use other, more time consuming, methods of finding the taxpayer's headquarters.
- Unavailability of managers (taxpayers) especially when the managers are not residents of the Macedonia.
- Lack of accounting records.
- Inaccurate record keeping (bookkeeping).
- Lack of cooperation by the taxpayers to establish the facts for tax purposes.

**4 most common methods of tax evasion according to the PROs experience:**

- Registration of fictitious companies in order to generate fictitious documents, such firms which often and quickly deregister in order to hide the documentation traces.
- Some taxpayers using fictitious invoices and fraudulent practices, especially in the VAT system, in order to convey a fictitious tax claim which made unlawful discharge of the budget.
- Extracting cash from the company through loans in order to evade tax.
- Inspectors have difficulty in proving the authenticity of the documents concerning business turnover.

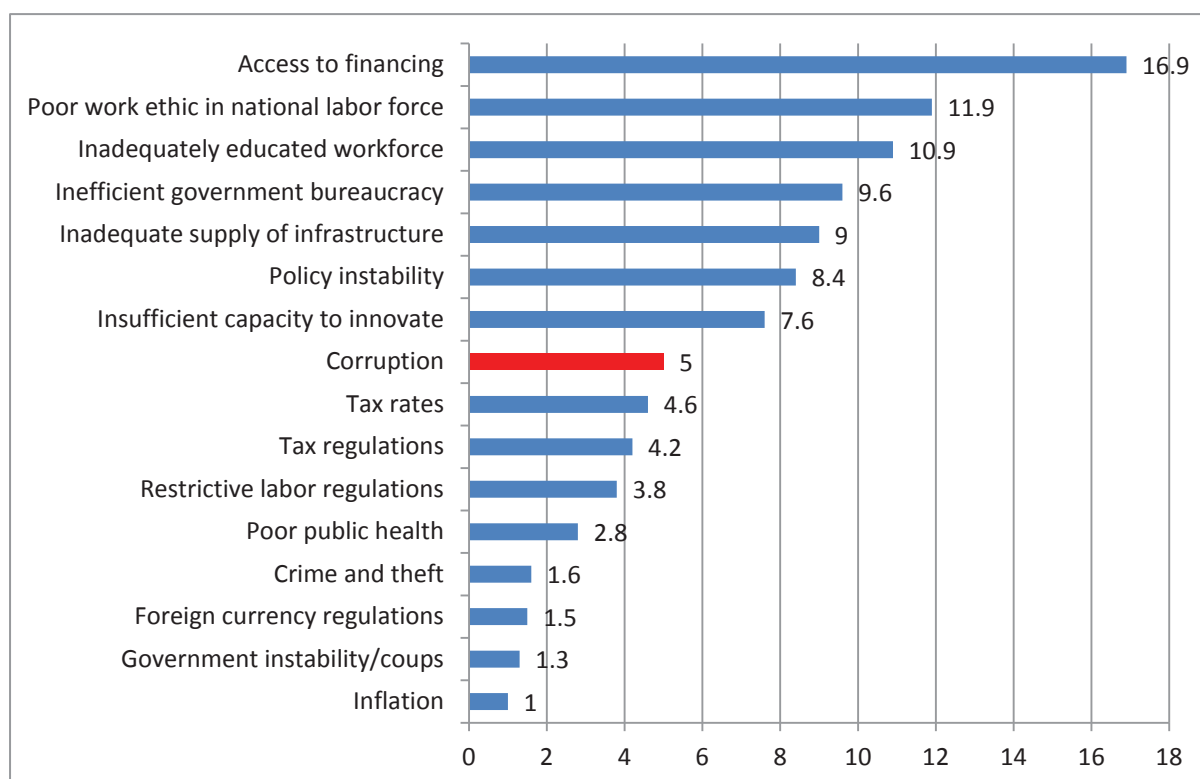
<sup>46</sup> Calculated by taking 7.9% of Macedonia's GDP for 2013 which is estimated at 10.2 billion USD or 9.02 billion EUR.

## 7. Business Environment and the Hidden Economy in Macedonia

In Macedonia, most informal employees and employers do not work at home, indicating some sort of organization close to firms. The proportion of non-agricultural informal employers who do not work at home is 95.2 % and for those in agriculture the proportion is even higher (Novkovska, 2008). Emphasis has been placed on the agricultural market stalls coined 'green bazaars' as the activity which is the most affected by hidden economic activity, in addition to, jobs in construction, domestic services and agriculture, which currently contributes 12% towards the Macedonian economy.

**Ostensibly, forming a department or organisation which embarks upon tackling the informal economy would be a vital stepping stone.** Dekker et al<sup>47</sup> found that only 8 out of 31 European countries (26%) had established one body dedicated to tackling undeclared work. This was either a single agency responsible for combating undeclared work or central coordinating committee responsible for tackling undeclared work. In Macedonia, no one single compliance body is responsible for tackling undeclared work, hence, research on the shadow economy must be implemented to reduce the structural disorders in the economy.

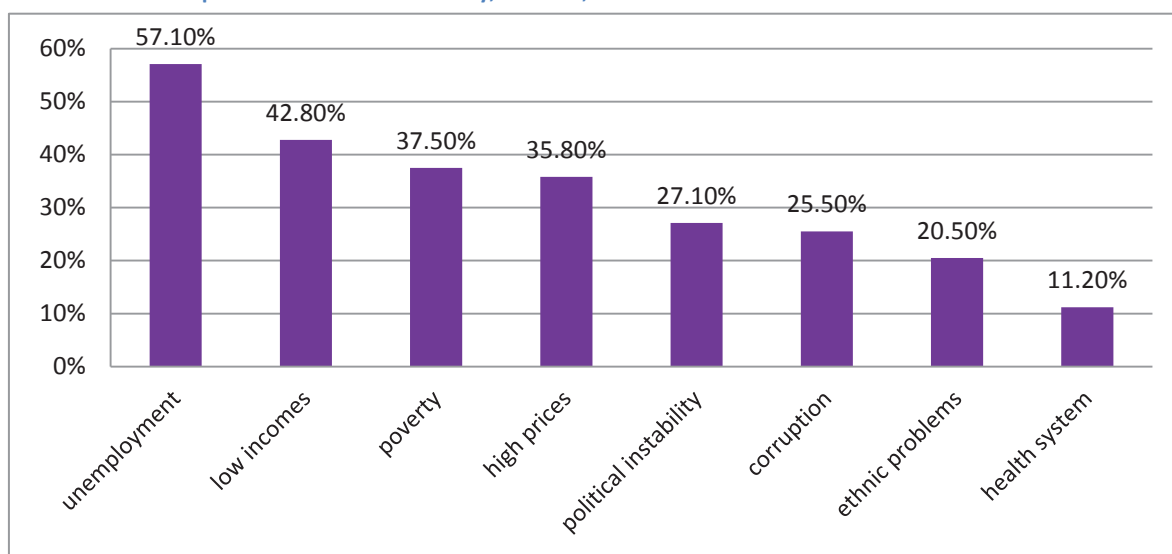
Figure 42 – Barriers (16) to doing business in Macedonia, in %. World Economic Forum – World Competitiveness Reports 2010 – 2015 (business)



<sup>47</sup> Dekker et al., 2010, *Joining up in the fight against undeclared work in the European Union*, DG Employment, Social Affairs and Equal Opportunities, Brussels. <http://ec.europa.eu/social/main.jsp?catId=471&langId=en> Date accessed 29 June 2015.

Nevertheless, the International Labour Organisation has backed awareness campaigns on the informal economy in Macedonia and this has had a knock on effect on its citizens as the relative size of the shadow economy in Macedonia has decreased over the last decade from 45% in 2001 to 34% in 2010. Furthermore, Macedonia had been ranked as the 4th "best reformatory state" out of 178 countries by the World Bank in 2009, in terms of economy. Hence, improvements are being made alongside accruing progress, which can help deal with the issue of the informal economy.

**Figure 43 - Three basic problems which Macedonia is facing (business).**  
 Source: National representative business survey, October, CRPM 2014

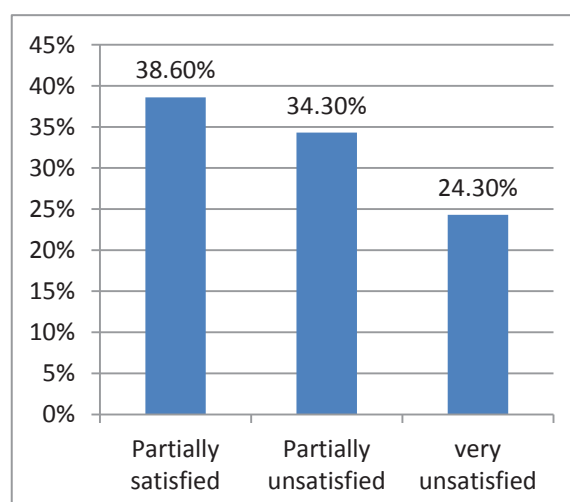


Perceptions and experience differ depending on which side of the hidden economy spectre the subjects belong to. Business representatives express somewhat different opinions compared to citizens, and rate corruption as the biggest problem the country is facing, followed by political instability, unemployment, bad climate for business development and low incomes. However, if one compares these results with the World Economic Forum competitiveness reports, corruption as a problem for businesses takes the 7<sup>th</sup> position in 2014 (out of 16). This discrepancy is likely due to the different methodologies used during data gathering.

According to the State Statistical Office (SSO), in 2014 there were 70.659 active businesses which compared to Bulgaria, for example, with a population that is 3.7 times larger (3.4 businesses per 100 citizens), its number of business entities is 5.3 larger than Macedonia's or 373.383 business entities (5.1 companies per 100 citizens).

Certainly the number of business entities is not the single most important factor in estimating how well they can project their

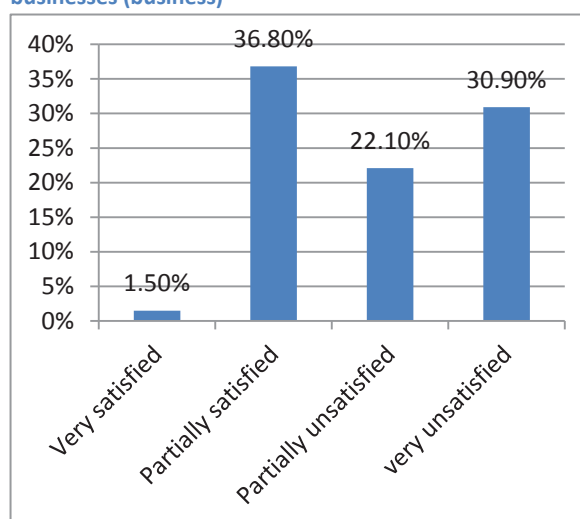
**Figure 44 - Satisfaction with laws/procedures influencing businesses (business)**





needs and concerns towards the policy makers but it does describe some dimensions such as lobbying power and influence over the long-term policy making process. In line with that, company representatives are rather divided when it comes to their opinions on the quality of procedures and public officials whose work directly influences businesses. **One third are partially satisfied with the quality of laws and administrative procedures, which directly influence businesses, while another third are partially unsatisfied.** Every fourth representative is very unsatisfied with the quality of such documents. Perhaps the reason lies in the perception of more than half of company representatives that laws are partially (27.5%) to a large extent unpredictable (26%) and they have become more unpredictable during the past 3 years (opinion held by half of representatives).

Figure 45 - Satisfaction with public officials dealing with businesses (business)



In addition to this is the perception that the business sector is only sometimes (40%) or never (24%) informed in advance concerning the laws and regulations influencing its work; and even when informed, the government only sometimes (41.1%) or never (28.6%) takes into consideration the opinion of businesses/business associations. This leads to the interpretation that **unpredictability of regulations is shaped by unknown insiders' interests protected by law-makers.**

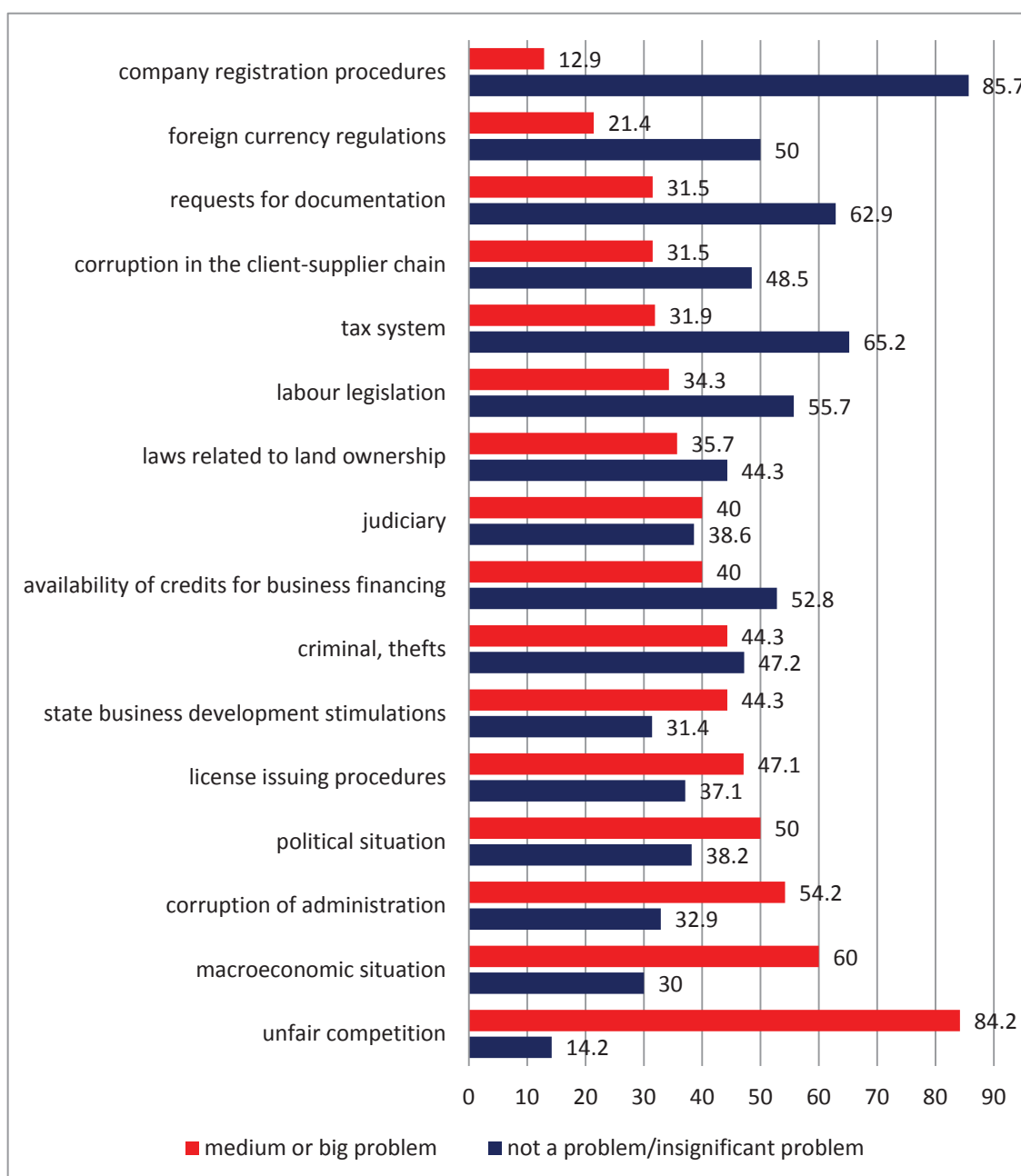
**Unpredictability of laws coupled with negative perceptions** of the Government's lack of 'hearing' and lack of timely information sharing about new laws should serve as quality assurance indicators to the Government and its policy makers about the products they are creating. Frequent and drastic changes do not give enough time for businesses to adapt and later fully comply with the new laws despite their willingness to do so. Certain institutions such as the PRO, as indicated in the background analysis<sup>48</sup>, show certain flexibility when dealing with companies in terms of tax compliance and providing companies with relevant information. **The flexibility is often motivated by the fact that administrators not linked with the top political power see the unlawful alliances between party leaders, law-makers and certain firms benefiting from the changes in the regulations and this is their fair response to unconnected firms.** The source of the problem with law unpredictability by no means is at the implementation level, but rather deeply rooted at the formulation/adoption level of policy making and indicates a serious state capture.

<sup>48</sup> Mickovska R. A; Shurkov E. *Background Analysis on the Spread and Trends of the Hidden Economy in Macedonia* (CRPM/CSD 2014). Retrieved from: <http://www.crpm.org.mk/?p=13971>

The unfair competition is detected by businesses as the major problem for the development of their business. This is in line with the data from the WB survey where companies are most concerned with the informal businesses which actually represent their unfair competition. More than half see a threat in the macroeconomic situation and the corrupted administration. In terms of company size one can observe different perceptions, on one hand the judiciary and macroeconomic situation present a bigger problem for small/medium companies than micro companies.

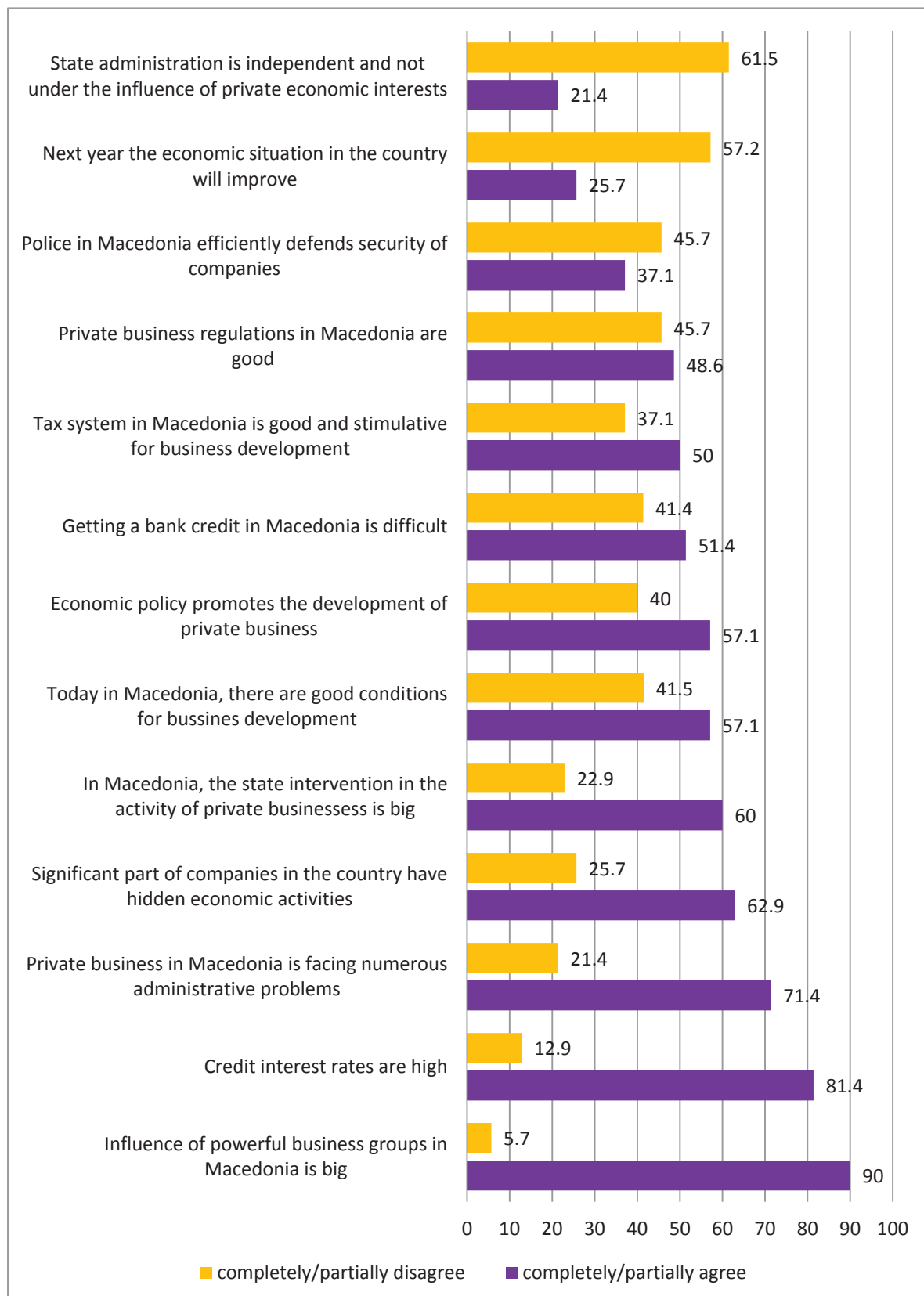
On the other hand, unfair competition presents a bigger problem for micro companies. Micro companies already work with smaller profit margins, smaller reserve capitals, and their products and services usually lack economies of scale which means that unfair competition can easily hamper and challenge their operations.

Figure 46 - Main problems for businesses in Macedonia (Q. C8) (business)



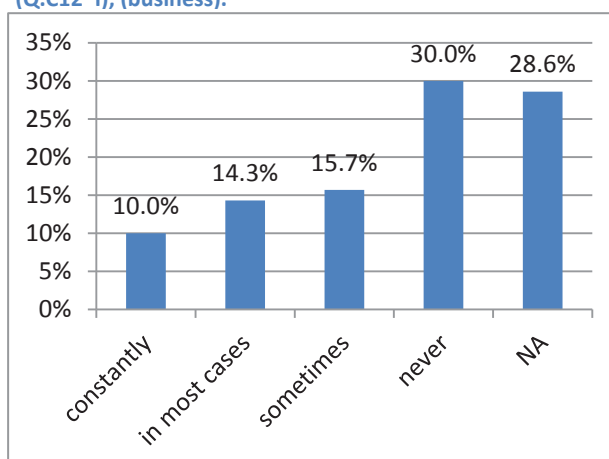
The data indicates that problems for businesses can be compiled into three different

Figure 47 - Level of agreement with issues related to functioning of businesses (Q. C9) (business)



sources: (1) other businesses which function partially or completely break the law; (2) corruption in the administration; and (3) unstable macroeconomic situation. Since the core of these issues is fundamentally different, they all need to be tackled separately. In effect Figure 46 provides policy makers with a map for establishing the present situation and evaluation of present and future policies as trends can be followed as data is updated.

Figure 48 - Performing procurement without tender (Q.C12\_I), (business).



The responses to the two questions show in more detail and point directly to certain elements of the business environment which are responsible for businesses satisfaction/dissatisfaction. Just as in the previous case, this figure can be used as a policy map for business environment efficacy and proper policy targeting. The data implies that **state capture prevails in Macedonia:**

- **90% of businesses partially/completely agree that the ‘influence of powerful business groups in Macedonia is big’**
- More than 80% partially/completely agree that ‘private business is facing numerous administrative problems which goes in line with the 60% or more who perceive the state administration as dependent and influenced by private economic interest.
- More than 60% partially/completely agree that there is large scale state interventionism in the activity of private businesses
- **More than 60% partially/completely agree that significant share of companies perform hidden economic activities.**

Figure 49 - Performing illegal inflow or outflow of financial assets (Q.C12\_K), (business).

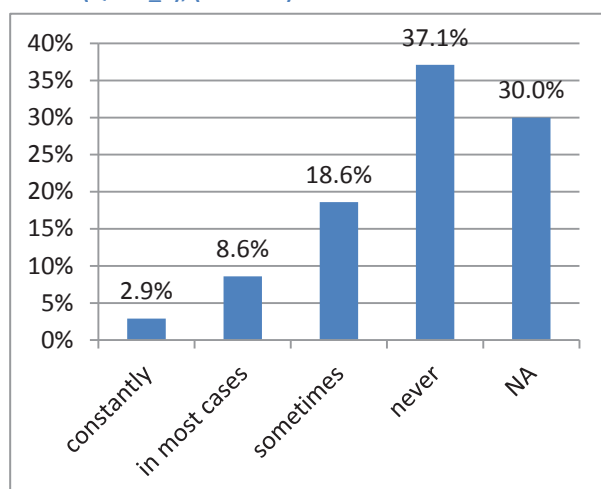
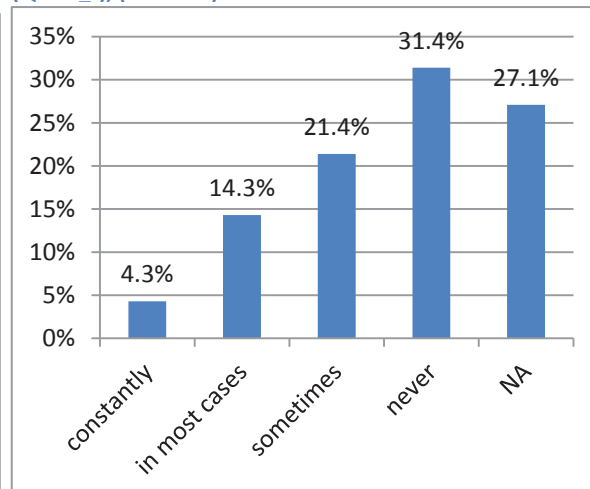


Figure 50 - Executing deals in-kind or exchange of goods (Q.C12\_J), (business).



- More than 80% partially/completely agree that loan interest rates are high which impedes on general access to capital which was also marked as a top problem for businesses in 2014-2015<sup>49</sup>.

It is not very common for companies to pay cash when it comes to concluding big deals in cash. Namely, only 4% stated that there is constant practice of paying in cash, while 13% in most of the cases practice cash payments. Most of the companies never (37%) pay cash in this type of deals.

**Box 5 - Most effective methods for tackling the hidden economy according to the Public Revenue Office of Macedonia.**  
Source: In-depth interviews with the PRO

**a. Most effective general methods for tackling hidden economy are:**

- **Informing the subjects** of compulsory registration of their economic activity
- **Raising awareness** on the voluntary payment of tax liability
- **Advisory assistance** for registration and settlement of liabilities
- **Simplifying the procedure** for registration and submission of tax returns.

**b. Most effective particular methods for tackling hidden economy are:**

- 1. The operation of the “hot line 198 - report irregularities”** and reporting irregularities electronically which helps to locate taxpayers who perform undeclared work.
- 2. Conducting visits to the already identified unregistered taxpayers** which helps with educating and guiding taxpayers on correctly performing a registered activity.
- 3. The introduction of a register of taxpayers that perform temporary business.** Extends the scope of tax collections over unregistered taxpayers, legalizes their business and ensures payment of taxes.
- 4. Lowering the threshold for registration for VAT purposes** from 2.000.000 MKD to 1.000.000 MKD (from 33.000 EUR to 16.500 EUR). With the increase in the number of taxpayers who have a legal obligation to register for VAT purposes, there was a decrease in the number of legal entities that do not calculate VAT and thereby providing fair market competition.
- 5. Fiscal education of the youth.** Implementing the project Fiscal education of young people (high school and university students) explained the social benefits of paying taxes in order to create real prerequisites for the creation of conscientious and socially aware future taxpayers.
- 6. Performing tax (inspection) controls.** Including but not limited to: Detection of unregistered taxpayers, identifying irregularities, inaccurate determination of the tax base, etc.

Regarding procurement activities the perception of the business representatives is that approximately one third of the companies never (30%) conduct procurement without adequate tender procedure. On the other hand, nearly half (46%) of the respondents stated that companies bypass the legal provisions when it comes to tendering procedures. Most of them avoid tendering procedures only sometimes 15.7%, while 14.3% in most cases. Significant portion of 10% stated that companies constantly conduct procurements without upholding to the envisioned legal tendering procedures.

<sup>49</sup> World Economic Forum (WEF), World Competitiveness Report 2014 – 2015. *Barriers to doing business in Macedonia*. Retrieved from: <http://www3.weforum.org/docs/GCR2014-15/MKD.pdf>

Regarding the question “**How often do companies conclude deals in kind/goods within your sector?**” (Figure 50) business representatives stated that 31.4% of the companies never execute this type of deal. Respondents reported that 14% of the companies conclude deals in kind or goods in most cases, while approximately 20% of the companies practice this type of deals only sometimes. According to business representatives perceptions, **illegal inflow or outflow of financial assets** (Figure 49) is not very common among the companies. Namely, up to 37% consider that companies never execute illegal inflow/outflow of financial assets, while significantly smaller proportion 18.6% sometimes and 8.6% never think that companies perform illegal inflow/outflow of financial assets.

## 8. Conclusions and Recommendations

Macedonia has a **serious problem** with the size and the proliferation of the hidden economy and its different components. The Hidden Economy Index presented in this report confirmed that both its business and households sectors see the hidden economy as a substantial obstacle to their operations and a **widely accepted practice**. Hidden employment is the component that stands out as the most urgent and problematic issue to tackle. This is particularly true for the most **vulnerable groups, such as lower income, lower education households**, which are most often victimised through hidden employment at the backdrop of the very unemployment rate in the country. A third of the employed under-declare income, and another 6% do not have a contract at all. Tax morale increases with income but even at levels higher than the average monthly wage in Q1 2015, a fifth of the people declare they would still choose to hide income. **The latter indicates long-term structural problems, which requires patience, persistence, and determination to tackle.** These results, despite notable discrepancies in the different data sources, conform to the findings of the Labour Force Survey, the System of National Accounts calculations, as well as to other national and international, academic and policy studies.

The Government of Macedonia has understanding of the problem, and under pressure from the EU, has increasingly engaged in deliberate policy action to tackle the hidden economy. Appointing the Ministry of Labour and Social Policy as the coordinator of the action plan on countering the hidden economy clearly demonstrates the government's apprehension that it is hidden employment that needs the most urgent attention. **The government's overall economic policy towards lowering tax rates and improving the ease of doing business deserves commending as it seems to have contributed to the lowering of non-compliance.** But the authorities in Skopje should carefully reconsider their longer-term strategy, as general government revenues have fallen steadily below 30% of GDP after 2011, which is a worrying indication of its **capacity to provide better public services in the future.** This implies a drastic increase in the efficiency of delivering public goods to the public, which does not seem to materialise.

The Macedonian government needs to step up its efforts in tackling the hidden economy by **ensuring better coordination and collaboration** between the key different ministries and institutions, such as the Ministry of Labour and Social Policy, Ministry of Finance, and the Ministry of Economy. In addition, there is a need for a much bigger involvement of **the Macedonian parliament and the political parties** in finding working long-term solutions, as it is likely that the problem is here to stay irrespectively of the power constellation. **Ethnic Albanian parties** should be particularly active in providing and following up on ideas, as data suggests hidden economy issues are particularly pronounced among the Albanian part of society. Even more importantly, this is where the largest part of the most



vulnerable groups also is. Upcoming elections in early 2016 will provide suitable platform for exchanging views and engaging with long-term ideas about policies to tackle the hidden economy.

Important allies to the Government of Macedonia in its efforts to tackle the hidden economy should be active civil society organisations, as well as the social partners. It is advisable that these be brought together to meet two to four times annually under the auspices of the leading ministry to review progress and chart new ideas. Their work should be aided through the **establishment of a regular monitoring mechanism**, such as the Hidden Economy Index, as well as of formal *ex ante* and *ex post* policy evaluations of particular measures, based on best EU **evaluation standards**. The EU Delegation should also be involved in the work of the Task Force to ensure EU support and compliance with the overall EU accession process.

The hidden economy is a highly complex phenomenon and **requires systemic and complex solutions** and not just campaigns targeting isolated manifestations. **Formalisation of businesses** might also be a **long and complex process with impacts market structure, rebalancing of the market power of existing players and consumers, and employment**. Hence, governments should plan their policies to tackle the hidden economy accounting for the impacts of the process and making sure it is fair and transparent. **Sequencing of reforms** is of paramount importance for limiting the social cost of transition from hidden to formal economy and preventing unfair advantages for business owners, who are close to law enforcement and control officials in charge of legalization processes. In order to design and implement a long-term comprehensive program to tackle the hidden economy it is important to have:

- A widely accepted by policy makers, business associations and civil society holistic **measurement system of the hidden economy**, which will allow for thorough, reliable, valid, timely and sensitive to changes assessment of its dynamics, its causes, costs and effects. The Hidden Economy Indexes could serve as a first iteration to developing such a system;
- An **efficient inter-ministerial and public-private coordination and cooperation mechanism** to counter hidden economy should be in place. The proposed Task Force on Hidden Economy by CRPM and CSD can serve as a secretariat for this mechanism. The **coordination should be planned on different levels** – both **analytical** and **strategic** (e.g. with Organized Crime Threat Assessment regularly implemented by the Ministry of Interior) and **operative** (e.g. with simultaneous inspections by different control units or information exchange between them);
- The Task Force on Hidden Economy should prepare a **Strategy and action plan with appropriately sequenced reforms** to be accepted by policy makers, business associations and civil society.

- The action plan should provide for a **regular monitoring of hidden economy** against the implementation of reforms with the measurement system described above.
- The action plan should provide cost-benefit and impact analysis for different formalisation strategies that can be applied in order to guarantee a transparent and fair process;
- The inter-ministerial and public-private coordination and cooperation mechanism should provide **technical and business interoperability between the information systems** of all engaged with countering the hidden economy.

The Macedonian economy and domestic consumption in particular is highly dependent on remittances, domestic private transfers, unrecorded production and retail of agricultural products, and the provision of various services to households and individuals on a non-market basis. Although some of the remittances are used as investments, most of it goes in the hidden economy and even in unregistered firms (relatively large extended family handicraft informal organisations). A significant share of the long-term unemployed are actually participating in the hidden economy and/or relying directly or indirectly to a combination of remittances and hidden economy through relatives. So, **a pragmatic policy to foster entrepreneurship and investments in the formal sector based on remittances** might contribute to the creation of new workplaces and economic growth and lower the hidden economy. In particular, this report has the following recommendations on the remittances policy:

- Improve the way **remittances are measured and assessed** by the state authorities, as the official transfers (accounted through the International Transaction Reporting System) represent only a small fraction (still a sizable share of GDP – 2,5% of GDP) of all remittances;
- **Simplifying and reducing transaction costs** associated with remittances to reduce their hiding. Sending remittances home officially is usually extremely expensive and regressive. But, still, whatever way people find to send money home it still could be optimised through a modern financial system and the cost differential to be used for socially productive purposes.
- A lot of remittances come themselves from sources in the hidden economy of the host country (not surprisingly, even from similar sectors – construction, children and elderly care, low-paid and low-skilled work in services, transportation, prostitution, etc.). Hence, cooperation **between national authorities in particular in the EU is needed to counter hidden economy in cross-country cases**.
- **Strong political engagement in support of diaspora projects** – be it start-ups, business support centres or pure philanthropy. The message politicians and civil

society organizations should send both the recipients and senders of remittances is that **engaging as investors and mentors to businesses in Macedonia contributes better than just sending cash.**

- Even in cases when the sender has not enough background and skills to serve that role (investor, mentor) and does not have enough funds to invest, but has enough to support his immediate family, the government might be able to help by:
  - **Securitisation of diaspora savings or even remittances** (diaspora bonds) that could in turn be used to fund public or private socially responsible projects. Governments of India and Israel have managed to do that successfully, along with other developing countries.
  - **Provide necessary training (or fund it) of personnel** and needed consulting services through business incubators to start-ups of diaspora, who would like to help their families or dependents start a business with their help. Special emphasis and support should be given to initiatives that would formalise unregistered businesses and would generally reduce the hidden economy.
- **Develop co-financing schemes for engagement of unemployed** with different magnitude of support based on type of unemployment and area of projects (youth unemployment, long-term unemployment, etc.). Long-term unemployment has already turned into permanent loss of employability for most of this group, which calls for sustained government social support.
- **Improve the success rate of programs dedicated for employment of members of vulnerable groups (Roma unemployed and social assistance receivers) through cooperation with external social partners and NGOs.** The Employment Agency has built good track record on implementing different employment programs. However, there are certain deficiencies in generating successful employment especially among the most vulnerable groups who are the most frequent suppliers and providers of hidden economic activity. Subsidizing the employment of users of social assistance and integration of the Roma population into the formal economy is important for reducing social tensions.
- **Strong political engagement in fighting income inequality** on a state and regional level especially concerning the vulnerable groups (low income, low educated, women, long-term unemployed, ethnicities). Political party agendas should reflect a clear strategy for decreasing income inequality among its respective electorate that goes beyond the prerequisites for proportional employment of ethnic groups in the public administration that are drawn from the 2001 Ohrid Framework Agreement (OFA). Even though these prerequisites improve the general position of the ethnic groups in Macedonia, nevertheless they show a lack of any focus on

vulnerable groups which is even further exacerbated by corruption and clientelism that plagues the political system and the society as a whole.

Macedonia has **relatively simple tax system** and relatively low rates of profit and income tax, as well as VAT though tax service delivery seem to remain rigid, as the share of businesses dissatisfied with certain aspects of the tax system remains high. Social security contributions, though are in a league of their own, as people overwhelmingly consider they do not get the protection they (should) pay for. The cap for social security is significantly higher than in Bulgaria (close to twice), compared to the average salary, and also the rate is higher, hence there is a huge incentive not to report the salaries partially or in full. It is important that authorities focus on finding a long term balance, which would require less intervention later on, even if it necessitates stronger budget support now. The following is a non-exclusive list of ideas, which might help ease the situation with social security non-payment:

- **Increase tax compliance readiness:** Social security currently does not pay off in the eyes of private employers and employees and this is a decisive factor for evasion. Simultaneous reduction of the cap and rates of social security with increase of the base of those paying could be helpful. Currently, it seems that the pension system works fine primarily for the privileged public officials and managers of state owned enterprises. Data from Macedonia already suggests that reducing rates for social insurance might actually increase revenues through higher compliance<sup>50</sup>.
- **Increase the capacity of the administration** to detect non-compliers and to collect its debts. This could include introduction of risk management system (selectively inspecting those with the highest potential negative impact), but the most important measure would be to unify the tax administration with that responsible for social security contributions collection.
- Existence of various **exceptions in the tax base for VAT is a strong incentive for VAT fraud**, so broadening and harmonization of the VAT tax base would serve as an important instrument to limit the hidden economy.
- **Expedite VAT returns** in-line with increased institutional interoperability and data sharing. According to businesses, VAT returns are lagging significantly and increasing overall financial and administrative burden on companies and increases incentives to operate within the informal economy.
- **Abolish the municipal corporate tax (firmarina)**, which although not substantial generates a lot of confusion and frustration. Firmarina is a fixed amount paid by

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<sup>50</sup> Shurkov, E, Mickovska R.A. , (2014) "Hunting the Shadows – Tax Evasion Dynamics in Macedonia" Policy Brief nr. 33, Dec. 2014. Retrieved from: [http://www.crpm.org.mk/wp-content/uploads/2015/03/PolicyBrief33\\_ENG.pdf](http://www.crpm.org.mk/wp-content/uploads/2015/03/PolicyBrief33_ENG.pdf)

office, no matter how big or small the company is in terms of employed or turnover. Alternatively, the policy makers can look into the possibility of tax payment in semi-annual or quarterly instalment payments in order to spread the burden across a wider period and soften its negative effects especially on micro businesses, which take longer periods to accumulate income and profit.

- **Invest in the newly proposed Paperless Tax Administration** (new IT system for the Public Revenue Office). In accordance with the Study it will entail an investment of 5 million EUR for three consecutive years to develop the system. It points out that, in accordance with experience from the implementation of such systems in other tax administrations that the new IT system with only 1% increase in the tax and contributions collection rate the return of investment pays out after the first year of implementation of the new IT system. The new system should increase efficiency and interoperability among different agencies.

Hiding imports at the customs is one of the most potent hidden economy activities, which provides quick returns for the perpetrators, and send shock waves of informality down the value and retail chain. The situation at the Macedonian customs shows some alarming indicators. Citizens and businesses perceive corruption at the customs as high. Mirror statistics prove that, for instance, only 67% of officially exported goods from Greece to Macedonia in 2014 (as reported by Greek customs) has been officially imported in Macedonia from Greece (as reported by Macedonian customs)<sup>51</sup>. Limiting the hidden imports to Macedonia, can be achieved through:

- **Highlighting the linkages between smuggling and contraband and political party financing through the undue savings from import duties and taxes.** Hidden imports **could be traced down to specific groups of goods**, and then linked to the main importers involved, and whether they have party funding or kin relationships with decision-makers. Although ComExt database has always been public, it is rarely if at all used by investigative journalists, custom officials, revenue agency or law enforcement officers.
- **Implement rotations (officer rotations, shift rotations, randomised computer generated check schedules) at the customs to prevent routinizing the corrupt relationships between officers and companies/truck drivers.** Introduce random checks by mobile units, unaware of what they will be checking, randomly generated routes etc.
- **Strengthen country-wide** whistle-blowing programmes piloting them in the customs. The program within customs should be synchronised with the rotation management, and random checks and this might have a considerable effect on corruption and hiding.

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<sup>51</sup> As retrieved from ComExt database of Eurostat: <http://epp.eurostat.ec.europa.eu/newxtweb/>

- **Introduce sophisticated IT systems**, which can connect customs within Macedonia, but also to their neighbours to have real-time data and automatic fraud detection and, red-flagging of imports or importers.
- **The State Labour Inspectorate (SLI) should develop a reporting system that is compatible with the major data management systems and software.** A more detailed view of the irregularities they detect such as unregistered workers, unpaid wages, envelope wages etc., and the context in which they happen can give analysts and advisors within the MLSP and EA as well as external researchers, powerful tools for comprehensive analysis of the labour market and its irregularities, which can be linked to the hidden economy. This reporting system, however, has to be compatible and adopted by other related institutions and agencies that provide publicly available data on their activities, such as the Financial Police (FP), State Market Inspectorate (SMI), Customs, etc. This data management compatibility among institutions will increase their interoperability, and will provide researchers with ample detailed data that can lead to faster policy recommendations, proof-based policy evaluations, and data and feedback for improving policy implementation, which has been noted as a continuing problem by the EU progress reports.
- **The Financial Police (FP) should implement the same data management system as the SLI, and ensure data exchange with the Public Revenue Office (the PRO).** Additionally, it should develop a data exchange system with the courts, which process the cases they have provided against the perpetrators especially in terms of revenues lost and fees collected. The PRO can have a leading role in the design of this connection between the FP and the Courts due to their extensive experience in data exchange and implementing reporting and data management systems. This data will provide insights into the scale of these offenses as well as the efficiency of the FP and the courts in processing such cases, which is important for discouraging new offences and encouraging tax morality.

Macedonia, as most EU 28 countries, employs measures targeting undeclared work and tax evasion which **focus predominantly on repressive and punitive measures** despite some recent measures towards enabling formalization of labour and businesses. The GoM should consider, first, **changing the balance among the existing punitive measures** (progressive punishments fees) and second, **the balance between punitive measures and incentives**. Businesses claim that incentives are lacking - pointing out that this is a primary reason to hide economic activity. Coupled with preventative measures such as **increased and better targeted outreach and education measures towards the main risk groups** should be able to overhaul the balance of measures in favour of enabling formalisation.

However, there is evident **absence of evaluations of different policies and measures**, especially in-depth assessments which go beyond the basic numeric indicators. This in

turn prevents more valid estimations of the effectiveness of different policies and particular measures. **Evidence-based policy making is a must in order to achieve the appropriate balance between punitive, preventative and stimulating measures.**

Last, but not least, **the unpredictability of laws** has been posed as a **big problem** by more than half of businesses. It should serve as an important indicator to the government and to policy makers. **Frequent and deep changes do not give enough time for businesses to adapt and later fully comply with the new laws despite their willingness to do so.**



## Annexes

### 1. Methodology and Characteristics of the Samples

Data in this report is primarily sourced from two national representative surveys, which CRPM conducted during the month of October 2014.

The **population survey**'s sample was based on census data from 2002, and was conducted nationwide, through face-to-face interviews lasting between 30 to 40 minutes. The questionnaire was adapted from CSD's population survey questionnaire for Bulgaria to ensure comparability of results. While certain questions were adjusted to fit the Macedonian context additional questions were added in order to catch more facets of the Macedonian society and local policies. It consisted of two sections: hidden economy and general demographic information. The section about hidden economy consisted of five sub-sections: merchandise and services; expenses and savings; perceptions of the hidden economy; employment; and taxes. The questions reflected the respondents' actual experience with the hidden economy, following the victimization approach and their perceptions of the phenomenon. HE Indexes are based primarily on the actual experience questions from the survey.

The **business survey** was conducted nationwide, through a field survey, and the sample designed on the basis of data on the structure of companies in Macedonia, according to size, sector and regional distribution, available in the State Statistical Office report on active business unit.<sup>52</sup> The survey consisted of six sections: basic information; general perceptions on the subject and manifestations of the hidden economy; taxes, specific perceptions on the manifestations of hidden economy; customs operations connected with the import/export of goods; and in-kind payments/compensations and issuing of accounting documents.

The questionnaire was developed by CSD, following its experience in Bulgaria to ensure comparability of data, and was adapted and piloted by CRPM. Face-to-face interviews were conducted with each company representative, lasting from 40 to 60 minutes. Companies were asked to assess their branch or sector of economic activity (as they would understand it – those reference market players they compete with) from the point of view of different hidden economy characteristics instead of direct questions about their own behaviour as the best proxy available to measure hiding.

The data from the surveys were entered into two SPSS databases and processed by using SPSS.

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<sup>52</sup> State Statistical Office database on active business units. Available at shortened URL address: <http://goo.gl/xlrJ3Z>

**a. Population survey: characteristics of the sample**

The sample for the population survey consisted of 1116 respondents, with demographic characteristics nationally representative for the Republic of Macedonia. 52.1% of respondents were male and 47.9% female. 35.8% were aged 18-34, 36.9% 35-54 and 27.3% 55 and over.

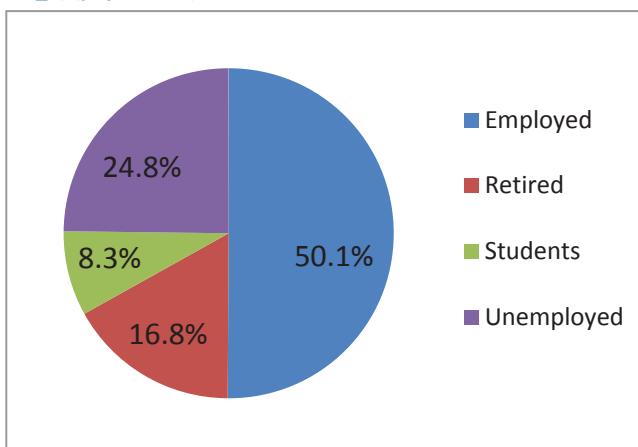
With regards to educational background, 2.2% had less than primary education, 15.4% - primary education, 48.7% secondary education, 8% higher and 25.4% university education.

Regarding the marital status, 27.5% were single, 63.2% married or living with a partner, 1.6%-divorced and 7.4% widowed.

According to their ethnic background, 68.4% were ethnic Macedonians, 22.8% ethnic Albanians, 2.4% ethnic Turks, 2.7% Roma, 1.7% ethnic Serbs, and 2% other ethnic groups. 23.2% lived in Skopje, 25.5% in a larger town, 16.1% in small town and 35% in a rural region.

According to their economic activity most (50.1%) were employed, 24.8% were unemployed, 16.8% were retired, and 8.3% were students.

Figure 51 - Interviewees according to their economic status (Q. D7\_7) (population).

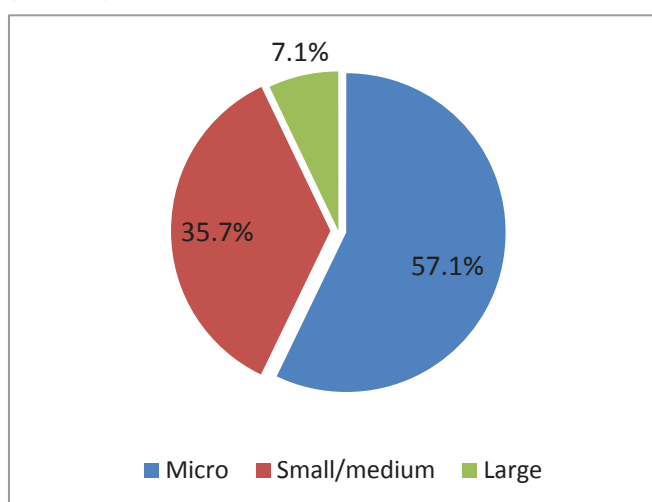


**b. Business survey: characteristics of the sample**

Although the sample seems small (70 businesses interviewed) CRPM have enough reasons to accept validity and reliability of the results mainly due to the sectorial structure of the sample and the fact that respondents were top decision-makers if not owners/partners. Larger samples are often implemented at the expense of two factors: a) reaching out

lower level personnel, who might not feel ready or comfortable talking about sensitive issues like hiding or circumventing; and/or b) reaching predominately sole-proprietors and businesses that represent a form of self-employment and their assessments are closer to general population rather than to companies from the sector. Other similar analyses have been made based on comparable samples, like the flat tax assessment by Stojkov,

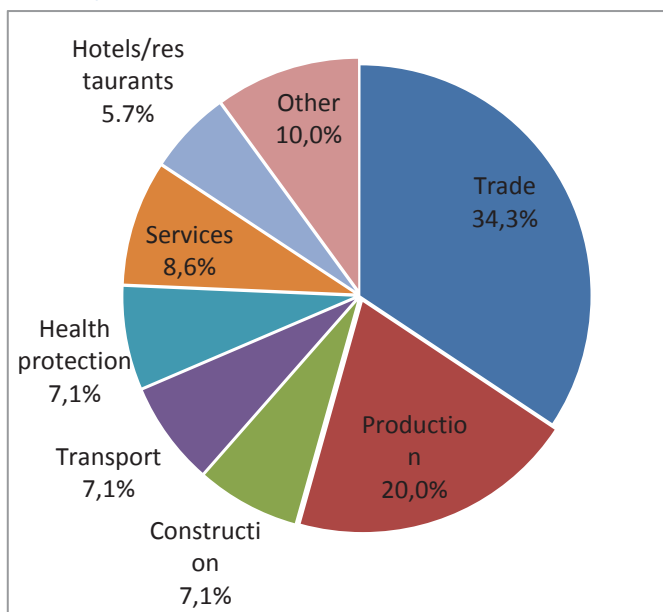
Figure 52 - Structure of interviewed companies by their size (business).



Nikolov and Smilevski (2008) made on a sample of 100 companies, and they have produced sound results.

Out of the 70 businesses interviewed, 40 (57.1%) were micro companies with 1-10 employees, 25 (35.7%) were small and medium companies with 11-250 employees and 5 (7.1%) were large, with over 251 employees. The size structure is biased towards bigger companies, however the sample best fits the economy according to turnover and value added criteria and thus would provide more valid and reliable data as it concerns the hidden economy.

Figure 53 - Distribution of companies according to sector business).



About one third (34.3%) were from the sector ‘trade’ combining small and large trading companies, 20% from ‘production’, 7.1% construction, health protection and transport, 8.6% services, 5.7% hotels/restaurants, and 10% from other sectors (see Figure 53).

Most of the interviewed company representatives were owners (42.9%) and directors (28.6%) of the company, 12.9% were sector managers and the rest were partners, executive board members, financial managers, and others. With regards to the legal status, the majority (67%) were Limited Liability Companies, 7.1% sole traders, 7.1% shareholder companies, and 18.6% had other legal status.

Less than one third of companies (31.4%) reported to be members of business associations or lobby groups. This is related to size. While all large companies and somewhat less than half of small and medium companies reported to be members, less than a quarter of micro companies have membership in such associations.

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