



# TACKLING UNDECLARED WORK IN THE FYR OF MACEDONIA: KNOWLEDGE-INFORMED POLICY RESPONSES

## GREY Policy Brief, No. 2, 2017

**Non-compliant practices are deeply ingrained in FYR of Macedonia.** Some 35% of adult Macedonians use personal connections in order to circumvent formal rules and procedures, 17.7% purchase undeclared goods and services, 6.1% work in the undeclared economy, and 13% of employees receive envelope wages from their employer, providing an additional 39% to their net income.<sup>1</sup> The GREY project research findings reveal that tax morale and personal views on the extent to which others participate are key determinants. The lower one's **tax morale** (i.e., level of 'vertical trust'), the higher is the propensity to participate in the undeclared economy. Likewise, the higher is the perceived number engaged in such activity (i.e., the level of 'horizontal trust'), the more likely is a citizen to engage in illegitimate economic practices.

### Macroeconomic Overview

**FYR of Macedonia has been engulfed in a serious state and political crisis since 2015.** It followed from the revelations of widespread wire-tapping in the country. The political instability illustrated the vulnerability of Macedonian democracy and its market economy, amounting to state capture or the

dysfunction of formal institutions<sup>2</sup>. The crisis provides a nourishing environment for engagement in non-compliant practices, including UDW.

#### KEY POINTS

- **Undeclared work has deep roots** in FYR of Macedonia. 1 in 16 adults and 1 in 8 of the employed engage in undeclared work. The use of informal connections to circumvent formal institutions is practiced by 35% of Macedonians.
- **Formal institutions in the country are underdeveloped.** Unemployment also remains unusually high compared with the EU average.
- The **traditional repression approach** to tackling undeclared work, which has been prioritised so far by the authorities, is ineffective.
- Increasing penalties and surveillance/control should at the very least be supplemented by **public awareness raising campaigns, educating citizens,** and the further **modernisation of the state institutions.**
- The government should **increase spending on the socially excluded,** including among the ethnic Albanians.

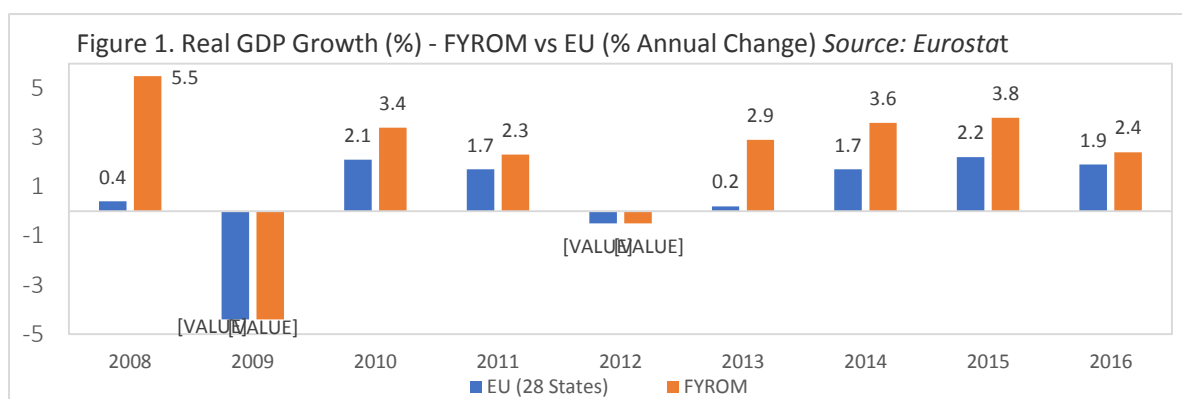
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**Authors: Ruslan Stefanov, Colin C. Williams and Peter Rodgers**

<sup>1</sup> Bezeredi, S. and Williams, C. *Illegitimate Economic Practices in FYR Macedonia*, Sheffield University Management School and Institute of Public Finance, Zagreb, May 2017, GREY Working Paper No.10

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<sup>2</sup> European Commission, *The FYR of Macedonia 2016 Report*, SWD(2016) 362 final, Brussels, 9.11.2016



Partly as a result of the political crisis, GDP growth in the Former Yugoslav Republic of Macedonia (FYROM) has slowed down by 1.4 percentage points in 2016 to 2.4% and even to 0.0% in Q1 2017. However, the growth rate has been higher than the EU average for most years since the recession but remains too low to allow real convergence or catching up to market economy standards (Figure 1).<sup>3</sup>

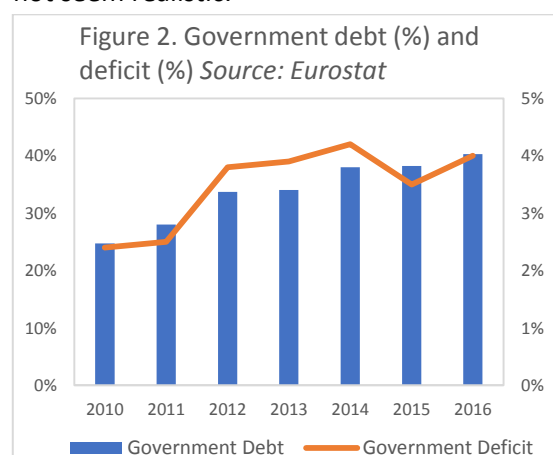
A further consequence of the political crisis is the deterioration of the business environment, especially in terms of weak enforcement and corruption.<sup>4</sup> While FYROM ranked 10<sup>th</sup> in 2017 on World Bank's Ease of Doing Business index, the country has become notoriously known for its government's tight control on business flows.

The macroeconomic stability of the country has been eroded by the rising levels of public debt. While trying to stave off the crisis, government debt has risen from 25% of GDP in 2010 to 40% in 2016 (Figure 2). Furthermore, government deficit has been on average 3.5% since 2010. This is primarily the result of a huge trade deficit, which is estimated at 19.9% in 2016 and which is expected to remain high, due to political uncertainty and a decrease in FDI. Authorities are planning a reduction in expenditures and

<sup>3</sup> European Commission, FYROM 2016 Report, 9 November 2016, available at: [https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key\\_documents/2016/20161109\\_report\\_the\\_former\\_yugoslav\\_republic\\_of\\_macedonia.pdf](https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2016/20161109_report_the_former_yugoslav_republic_of_macedonia.pdf)

<sup>4</sup> Ibid.

expect that government deficit will fall to 2.6% in 2018.<sup>5</sup> But given high public needs for social spending, and given that revenues have been exaggerated by an average of 6% each year in the period 2012-2016<sup>6</sup>, the plan does not seem realistic.



The labour market in Macedonia seems to contain some sustained structural weaknesses (Figure 3). The unemployment rate has been declining, but at 24% remains stubbornly high, being 15 percentage points higher than the EU average (9%). Thus, it is hardly surprising that past surveys have estimated that 1 in 5 citizens work in the undeclared economy.<sup>7</sup> Moreover, despite an activity rate of 65% in 2015,<sup>8</sup> the female participation rate is extremely low at 52%, illustrating the existence of a wide gender gap, which comes

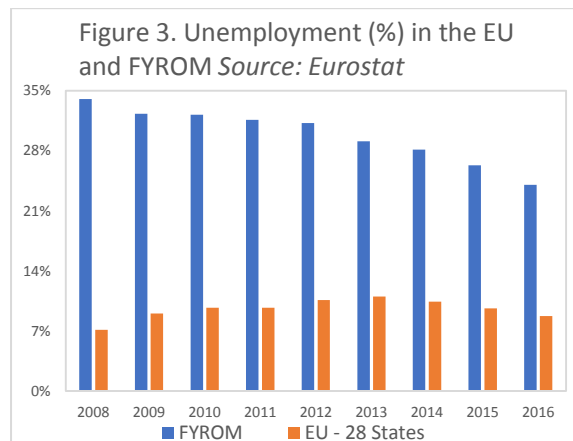
<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> CSD, *Hidden economy in Southeast Europe: Momentum to mitigate its negative effects*, 2016, Sofia: Center for the Study of Democracy

<sup>8</sup> Eurostat

on top of stark ethnic differences. The youth unemployment rate (48%) for the labour force aged 15-24 remains well above EU average (19%). Emigration partly offsets the high unemployment and poverty due to remittances back to FYROM.<sup>9</sup>



## Policy context

**Most of the policies towards undeclared work in FYROM are based on a repressive approach.** These policies are grounded in a *rational actor approach*. This view argues that people engage in undeclared work only if the costs of doing so exceed the benefits. If the costs are increased, people are expected to stop participating. Examples of such measures are improving surveillance over the undeclared economy and increasing sanctions for working in the undeclared economy.

While the share of the informal economy has fallen with time (Figure 4), and with the use of those measures respectively,<sup>10</sup> **it remains well above the average for the EU (18.3%).** The share is estimated to be between 27% and 44% of GDP<sup>11</sup>, based on different methodologies. Due to the magnitude of the problem, the selection of the most effective

<sup>9</sup> Ibid.

<sup>10</sup> Figure 4 is based on Schneider, F., Buehn, A., & Montenegro, C. (2010). *Shadow economies all over the world. New estimates for 162 countries from 1999 to 2007*. Washington, DC: World Bank Group.

<sup>11</sup> Szhekova, R., Franic, J., Mishkov, L., and Willimas, C., *Tackling the Undeclared Economy in FYR of Macedonia: A Baseline Assessment*, Sheffield University Management School, University of Sheffield, GREY Working Paper No. 3, 2014.

policies is essential for limiting undeclared work. In this respect the GREY project has shown that, the rational actor approach has become ineffective in tackling the undeclared economy.<sup>12</sup>

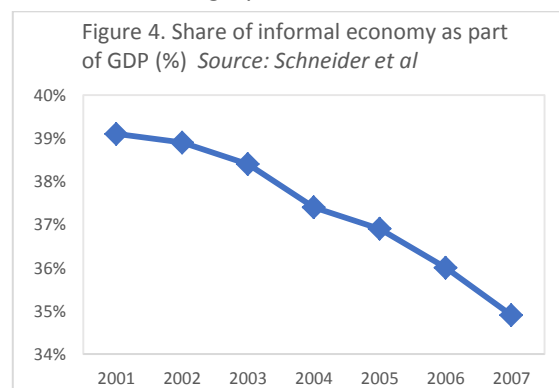
## Definitions

**Undeclared work** is defined by the European Commission as 'paid activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems among Member States'. This definition implies that if a good or service such as drugs is illegal, it is part of the criminal world, not necessarily part of the informal economy.

**Envelope wages** is a second wage paid to the employee, separately from the officially declared wage and without the required tax and social contributions. There is a difference between jobs where the wage is fully undeclared (a worker doing house repairs) and jobs where the wage is under-declared and an envelope wage is paid, i.e. some of the wage is given 'under the table' (a waiter who earns a minimum wage, but receives tips).

**The Demand side of undeclared work** is the engagement in the purchase of undeclared goods and services.

**The Supply side** consists of people who are doing some undeclared work and explores their sociodemographic characteristics.



**The GREY Project has thus proposed the social actor approach to aid government policies.** It states that if citizens have a low

<sup>12</sup> Bezeredi, S. and Williams, C. *Illegitimate Economic Practices in FYR Macedonia*, Sheffield University Management School and Institute of Public Finance, Zagreb, May 2017, GREY Working Paper No.10

intrinsic motivation to pay taxes (i.e. low tax morale), they are more likely to participate in the undeclared economy. When they do not believe that formal institutions represent the social norms (i.e. lack of **vertical trust**) or that a large share of the population is engaged in undeclared work (a ‘normalisation’ of undeclared work or lack of **horizontal trust**), their tax morale is low and they are more likely to engage in undeclared work. Policies based on that approach are aimed at changing people’s perception that it is normal to work in the undeclared economy and increasing their trust in formal institutions, rather than just increasing surveillance and punishment.

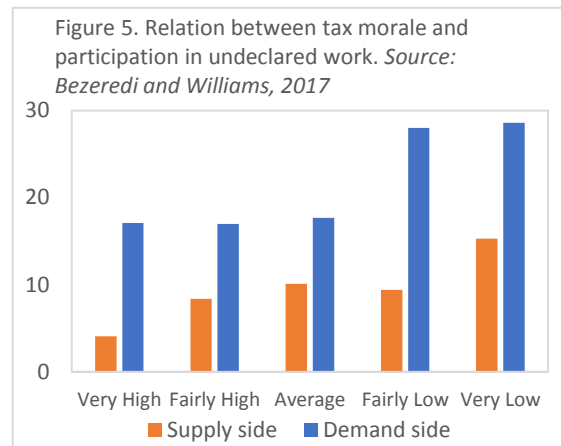
## Undeclared work

**Macedonians perceive undeclared work is widespread in their economy.** More than 55% believe that at least one in five people engages in undeclared work, whereas one in seven thinks that more than 50% of the population does so.<sup>13</sup> These numbers illustrate the ‘normalization’ of undeclared work in Macedonia – it is acceptable to earn a wage without paying the necessary contributions.

The GREY Project estimates illustrate that **the lack of horizontal trust leads to higher participation in undeclared work in FYROM.** Moreover, **the tax morale of citizens** (i.e. lack of vertical trust) **seems to be associated with the likelihood of doing undeclared work.** (Figure 5)<sup>14</sup> The lower the belief in the transparency of institutions (i.e. **vertical trust**), the higher is engagement in undeclared work.

**Thus, building vertical trust and horizontal trust are vital for targeting undeclared work effectively via the social actor approach.**<sup>15</sup> If they are lacking, Macedonians will continue

engaging in the undeclared economy, unless policy-makers revise the traditional approach, using the findings presented in this policy brief.



## General insights

**There is a correspondence between the main sectors on the supply and the demand side of the undeclared economy in FYROM.** (Figure 6). On the demand side, the most common areas are car (21%) and house (19%) repairs and the purchase of domestic food (32%). Similarly, on the supply side, those sectors are important with babysitting (10%) and selling products other than domestic food (10.5) being significant contributors as well.

**There are big differences between ethnicities and engagement in undeclared work.** (Figure 7) Macedonians and Albanians might be equally likely to purchase in the undeclared economy, but Albanians (11%) seem to be more than twice as likely as Macedonians (5%) to do undeclared work. Hence, policymakers should consider different ethnicities when addressing undeclared work.

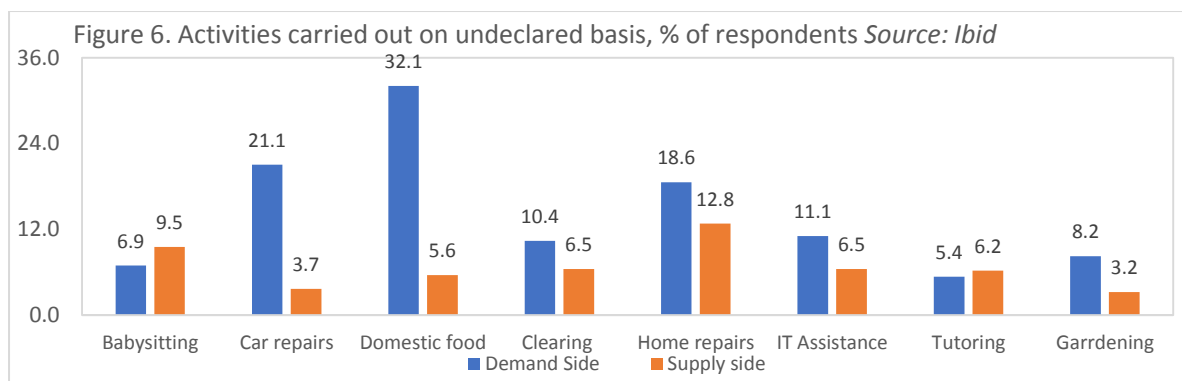
	Supply	Demand
Macedonians	4.5%	17.5%
Albanian	10.6%	18.1%

*Table 1. The relation between ethnicity and engagement in the undeclared economy*

<sup>13</sup> Ibid

<sup>14</sup> Bezeredi and Williams, 2017 refers to Ibid.

<sup>15</sup> Ibid.



**Policy-makers should understand and address the incentives of those working in the undeclared economy.** Broadly speaking, two groups of workers can be identified:

- **“Lower tier” exclusion-driven workers:** Left involuntary outside the declared economy. These workers are usually more likely to be struggling financially.
- **“Upper tier” exit-driven workers:** Participating voluntary in the undeclared economy. They tend to have less money problems than the other group.

In FYR of Macedonia, 6.2% of adults state that they engage in undeclared work. Moreover, every exclusion-driven worker corresponds 1.7 exit-driven workers (Table 2). This is a somewhat lower ratio compared with the other GREY countries – Bulgaria and Croatia, pointing to the need to pay much more attention to exclusion processes in FYROM. The exit-driven workers are moved by the belief that it is normal to do such work or the lack of horizontal trust.

	Exit	Exclusion	Both
<b>Share</b>	52.1%	31%	13.3%

*Table 2 Share doing undeclared work, based on their main incentives. Source: Ibid*

**At the same time on the demand side, adults in FYR of Macedonia are much more likely to engage in purchases from the undeclared economy based entirely on lower price.** (Table 3) For comparison, the failing of the formal economy is as equally an important factor as lower price in Bulgaria and Croatia.

This might be explained by lower incomes and less expectations from the formal institutions of the market economy in FYR of Macedonia.

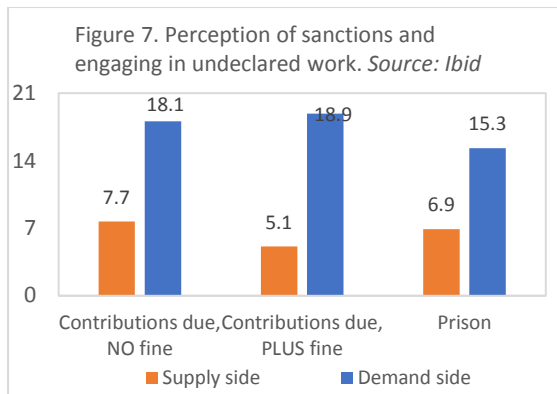
	Fail of formal economy	Redistributive	Lower price
<b>Share</b>	29.6%	24.4%	57.2%

*Table 3 Share purchasing undeclared goods, based on citizens’ main incentive. Source: Ibid*

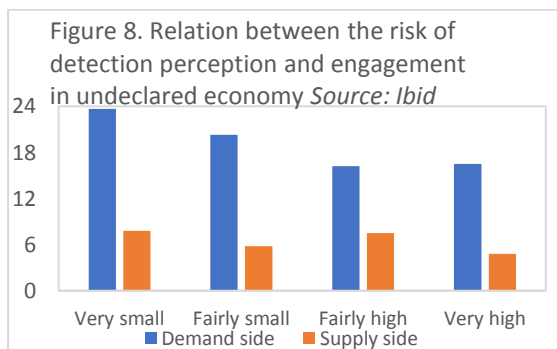
### Rational Actor Approach

**Repressive measures, based on a rational actor approach, do not seem to reduce people’s desire to purchase undeclared goods and services in FYROM.** (Figure 6 and Figure 7) Increasing sanctions is one very common example of a repressive measure. If sanctions are increased, less people should purchase such goods, since the costs from being caught are higher. However, this does not seem to be the case (Figure 7). On the supply side, people, who consider the sanction as entailing prison, are more likely to engage in UDW (7%) than citizens who consider the sanction as less severe (5%), i.e. entailing contributions due PLUS fine. On the demand side, people are more likely to buy undeclared goods if they see the sanctions as their normal tax or social contributions due PLUS a fine (18%) than if sanctions demand only their contributions and NO fine (19%).<sup>16</sup>

<sup>16</sup> The reason why the percentage for the supply side are smaller than the percentage for the demand side is the fact that only 6% of Macedonians do undeclared work whereas at least 18% purchase undeclared goods and services. Thus, the overall percentage of involvement from the population on the supply side is smaller.



Increasing the detection risk, another such measure, also does not seem to deter engagement in the undeclared economy on both the demand and supply side. (Figure 8<sup>17</sup>) Given these results, policymakers should consider how to make their policies more effective. One way forward is to supplement the traditional repressive view based on the rational actor with the social actor perspective.

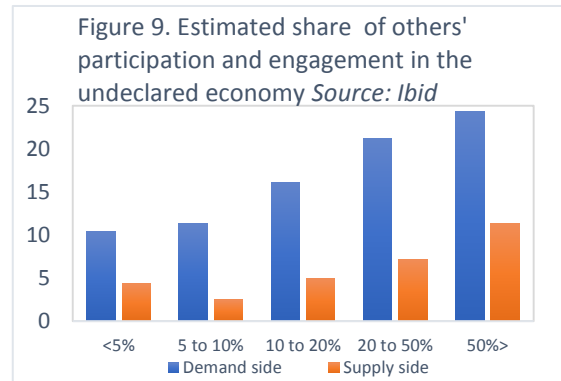


### Social actor approach

The lack of vertical trust (Figure 5) and horizontal trust (Figure 9), the building blocks of the social actor approach, seem to act as strong incentives for people to engage in undeclared work in FYROM. On the demand side, the higher the estimate of the share of people being involved, the more likely a Macedonian is to purchase in the undeclared economy. While less pronounced for the supply side, a rigorous statistical analysis shows that the estimated share of

<sup>17</sup> 18% of those seeing the risk as 'Fairly small' on the Demand side refused to answer. Thus, either the share is bigger, or these values are lower bounds of engagement in UDW.

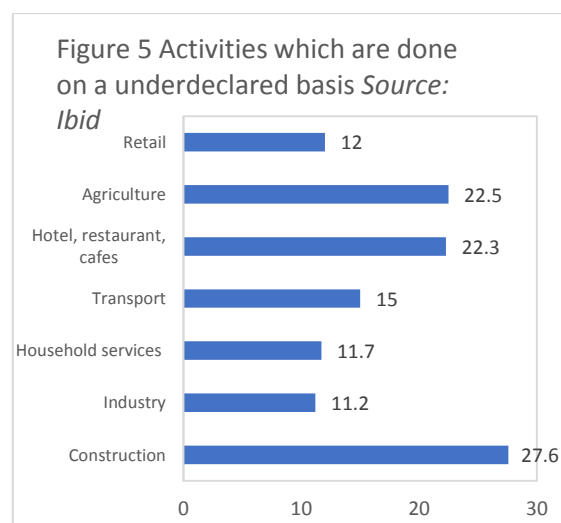
others' involvement in undeclared work is significantly correlated with the likelihood for doing undeclared work.<sup>18</sup> Thus, increasing horizontal trust is of vital importance for limiting undeclared work.



With decreasing tax morale (i.e. vertical trust), Macedonians are more likely to engage in undeclared work (Figure 5 above). Policymakers should at the very least supplement the rational actor view with the social actor view when considering how to tackle the undeclared economy.

### Envelope wages

Almost one in eight of the formally employed Macedonians (13%) engage in *under-declared* work (i.e. receive envelope wages). Figure 10 reveals that the top risk sectors are construction (27.6%), agriculture (22.5%), and hotels, restaurants and cafes (22.3%).



<sup>18</sup> *Ibid*



Similar to undeclared work, the majority of measures to tackle envelope wages used at present are repressive and do not produce the desired result. Paradoxically, people who consider the sanctions as leading to imprisonment (20%) are more likely to engage in this illegal wage practice than people who consider it as far less severe (14% and 11%) (Table 4). Thus, increasing sanctions will not have the desired impact. Similar results are valid for other repressive measures such as improving surveillance over under-declared practices.<sup>19</sup> Alternative approaches such as the social actor paradigm should be sought.

	Contribution due, no fine	Contribution due plus fine	Prison
Share	14%	11.4%	20.2%

*Table 4 Relation between receiving envelope wage, and perception of sanctions. Source: Ibid*

Contrary to popular opinion, it is not always the employer who coerces the employee into under-declaring their wage (Table 5). In nearly half of cases (46%), the employee actively participated in the initiative. While raising the costs of proposing an envelope wage for employers might lead to fewer such cases, the employee's incentives such as their tax morale should be addressed as well.

	Employer	Joint idea	Employee
Share	54%	24%	22%

*Table 5 The party which proposed the illegal practice. Source: Ibid*

Many employees who are already engaged in under-reporting tend to lack vertical trust in FYROM. In just 41.5% of cases, envelope waged employees would prefer to have their wage fully declared to the authorities (Table 6). Other interesting findings are that (i) people who are less needy financially tend to engage more in envelope wages and (ii) ethnic Albanians are twice as likely to do so as ethnic Macedonians. Both findings point to a lack of

trust in formal institutions and authorities. Given these results, the practice of envelope wages should be targeted in similar ways as undeclared work. Less emphasis should be put on the prevalent repressive measures and more on policies restoring the vertical and horizontal trust of Macedonians.

	Prefers full declaration	Happy now	Depends
Share	41.5%	32.7%	18.4%

*Table 6 Envelope waged employees' attitude towards declaring their wages. Source: Ibid*

## Policy Recommendations

An effective policy towards undeclared work and envelope wages requires changes in the institutional framework and the reversal of the positive attitudes towards such non-compliant activities in FYR of Macedonia. The traditional repressive measures that aim at changing the cost/benefit ratio associated with participating in the undeclared economy are clearly not sufficient. They need to be at the very least supplemented with social actor approach-based measures. This requires the development of measures to address two big building blocks:

### Vertical trust

Central government's tight control over the economy and state capture practices should be credibly curtailed to restore trust in institutions. Specifically, this requires the trial and sentencing of corrupt officials.

The public administration should be geared towards treating citizens more fairly. The Tax Office and Labour Inspectorate as well as other inspection offices, should be kinder to people who have made mistakes accidentally while filing their reports. More broadly, better treatment of citizens and the provision of higher quality administrative services should be ensured at all levels of the administration. More support should be provided for people who would like to exit the undeclared

<sup>19</sup> Ibid

**economy and (re)enter the formal one.** Such citizens should be encouraged, given specific guidance, and allowed time to settle in their new lives.

**Citizens' approval should be sought before the implementation of policies.** Currently, few policies are considered from the perspective of those who are actually affected. In this way, Macedonians will feel that they actually matter to policymakers.

**The accountability of the recently elected government should be ensured.** Not only would this bring stability and respectively foreign investment, but also avoid another political crisis.

**More data should be gathered.** The estimates on the undeclared economy differ considerably, because of the different methodologies employed. The National Statistical Institute should adopt the methodologies that are used in respected institutions such as the World Bank.

**The practice of pulling strings should be limited.** Currently, 35% of citizens have reported to have resorted to informal relations to circumvent formal institutions. If citizens feel that there is less nepotism, they will be more likely to believe in the fair treatment of formal institutions.

Given the very high share of exclusion-driven participation in undeclared work, the Macedonian authorities should consider **increasing spending on vulnerable groups**, and in particular the ones from the ethnic minorities to cushion their isolation and increase their trust in formal institutions.

## Horizontal trust

At the same time authorities should pursue long-term policies to **change the norms, values and beliefs** regarding the acceptability of participating in undeclared work.

**Citizens should be educated about the benefits of going formal and of paying their contributions.** This can be done for example through the introduction of a specific subject in the school curriculum or by sending letters to taxpayers with information about how their money is spent on public goods such as schools and infrastructure. People should be reminded more often that what they see around them in terms of infrastructure is very often the result of years of tax-payer spending.

**Citizens should be educated about the costs of not paying their contributions.** If their wage is not fully declared or under-declared, their access to some public goods, particularly their pensions and disability payments, will be reduced.

**Citizens that are more likely to engage in undeclared work should be targeted with educational campaigns.** It is more efficient to target more actively people in areas such as agriculture and construction, in which it is common to engage in undeclared work.

**The integration of ethnic minorities, in particular Albanians, into Macedonian society should be strengthened.** They will be less likely to engage in undeclared work, if they feel more welcome by the ethnic majority. The reverse is true as well. For example, the representatives of the Albanian minority in the Parliament should be tasked with specifically addressing the issues of undeclared work and envelope wages among the Albanians.



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