

Tackling the Undeclared Economy in FYR Macedonia

A baseline assessment

2014

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List of abbreviations

BPO – Bureau of Payments Operations
 CEA – Center for Economic Analyses
 EOM – Employers' Organisation of Macedonia
 ESC – Economic and Social Council
 Eurofound – European Foundation for the Improvement of Living and Working Conditions
 EVS – European Values Study
 FAO – Food and Agriculture Organization of the United Nations
 HLAD – High Level Accession Dialogue
 ICLS – International Conference of Labour Statisticians
 ILO – International Labour Organisation
 LFS – Labour Force Survey
 MIMIC – Multiple Indicators Multiple Causes
 NECC – National Entrepreneurship and Competitiveness Council
 PRO – Public Revenue Office
 SLI – State Labour Inspectorate
 SNA – System of National Accounts
 SSO – State Statistical Office

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Executive Summary

This report provides a detailed review of available evidence on the extent and nature of the undeclared economy in the Former Yugoslav Republic of Macedonia (FYROM), as well as on the institutional actors involved in tackling the phenomenon and their policy approach and measures used.

Extent and nature of the undeclared economy

Some widely cited international measurements that cover FYROM find that the share of its undeclared economy is larger than in all EU Member States, estimated at 35% of GDP in 2007 (Schneider et al, 2010). Data from the most recent national *Labour Force Survey* suggests that in 2012 around 22.5% of the workforce was engaged in undeclared work, and therefore was not covered by any social or legal protection (SSO, 2013). This survey further indicates that undeclared work has been declining since 2008, in parallel to an increase in the number of formally employed persons.

The age groups most affected by informal employment are young people aged 15-24 (40% of all employed in that age group), as well as those older than 65 years (over 85% of all employed from that age group). When it comes to gender variations, the data reveals that men are slightly more likely to work in the informal sector than women (23.3% of men compared to 21.3% of women for 2012). Moreover, there is a difference in the type of informal work performed with women being mainly informally involved in agriculture, whereas men are self-employed or employers in unregistered firms.

There is a clear link between undeclared work and job precariousness in the FYROM: undeclared workers are less likely to hold full-time, permanent waged jobs. Furthermore, wage earners are less likely to work undeclared than sole traders and the self-employed. These trends become even more pronounced in rural areas compared with urban ones, and among the young and ethnic minorities.

When it comes to sectorial and business variations in the incidence of undeclared work, the main findings of the *World Bank Enterprise Survey 2013* suggests that businesses in manufacturing are more likely than those in retail or services to face competition from unregistered firms. At the same time, formal businesses in retail are more likely to perceive such unfair competition as a major constraint to conducting business in the country. Medium-size enterprises, domestic firms and firms located in South Macedonia are also more likely to face competition from entities operating off-the-books.

In general, labour-intensive, low-earning jobs in construction, transport, catering, the textile industry, domestic services, agriculture and trade are particularly prone to undeclared work. Purchasing goods from undeclared merchants at markets is a particularly widespread practice. The share of informal employment in agriculture is significant – between 86.1% and 82.4% of all agricultural employment. This sector is also largely affected by non-standard work.

Barriers to formalisation

From a labour perspective, two major factors hamper formalisation: a) the lack of jobs in the official economy and high unemployment rates and b) some disincentives for engaging in formal work stemming from shortcomings of the welfare system. From the perspective of businesses the frequent changes in the tax system, as well as the lack of transparency and impartiality within state institutions need further attention. Enhancing the skills, expertise and powers of tax officials, improving judicial efficiency and ensuring greater independence of inspectors are some key objectives in the fight against

undeclared work. Auditing and arrears collection efficiency and the investigative capacity of the tax administration should be further improved.

Socio-cultural factors such as trust in public institutions and the perceived fairness of official rules and norms have a significant effect on tax morale and voluntary compliance. It seems that a significant proportion of taxpayers do not see a clear link between paid taxes and received benefits, which has resulted in a wide approval of disobedience with official rules. Therefore, all imminent efforts to eradicate undeclared work should put the improvement of the psychological contract between the state and its citizens high on the agenda.

Policy approach to tackle undeclared work

A number of labour market measures have been implemented in FYR Macedonia in recent years, focused mainly on stimulating employment in the official economy. However, when it comes to tackling undeclared work or the transition towards formal employment, the accent is still predominantly on repression through intensified controls and inspections.

Some progress has been achieved in reducing the compliance costs for doing business and easing the tax burden through a number of supply-side measures, such as tax incentives for business, a flat-tax system and tax rate harmonisation, as well as simplified procedures for company registration and paying taxes.

1. Introduction

This working paper is part of a series of papers associated with the project entitled 'Out of the shadows: developing capacities and capabilities for tackling undeclared work in Bulgaria, Croatia and FYR Macedonia' (Dzhekova and Williams, 2014; Franic and Williams, 2014; Williams, 2014a). Funded by the European Commission's Framework 7 Industry-Academia Partnerships Programme (IAPP), the aim of this project is to provide concrete policy recommendations about what policies may work better, based on rigorous empirical evidence, for those seeking to tackle the undeclared economy in the Balkans. In particular, the objectives of our project are to:

1. Conduct a comprehensive review of the policy approaches and measures being used to tackle undeclared work.
2. Empirically evaluate the measures for facilitating the shift of undeclared work into the declared economy in the selected target region.
3. Based on the results of the first two objectives, the final objective is to recommend possible new policy approaches and measures (or endorse old ones) that will facilitate the shift of undeclared work into the declared economy.

In this Working Paper, the objective is to provide a review of the extent and nature of the undeclared economy, as well as the policy approaches and measures being used to tackle undeclared work, in FYR Macedonia. Economic activities that are not declared to the authorities for tax, social security or labour law purposes when they should be, have been widely recognised to have negative effects on society and the functioning of the market economy. In the light of persisting high unemployment and economic recession across Europe, tackling this complex and multifaceted phenomenon has become a political priority not only for the EU and its Member States, but also for those countries aspiring to join the Union. The government of the candidate country FYR Macedonia has repeatedly declared its strong resolve to reduce the size of the undeclared economy, given the country's bleak economic

performance. Nevertheless, the share of the undeclared economy in the country remains substantial at over 30% of official GDP and is particularly illustrative for the difficulties to implement successful policy actions for tackling the issue in a transition context.

The aim of this report is to provide a baseline assessment of the size and nature of the undeclared economy in the FYR Macedonia along with how it is being tackled. To do this, the report takes stock of the diversity of measurement approaches applied at the national and international level in order to estimate the size of the undeclared economy in Macedonia, and provides a detailed overview of the specific characteristics and nature of the undeclared economy in the country, along with the context-embedded barriers to formalisation, which need to be considered when designing suitable policies to tackle the issue. It also reviews the current institutional framework for combating undeclared work in the country along with the policy approach and measures currently adopted. The lessons that this review aims to map out serves as the basis for discussing future policy options and the potential transfer of policy practices that have worked elsewhere.

2. Economic, social and political context

Having declared independence from Yugoslavia in 1991, the early transition period in the FYR Macedonia was marked by low economic growth, high unemployment and labour emigration, as well as slow structural reform and low levels of foreign direct investments (FDIs), particularly in the 1990s due to armed conflicts in the region. The unfavourable social, economic and political conditions for the development of the welfare state in Macedonia in the early 1990s led to rising social problems, which were addressed through short-term measures such as “targeted early retirement, unemployment and social assistance cash benefits” (Mitev 2007: 132), while long-term investments in education and training were neglected. Mitev (2007) further argues that the strong involvement of International Financial Institutions such as the World Bank and the IMF as agents for financial and technical support in Macedonia influenced significantly social policy creation in the country during this period, leading to somewhat conflicting policy objectives, such as targeting and selectivity in social services provision to ensure efficiency, while acknowledging the rising need for more inclusive social protection to tackle the social costs of transition and calm social tensions.

In 2000 Macedonia embarked on a route of rapprochement with the EU by signing a Stabilisation and Association Agreement with the EU that provided for a gradual process of trade liberalisation and institutional reform. Since 2005, Macedonia has the official status of a candidate country for accession, but it has not started yet official accession negotiations, although in 2009 the European Commission recommended the opening of such negotiations. The process has stalled most notably due to an unresolved long-standing dispute with Greece over the country's name. Bulgaria has also imposed conditionality on the opening of EU accession talks with Macedonia, due to what Bulgarian officials proclaimed as an “anti-Bulgarian campaign, and the manipulation of historical facts” on the part of Macedonian authorities (EurActiv, 2 November 2012). Internal inter-ethnic relations and political tensions have also hampered reforms. In 2012, the EC launched a High Level Accession Dialogue (HLAD) with Macedonia. Although it is not a substitute for formal accession negotiations, the HLAD is the main forum for feedback on the implementation of reforms.

The World Bank defines FYR Macedonia as an ‘upper middle income’ country with a GNI per capita of \$4,620¹. The unemployment rate in the first quarter of 2014 was 28.4%, having declined since 2012 when it stood at 31% (State Statistical Office, 2014). The IMF in its 2013 staff report noted that the reasons for the high unemployment in the country go beyond traditional labour market constraints,

¹ Based on the Atlas method. Source: <http://data.worldbank.org/indicator/NY.GNP.PCAP.CD>

considering that “employment protection legislation is slightly more flexible, on average, than in peers, the size and duration of social assistance does not provide notable disincentives to seek work, nor are labor tax wedges particularly high” (IMF 2013: 20). At the same time, the domestic economy continues to rely on low-productivity sectors, such as small-scale farming and heavy industry (IMF 2013: 20).

The World Economic Forum’s *Global Competitiveness Report* 2013-14 shows that the country’s performance is weakest with respect to the supply of infrastructure, an adequately educated workforce, the efficacy of the legal framework, and capacity to attract and retain talent, as well as innovation and business sophistication (World Economic Forum, 2013). With respect to economic criteria, the latest EC *Progress Report* on FYR Macedonia (EC, 2013) highlights the maintenance of financial stability as a positive development, but stresses the need to address the underlying reasons for high unemployment including skills mismatch, to ensure sustainability of public finances, as well as more tangible improvements of the business environment, which is “negatively affected by corruption, as well as lengthy and costly market exit procedures” (EC 2013: 2). The report also highlights the informal sector as an important challenge. At the same time, the inadequate capacity of the public administration to ensure “strategic policy formulation and implementation” is a worrying finding (EC 2013: 34). The report further found a mismatch between “economic and fiscal policy priorities” and “specific structural reform challenges”, which does not bode well for implementing and enforcing successful measures to tackle the undeclared economy.

3. Extent of undeclared work

There is no universally accepted method to measure the size of the undeclared economy. Some cross-national data-bases enable the extent and nature of undeclared work in Macedonia to be compared with the situation in the rest of Europe and beyond, including for example the *World Bank Enterprise Survey*. There are also a few studies that measure undeclared work in Macedonia using both direct surveys as well as indirect measurement methods that employ various proxy indicators and/or seek indications for the size of the undeclared economic sector in data collected for other purposes (e.g., Schneider et al, 2010; Elgin and Öztunali, 2012) as well as a number of national surveys (Stankovic and Stankovic 2012; Gavranlieva et al, 2012; Risteski, 2009). The following section provides an overview of the variety of approaches used and the different estimates produced.

Before comparing the outputs of different estimation efforts, it is important to define the scope of what is meant by the term ‘undeclared economy’, in order to better understand what aspects of the phenomenon are captured by different measurement approaches. Although in many developing countries, enterprise-based and jobs-based definitions have been widely employed (see Williams, 2013, 2014b; Williams and Lansky, 2013), in developed economies it has been activity-based definitions that have been more commonly used to define the scope of the undeclared economy. The most widely used activity-based definition, and the one adopted in this report, defines the undeclared economy as:

“all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002: 139).

This definition has been widely adopted in Europe (see European Commission, 2007b; Vanderseyppen et al., 2013; Williams, 2014c,d; Williams and Renooy, 2008; Williams and Round, 2008). This excludes illegal (criminal) activities and also unpaid work. Throughout this report, it should be noted, the terms undeclared economy and undeclared work are used interchangeably.

The Public Revenue Office of the FYR Macedonia defines the undeclared economy as “all economic activities which are legal but unofficial and undeclared for tax purposes, from individuals, unofficial groups and organizations” (Risteski, 2009). This definition is largely in line with the OECD definition provided above. When analysing the nature and extent of the undeclared economy in Macedonia, local studies in many cases adopt the definition of the ‘non-observed economy’, whose size is calculated for the purpose of exhaustiveness of GDP in the so-called System of National Accounts (Stankovic and Stankovic, 2012). Undeclared work from an employment perspective is measured by the State Statistical Office (SSO) within the Labour Force Survey, which is based on ILO definitions and methodology (Hussmanns, 2005). In line with this, SSO uses the term ‘informal employment’, which encompasses all undeclared employees (those not covered by social and legal protection), regardless if they work in regular firms, un-registered or un-incorporated entities, own-account enterprises or in the household sector.

3.1 Indirect methods

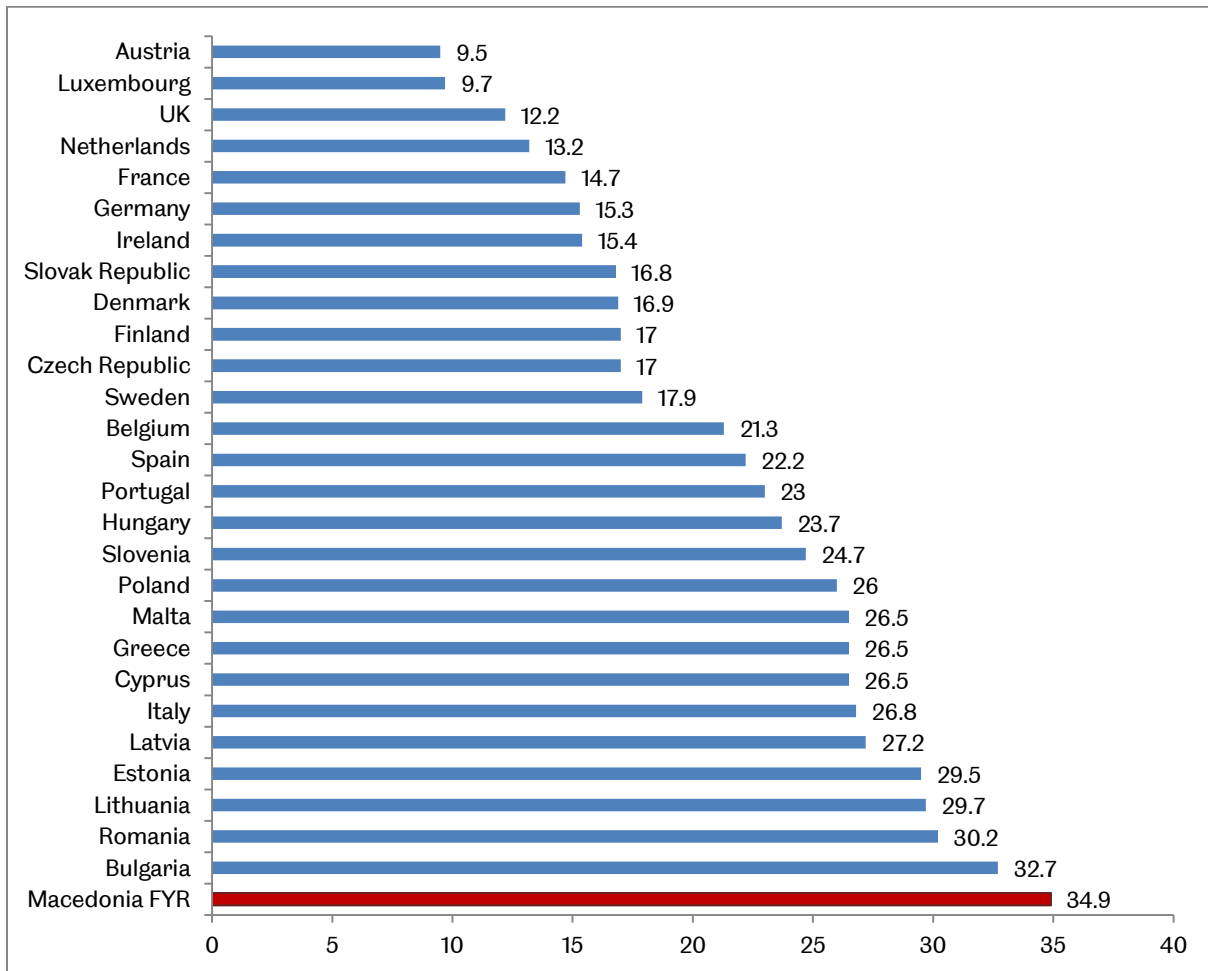
Indirect methods for estimating the size of the undeclared economy are based on an analysis of macroeconomic aggregate data. The most commonly applied indirect measurements include the following methods:

- Monetary methods
- Income-expenditure discrepancy methods
- Labour supply-demand discrepancy methods
- Physical input (vs. official product) methods (electricity consumption)
- Multiple indicators – multiple causes

Some widely cited international measurements that cover Macedonia conclude that the share of its undeclared economy as % of GDP is larger than that of the EU Member States (see Figure 1). Using the Multiple Indicators Multiple Causes (MIMIC) method, Schneider et al (2010) found that Macedonia’s undeclared economy in 2007 was equivalent to 35% of GDP, compared to an EU average of approx. 19%. According to this estimate, the average size of the undeclared economy in Macedonia between 1999 and 2007 was 37.4 % (Schneider et al, 2010), and has been on the decrease ever since, akin to other EU member states. Household services and production, as well as purely criminal (illegal) activities are excluded from this measurement.

There have been several attempts at national level to estimate the size of the undeclared economy since the 1990s. These apply different indirect measurement methods and cover different time periods, which renders a direct comparison of the results difficult. Even if applied for the same period, various methods arrive at different estimates.

Figure 1. The size of the shadow economy in European countries in 2007 (% of GDP)



Source: Schneider et al, 2010.

The electricity consumption method was applied by Micevska et al (2002, cited in Stanchev 2005: 103) for the period 1990-2000. This approach is based on the assumption that the energy consumption is proportional to the total economic activity in a country. Consequently, fluctuations in energy consumption that cannot be accounted for by measures of the total economic activity are due to the undeclared economy. The study found that electricity consumption increased by 18% during this time, while the official GDP decreased by 14%. The authors conclude that the size of the real GDP could be adjusted upwards by 30% compared to the officially estimated, to account for the undeclared economy. Based on the same method, Nikolov (2005) calculated that the size of the undeclared economy has declined from 40.3% of GDP in 1996 to 35.3% in 2004. However, the shortcomings of this measurement method have been recognised in the literature, in particular the lack of “specific micro-level data allowing definition of an explicit relationship between energy use and economic activity” (Kyle et al, 2001).

There are few recent estimates of the size of the informal economy in FYR Macedonia. For example, Elgin and Öztunali (2012) applied a two-sector dynamic general equilibrium model in 161 countries for the period 1950-2009 using, concluding that the share of the undeclared economy in Macedonia has not changed significantly between 2000 and 2008, with a minimum value of 34.4% in 2008 and maximum of 35.1% in 2000 (see

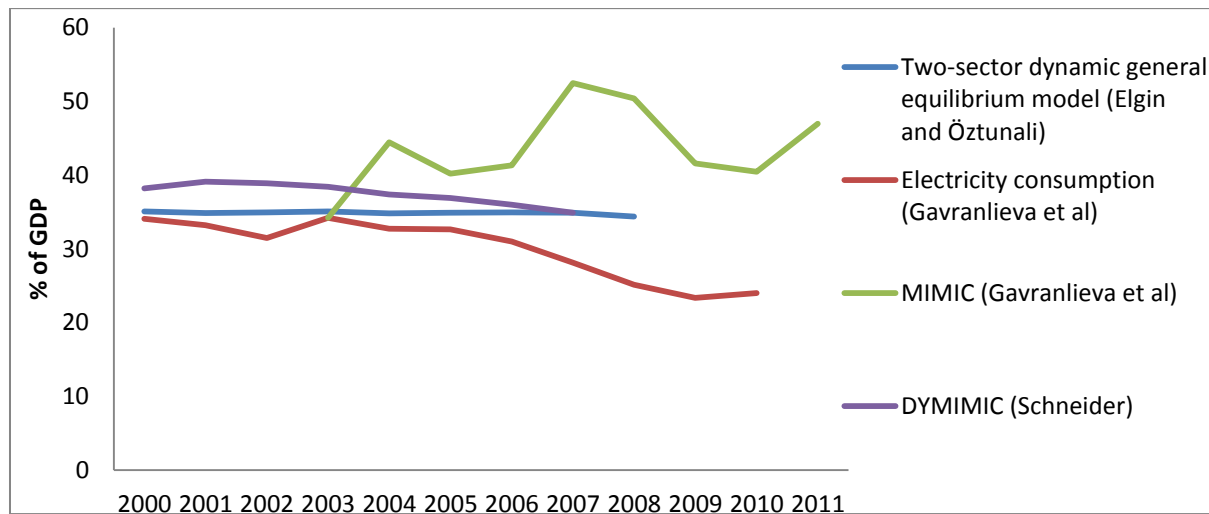
Table 1). Garvanlieva, Andonov and Nikolov (2012) applied both, the electricity consumption and the MIMIC method with remarkably different outcomes for the period 2000-2011. While estimates based on the electricity consumption method show a constant decrease after 2003 (except for 2010), the MIMIC approach produced results with an increasing trend in the reviewed period.

Table 1. Dynamics of the estimated size of the undeclared economy in Macedonia (2000-2011) based on different approaches

	Two-sector dynamic general equilibrium model (Elgin and Öztunali, 2012)	Electricity consumption (Garvanlieva, Andonov and Nikolov, 2012)	MIMIC (Garvanlieva, Andonov and Nikolov, 2012)	MIMIC (Schneider, Buehn and Montenegro 2010)
2000	35.10	34.10	-	38.2
2001	34.86	33.23	-	39.1
2002	34.97	31.49	-	38.9
2003	35.06	34.22	34.22	38.4
2004	34.80	32.75	44.44	37.4
2005	34.89	32.67	40.18	36.9
2006	34.97	31.02	41.32	36
2007	34.90	28.14	52.48	34.9
2008	34.39	25.16	50.39	-
2009	-	23.38	41.58	-
2010	-	24.01	40.46	-
2011	-	-	46.99	-

Figure 2 provides a comparison of different estimates of the share of the undeclared economy in the Macedonia, applied in different periods and using different methods. This shows how the estimates produced are highly dependent on the method of applied. The largest estimates are observed with the MIMIC model used by Garvanlieva et al (2010) and the smallest with the electricity consumption model, applied by the same research team. Looking at 2008 (for which estimates from the three approaches are available) the discrepancies are as large as 25%. All measurement methods indicate that the share of the shadow economy is significant, especially compared to the EU and thus requires appropriate attention. Nevertheless, one has to be cautious before making any general conclusions about the dynamics of the size of the undeclared economy in the FYR Macedonia.

Figure 2. Dynamics of the estimated size of the undeclared economy in Macedonia (2000-2011) based on different approaches



Sources: Elgin and Öztunali (2012); Gavranlieva, Andonov and Nikolov (2012); Schneider, Buehn and Montenegro (2010).

Labour Force Survey

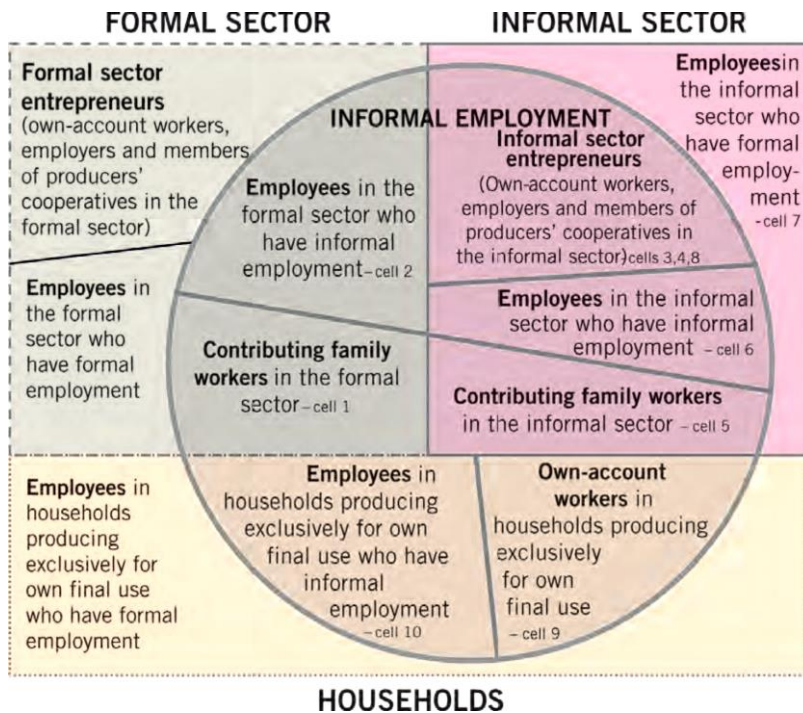
The *Labour Force Survey* (LFS) provides a more precise picture of the size of undeclared work in the country. The latest LFS conducted by the State Statistical Office of the FYR Macedonia indicates that in 2012, 22.5% of all employed were engaged in informal employment (SSO, 2013). This is slightly lower than the ILO LFS estimate where informal employment accounted for 25.4% of all non-agricultural employment (ILO, 2012a).

Informal employment and informal sector - definitions

The term 'informal employment' used here needs clarification. The SSO methodology has adopted the definitions set out by the International Conference of Labour Statisticians (ILO, 2013), where 'informal employment' refers to "employed persons who are not registered (in their main job) in the Pension Fund, the Health Fund and/or an Employment Agency" (SSO, 2013), and thus generally lack basic social or legal protections or employment benefits (see the circled field in Figure 3). Informal employment can occur in the formal sector (registered firms), informal sector (non-registered and/or non-incorporated firms) or the household sector. However, it should be noted that this definition does not capture formal jobs where only part of the salary is declared ('envelope wages'), while the rest is paid in cash – a widespread phenomenon in post-socialist transition countries in Eastern Europe

Employment in the informal sector is an enterprise-based concept and covers persons working in units that have "informal" characteristics in relation to, e.g., the legal status, registration, size, the registration of the employees, their bookkeeping practices, etc. Informal employment is a job-based concept and encompasses those persons whose main jobs lack basic social or legal protections or employment benefits and may be found in the formal sector, informal sector or households. Almost all persons employed in the informal sector are in informal employment. However, not all those in informal employment belong to the informal sector: there may be persons working outside of the informal sector (i.e., either in the formal sector or in households producing for own final use) that have informal employment. Source: ILO (2012a) *Statistical Update on Employment in Informal Economy*.

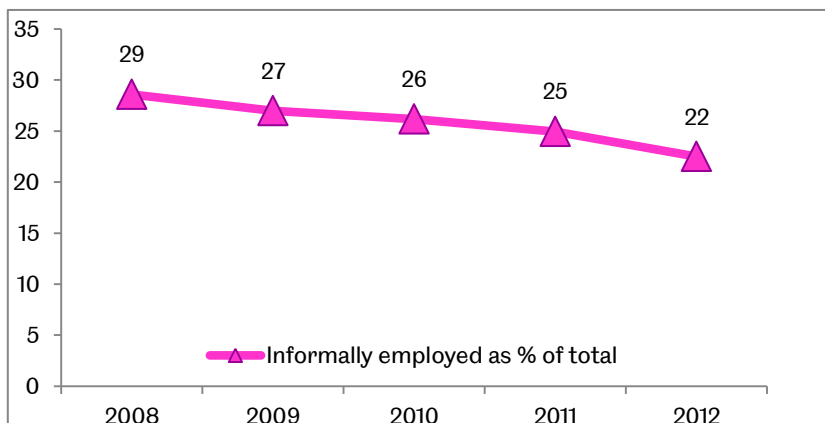
Figure 3. Components of informal employment – ICLS guidelines



Source: ILO (2013) *Measuring informality: A statistical manual on the informal sector and informal employment*.

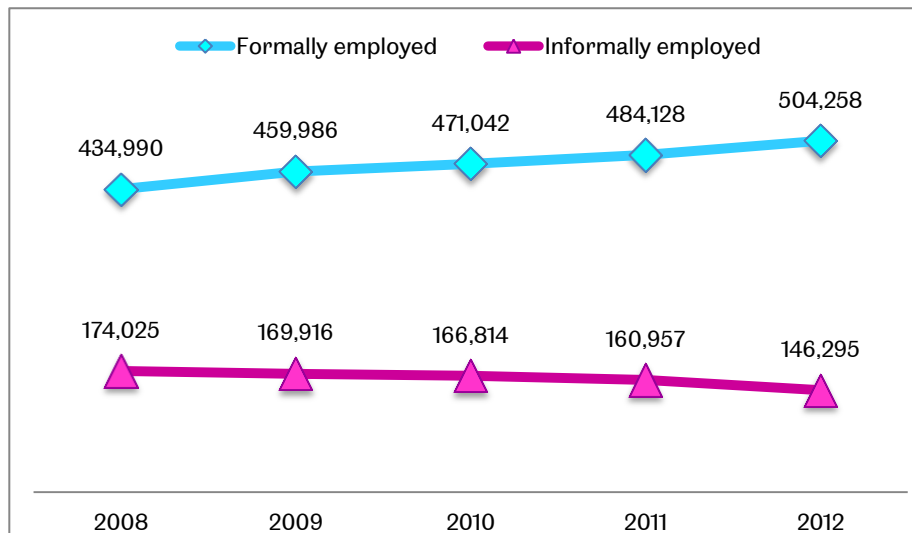
The data from the national LFS shows that the share of informal employment from total employment has declined since 2008, parallel to an increase in the number of formally employed persons (Figure 4 and 5). The age groups most affected by informal employment are young people aged 15-24 (40% of all employed in that age group), as well as those older than 65 years (over 85% of all employed from that age group). Analysing gender variations, the survey reveals that men are slightly more likely to work in the informal sector than women (23.3% of men compared to 21.3% of women for 2012). The discrepancies for previous years are larger and in the range of 4%. Moreover, there is a difference in the type of informal work performed by genders with females being mainly informally involved as unpaid workers in agriculture, whereas males as self-employed or employers in unregistered firms.

Figure 4. Informally employed persons as % of total employed (2008-2012)



Source: State Statistical Office (2013), *Labour Force Survey 2012*.

Figure 5. Number of persons in formal and informal employment (2008-2012)



Source: State Statistical Office (2013), Labour Force Survey 2012.

Another method for assessing the extent of undeclared salary payments is to estimate the discrepancies between data on registered employment from the LFS and data on salary payments processed by the Bureau of Payments Operations (BPO). Micevska et al. (2002, cited in Stanchev 2005: 104) used this approach to find that there were 418,000 registered salary recipients according to the BPO in 2001, while the LFS reported 599,300 registered employees. Accordingly, around 30% of the employed received salaries that were not declared to the authorities. However, it is also possible that salary payments were officially declared, but were simply processed outside the BPO system.

System of National Accounts

Some of the earlier efforts to estimate the share of the undeclared economy have been carried out in the first half of the 1990s within adjustments of the national GDP for non-exhaustiveness. In 1994 the State Statistical Office attempted to estimate the share of the non-observed economy (NOE) in national accounts, based on analysis of a number of sources (Bogov, 1997). These included annual financial reports of registered entities, data from the tax and the pension insurance authorities on employees engaged in the 'un-incorporated sector', as well as data on cigarette excise duties paid vs. consumption. The national accounts for 1994 were accordingly adjusted by a 0.2% increase of GDP due to tobacco smuggling, and by a 6.3% increase due to underreporting of registered producers (Bogov, 1997).

In 2002 OECD conducted a pilot study on the non-observed economy in the Western Balkan countries using Eurostat's *Tabular Approach to Non-Exhaustiveness of National Accounts* (Ahmad, 2007; Eurostat, 2013; UNECE, 2008). The pilot project led to significant improvements in the national statistical procedures for gathering and analysing data on non-exhaustiveness. This approach is based on a consistent procedure to identify different sources of underestimation of GDP due to "omissions from the source data used in compiling national accounts" (UNECA, 2013). Eurostat's framework differentiates between seven types of non-observed economic activities, while the non-exhaustiveness of data comes from the following main factors:

- Unregistered (underground) economic activities (deliberately not registered entities)
- Deliberately misreporting entities
- Informal (non-market) sector production

- Illegal production
- Unknown or not covered entities
- Entities not required to register
- Other statistical reasons (non-response, wages and salaries in kind)

The OECD study on the Western Balkans found that the share of non-observed economy in the early 2000s was mainly found in the household sector and in trade activities (UNECA, 2013). It also found that Western Balkan countries were relying mainly on the “expert method” when estimating the non-observed economy, which requires consulting tax officials and other relevant experts. The labour force surveys have been increasingly used, along with ad-hoc surveys and supply-demand methods (Ahmad, 2007).

Macedonia uses mainly the Labour Force Survey (conducted since 1996), as well as the supply-demand method to estimate the share of the so-called underground production (entities intentionally not registered although obliged to, as well as deliberately misreporting producers) and the informal production (small-scale household production, own-use). Adjustments of national accounts are made for underreported wages, non-registered employees and under-reported or non-registered sales in trade (UNECE, 2008). The share of the non-observed economy in Macedonian national accounts was estimated at 17.2% in 2002, with misreporting contributing most significantly to non-exhaustiveness (9.7% of non-observed economy)(Ahmad, 2007). Non-market (informal) production was equivalent to 1.9% of NOE and underground producers (intentionally not registered) accounted for 2.5%. According to this estimate, 5.3% the non-observed economy was found in trade, followed by manufacturing (3.3%).

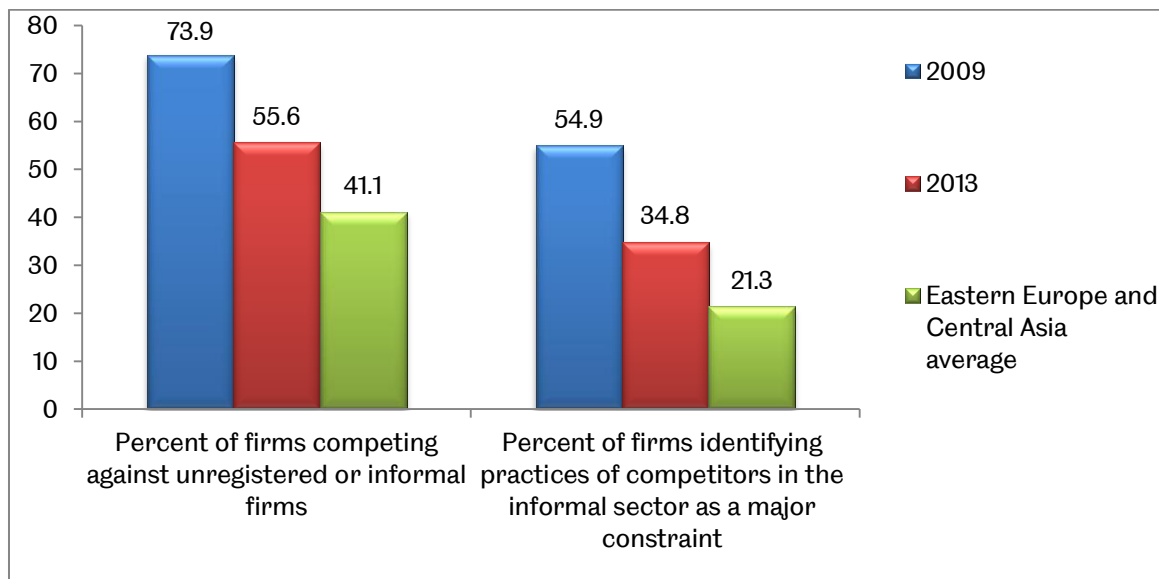
3.2 Direct methods

In recent years Macedonia has been included in a number of cross-national studies on the size of the undeclared economy, which allows comparisons with the EU Member States, as well as internationally.

According to the World Bank *Enterprise Survey* for Macedonia, in 2013 55.6% of firms reported that they compete against firms operating on an undeclared basis, which is a considerable decline from 2009, when 73.9% of firms faced such competition. There is also a decline in the share of firms that identify the practices of undeclared competitors represent a major constraint on the growth of their business, from 55% in 2009 to 35% in 2013. However, these percentages are higher than in all other EU Member States

In 2011 Stankovic and Stankovic (2012) conducted a country-level direct survey of 1,200 respondents to assess citizens’ attitudes towards undeclared work and its consequences. The sampling method was based on a ‘door-to-door’ approach. The results indicate that 14% of respondents had personal experience with undeclared work. When respondents were asked what they would do if they were to be employed on an undeclared basis, 48% answered they would keep silent to keep the job, 20% would report the employer and only 15% would quit their job. When it comes to the demand side, some 35% of respondents have been purchasing goods from undeclared production on a daily basis, 37% buy such products once or more per week, while only 11% reported that they never buy such products (see Figure 6).

Figure 6. Extent of informality in FYR Macedonia (2009 - 2013)



Source: World Bank Enterprise Survey 2009 and 2013. Base: N 2009=360; N 2013=366.

4. Nature of the undeclared economy

This section explores the nature of the undeclared economy in FYR Macedonia, including its prevalence in specific sectors and business types, as well as its different forms and the socio-economic and spatial variations.

4.1. Sectorial and business variations

Most available data on the sectorial distribution of the undeclared economy comes from direct surveys among businesses and the population. To evaluate the distribution of the undeclared economy in Macedonia from the perspective of businesses and across sectors in a manner that is comparable cross-nationally, the World Bank *Enterprise Survey 2013* can be analysed. The survey results suggest that businesses in manufacturing were more likely than those in retail or services to face competition from unregistered firms. At the same time, formal businesses in retail are more likely to perceive such unfair competition as a major constraint to conducting business in the country. Medium-size enterprises (20-99 employees) are also more likely to face competition from entities operating off-the-books, followed by small firms. Domestic firms located in South Macedonia are also more affected by the practices of informal competitors.

The ILO Labour Force Survey 2010 (ILO, 2011a) examines in more detail the prevalence of informal employment in certain economic sectors. As mentioned earlier, the term informal employment captures those jobs that are not covered by social insurance, legal protection or employment benefits. These jobs can be in the formal, informal or household sectors. Tevdoski (2011), Stankovic and Stankovic (2012), Jackman and Corbanese, (2007) argue that a certain share in all economic sectors goes undeclared, but this phenomenon is particularly prevalent in labour-intensive, low-earning jobs in construction, transport, catering, the textile industry, domestic services, agriculture and trade. Risteski (2009) adds tourism, private renting, green market trade, car repairs, home maintenance and cosmetic services to the list. Nenovski (2012) stresses that the trade sector is particularly prone to undeclared economic activity due to fact that it was dominated by small and medium-sized firms during the last twenty years. Some new forms of informal activities emerged recently, such as IT

services, translation, tutoring etc. (Stankovic and Stankovic 2012; Tevdoski, 2011). Furthermore, the development of tourism in the last few years enhances different forms of undeclared work.

Figure 7 displays what portions of work in different sectors is informal employment. It shows that 43% of jobs in construction are informal employment, 16.5% in transportation and 13% in trade, followed by around 8% in manufacturing and services. When looking at the sectorial distribution of total informal employment, the consequent finding is that it is most prevalent in construction (27.4% of informal employment) and services (25.8), followed by trade (19.5), manufacturing (17.9%) and transportation (9.2%) (ILO, 2011a).

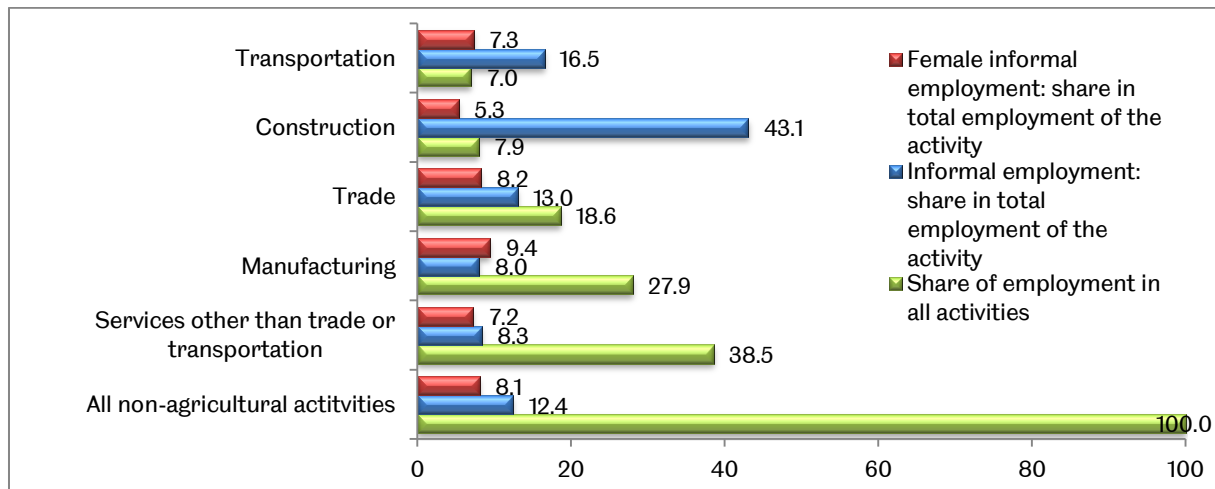
Table 2. Extent of informal practices in Macedonia by sector, firm size and location (2013)

Sector / firm size	Percent of firms competing against unregistered or informal firms	Percent of firms identifying practices of competitors in the informal sector as a major constraint
By sector		
Manufacturing	66.3	35.5
Retail	54	39.8
Other Services	51.5	31.6
By firm size		
Small (5-19)	52.8	33
Medium (20-99)	75.6	46.8
Large (100+)	35	19.5
By location		
Eastern Macedonia	38.4	18.5
North-West & West Macedonia	60.2	37.6
Skopje	56.7	36.8
South Macedonia	70.7	45.8
By ownership type		
Domestic	58.9	37.1
10% or more foreign ownership	12.1	2.6

Source: World Bank Enterprise Survey 2013.

Tevdoski (2011), Stankovic and Stankovic (2012), Jackman and Corbanese, (2007) argue that a certain share in all economic sectors goes undeclared, but this phenomenon is particularly prevalent in labour-intensive, low-earning jobs in construction, transport, catering, the textile industry, domestic services, agriculture and trade. Risteski (2009) adds tourism, private renting, green market trade, car repairs, home maintenance and cosmetic services to the list. Nenovski (2012) stresses that the trade sector is particularly prone to undeclared economic activity due to fact that it was dominated by small and medium-sized firms during the last twenty years. Some new forms of informal activities emerged recently, such as IT services, translation, tutoring etc. (Stankovic and Stankovic 2012; Tevdoski, 2011). Furthermore, the development of tourism in the last few years enhances different forms of undeclared work.

Figure 7. Informal employment as % of total employment by sectors



Source: ILO Labour Force Survey 2010.

The Centre for Economic Analyses (CEA) in 2009 conducted a survey of the ‘handicraft shadow economy’ (Risteski, 2009). With 85 households surveyed in the city of Skopje and 10 other big towns, the aim was to estimate how much households spend annually without getting a receipt on nine different services: additional education, cleaning services, car repairs, home maintenance, green markets, hairdressing and make up services, software and hardware services, cutting firewood and fortune tellers. Overall, for more than 90% of respondents the access to undeclared goods and services is easy or very easy. The research showed that families spend around 23% of their income in the undeclared handicraft economy, almost half of which (10.6%) is spent at green markets - for purchasing fruits and vegetables from unregistered traders. Other types of undeclared goods and services purchased accounted for less than 4% of household income. Undeclared products from green markets are also the category with the greatest overall share of household money spent – around 47.1% from all money spent on goods and services without receipt, followed by car repairs (14.5%) and cosmetic services (10.4 %). Only 1.4 % of respondents never buy fruits and vegetables from nonregistered merchant in the green markets.

This is in accordance with the aforementioned study conducted by Stankovic and Stankovic (2012) where the sale of agricultural produce at so-called ‘green bazaars’ is recognised as the activity most affected by undeclared work, followed by trade of piracy and counterfeited goods, as well as import-export activities.

Novkovska (2008 and 2013) analysed the size of informal employment in the agricultural sector based on the SSO’s *Labour Force Survey*, which is one of the few sources collecting data on undeclared work in this sector. Novkovska (2013) highlights that the share of informal employment in agriculture is significant – between 86.1% and 82.4% of all agricultural employment for the period 2008-2012. The LFS data further shows that the overall trend is decreasing, and that women are to a much higher degree involved in informal agricultural jobs – equivalent to more than 90% of all women employed in agriculture, while for males this percentage was between 76.5% and 81.4%.

Approximately 39% of the total land area of the FYR Macedonia is agricultural land, while another 37% is forestland (EC, 2011a), what makes agriculture one of the most important sectors in FYR Macedonia. According to Food and Agriculture Organisation (2012), the contribution of agriculture, forestry and fishing to the GDP was 11.1% in 2011, while 18.1% of all employment was in agriculture. Furthermore,

40.7% of the population live in rural areas. This suggests that more attention in the future should be paid on agriculture when estimating and tackling undeclared work in FYR Macedonia.

4.2. Types of undeclared work and socio-economic variations

An OECD pilot study on the size of the non-observed economy in Macedonia's national accounts found that one of the main types of non-exhaustiveness is underreporting of economic activity to avoid paying turnover taxes, import duties, personal income and labour taxes (Ahmad, 2007). Within misreporting practices, underreported salaries ('envelope wages') are a significant aspect (see Williams, 2009, 2010, 2013a; Williams and Padmore, 2013a,b). Other common types of misreporting in the non-financial and household sectors include over-reported intermediate consumption, non-registered employment and non-registered sales in trade (UNECE, 2008). This is similarly the situation elsewhere in Europe (Williams and Martinez, 2014a,b,c).

The 2010 ILO Labour Force Survey (ILO, 2011a) provides further insight into the different types of undeclared work in Macedonia (see Table 3). In 2010, 12.6% of the workforce were involved in informal employment (undeclared workers, or those not covered by social and legal protection and employment benefits, regardless if they work in registered or unregistered firms or households), 7.5% had jobs in the informal sector (unregistered or unincorporated enterprises). A further 5.2% of employed were undeclared workers outside the underground sector and another 0.4% are formal workers in informal sector enterprises.

Table 3. Types of informal employment in the non-agricultural sector in FYR Macedonia (2010)

	Total	Women	Men	Urban	Rural
<i>In thousands</i>					
Persons in informal employment	65	16	49	34	31
Persons employed in the informal sector	39	5	33	18	20
Persons in formal employment in the informal sector	2	1	1	1	0
Persons in informal employment outside the informal sector	27	11	16	17	11
as % of non-agricultural employment:					
Persons in informal employment	12.6	8.1	15.4	9.5	19.4
Persons employed in the informal sector	7.6	2.5	10.3	5.0	12.5
Persons in formal employment in the informal sector	0.4	0.5	0.3	0.3	0.2
Persons in informal employment outside the informal sector	5.2	5.6	5.0	4.8	6.6

Source: ILO Labour Force Survey 2010.

Stankovic and Stankovic (2012), as well as Tevdovski (2011) note that undeclared work occurs most notably in relation to seasonal jobs, temporary or part-time work and affects mostly those with low level of qualification, as well as low earners. Novkovska (2013, 2008) studied the level of undeclared jobs within non-standard employment (part-time, fixed-term and own-account jobs/self-employed) based on data from the SSO's *Labour Force Survey* and found that in 2007 more than 77% of informal wage employment was non-standard and temporary employment, while only 11% of formal employment were non-standard and temporary jobs. The problem is particularly prevalent in the agricultural sector, where in 2012 over 85% of jobs were own-account and unpaid family workers, indicating that agricultural workers are simultaneously involved in informal and non-standard employment (Novkovska, 2013), putting them at greater risk of poverty and social exclusion.

With respect to own-account work (self-employment), the LFS 2010 (ILO, 2011a) shows that 34.7% of non-agricultural self-employment is informal, with 48.6% of all sole traders (own-account enterprise owners) operating on an undeclared basis. This is a similar level to other countries (Williams, 2007, 2013b; Williams and Round, 2007, 2009; Williams and Yousseff, 2014). The share of undeclared self-employment is much higher in rural areas, where 44.8% of the self-employment is undeclared compared to 28.3% in urban areas.

When it comes to dependant wage employment, the survey reveals that 9.2% is undeclared wage employment (21.4% of agricultural employees and 8.8% of employees in all other sectors). Undeclared wage employment is higher in rural areas where 14.5% of all wage employees are undeclared, while in urban areas only 6.9% of waged employment is informal.

These findings indicate a clear link between informality and job precariousness: informal workers are less likely to hold full-time, permanent waged jobs. Or as Mojsoska-Blazevski et al (2009: 64) suggest, “informal employment is probably the single most important source of non-decent work”. Furthermore, wage earners are less likely to work undeclared than sole traders and the self-employed. These trends become even more pronounced in rural compared to urban areas, and among the young and ethnic minorities (Mojsoska-Blazevski et al, 2009). Finally, although the latest LFS data conducted by the SSO (2013) shows that men are more likely to be engaged in undeclared work than women, there are gender differences between the types of undeclared work performed. The evidence discussed so far supports the finding that women are more likely to be engaged as unpaid workers in agriculture, while men tend to be over-represented in the categories of undeclared self-employed and owners of unregistered/unincorporated firms.

5. Causes of undeclared work and barriers to formalisation

5.1. Causes of undeclared work in FYR Macedonia

The question of the underlying motivations for engaging in the undeclared economy has been at the centre of current academic debates on the informal economy. Broadly speaking, the vast body of literature on this matter can be divided into five schools of thoughts (see Adom and Williams, 2014; Williams 2014b; Williams et al., 2013). Developed as a critique of preceding standpoints or derived from field studies all around the world, each of the five schools has significantly contributed to understanding of this multifaceted phenomenon. Although they scrutinise undeclared work from different angles, we should not consider them as contradicting theories, but rather as supplementing fragments of the complex theoretical mosaic. Before moving to the discussion about the underlying causes for the undeclared economy in the FYR Macedonia, we shall briefly present the key views of these five schools.

The dualist school perceives undeclared work as a direct consequence of the disparity between labour market demand and labour supply (Hart, 1973; Sethuraman, 1976; Tokman, 1978). The main argument here is that individuals with restricted formal employment opportunities often find undeclared work as the only source of income (ILO, 1972). Given this, a decision to engage in any type of work concealed from the authorities is depicted as a survival strategy, and only the creation of new jobs is a viable solution to tackling this unwelcome phenomenon (Hart, 1973). The most important drawback of this pioneering set of ideas about the causes and nature of undeclared work is its belief that the formal and informal dimensions of the economy are separated and completely independent of each other. However, despite being perceived nowadays only as a sketchy attempt to understand undeclared work (Moser, 1978), the arguments of this school of thought are far from being invalid. Its main value lies in acknowledging the role of the unemployed in activities that are hidden from the authorities.

Unlike the dualist approach which is focused only on the labour supply side, two subsequent schools scrutinise undeclared activities from the perspective of business. The first among them is the legalist school, which points at the state as the main actor responsible for development of the undeclared economy. From the standpoint of legalists, undeclared work arises as a response to burdensome state regulations (de Soto, 1989). Consequently, some entrepreneurs find it much more attractive to work on undeclared basis where financial and administrative burdens represent significant expenses in terms of money and/or time. In line with that, undeclared work is described as a “popular resistance to an unfair and overly intrusive state” (Rakowski, 1994: 506). Given this, legalists advocate less state influence in regulation of the business environment, particularly when it comes to taxation (Gërzhani, 2004).

The structuralist school, on the other hand, is focused on the role of capitalism in the process of ‘informalisation’. The accent here is on small-scale firms (and the self-employed) and their subordinated position in business interactions with large ones (Moser, 1978). As structuralists argue, undeclared work arises from the efforts of large formal firms to survive on the market, which is characterised by severe competition (Castells and Portes, 1989). The main strategy applied by those formal firms is to decrease the total cost of the final product by subcontracting part of the work to small-scale undeclared enterprises and self-employed individuals. However, from the perspective of structuralists, these subordinated entities do not choose to voluntarily conceal their activities, but this decision is rather imposed by large firms. In line with that, contrary to legalists who advocate less state influence, structuralists call for more regulation in order to protect small businesses (Portes and Sassen-Koob, 1987).

According to the voluntarist approach, non-compliance is a rational choice decision made by individuals and firms “after weighing the costs-benefits of informality relative to formality” (Chen 2012: 5). From this standpoint, financial gain is the key rationale for non-compliance. If taxpayers assess that the expected cost (financial and/or administrative) of being caught and punished is lower than the extra profit made by evasion, they will opt to conceal their activities from the authorities (Allingham and Sandmo, 1972). Thus, entering the informal realm is not a result of necessity or external pressure, as it was explained by all preceding schools of thoughts, but is rather a voluntary decision. Given this, proponents of the voluntarist school see the increase of the cost/benefit ratio as the only efficient solution to combat undeclared work (Maloney, 2004). This is usually done by increasing the cost side, i.e. increasing the number of audits, improving the efficiency of audits, raising penalties etc. (Williams and Renooy, 2008).

Finally, the so-called complementary approach is focused on activities not necessarily motivated by financial gains. This relatively new and quite different set of ideas scrutinises undeclared work from a societal perspective. As Williams and Round (2008) argue, there are many non-financial incentives for people to engage in undeclared activities, such as the reinforcement of social ties, improvement of the position in a community, or simply a desire to help neighbours, acquaintances and kin. The emphasis is on small-scale, mainly community-oriented assistances which constitute “a good part of the informal economy”(Gaughan and Ferman 1987: 25). Hence, these activities are perceived as praiseworthy rather than harmful and as such should be nurtured, not combated.

Apart from these five schools, there are some recent studies on the socio-cultural aspects of tax compliance. This research area is focused on the role of the ‘tax morale’, which can be roughly defined as “an individual’s intrinsic willingness to pay taxes” (Alm and Torgler 2006: 224). As Torgler and Schaltegger (2005) explain, this latent factor is an outcome of personal characteristics, a complex mixture of one’s level of religiosity, national pride and trust in institutions, as well as of the perceived tax burden, and the level of satisfaction resulting from interactions with tax authorities.

According to Feld and Frey (2002), the level of compliance is determined by the psychological contract that exists between the state and its citizens. This entails that taxpayers would be less willing to comply if they think the government does not spend their money efficiently and fairly. Similarly, if a tax administration relies on deterrence rather than cooperation, taxpayers would demonstrate greater levels of disobedience. In addition, some recent findings indicate that the perception of prevailing norms in society also plays an important role in one's decision about (non)compliance (Williams and Martinez, 2014d; Wintrobe and Gërkhani, 2004). This indicates that individuals who are surrounded by evaders are more likely to disobey. Indeed, Wenzel (2004) found that taxpayers identify themselves with other taxpayers in their surrounding and tend to act in accordance to prevalent behaviours within the group.

5.2. Barriers to formalisation from the perspective of businesses

A valuable source of information about the business climate in FYR Macedonia is the World Bank *Doing Business Survey*. This study, which evaluates 11 key factors for starting and running a business, enables us to examine how the FYR Macedonia fares in comparison with other 189 surveyed countries all around the world. In addition, as the study is repeated on annual basis, it provides insight into the development of the business climate in this EU-candidate country during the last decade. The effectiveness of the legislation is evaluated in the fields of starting a business, protecting investors, getting credit, dealing with construction permits, registering property, getting electricity, paying taxes, enforcing contracts, trading across borders, employing workers and resolving insolvency. For each of these areas, individual rankings are given, which are then extrapolated into the overall country ranking².

In general, although the business environment in FYR Macedonia can be assessed as satisfying, there is still a lot of room for improvement. In terms of the overall ranking given in the *Doing Business 2014*, the country ranks 25th out of 189 countries (World Bank, 2013a). Having in mind that the EU27³ as a composite is ranked 40th (World Bank, 2013b), it can be concluded that the business climate is more favourable for entrepreneurs in FYR Macedonia than in its average European counterparts. In fact, only 9 out of 28 member states are ranked higher than this EU candidate country (Figure 8). Taking into consideration only those member states that have gone through a transition process, the data reveals that apart from the three Baltic countries (Lithuania, Estonia and Latvia), FYR Macedonia fares better than any other post-communist member state.

Such a good ranking is a result of numerous reforms that aimed at removing disincentives for formalisation. This particularly applies to the field of starting a business which was significantly improved by introduction and continuous developments of a 'one-stop-shop' system⁴ during the second half of the 2000s. However, the most significant reforms have been conducted in the field of paying taxes. In 2006 the authorities launched the income tax reform which resulted in the so called 'flax tax system'. In the first stage both personal income and corporate income tax rates were decreased and equalised: the three personal income tax rates (15%, 18% and 24%) were replaced with a single rate of 12%, while the corporate income tax rate was reduced from 15% to 12%. In addition, in 2008 this rate was again reduced to 10%. The tax burden for businesses was further decreased in 2011 – corporate income tax was to be paid only on distributed profits (Baric and Williams, 2014). There was

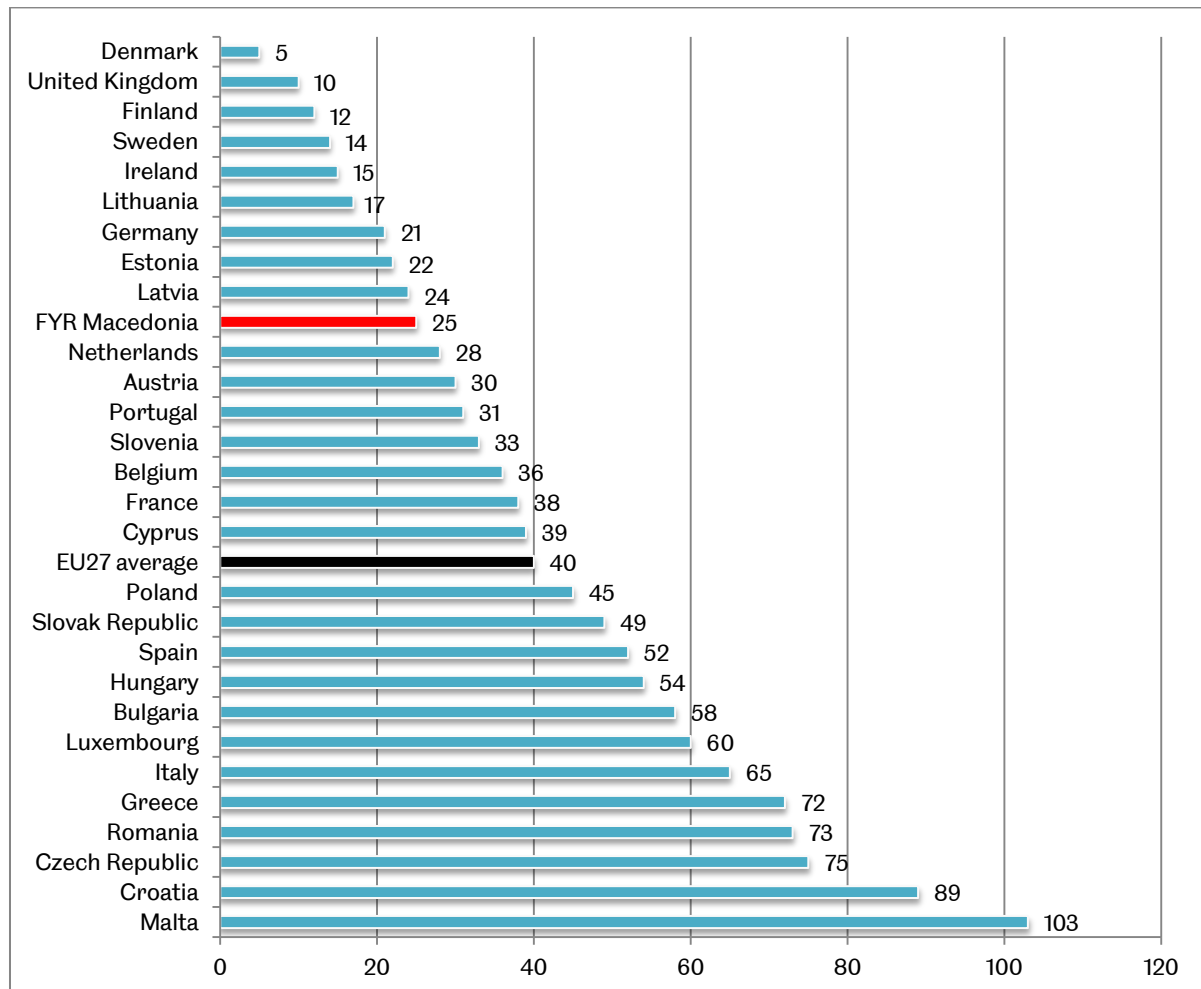
² With exception of the score in the field of employing workers which is for practical reasons excluded from the overall ranking. For more details, see <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Chapters/DB14-Ease-of-doing-business-and-distance-to-frontier.pdf>

³ Croatia is excluded from the composite EU-ranking.

⁴ One-stop-shop systems entail simplified procedures for registering a business, which allows issuance of all necessary documents in a single place during a very short time period (usually one to three days).

also a reduction in social contribution rates. For instance, the pension insurance rate was first decreased in 2009 from 21.2% to 19% of the gross wage and then to 18% in 2010. These are just the most important reforms that aimed at easing the process of starting and running a business in FYR Macedonia. A more comprehensive list of measures in this field is provided later in the report.

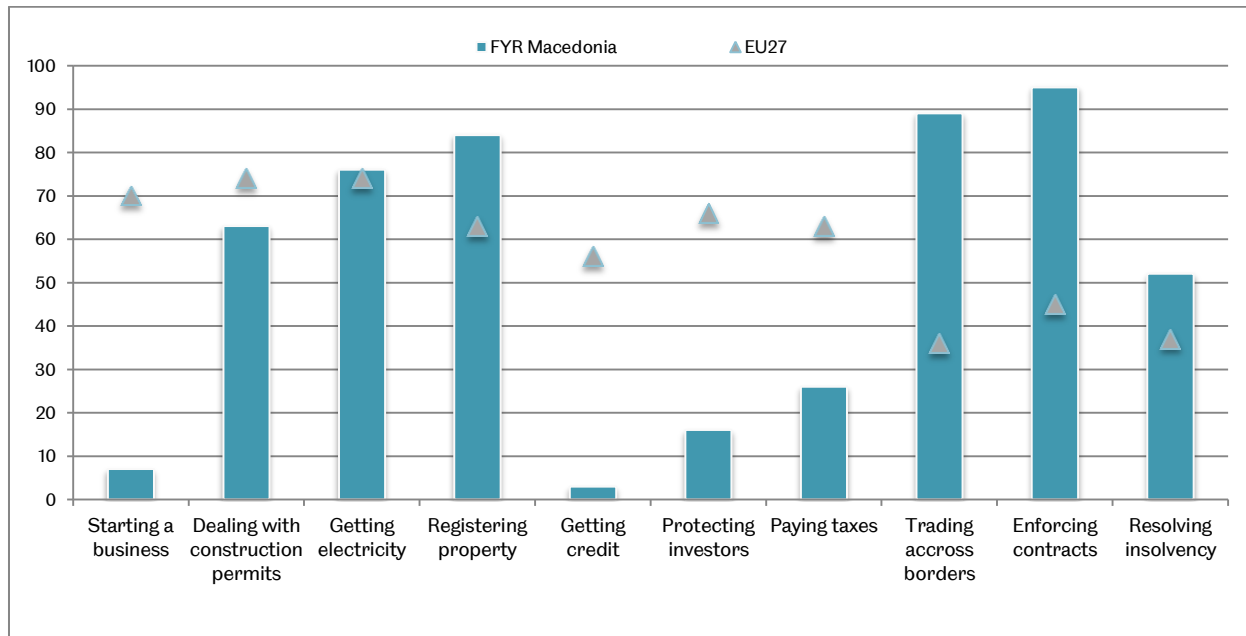
Figure 8. Overall country rankings in Doing Business 2014, EU member states and FYR Macedonia



Source: Based on World Bank (2013a) and World Bank (2013b)

However, the overall 'doing business' ranking does not provide a comprehensive picture, and can even be quite misleading. Indeed, more detailed analysis reveals that the situation is more complex. As Figure 9 suggests, a significant disparity between rankings in individual areas is noticeable. While being among the best economies in the world considering certain areas, achievement in other aspects crucial for a business are quite modest. The most developed areas by far are getting credit (ranked 3rd) and starting a business (ranked 7th), followed by protecting investors (16th) and paying taxes (26th). On the other hand, in fields such as enforcing contracts (95th), trading across borders (89th) or registering property (84th) FYR Macedonia scores far below the EU27 average.

Figure 9. Doing Business rankings, comparison of FYR Macedonia and EU27

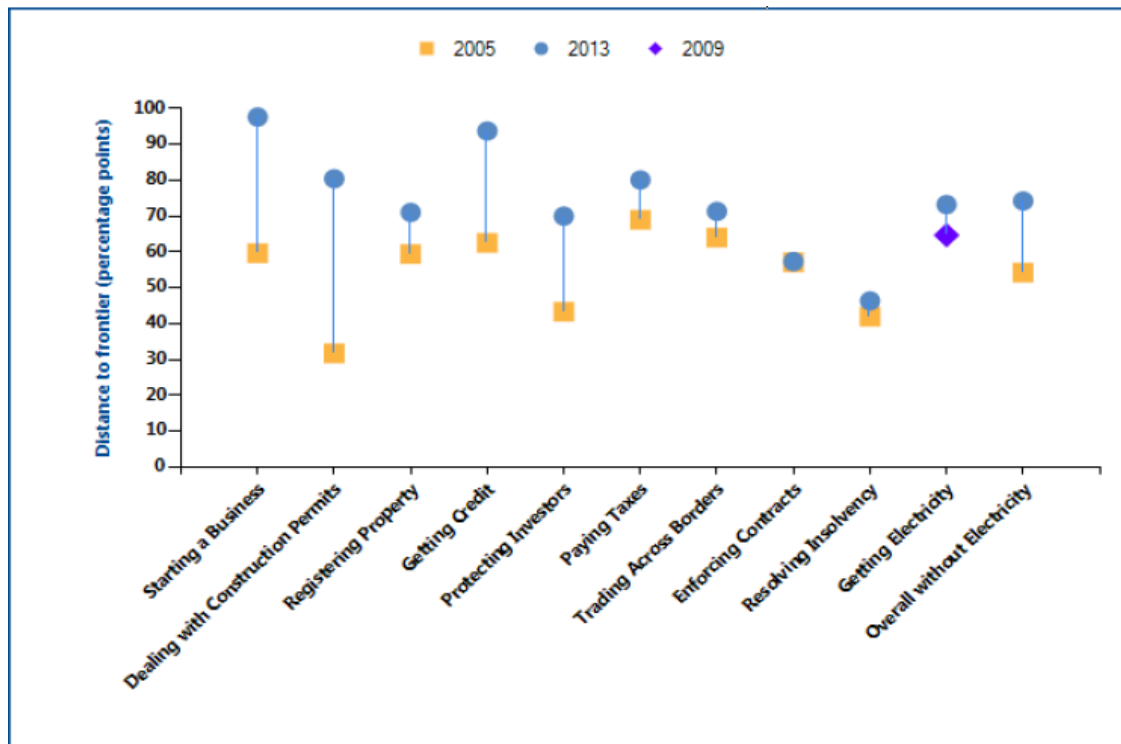


Source: World Bank (2013a)

Although they provide a useful tool for comparing of economies all around the world, these rankings do not tell us anything about progress over time, or about the potential for improvements of the business environment. To answer these two questions, we should examine the country's distance to the frontier measure (the highest achievers). It displays the improvement Macedonia has made in the aforementioned areas since 2005. For each individual field, the country with the best performance (among all 189 analysed countries) is taken as a benchmark. Accordingly, the most advanced economy in a certain field scores 100, while individual achievements for all other countries range between 0 and 100 depending on comparison with the best one.

The scores on the distance of FYR Macedonia to the frontier measure (see Figure 10) unmask the real reason for the aforementioned discrepancies among scores in individual criteria. It is evident that significant efforts have been made to improve some aspects of the business environment, while others have been neglected. For instance, very little, if at all, has been done to stimulate enforcement of signed contracts, as well as in the field of resolving insolvency or reducing export barriers. In line with that, one can understand why all endeavours to improve the business climate have not had significant impact on the reduction of the informal economy (see Mojsoska-Blazevski, 2012; Stankovic and Stankovic 2012; Nenovski, 2012; Stojkov, Nikolov and Smilevski, 2008). If the authorities want to encourage greater compliance, it is necessary to focus on all areas of business life, not just on isolated goals.

Figure 10. Progress of FYR Macedonia in the areas measured by Doing Business (2005-2013)



Source: World Bank (2013a)

In order to get a more comprehensive picture of the obstacles which firms face when doing business in FYR Macedonia, it is important to scrutinise how their owners and managers perceive the overall quality of legislation and the business climate in general. Some answers on these questions are provided by a survey of 100 companies conducted in 2008 by the Institute for Democracy, Solidarity and Civil Society (Stojkov, Nikolov and Smilevski, 2008). From the perspective of the firm representatives surveyed, the market is characterised by a high degree of uncertainty due to frequent changes in tax regulation. Having a harmful impact on planning and investment, this obstacle is identified as the most important one by almost a half of firms. The problem of uncertainty is particularly emphasised by large companies, with 75% of them recognising the necessity for a more stable environment.

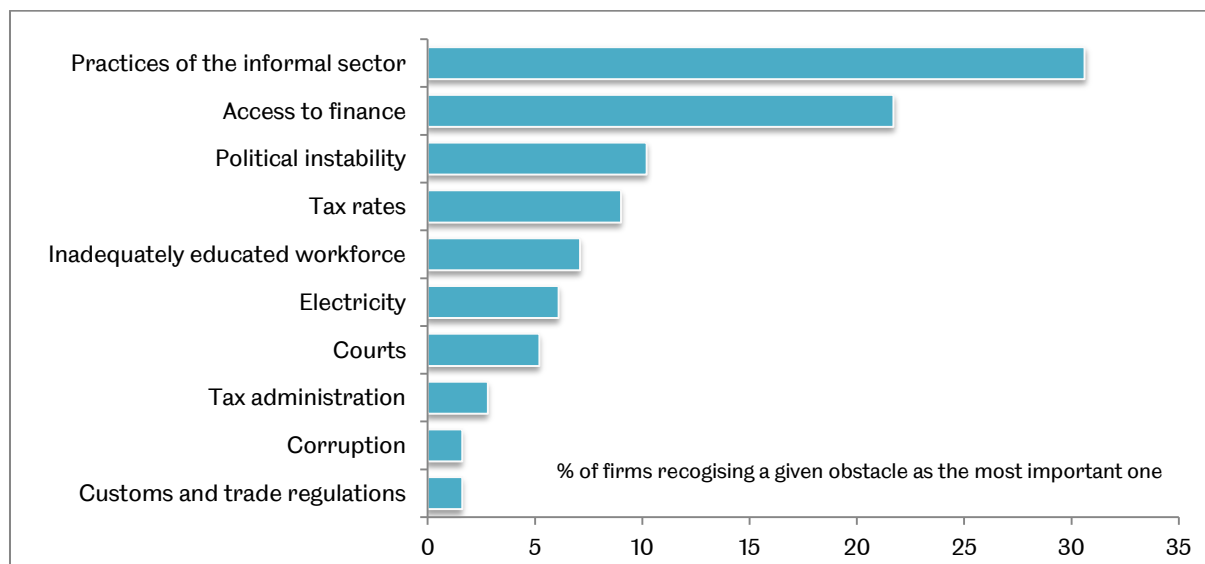
The weak capacity of the Public Revenue Office is yet another obstacle indicated by surveyed businesses. Both the insufficient number of tax officers and the unsatisfactory level of skills of existing personnel often cause undesirable complications in the process of paying taxes. This certainly directs a proportion of firms into the informal realm, which is the easiest strategy to avoid hassle with the administration.

Another issue is the weak performance of inspections, which are prone to political influence (Stojkov, Nikolov and Smilevski, 2008). This provides a secure shield for some privileged companies engaged in informal operations. However, even those who are detected often manage to remain unpunished due to inefficient and corrupt judicial system (Garvanlieva, Andonov and Nikolov, 2012). With court trials lasting for several years and rarely producing a fair verdict due to insufficient evidence, the system contributes to the low perception of risk for those who operate in the undeclared economy. In its *Progress Report* for 2013, the European Commission (2013) stressed that the problem is not in the legislation itself, but rather in its (non)enforcement – a common problem in many transition countries. Empowering the Public Revenue Office, improving judicial efficiency and ensuring greater

independence of inspectors are therefore three crucial objectives in the fight against undeclared work in FYR Macedonia.

The results of The World Bank *Enterprise Survey* conducted in 2013 clearly illustrate the negative influence of undeclared practices on the economy. According to managers and owners of 360 firms surveyed from November 2012 and May 2013, competition from their undeclared rivals represent the greatest problem in doing a business (World Bank, 2014). From a list of 15 major obstacles to operating a business in the country, almost every third respondent named the practices of informal competitors as the most salient one (Figure 11). Given this, there is a risk for the future expansion of the informal realm. Undeclared businesses are often able to provide cheaper products and services due to lower labour and administrative cost, and thus narrow the market for the formal ones. Faced with the drop in demand, formal firms may resort to 'informalisation' of their own activities as the only survival strategy.

Figure 11. Top 10 major constraints to the business environment (2013)



Source: World Bank Enterprise Survey 2013

Notwithstanding the findings of the *Doing Business Survey*, firm representatives surveyed in the World Bank *Enterprise Survey* recognise access to finance as the second most important obstacle. This especially applies for small and medium enterprises. No public credit guarantee schemes exist, while financing through risk capital and leasing has been significantly decreased after the onset of the crisis (European Commission, 2013). Yet another associated issue is the inadequacy of the banking system. Stankovic and Stankovic (2012) point at the high costs of bank transactions accompanied by the low quality of banking services as two important factors which put entrepreneurs off from using formal financial institutions. Therefore, some firms find the undeclared realm as the more attractive option.

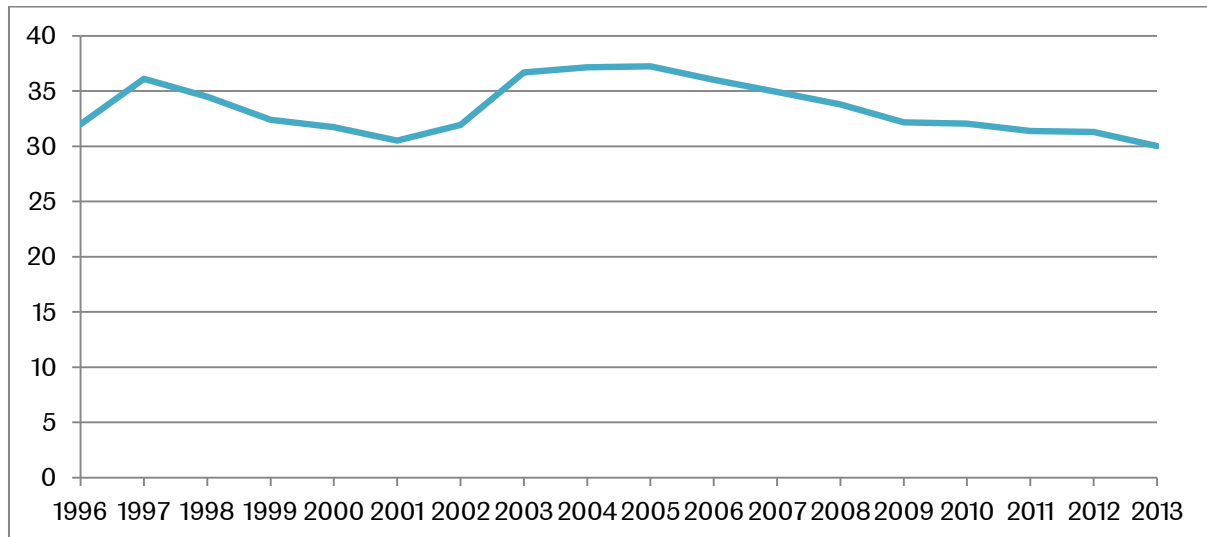
Finally, in spite of all recent changes aimed at easing the process of starting a business, there are still many licenses, decisions, certificates and long-lasting procedures in place (Nenovski, 2012). Faced with administrative perplexity, it is a common practice for start-up companies in FYR Macedonia to start operating unregistered. Given this, some reforms are still to be done to ease the process of registering a firm.

5.3. Barriers to formalisation from the perspective of labour supply

When examining the causes of undeclared work in FYR Macedonia from a labour-supply perspective, most scholars point at the prevalent unemployment as a major contributing factor (Stankovic and

Stankovic, 2012; Jackman and Corbanese, 2007; Risteski, 2009; Nenovski, 2012). A progressive reduction of formal employment during the transition period resulted in extremely high unemployment rates, which have remained above 30% throughout the last two decades (Figure 12). In comparison, while in 1992 there were 180,000 unemployed, the number has almost doubled in 2010, accounting for 321,000 (Nenovski, 2012).

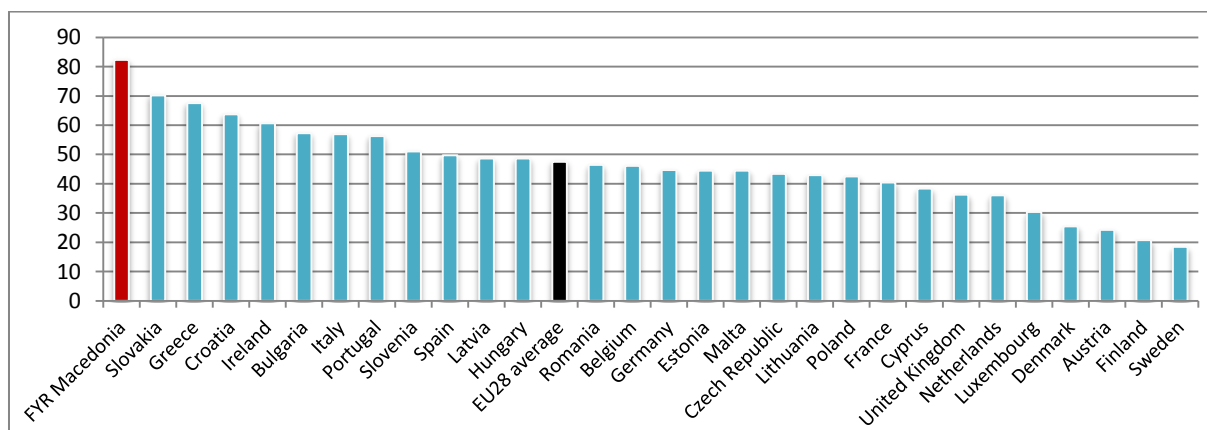
Figure 12. Unemployment rate in FYR Macedonia, 1996-2013, %



Source: International Monetary Fund (2014)

Some particularly concerning features of the labour market in FYR Macedonia are high long-term and youth unemployment, which indicate “deep-rooted structural impediments in the labour market” (European Commission 2013: 18). As Figure 13 reveals, 82.3% of all unemployed persons in 2013 were long-term unemployed, i.e. those who have not found a formal job for more than 12 months. In comparison, the average long-term unemployment rate in the EU28 was 47.5%. Such an extreme rate, far higher than in any EU member state, clearly demonstrates the presence of an unemployment trap. Individuals who lose their job, or have not managed to find one upon finishing their education, are at risk of remaining outside formal employment for a long period.

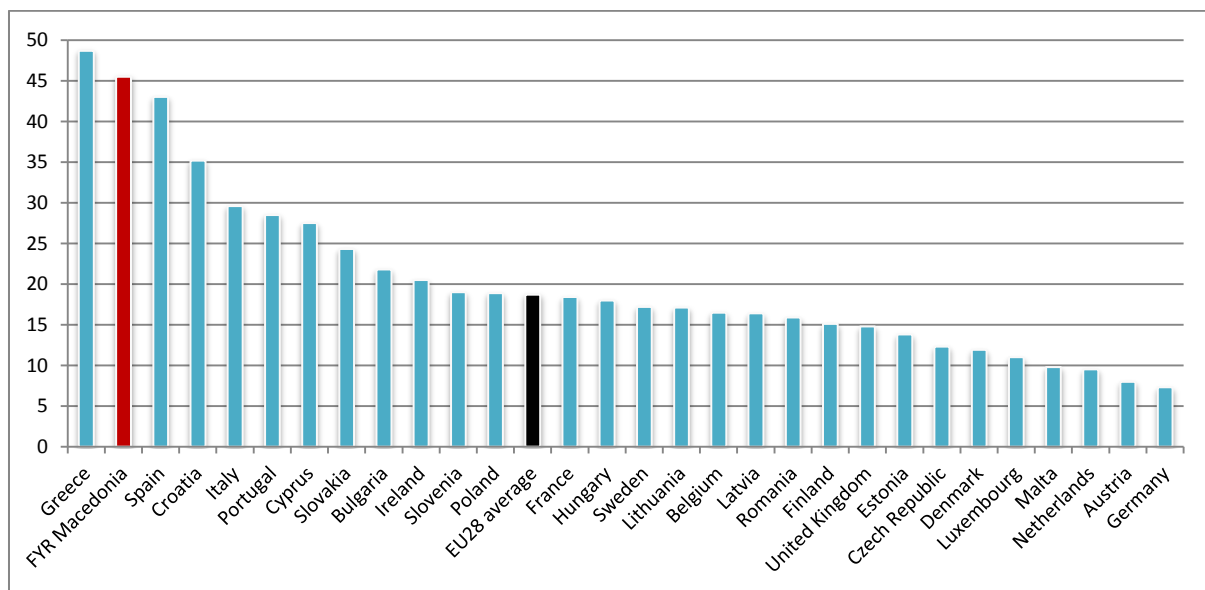
Figure 13. Long-term unemployment in the EU and FYR Macedonia, % of unemployed (2013)



Source: Eurostat (2014a)

Similarly, FYR Macedonia is placed at the top compared to the EU when it comes to youth unemployment (Figure 14). Accounting for 45.5% in 2013, the youth unemployment rate was higher than in almost all EU member state (with the only exception of Greece where it amounted to 48.7%). Given that 4 out of 5 unemployed are long-term unemployed and almost every second work-capable person between 15 and 29 years of age remain outside formal employment, such a high share of undeclared work is not surprising. Indeed, a significant part of the unemployed find informal employment as the only income opportunity. According to some estimates, 70,000 of the officially unemployed people in FYR Macedonia are engaged in undeclared work (Garvanlieva, Andonov and Nikolov, 2012).

Figure 14. Youth unemployment rates in 2013, EU member states and FYR Macedonia



Source: Eurostat (2014b)

A recent survey on the rationales for engaging in undeclared work in FYR Macedonia, conducted on a representative sample of 1,200 respondents (Stanković and Stanković, 2012), indisputably confirms that unemployment plays the most important role. According to the survey, about 56% of Macedonians see the inability to satisfy existential needs and the unfavourable economic situation as the major factors fostering undeclared activities. In fact, almost half of the respondents are ready to accept any offered job, regardless if formal or informal. This suggests that undeclared work has become a widely accepted phenomenon, deeply ingrained in every part of society. Indeed, every third respondent thinks that these practices should not be sanctioned at all (Stanković and Stanković, 2012).

Another salient feature of the labour market in this EU-candidate country is the high proportion of inactive people. Some estimates for 2012 reveal that 17.4% of population between 25-40 years of age were neither employed, nor registered as unemployed (Janeska, 2013). This share is even higher for those aged 25-29, accounting for almost 22%. Although some individuals inside this group rely on financial support from family and relatives, a considerable number of them are certainly engaged in undeclared activities. According to Janeska (2013), many are working in agriculture, a sector employing some 80,000 unregistered workers.

However, the lack of formal employment opportunities is not the only reason for prevalent unemployment and pervasive undeclared practices in FYR Macedonia. For instance, in their discussion

⁵ Include people between 15 and 29 years of age.

about the shortcomings of the social welfare system, Mojsoska-Blazevski, Petreski and Petreska (2013) argue that the system provides a number of disincentives for unemployed to accept formal jobs. As the authors explain, social benefits are means-tested, meaning that the amount of received benefits is proportionally decreased for the amount earned by formal employment. This further implicates that for a significant part of unemployed people any formal employment would result in complete withdrawal of benefits due to low entitlement thresholds set by the authorities. Apart from the financial loss, it would entail the loss of other for household bills, personal computers sponsored by the state, in-kind support from civil organisations etc. Given all this, many workers opt to stay inside the social welfare scheme and carry out undeclared work in parallel.

Another disincentive for formal employment is the free health care for the unemployed. Even after termination of entitlement to unemployment benefits, registered unemployed do not lose their health insurance. In addition, free health insurance is also provided to low-income earners, which makes it much easier for these individuals to accept 'envelope wages'. On the other hand, the system fails to provide significant activation policies for the recipients, i.e. making benefits provisional upon their efforts to find a formal job (Stanković and Stanković, 2012). Therefore, apart from creating new jobs, efforts to reduce undeclared practices in FYR Macedonia should certainly include the reform of the existing social welfare system.

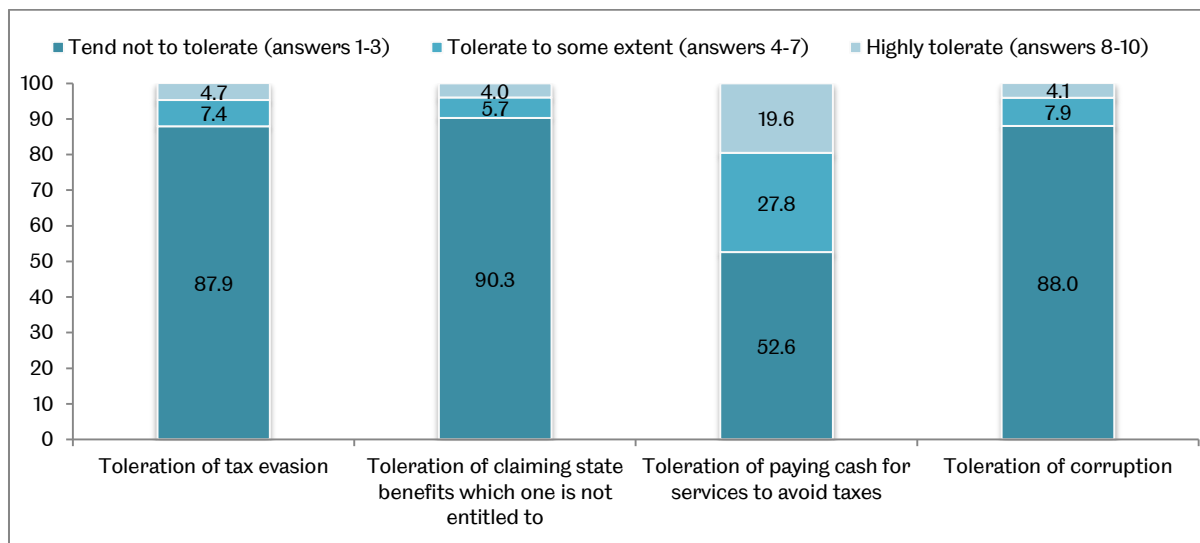
5.4. Socio-cultural determinants of undeclared work in FYR Macedonia

When discussing factors that shape one's decision about (non)compliance, we must not neglect the importance of socio-cultural factors. A valuable data source in this matter in FYR Macedonia is provided by the *European Values Study*. This cross-national survey first conducted in 1981 and then repeated every nine years, provides insight into the attitudes of people all around Europe (and some non-European countries such as the United States and Canada) towards various aspects of life. Among other things, people were asked what they think about politics, work, society, family and religion. The FYR Macedonia was included only in the last wave conducted in 2008. The survey encompassed 1,500 respondents above 18 years of age, selected through stratified clustered sampling.

For the purpose of this report, we are interested in the attitudes of Macedonian citizens towards four types of violating behaviour directly linked to undeclared work. Respondents were asked to what extent the following actions can be justified: cheating on tax, claiming state benefits to which one is not entitled, paying cash for services and corruption. Answers are given on the scale from 1 to 10, with 1 indicating zero-toleration and 10 indicating absolute toleration. Figure 15 illustrates the range of responses, summarised in three subgroups.

These results reveal two quite different perspectives. While the majority of respondents tend not to tolerate cheating on taxes, false-claiming of state benefits and taking a bribe, the situation is not so clear when it comes to cash-in-hand activities. Only 52.6% of citizens would never or rarely justify cash payments without declaring the transaction to the authorities. On the other hand, almost every fifth considers these practices as completely acceptable, while additional 27.8% tolerate them to some extent. This clearly confirms the wide acceptance of undeclared work in society.

Figure 15. Public tolerance towards types of non-compliant behaviour, % of respondents



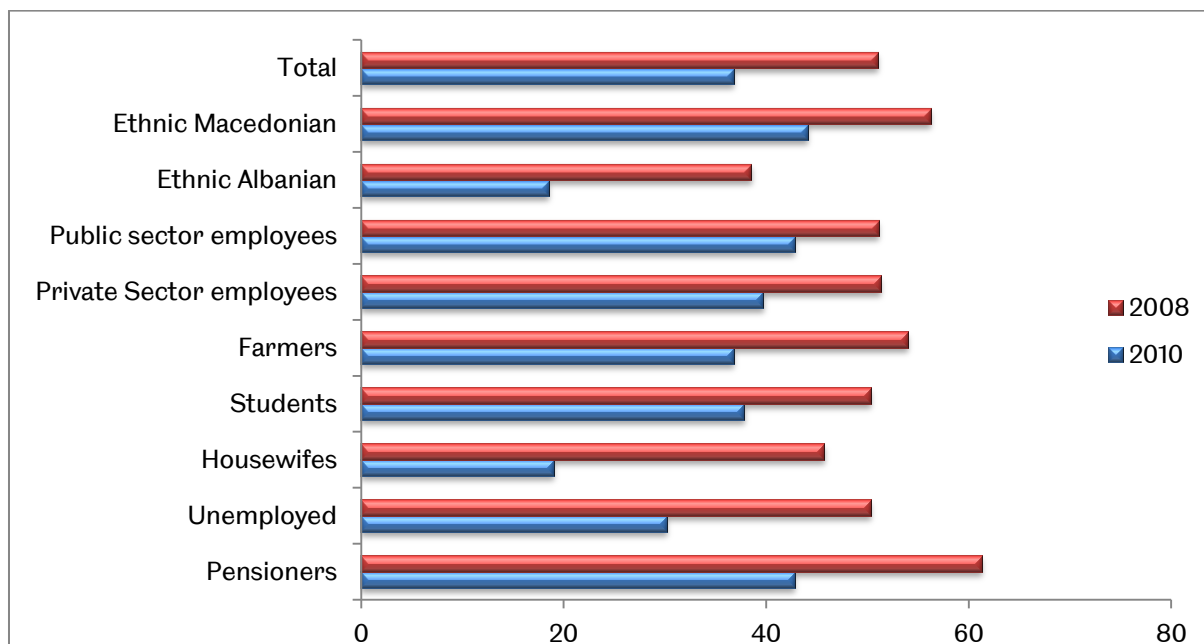
Source: Authors' calculations based on EVS (2011)

Ristovska, Mojsoska-Blazevski and Nikolov (2013) used data from the *European Values Study* to analyse the determinants of the tax morale in FYR Macedonia. However, they used only toleration of tax evasion as a proxy for tax morale, while paying cash for services was not included in the model. By using an ordered probit model, the authors found that trust in institutions and pride have leading roles in shaping the level of individuals' tax morale. Variables such as trust in government, trust in civil service, trust in judicial system, level of national pride and satisfaction with life all have a positive effect on tax morale.

On the other hand, besides age, income and ethnicity, the authors found no significant link between tax morale and any other demographic and economic factor. For instance, gender, marital status, level of education and employment status were not significant in the model. However, special attention here should be paid to ethnic differences. Macedonia is a multi-ethnic country, with ethnic Macedonians comprising only around 64% of the population. One quarter of citizens identify themselves as ethnic Albanians, while the remaining 11% are mainly Turks, Roma, Serbs and Bosnians (State Statistical Office, 2005). In the given quantitative analysis, ethnic Macedonians were 60% more likely to display the highest level of tax morale in comparison to other ethnicities. This suggests the existence of a deep division in the multi-ethnic Macedonian society where minority ethnicities do not identify themselves with the state and therefore have a weaker sentiment towards the importance of tax compliance.

Indeed, according to research conducted by the Macedonian Center for International Cooperation (Klekovski, Nuredinoska, and Stojanova, 2010), in 2010 only 18.5% of citizens who identify themselves as Albanians had confidence in the government, while this share for ethnic Macedonians was 44.1% (see Figure 16). Nonetheless, both ethnicities show a decline in the level of trust. In general, slightly more than one third of the population had trust in the government while two years earlier every second citizen did so. This significant drop in the level of trust is noticeable among all socio-economic groups and seems to be a direct consequence of the economic downturn.

Figure 16. Trust in the Government, 2008 and 2010, in %



Source: Klekovski et al, 2010

One important issue not to be neglected when considering trust in institutions is the level of corruption in public administration. As revealed by a representative survey of 3,500 citizens conducted in 2010 (UNODC, 2011), corruption and bribery transactions are deeply entrenched in each segment of public life. For instance, one in ten respondents had an experience with bribery in interaction with public officials during the twelve months preceding the survey. This was mainly for speeding up a procedure (50%), followed by finalising a procedure (12%) and receiving a better treatment (11%). In addition, one quarter of the population see bribe-taking as a common practice in public institutions, while 36% think its prevalence will even increase in the future. This is particularly emphasised in the case of appointment procedures. There is a broad belief among respondents that skills play only a minor role in getting a job in public institutions, while corruption, nepotism and cronyism dominate.

The findings presented clearly point at a substantial gap between the norms and values of taxpayers and the state. It seems that a significant proportion of taxpayers do not see a clear link between paid taxes and received benefits, which has resulted in a wide approval of disobedience with official rules. For instance, according to the aforementioned population survey by Stankovic and Stankovic (2012), one in four respondents does not think they are obliged to report violators or should stop buying undeclared products. Given this, not only is undeclared work a broadly accepted phenomenon in FYR Macedonia nowadays, but there is a reasonable concern that this trend will continue in the future. Therefore, all imminent efforts to eradicate undeclared work should put the improvement of the psychological contract between the state and its citizens high on the agenda.

6. Institutional framework for fighting undeclared work

This section provides an overview of the main institutional actors involved in detecting, limiting and preventing undeclared work, as well as the role of social partners. There is no single body in Macedonia responsible for tackling undeclared economic activity. Instead, several ministries are

involved in this policy area through specialised agencies, with cooperation and joint actions taking place with respect to certain control tasks.

A 2010 study of 31 European countries (Dekker et al, 2010) reveals that only eight countries (26%) have either a single agency responsible for the fight against undeclared work or central coordinating committee responsible for ensuring coordinated action by the multifarious departments involved in tackling undeclared work. Furthermore, the study found that there are three main pillars where the authorities' efforts are focused: labour, social security and taxes (Table 4). Macedonia, similar to other transition countries from Eastern Europe, belongs to the group of countries where the main focus in tackling undeclared work is on labour law violation. Although there is no single body responsible for coordinating the fight against undeclared work, the labour inspectorate within the social ministry is the lead agency when it comes to combating undeclared work, while the public revenue office is mainly concerned with tackling tax and social security fraud and evasion.

Table 4. Undeclared work policies in Europe: focus on three pillars

Focus on Labour	Focus on Social Security	Focus on Taxes
Bulgaria	Belgium	Austria
Cyprus	France	Denmark
Czech Republic	Switzerland	Estonia
Greece	Liechtenstein	Germany
Hungary		Finland
Italy		Ireland
Iceland		Netherlands
Latvia		Norway
Lithuania		Sweden
Malta		United Kingdom
Luxembourg		
Poland		
Portugal		
Romania		
Slovakia		
Slovenia		
Spain		

Source: Dekker et al (2010).

6.1. State institutions

The Ministry of Labour and Social Policy (MLSP), develops drafts of legislation, proposes programmes and measures related to labour market regulation, including in the field of tackling undeclared work. As such, the MLSP implements state policy through its specialized units, namely the Employment Agency, State Labour Inspectorate, Social Assistance Agency and their regional structures. It regulates the activity of labour market institutions at national and regional level. It also participates in the development of the main parameters of social security and payments related to it.

The envisioned national efforts to tackle the undeclared economy are set out in the *Action Plan for the reduction of the grey economy* (Ministry of Economy, 2013; MLSP, 2014). The MLSP drafted the plan in consultation with all relevant state institutions, and has the main responsibility for coordinating and monitoring its implementation. In 2013 the MLSP has announced it would implement innovative measures to tackle the phenomenon, drawing for example on the Belgian voucher system (ICF and GHK, 2013). The 2014 Action Plan envisions repressive, as well as preventative measures, as well as fostering commitment and increasing the population's tax morale. The main government bodies

responsible for the implementation of the various aspects of the action plan, including their specific tasks are presented in Table 5.

Table 5. National action plan to tackle the undeclared economy (2014): responsible institutions and tasks

Responsible department	Planned actions for 2014
<i>Enabling regular employment:</i> MLSP and the Employment Agency	<ul style="list-style-type: none"> • Measures to improve regulations related to seasonal workers and registered unemployed persons; • Subsidising the employment of social benefit recipients and their potential employers; • Improving the regulation establishing jurisdiction for determination of undocumented workers by the market inspection and PRO; • Support for formalisation of undeclared work by unemployed/unregistered businesses.
<i>Increasing tax compliance:</i> Ministry of Finance and Public Revenue Office	<ul style="list-style-type: none"> • National campaign for increasing citizens' tax morale and public awareness of the benefits of paying taxes.
<i>Youth education:</i> Ministry of Education and Science	<ul style="list-style-type: none"> • Educating students in secondary school on the negative effects of undeclared work
<i>Labour inspections and control:</i> State Labour Inspectorate	<ul style="list-style-type: none"> • Strengthening inspection and control on a sectorial basis • Strengthening cooperation between regional inspectors • Publishing a 'Black List' of firms with detected irregularities
<i>Tax revenue collection and control:</i> Public Revenue Office	<ul style="list-style-type: none"> • Detecting taxpayers performing undeclared activities (with SLI) • Detecting taxpayers in temporary employment • Detecting undeclared taxable income of individual taxpayers • Implementing and monitoring the fiscal cash registers system
<i>Customs duties collection and control:</i> Customs Administration and Ministry of Interior	<ul style="list-style-type: none"> • Strengthening border control (legal and illegal border passages) and determining correctly the size of the customs duties • Enhancing control over individuals crossing the borders ('shuttle trade')
<i>Market regulation:</i> Ministry of Economy (incl. State Market Inspectorate, State Inspectorate for Technical Inspection, State Inspectorate for Construction and Urban Development)	<ul style="list-style-type: none"> • Strengthening control over undeclared commercial activities at restricted places (green markets, pavements and squares) • Strengthening control over undeclared activities in catering and tourism • Strengthening control over concessionaires performing geological research and exploitation of mineral resources • Regionalisation of the State Inspectorate for Technical Inspection • Strengthening control over marketed products in line with the Law on Product Safety and the Law on Construction Products • Strengthening control in relation to consumer rights observance

Source: Non-exhaustive list of measures based on the national Action Plan for the reduction of the grey economy for 2014 (MLSP, 2014).

This action plan is a step in the right direction, as it captures the various aspects of undeclared work, and demonstrates how tackling the phenomenon falls within the jurisdiction of diverse public bodies. However, two areas for improvement stand out: a) the focus is mainly on detection and control, although some efforts to support and enable formalisation and change attitudes are also starting to emerge; b) in order for the fight against undeclared work to become a joint effort of the public administration as a whole, the plan would need to go beyond simply reinforcing the main tasks of each body separately, and provide a more substantial basis for cooperation and coordination of measures

through shared strategies and targets, as well as mechanisms for information sharing and joint reporting (see Dekker et al, 2010).

The coordination between the State Labour Inspectorate and other enforcement agencies remains limited, judging by the lack of formal coordination procedures and joined-up strategies, as well as the lack of common targets for different departments (Williams, Baric and Renooy, 2013). Joint inspections take place mainly in the field of safety at work, and increasingly within tax collection campaigns (between the SLI and the PRO). Some efforts are underway to implement network software enabling the SLI to access relevant data from other institutions, such as the Central Registry (commercial register), the PRO and the Employment Agency, among others.

The State Labour Inspectorate (SLI) within the MLSP is the main enforcement body exercising control over the observance of labour laws under the Labour Code, including the area of undeclared work. It has four departments:

- The Labour Relations Department,
- Safety and Health at Work Department,
- Department for Legal Matters in the field of Safety and Health at Work, and
- Department for Coordination, Training and Administrative Enforcement.

The SLI has 30 local offices organised into three regional departments. There are three types of control activities performed by the SLI: planned visits scheduled in the Annual Plan, control checks following complaints and own-initiative visits (ILO, 2011b). Around 4% of all inspections are initiated following complaints filed through different channels (hotlines, written form, etc.). In 2007, around 65% of the economically active population was covered by labour inspections. Each of the 100 inspectors conducted around 300 visits in the year 2007 (Macedonian National Occupational Safety and Health profile report 2007, cited in Mojskoska-Blazevski, 2008). Joint inspections between labour relations and OSH inspectors constitute about 10-20% of all inspections, but each department writes its own reports (ILO, 2011b).

In the period 2006-2010 the SLI intensified its control activities: 40,000 labour inspections were conducted in 2008 alone, followed by 32,000 in 2009-2010 (Mojskoska-Blazevski, 2011). This led to an increased registration of previously undeclared workers. In 2009 a significant drop by 78% was registered in the number of detected undeclared workers, compared to previous years. According to Mojskoska-Blazevski (2011), however, this decline in the incidence of undeclared work is only partially due to inspections. The loss of jobs in the undeclared economy due to the financial crisis has also contributed to the overall declining trend.

The Public Revenue Office within the Ministry of Finance is the main government body responsible for collecting state receivables and tackling tax evasion and other violations of the tax regime through its General Tax Inspectorate. Overall, the number of tax audits performed in 2013 was 6806, which is a decline compared to previous years (Table 6). The number of irregularities, however, has increased from 1900 in 2011 to 2274 in 2013, which may be an indication of the increased efficiency of the tax authorities.

Table 6. Audit activity of the General Tax Inspectorate (2011-2013)

	Total audits conducted	Audits with irregularities detected	Total number of irregularities detected
2013	6806	3171	2274
2012	7292	3698	2035
2011	7771	3522	1900

Source: Public Revenue Office.

When it comes to the types of violations detected following audits in 2013, the largest proportion are cash register irregularities (e.g., failure to issue a cash receipt), followed by tax evasion (34%). In previous years the share of tax evasion cases was higher – 41.8% in 2012 and 38.9% in 2011 (Figure 17). Violations related to payment of social security contributions are only a small share of the total irregularities detected – around 2% in 2013.

Figure 17. Types of irregularities as % of all irregularities detected during tax audits



Source: Public Revenue Office.

In 2013 the PRO established a Forensic Laboratory responsible for fighting high-risk tax fraud (EC, 2013). Overall, efforts have been undertaken to render the tax authorities more efficient and effective, and to ease businesses' cost of compliance with the tax system through simplifying rules and procedures.

6.2. Role of social partners

While during the 1980s the trade union density (trade union members as percentage of all employees in dependent employment) in FYR Macedonia amounted to 97%–98% (due to fact that all employees were members of a trade union during socialism), this density was only about 28% in 2010 (Eurofound, 2012). Those unions (and their members) that did not apply for representativeness at national level are not included in these estimates. The possible reason for this drop is the general lack of public trust in trade unions, which are not seen as important social actors. On the contrary, they are seen as close to the political elites and unable to promote and protect the interests of employees. Trade unions have often publicly supported political parties and their election candidates. In 1998 some union leaders were even nominated as left-oriented political party candidates in the parliamentary elections. A

similar lack of trust exists when it comes to the employers' organisation, whose density was also below 24% in 2010 (Eurofound, 2012).

In addition, trade unions' fragmentation, lack of finances and management capacity contribute add to their fading influence. However, some positive changes are noticeable in the last few years. For example, a memorandum of cooperation was signed in 2010 by the three trade union confederations (the Federation of Trade Unions of Macedonia, The Confederation of Free Trade Unions of Macedonia and the Union of Independent and Autonomous Trade Unions of Macedonia).

There is only one employers' organisation that meets national representativeness criteria – the Employers' Organisation of Macedonia (EOM), which covers about 23% of the private sector employees.

Bipartite and tripartite social dialogue occurs mainly through the Economic and Social Council (ESC), consultative body established in 1996. The Government is represented by the ministries of labour, economy, finances and the deputy prime minister. The trade unions participating in the ESC are the Federation of Trade Unions of Macedonia and the Confederation of Free Trade Unions of Macedonia, while the only representative of employers participating in the ESC is the Organization of Employers of Macedonia. Each social partner has 4 members in the ESC, with the minister of labour acting as the council's president (there is no rotation principle). The current ESC was reinforced in September 2010 through a new agreement for social dialogue.

The ESC failed to play a significant role in the past due to lack of interest or conflict between its members, which resulted in limited activity taking place within the council. For example, no single meeting was held between May 2008 and September 2011. However, there have been some improvements in the last few years, especially following the new agreement of 2010. The ESC members started holding regular meetings, at last. (Friedrich Ebert Stiftung, 2013). Nevertheless, in 2011 the government changed the Law on Employment and Unemployment Insurance without consulting social partners, although the law is subject to obligatory social dialogue (Anceva, 2012).

A bipartite social agreement between the Government and the Federation of Trade Unions of Macedonia was signed in 2002 in order to ease the collective bargaining for public employees. Its implementation, however, proved problematic, as none of the partners managed to fulfil their commitments (Eurofound, 2012).

In addition to the ESC, social partners are represented in steering committees (for example in the Employment Service Agency, Pension and Disability Fund, Health Insurance Fund, the VET Council); and cooperate with the MLSP on regular or ad-hoc basis.

In 2012, a form of institutionalised public-private-civil dialogue in relation to economic development and improving the business environment was strengthened, through the reinforcement of the National Entrepreneurship and Competitiveness Council (NECC) (Lazarevski, 2014). It comprises chambers of commerce and business associations, civil society organisations, as well as public sector representatives.

7. Policy approach and measures to tackle undeclared work

7.1. Typology of policy approaches

It has been widely recognised, at EU- as well as at national level, that the fight against undeclared work requires a holistic policy approach that pursues not only eradication and repression (through

penalties, increased cost of informality and increased risk of being caught), but also one that provides incentives for formalisation. The European Commission has repeatedly called on Member States to adopt policy responses that aim at transforming undeclared work into regular work, including through simplification of the business environment, improving law enforcement and more effective sanctions, as well as providing incentives in the tax and social benefit system (European Commission, 2003, 2007).

According to Williams and Renooy (2008), such measures are generally three types: preventive (detering entry into the undeclared economy before it occurs), curative (facilitating the transfer of those already operating undeclared into the formal realm), and commitment measures (aimed at changing attitudes towards tax compliance and playing by the rules). Although in recent years Member States have started to develop such enabling and preventative measures, the focus seems to be still very much on repression and control, as these approaches are assessed by national institutions as most effective. A study of the policy approaches to tackle undeclared work in 31 European countries (Dekkar et al, 2010) revealed that the majority of stakeholders consulted cited measures to improve detection as the most effective category, followed by preventative measures. Policies aimed at fostering commitment are assessed as the least effective (Table 7). These trends in stakeholders' assessment of different measures' importance and effectiveness are even more clearly distinguishable within EU candidate countries. Measures fostering voluntary commitment with formal rules and regulations enjoy a particularly low level of popularity among stakeholders.

Table 7. Stakeholder opinion of the importance of different types of policy measures

% for 31 European countries (% for 5 candidate countries, in brackets)	Most important	2nd Important	Least important
Measures to improve detection	57 (80)	17 (20)	16 (0)
Preventative measures	19 (20)	46 (60)	23 (0)
Curative measures	14 (0)	19 (20)	32 (60)
Fostering commitment	10 (0)	18 (0)	29 (40)

Source: Williams, Baric and Renooy (2013).

7.2. Overview of the policy approach in FYR Macedonia

Reviewing the implemented approaches and measures to tackle the problem of undeclared work in Macedonia compared to 31 European countries (Table 8), it is evident that repressive measures (including penalties and measures related to improving detection) are the dominant approach in FYR Macedonia as well as in the rest of the EU countries. However, despite the existence of punitive measures against employers in FYR Macedonia, there are no particular administrative sanctions or punitive measures envisioned for undeclared workers (unlike in 83% of the European countries), and obligatory registration of workers prior to starting work (a practice in 74% of the other EU countries).

In general, the policy measures tend to target the workforce which is about to enter the labour market, while paying less attention to the formalisation of those already operating in the informal sector (e.g., such as the 'amnesty for undeclared work' in Spain from 2011, allowing employers to register undeclared workers and sign at least a six-month contract with them within a set deadline after which tighter sanctions upon detection of an undeclared worker were foreseen for the respective employer – see Eurofound, 2013). In addition, a sector-specific approach is absent, except when it comes to

targeted inspections in certain high-risk sectors. For example, more inspections or tailored curative measures could be used to target construction sites, hotels, restaurants, etc., as it is the case in Romania, Latvia, Portugal and Sweden (Eurofound, 2013) or introducing an obligatory ID registration for workers in these sectors, as it is the case in Belgium (Eurofound, 2013). On the other hand, substantial progress has been achieved in reducing the compliance costs for doing business and easing the tax burden through a number of supply-side measures, such as tax incentive, a flat-tax system, tax rate simplification, as well as simplified procedures for company registration and paying taxes.

Within the category of measures enabling compliance, there are very few measures implemented in Macedonia aimed at facilitating formalisation (curative) or fostering commitment through public awareness and education campaigns. This is also evident from the national Action Plan for reducing the informal economy, where the focus is on intensified control (MLSP, 2014; see also Table 5). While the performance of the inspection and control authorities has improved in recent years, resulting in the formalisation of a large number of undeclared workers (Mojsoska-Blazevski, 2011), a more holistic and varied approach is required to achieve sustainable results.

Table 8. Types of policy measures used in FYR Macedonia compared to 31 European countries

Policy measure	Used in FYR Macedonia	Percent of 31 European nations using measure
Repressive measures		
<i>Penalties</i>		93
Administrative sanctions for purchasers/companies	✓	87
Administrative sanctions for suppliers/employees		83
Penal sanctions for purchasers/companies	✓	74
Penal sanctions for suppliers/employees		52
<i>Measures to improve detection</i>		100
Data matching and sharing	✓	83
Workplace inspections	✓	100
Registration of workers prior to starting work or on first day of work		74
Coordinating strategy across government		57
Certification of business, certifying payments of social contribution and taxes		65
Use of peer-to-peer surveillance (e.g. telephone hotlines)	✓	39
Coordination of operations across government		61
Coordination of data sharing across government	✓	65
Mandatory ID in the workplace		65
Measures enabling compliance		
<i>Preventative measures</i>		90
Reduce regulations	✓	48
Simplify compliance procedures	✓	87
Technological innovations (e.g. certified cash registers)		43
New categories of work (e.g. for small or mini-jobs)		35
Direct tax incentives (e.g. exemptions, deductions)	✓	61
Social security incentives	✓	35
Ease transition from unemployment into self-employment	✓	65
Ease transition from employment into self-employment		44
Changing minimum wage upwards	✓	48

Changing minimum wage downwards		9
Training and support to business start-ups	✓	61
Micro-finance to business start-ups	✓	52
Advice on how to formalise		61
Connecting pension schemes to formal labour	✓	61
Introducing supply chain responsibility		17
Restricting free movement of (foreign) workers		43
Curative measures		64
Stimulate purchasers to buy declared goods and services		
Service vouchers	✓	26
Targeted direct tax incentives	✓	61
Targeted indirect taxes		17
Stimulate suppliers to formalise		
Society-wide amnesties		9
Individual-level amnesties for voluntary disclosure		17
Formalisation advice to business	✓	30
Formalisation support services to businesses		30
Targeted VAT reductions		17
Free record-keeping software to businesses		13
Fact sheets on record-keeping		22
Free advice/training on record-keeping		22
Gradual formalisation schemes		13
Fostering commitment to declared work		69
Campaigns to inform undeclared workers of risks and costs of working undeclared		61
Campaigns to inform undeclared workers of benefits of formalising their work		57
Campaigns to inform users of undeclared work of the risks and costs		61
Campaigns to inform users of undeclared work of the benefits of declared work	✓	52
Use of normative appeals to people to declare their activities		52
Measures to change perceived fairness of the system		26
Measures to improve procedural justice of the system (i.e. degree to which people believe government has treated them in a respectful, impartial and responsible manner)		17
Measures to improve knowledge of tax, social security and labour law	✓	65
Adoption of commitment rather than compliance approach (e.g. 'responsive regulation')		30
Campaigns to encourage a culture of commitment to declaration		39

Source: Adapted from Williams, Baric and Renooy (2013) and updated (text in blue colour).

In the last couple of years, some substantial reforms in relations to the tax system and labour market have been introduced which had an impact on undeclared work:

- Introduction of the flat income tax (2007-08),
- gross-based formation of the national wage (2009),
- reduction in the social security contribution rates (2008-2011),
- introduction of a national minimum wage (2012),
- improvements in electronic data sharing among national agencies,
- simplifications of tax compliance and use of e-services.

The primary objective of these reforms is the reduction of the high unemployment rate, especially among the young population (15-24) and women, but also boosting the private enterprise sector and reducing tax evasion and undeclared work in order to increase state budget revenues. In 2013, an important set of measures to promote employment in the official economy were introduced within the *Operational Plan for Active Policies and Measures for Employment* (Employment Agency, 2013). The plan foresees easing the eligibility conditions for self-employment and start-up loans. Loan eligibility was extended to all persons registered as unemployed, regardless of the duration of the registered period, whereas the previous rule was a minimum of six months. In addition, all companies operating more than a year and having at least one employee for minimum three months are eligible for a micro and small firms' loan, plus additional funds for employing up to three previously unemployed persons (Employment Agency, 2013)⁶.

The following provides an overview of the more significant measures implemented since the early 2000s and a brief assessment of their impact on undeclared work, whenever available.

7.3. Review of types of measures applied in FYR Macedonia

The policy approaches framework provided by Williams and Renooy (2009), displayed in Table 9, can be used to analyse the existing infrastructure of measures implemented by the Macedonian authorities to restrict and prevent undeclared work. It should be noted that in practice many of the policies launched include elements from several of the categories. The list of measures provided in Table 9 and discussed below is not exhaustive, but it is a good starting point to illustrating the key features of the national policy approach in the fight against the undeclared economy.

Table 9. Types of approach and measures to tackle undeclared work applied in FYR Macedonia

Approach	Method	Type of implemented measure
Deterrence (pursue and punish)	Improving detection	<p>Labour inspections</p> <ul style="list-style-type: none"> Establishment of a Misdemeanour Body within the Ministry of Labour and Social Policy consisting of two commissions – one for labour relations and one for occupational safety and health (2009/10) Strengthened rules for registered unemployed, e.g. required verification of job search activity (2012) <p>Control over the payment of income tax and social contribution</p> <ul style="list-style-type: none"> Establishment of 'Centre for debt collection', 'Centre for seized goods', 'Tax Academy for training' and a 'forensic laboratory' within the Public Revenue Office to tackle high-risk fraud and tax evasion (2011) Strengthened administrative cooperation and mutual assistance through electronic data exchange (Public Revenue Office, State Labour Inspectorate, etc.) (2012 and 2013)
	Increasing penalties Increasing perception of risk	<ul style="list-style-type: none"> Obligation of the employer within 15 days to officially employ an undeclared worker upon detection by a labour inspector, as well as to pay to the worker three gross wages (2011)
Enabling formalisation/compliance	Preventative (deter entry)	<p>Simplification of regulatory compliance</p> <ul style="list-style-type: none"> Simplifying regulations for starting a business ('one-stop-shop' system) (2009);

⁶ Details on the nationwide campaign for self-employment and development of micro and small enterprises can be found here: <http://www.samovrabotuvanje.mk/> [in Macedonian].

	<ul style="list-style-type: none"> ▪ Decentralisation of the tax service payments, e.g., opening of local 'Service Points' (2011) ▪ Encouragement of electronic filing of tax returns and electronic payment of the corporate income and VAT taxes (2013/14) <p>Direct tax incentives</p> <ul style="list-style-type: none"> ▪ Reduction and equalisation of the corporate and the personal income tax rate ('flat-tax rate') at 10% (2008) ▪ Tax rate of 1.5 % on total income for small businesses with an annual turnover of up to 3 million MKD (2008) ▪ Tax relief for reinvested profit (for investments over 100,000 Euros) (2008/09) ▪ Zero corporate income tax for non-distributed profits (2011) <p>Incentives for involvement in official employment and business operations</p> <ul style="list-style-type: none"> ▪ Tripartite Collective Agreement for social dialogue (2009) ▪ Harmonisation of the minimum and maximum social contribution base with the amount of the individual gross wage (2009) ▪ Progressive reduction in the compulsory social contribution rate to 26.5% (2011) and the pension contribution rate to 18% of the gross wage (2010) ▪ Adoption of the 'Minimum Wage Law', setting the national minimum wage at 36.9% of the national average gross wage for the given branch for the previous year (2012) ▪ Decrease in the maximum period of remuneration for unemployment from 60 to 18 months (2012) ▪ Provision of microfinance to business start-ups (particularly SMEs) (2012/13) ▪ Reduction in the cost of seasonal workers by easing the requirements for severance pay (introducing trial work in seasonal jobs and reducing the time for a firing notice) (2013)
<p>Curative (encouraging movement out of the shadow economy)</p> <hr/> <p>Fostering commitment</p>	<ul style="list-style-type: none"> ▪ Lower tax base for registered individual farmers (20% of the national average net wage (2008) ▪ Farmers with an annual income <300,000 MKD are exempted from paying an income tax (2008) <p>Public campaigns and rising awareness initiatives</p> <ul style="list-style-type: none"> ▪ Hotlines for reporting undeclared work and labour-related irregularities (Ministry of Labour and Social Policy, National Employment Agency, Pension and Disability Insurance Fund and State Labour Inspectorate) ▪ Checklist for employers and employees of their respective legal rights and obligations (web page of the State Labour Inspectorate) ▪ Awareness raising campaign targeted at youths to promote successful transition from school to decent work.

Source: Policy framework adapted from Williams and Renooy (2009).

Repressive measures

Labour inspections

For the evidence available, it appears that repressive measures against undeclared work in FYR Macedonia have been tightened since 2008 following amendments to the *Law on Labour Relations*, the *Law on Labour Inspections* and the *Law on Records in the Field of Labour*.

Indeed, the latest amendment of the *Law on Labour Relations* (Official Gazette of the Republic of Macedonia, No. 54/13) stipulates that the penalties for detecting an undeclared worker at the workplace are set at €7,000 for the employer and up to €4,000 for the responsible person at the legal entity.

In June 2009, a misdemeanour body was also established within the MLSP for irregularities in labour relations, consisting of two commissions: one for labour relations and one for occupational safety and health. In addition, the misdemeanour procedure is no longer managed by the court, but by the MLSP. Whether this has proved more effective in reducing undeclared work is not known.

Despite these changes, the number of inspectors nevertheless remains low and the inspection system still faces some efficiency issues. In 2009, the ILO conducted an audit of the labour inspection system in FYROM upon request from the MLSP (ILO, 2009). Some of the findings indicate poor planning of visits due to lack of registries or databases, understaffing as well as limited formal cooperation with other key institutions.

Tax revenue collection

The EC regular progress reports on FYROM have repeatedly highlighted the following shortcomings related to the operational capacity of the tax administration (EC, 2010, 2011b, 2012 and 2013):

- Limited tax investigation and intelligence capacity
- Weak auditing and enforced collection capacity
- IT infrastructure needs further improvement

In the past few years the country has undertaken several administrative and legislative improvements in order to address these shortcomings. The *Law on Tax Procedure* was amended to provide a clearer penal policy and improved tax appeal procedure (2011b). In addition, in 2013 the following changes to the *Law on Tax Procedure* were introduced (Official Gazette of the Republic of Macedonia No. 187/13) (KPMG, 2014):

- The PRO was given the mandate and powers to conduct financial and accounting forensic analysis of taxpayers.
- Electronic submission of tax returns extended not only to cover VAT and corporate income tax, but also the personal income tax.
- PRO to publish monthly lists with names of taxpayers with overdue taxes above MKD 120,000 (for individuals) and MKD 300,000 (for legal entities).

In 2011 the EC notes in its progress report (EC, 2011b) that PRO extended its audit activities and started implementing a new risk assessment tool, which combined with the enhanced e-filing of tax returns led to some positive results in arrears collection. Overall the number of audits decreased while the tax revenue collected increased.

The PRO's specialisation and enforcement capacity were further improved by the establishment of a 'Centre for debt collection', a 'Centre for seized goods' and a 'Tax Academy for training' (EC, 2011b). In addition, a forensic (not yet operational) laboratory has been established for tackling high-risk tax fraud (EC, 2013). In 2012, administrative cooperation between the PRO and key investigative bodies was extended through signing of a memorandum for electronic data exchange with the Financial Police and the Financial Intelligence Unit (EC, 2012). In 2011 and 2012 specialised training programmes were implemented at the PRO, and a performance appraisal process was introduced for all PRO staffs.

Preventative measures

Gross wage, minimum wage and collective bargaining

A *Minimum Wage Law* was adopted in 2012 (Official Gazette of the Republic of Macedonia No. 11/12), defining a minimum wage as "the lowest monthly amount of the basic salary that the employer undertakes to pay to the employee for the work completed under full time and accomplished norm". It stipulates that the minimum wage for the respective branch is calculated as 39.6% of the national gross average wage for the preceding year as estimated by the State Statistical Office of FYR Macedonia. For 2013 the minimum national wage in FYR Macedonia was set at 12,268 MKD (around 200 Euros) (State Statistical Office of the FYR Macedonia). The main problem with the *Minimum Wage Law* according to Tevdovski (2011) was that it came into force only for certain sectors, excluding the production of textiles, clothing and leather manufacturing. For the latter the law will apply from 1 January, 2015. It is worthwhile underlining that particularly these three sectors employ about 80% of the employees with a net salary below the threshold stated in the *Minimum Wage Law*. Another problem in the estimation of the minimum wage stems from the fluctuations in the living costs in the country, the general economic climate, among other factors, which require an adjustment in the minimum wage amount on a regular basis (Tevdovski, 2011).

After amendments to the *Law on Labour Relations* in 2009, the *National Collective Agreements* became obligatory for all employers in the private as well as in the public sector. Wage collective bargaining occurs at three levels:

- *national* (between confederations of unions and employers' associations for private sector, and confederations of unions and the minister of labour in the public sector)
- *branch* (between representative unions and employers' organizations) and
- *company* (between the representative union organization in the company and the employer)⁷

Tevdovski (2011), however, warns of the marginalisation and politicisation of trade unions, with the latter progressively losing credibility among their members and influence with employers and the government. For instance, after the adoption of the collective agreement in 2009, the government pushed through some amendments to the *Law on Labour Relations* regarding the activity of labour unions, which affected their rights negatively. This was done without holding the required social dialogue consultations (Tevdovski, 2011).

Reduction of social security contribution rates

With the amendments to the *Law on Contributions for Compulsory Social Insurance* in 2008, a progressive decrease in the compulsory social contribution rate was introduced, from 32% of the gross wage in 2008 to 26.5% in 2011 (Official Gazette of the Republic of Macedonia, No. 142/2008, No. 185/2011). In addition, the compulsory social contribution burden was shifted from the employer to the

⁷ *General Collective Agreement* (2009), available t:
<http://www.ilo.org/dyn/natlex/docs/MONOGRAPH/90945/105190/F2007914708/MKD-90945.pdf>

employee. Moreover, a gradual reduction in pension and disability insurance rates has been undertaken since 2009, from 21.2% to 19% of the gross wage in 2009, and then to 18% in 2010. A further decrease to 17.6% is envisaged for 2015 (see Table 10). In addition, the maximum threshold for the payment of social contributions is fixed at four average gross wages (Official Gazette of the Republic of Macedonia, No. 62/09; No. 142/08; No. 64/09; No. 156/09 and No. 185/11).

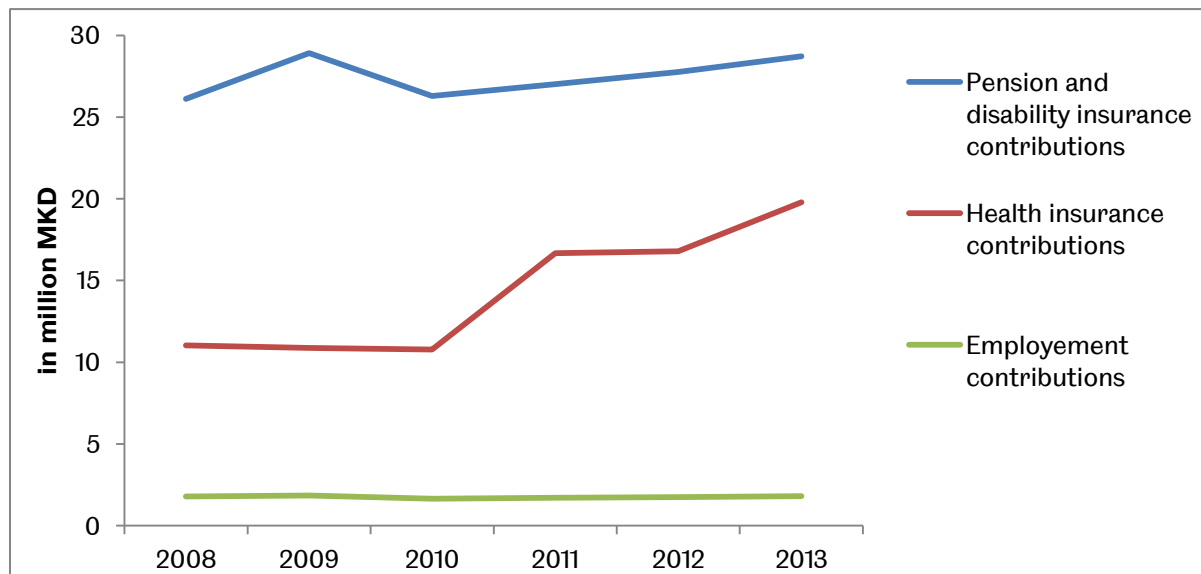
Table 10. Social security contribution rates – reductions since 2011

Contribution type as % of national gross wage	2012 and 2013	2014	2015
Pension and disability	18%	17.6%	17.5%
Health insurance	7.3%	7.3%	7.3%
Unemployment insurance	1.2%	1.2%	1.1%
Additional health insurance in case of accidents at work and work-related injuries	0.5%	0.5%	0.5%
Total	27%	26.6%	26.4%

Source: KPMG (2012).

Looking at the statistical data on the revenues collected from social security contributions since 2008, one could observe a positive tendency for the amount of revenues collected after 2010. This could be potentially considered a positive effect from the adopted amendments to the *Law on Contributions for Compulsory Social Insurance* (Figure 18).

Figure 18. Tax revenues from social contributions (2008-2013), in million MKD



Source: Public Revenue Office of the FYR Macedonia.

Mojsoska-Blazevski (2012) analysed the influence of the labour legislation changes on the employment rate and the size of the informal economy by estimating a labour demand function for the period 1998(Q1) - 2010(Q3). She disentangled the total tax wedge into two components: the income tax wedge and social contributions wedge to investigate their respective burden on the employed (Majsoška-Blazevski, 2012). The study found that the reduction of social security contributions had a positive impact on the employment rate, in contrast with the impact of the flat tax reform. This finding, if looked at through the prism of labour costs analysis, suggests that social contributions are the main

constraint on employment in the FYR Macedonia. This is also explained through the predominance of low-skilled jobs in transition economies. Moreover, the introduction of the gross wage concept led to a shift from undeclared work to formal employment and correspondingly had a significant impact on employment.

Mojsoska-Blazevski (2011) concludes that the social security and tax reforms aimed at reducing labour costs had the following positive effects: (a) helped employees during the crisis, (b) had an effect on employment, (c) increased the net wage, (d) diminished the extent of informal economy, (e) improved tax compliance and (f) increased the number of individuals insured in the pension system. Tonin (2011) examines the interaction between minimum wage legislation and tax evasion upon employment, and based on a theoretical model shows that the introduction of a minimum wage creates a spike in the distribution of declared earnings and induces higher compliance by some actors, however, leading to a reduction in their disposable income.

Simplification of regulatory compliance and e-government

FYR Macedonia has gone a long way in simplifying the rules and procedures for regulatory compliance for both, individual taxpayers and the business sector. E-government services have been constantly upgraded and developed since the launch of an USAID-supported e-government project in 2004, ensuring improved communication between the public administration and citizens. The electronic services available today to citizens and businesses include company registration, paying taxes (e-Tax), an online employment registration system, online payments of social security contributions, e-procurement platform, online job application in public services, an online system for cargo transport licensing, a system for import-export licenses, among others.

A 'one-stop-shop' system for company registration was introduced in 2009, aimed at reducing the time, procedural steps and financial costs required for starting a business. The second phase of the system was implemented in 2010, consisting of three components (Bertelsmann Stiftung, 2012):

- online application for company registration
- electronic system for the classification and listing of companies under the court procedures for insolvency
- an electronic system for registration of collateral and leasing.

Since 2010 taxpayers' services have been under a process of decentralisation, with the opening of 'Service Points' in 2011 (EC, 2011b). Further reforms in 2013 extended the availability of electronic services and the mandatory registration of cash payments (EC, 2013). At the same time, electronic filing of VAT and profit tax returns became compulsory (EC, 2013).

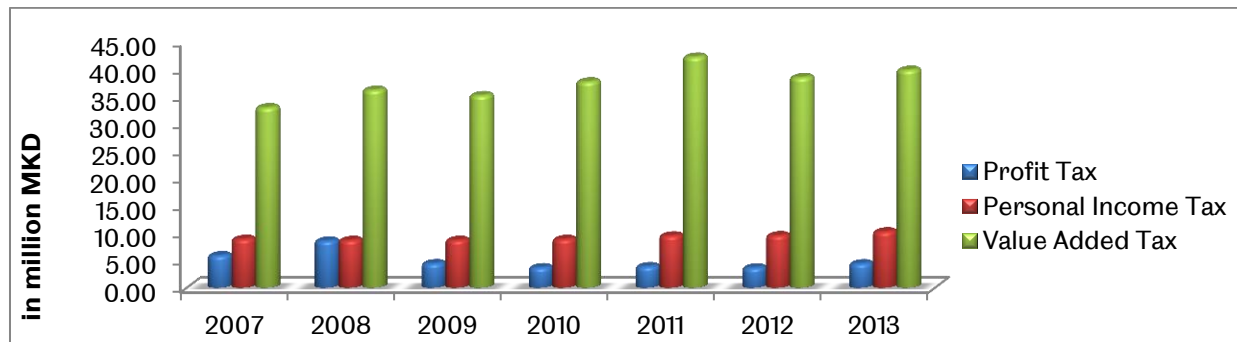
Direct tax incentives

A 'flat tax system' was introduced in 2007, decreasing and equalising the personal income and corporate income tax rates to 10%. The previous progressive personal income tax system, with progressive marginal tax rates of 15%, 18% and 24%, was initially replaced with a flat tax rate of 12%. The corporate income tax rate was decreased from 15% to 12% in 2007. Later on during 2008 the tax rate was further reduced from 12% to its current rate of 10%. In addition, a 1.5% tax rate on total income for small businesses with annual turnover up to 3 million MKD was introduced. Furthermore, a tax relief system for investments over 100,000 Euros was replaced with a system for stimulation of reinvested profit, allowing for a reduction in the companies' tax base in the next year up to the amount of the reinvested profits (Stojkov, Nikolov and Smilevski, 2008). In 2010, the *Profit Tax Law* was

amended to exclude from the taxable accounts of resident legal entities dividends, which were not paid out (EC, 2010).

An examination of the amount of collected tax revenue in the last six years shows that despite the reduction in the tax rates for individuals and businesses, the revenue collected from personal income tax and VAT have remained relatively stable throughout the period 2007-2013 (Figure 19). This indicates a positive tendency in relation to tax compliance, as well as institutions' ability to enforce tax collection. Nevertheless, the collected profit tax revenue from profit tax declined twice.

Figure 19. Collected tax revenue for the period 2007-2013, in million MKD



Source: Public Revenue Office of the FYR Macedonia.

A survey conducted by the Institute for Democracy, Solidarity and Civil Society in 2008 on a sample of 100 companies found that the introduction of flat tax had a positive effect on job creation (Stojkov, Nikolov, Smilevski, 2008). However, this positive effect was felt mainly by foreign-owned companies and companies from the metal and pharmaceutical/chemical industry. These were in fact the companies that reported a significant employment growth after the introduction of the flat-tax system. Yet, small firms did not regard the above mentioned changes as a decrease in the overall tax burden, mostly due to the introduction of taxation on total income for them (see also Hudson et al, 2012). Medium-size companies did not perceive that the broadened tax base has increased the tax burden, but large companies stated that this change cancelled out the potential benefits from the flat tax. Overall, 56% of the companies surveyed regarded the new system aimed at stimulating the reinvestment of profits as a positive change, while 33% believed that the previous tax relief system was a better approach (Stojkov, Nikolov and Smilevski, 2008). Furthermore, by examining the change in the labour tax burden in three Balkan countries (Macedonia, Montenegro and Bosnia and Herzegovina) which introduced flat tax rates, Kreso and Pita (2011) find a significant decrease in the level of the tax burden from 2006 until 2009 for Montenegro and the FYR Macedonia.

Curative measures

There are two recently introduced measures which aim at fostering formalisation in the agricultural sector in the FYR Macedonia. First, the *Law on Obligatory Social Insurance Contributions* in 2008 postulated a lower tax base for registered individual farmers. The tax base for self-employed has been determined as the national average net salary per employee in the current month, while the tax base for individual farmers was calculated at 20% of the national average net wage. Furthermore, farmers with an annual income below 300,000 MKD (5,000 Euros) have been fully exempted from the income tax (Bexheti, 2010; Mososka-Blazevski, 2011).

Fostering commitment

The SLI opened a call centre for reporting irregularities with respect to employment-related issues. Its web page provides information to employees and employers on their rights and obligations. In

addition, it provides online checklists, which could be a helpful tool for employers to track to what extent they comply with legal provisions.

In 2012, the ILO Decent Work Technical Support Team and Country Office for Central and Eastern Europe assisted with the development, organisation and the conduct of awareness raising campaigns with the population on the negative effects of undeclared work as well as on the everyday serious hazards of activities in the agricultural and construction sectors in FYR Macedonia and Moldova, with the two sectors being highly affected by indecent work practices (ILO, 2012b).

In 2012, the State Statistical Office with funding from the ILO Work4Youth partnership with the MasterCard Foundation conducted a school-to-work transition survey which aimed at helping policy makers to design better measures to support youths in finding decent work after school and knowing their rights when about to enter the labour market (Elder et al, 2012).

It is evident that the Macedonian institutions and legislative framework are undergoing constant development to respond to the challenges posed by the given socio-economic context. Although there are many noticeable legislative and institutional initiatives against undeclared work, there is still a considerable amount of work to be done. Overall, there is a lack of evaluations of the effect of implemented measures. Another phenomenon requiring attention is the limited enforcement of the various regulative frameworks against the undeclared economy.

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