

HIDDEN ECONOMY AND GOOD GOVERNANCE IN SOUTHEAST EUROPE

REGIONAL ASSESSMENT REPORT

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CHAPTER I: OVERVIEW OF THE HIDDEN ECONOMY IN SEE

Measuring hidden economy is primarily justified by the need to understand better the overall economic dynamics and effects of policy measures taken. Despite differences in naming and approaches to assessing hidden economy across countries, all experts agree that hiding economic activities is a rational response to the institutional environment of doing business. Corruption is perceived to appear at the margins between the formal and informal economies, where businesses and individuals pay dues or bribe institutions to stay hidden and/or non-compliant, or to facilitate cheaper, smoother legalization, if inevitable or necessary. A persistent hidden economy indicates institutional inefficiency and is costly for some businesses, but may have social and economic benefits for society. Recognizing the fact that firms do not report everything adequately to state institutions, National Statistical Institutes adjust GDP estimates to account for the non-observable economy. Yet, despite the significance of the phenomenon and its impact on virtually all public policies, as a rule this information is not widely available on the web sites of NSIs and Eurostat. The OECD and UNECE conduct international comparative assessments of methodologies applied, and actual imputations are published, but with lengthy delays.

Countries in Southeast Europe have very different patterns of economic development with respect to the non-observed economy. In all countries, GDP per capita was growing before the international financial crisis in

TABLE 1. NON-OBSERVED ECONOMY IN GDP (OFFICIAL IMPUTATIONS)

Country	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	
Albania		31.1	30.2	28.9	30.7	32.8	34.2	30.4	30.5	30.8												
Bosnia and Herzegovina							34.1	35.4		36.7					23.0							33.0
Bulgaria		18.3	27.8	31.2	12.3	12.0	15.2	14.7	14.7	14.8	12.7	12.4	11.4	10.4	10.4							
Croatia			9.5	9.5	8.6	8.3	8.5	8.3	8.2	7.5	7.4	7.3										
Macedonia					16.2	13.7	12.9	14.9	14.4	16.3	16.3	15.3	17.9	14.7	20.1	21.0	19.6	20.0	19.2			
Montenegro									7.8			5.3				3.0	4.0	4.0	4.4	3.0	3.5	
Romania	12.6	16.6	18.4	18.6	23.3	21.1	21.1		17.7													
Serbia										14.6						9.1	9.0	9.3	10.2	13.0	14.3	
Turkey							1.59	1.68	1.64	1.63	1.66	1.67										

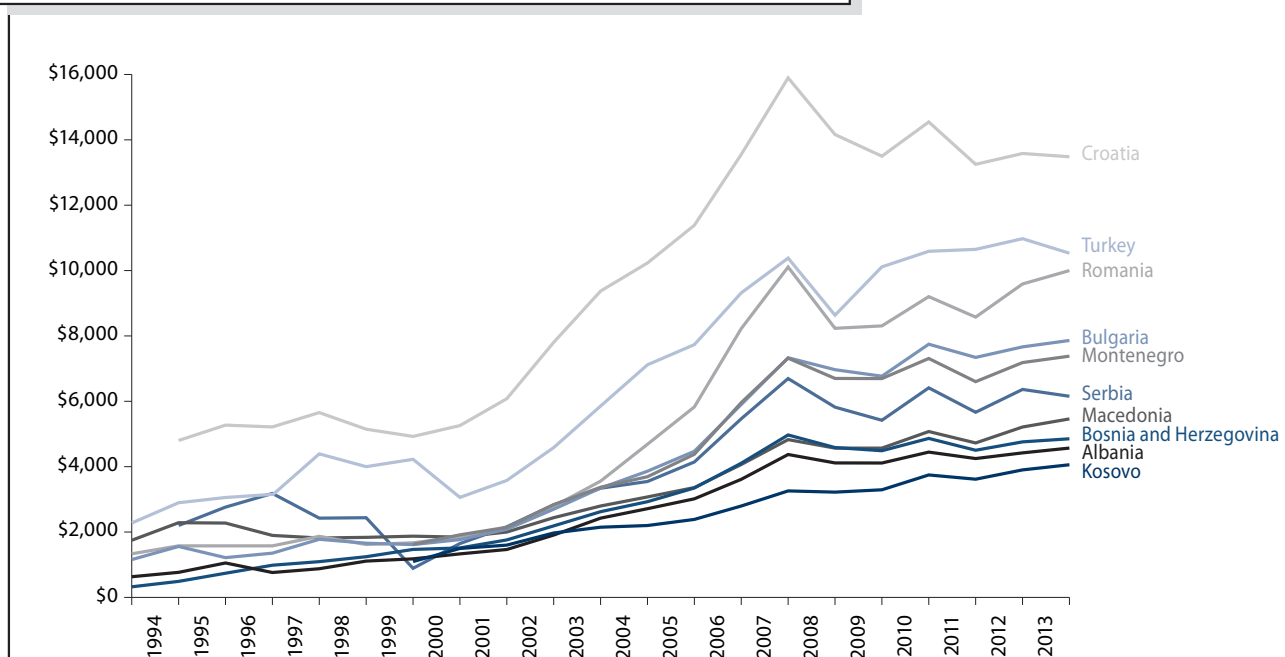
Source: Feige (2016)¹ and SELDI partners.

¹ Feige, E. (2016). *Reflections on the meaning and measurement of Unobserved Economies: What do we really know about the "Shadow economy"?*, Journal of Tax Administration, Vol. 2, No 1.

2008, albeit at different rates. Montenegro and Bulgaria were growing at a similar pace, faster than other Western Balkan countries, but lagging behind Turkey, Croatia and Romania. However, the crisis had different effects on these countries – their leaders halted growth, so that Croatia has been losing GDP per capita since 2009. A slight downward trend has been observed for Serbia, while Bulgaria, Kosovo and Macedonia continue to grow.

The available data supports the conventional wisdom that higher rates of hidden economy are found in relatively poorer (lowest levels of household consumption) and lower GDP countries (Albania, Bosnia and Herzegovina, Macedonia, Kosovo).² Yet, reducing the non-observed economy led to accelerated growth (Croatia and Bulgaria) or decelerated growth (Albania), while increasing the non-observed economy co-existed with accelerated growth (Turkey) and decelerated growth (Macedonia and Bosnia and Herzegovina), based on the period 2000 – 2003. These combinations derive from various sources – internal economy, external influence (remittances, FDI), statistical issues, etc.

FIGURE 1. GDP PER CAPITA (CURRENT USD)



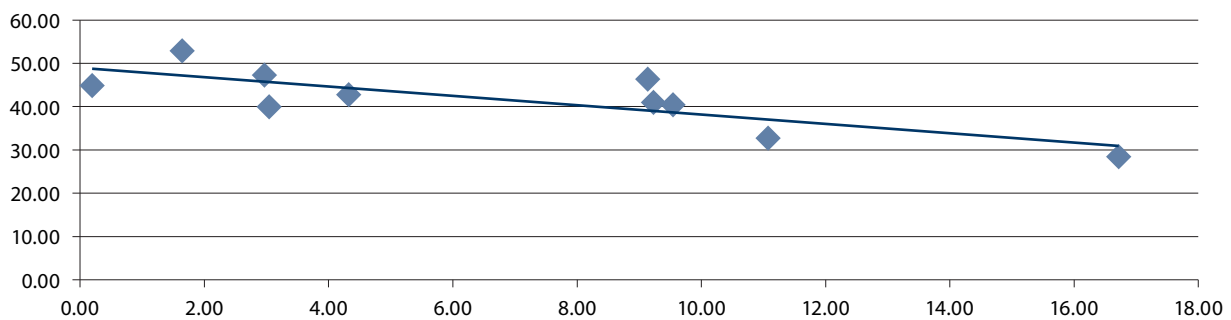
Source: World Bank.

A major reduction in the unobserved economy in Croatia has occurred in wholesale and retail trade, transport, storage and communication, construction and real estate rentals, and business services, sectors which have grown. Yet, hiding in manufacturing has grown over the years, mostly in small businesses. The economic boom in Croatia and Bulgaria,

² Although there is no official data on Kosovo, Institute Riinvest's estimates of the hidden economy put the country in the same group.

fuelled by FDI growth and financial sector development anticipating EU accession, was widespread, so many firms decided to formalize their operations for economic reasons, encouraged by the increased administrative efficiency of control institutions. At the same time, Albania and Bosnia and Herzegovina experienced a dramatic relative drop in remittances received (as a share of GDP), which was a major barrier to higher GDP growth. In 2000, remittances accounted for 29 % of GDP in Bosnia and Herzegovina and 16.5 % in Albania. Remittance levels dropped to 21 % and 15 % respectively in 2003, and formed 11 % and 9 % of GDP in 2015. Not surprisingly, in Albania the highest levels of hidden economy are in construction, catering and retail (above 50 %). Since 2005, the regional remittance leader has been Kosovo with 18.8 % of GDP, currently 16.7 % (2015). Kosovo is 19th and Serbia is 39th worldwide in terms of this indicator.³ Still, many households throughout almost all of Southeast Europe rely on a subsistence economy (producing their own food and bartering) to make a living, especially in rural and less urban areas.

FIGURE 2. EMPLOYMENT TO POPULATION RATIO (Y) AND SHARE OF REMITTANCES IN GDP (X), YEAR = 2014



Source: World Bank.

For many countries in transition, especially Western Balkan countries, emigration has been, or is still a powerful valve for easing the problem of domestic unemployment and poverty, through employment abroad with the subsequent flow of remittances to relatives at home. A 1 % increase in remittances is associated with a 1.8 % decrease in employment across countries.

By all accounts, the link between remittances and hidden employment is positive. Remittances positively affect the level of hidden employment, as shown for Kazakhstan, FYR Macedonia, Moldova, Serbia, Tajikistan and Ukraine.⁴ Remittances fuel internal consumption (green markets are as a rule almost entirely hidden), serve as a social safety net encouraging riskier hidden employment, and increase domestic investments and entrepreneurship, most often also hidden (suitcase trade, crafts, agriculture).

³ [Data from the World Bank.](#)

⁴ A. Ivlevs, (2016). *Remittances And Informal Employment: Evidence From Transition Economies*, mimeo.

Often, immigrants themselves take up hidden employment in European countries and use expensive money transfer mechanisms.

Comparing unobserved economy data in Southeast Europe, two countries are significant outliers, Montenegro and Turkey, which do not properly follow the Eurostat/OECD methodology for adjustments to GDP. Montenegro, with less than 4 % of unobserved economy lately (2013 – 2014) significantly underestimates the catering business, construction, real estate and business services, all related to tourism. Even the subsistence economy/agriculture, although present in GDP, is underestimated. Similarly, Turkey's less than 2 % unobserved economy accounts only for households' unreported economic activities and unregistered micro-businesses, and does not provide any estimate for underreporting sales for tax purposes.

Macedonia's hidden economy is predominately in construction, tourism, including nightlife (with its organized crime influence), agricultural production and distribution (green markets) and small retail business.⁵ In Bosnia and Herzegovina, the authorities and tax inspectors exercise virtually no control over open markets/bazaars for goods, including consumables and textiles. Almost all major squares, bus stations and public areas with significant traffic are occupied by illegal traders, who bring cardboard boxes and display their goods, as a rule smuggled out of other countries (the original source usually being China) with no VAT paid and no guarantees provided. The items offered include a range of home-grown fruits and vegetables, dairy products, and sometimes dried meats, clothes, shoes, and textiles. Products are not subject to recognized production processes and are hence hazardous to health. Prices are extremely low compared to traditional shops, and therefore attractive to consumers.

The only publicly available comparison between Western Balkan countries in terms of sectoral assessments of non-observed economy was made through the Eurostat-OECD GDP Exhaustiveness project for Western Balkan countries in 2004.⁶ It also provided insights into internal differences between the Federation of Bosnia and Herzegovina and Republika Srpska (RS adjusted more for agriculture and Bosnia for construction). Data for new member states include all 10 countries which joined the EU in 2004, except Cyprus.

The represented value of unobserved economy per se is not that telling; however, if it is accompanied by detailed methodology on data discrepancies, it adds significant value to how markets function. Such discrepancies are labour statistics from tax/social security authorities, those reported for statistical purposes, and labour force survey data; registered entities and not reporting; huge discrepancies in productivity data within an industry, or at times of control/inspection, mirror statistics on international trade, etc. Last, but not least, the officially represented unobserved economy in GDP with full methodological notes might

⁵ [Corruption and Organized Crime Threat Monitoring Report](#), MCIC and CSD, 2015.

⁶ [Nadim, A. \(2004\), *Measuring GDP in the Balkans: Experiences and Lessons Learnt*, OECD.](#)

TABLE 2. RELATIVE IMPORTANCE (PER CENT) OF NON-EXHAUSTIVENESS BY TYPE OF ECONOMIC ACTIVITY

		Albania	Bosnia and Herzegovina	Republika Srpska	Fed. of Bosnia Herzegovina	Croatia	Macedonia	Montenegro	Serbia	Average Western Balkans	New EU Member States
		INSTAT	BHAS	SIRS	FOS	CBS	SSORM	MONSTAT	SORS		
		2001	2003	2003	2003	2002	2002	2002	2003		
A	Agriculture	8.9	11.9	23.2	6.3	6.3	0.6	26	3.4	10.8	Incl. in not specified
D	Manufacturing	1.9	11.9	10.1	12.7	20.5	19.4	2.6	10.9	11.3	12.6
F	Construction	22.8	19	13.1	22.8	8.9	10	9	15	15.1	12.8
G	Trade etc.	41.9	29.7	30.3	29.1	19.6	31.1	37.7	30.6	31.3	26.3
H	Catering etc.	7	8.3	9.1	7.6	8.9	5.3	3.9	2	6.5	7.3
I	Transport etc.	14.9	7.1	12.1	5.1	5.4	6.5	11.7	2.7	8.2	7.8
K	Real estate etc.	1.3	4.8	1	6.3	13.4	9.4	2.6	8.8	6	13
O	Other community	1	3.6		5.1	11.6	2.9		17	5.2	8.4
	Not specified	0.3	3.6	1	5.2	5.4	14.7	6.5	9.6	5.6	11.7
	Total	100	100	100	100	100	100	100	100	100	100

Source: OECD.⁷ Data for Bosnia and Herzegovina do not include Brcko District.

provide meaningful insights into calibrating Schneider's Shadow Economy assessments (SSE), in order to understand the actual level of GDP. SSE is so widespread that despite all criticisms against it (by Feige and others),⁸ even if it is not accurate, it significantly shapes the policy-making agenda.

In the Turkish GDP there is almost no hidden economy represented, so in order to understand the actual GDP, one should take Schneider's assessment. However for Albania and Bosnia and Herzegovina, if the unobserved economy is deducted from the official GDP and then multiplied by Schneider's factor, the resulting GDP will be less than the official one. None of Schneider's papers (with co-authors) discuss this issue. Yet, it is unclear how the MIMIC models could be adapted

⁷ Nadim, A. (2004), *Measuring GDP in the Balkans: Experiences and Lessons Learnt*, OECD.

⁸ Feige, E. (2016). Reflections on the Meaning and Measurement of Unobserved Economies: What do we really know about the "Shadow Economy"? *Journal of Tax Administration*, Vol. 2, No. 1.

to the imputed non-observed economy factor in GDP, due to various requirements. Another drawback of the SSE approach is that different Schneider papers often provide different estimates for the same country for the same year. This is true also for the SEE countries and the three papers cited for the compilation of the table. Although National Statistical Institutes provide updates on input variables, these discrepancies, without proper referencing as to why it is so, are very disturbing.

TABLE 3. SCHNEIDER'S SHADOW ECONOMY ESTIMATES (SHARE OF GDP)

	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13
Turkey	32.7	32.1	32.8	32.4	31.8	31	30	29.5	29.1	28.4	28.9	28.3	27.7	27.2	26.5
Croatia	33.8	33.4	33.2	32.6	32.1	31.7	31.3	30.8	30.4	29.6	30.1	29.8	29.5	29	28.4
Romania	34.3	34.4	33.7	33.5	32.8	32	31.7	30.7	30.2	29.4	29.4	29.8	29.6	29.1	28.4
Albania	35.7	35.3	34.9	34.7	34.4	33.9	33.7	33.3	32.9						
Bulgaria	37.3	36.9	36.6	36.1	35.6	34.9	34.1	33.5	32.7	32.1	32.5	32.6	32.3	31.9	31.2
Macedonia	39	38.2	39.1	38.9	38.4	37.4	36.9	36	34.9						
Bosnia and Herzegovina	34.3	34.1	34	33.9	33.5	33.6	33.3	32.9	32.8						
Serbia			33.2	32.7	32.1	32	31.6	31.2	30.7	30.1	30.6	30.1			

Source: Data from 1999 to 2007, except Serbia from Schneider, Buehn and Montenegro, 2010.⁹ Data for Serbia from Schneider et al, 2015.¹⁰ All other data from Schneider, 2013.¹¹

According to Schneider et al. (2010)¹² the presence of the informal economy as a percentage of Gross Domestic Product (GDP) averaged 37 % in Transition Economies, while in OECD countries it is around 13 %. Kosovo is absent from Schneider's estimates, but recent studies by Riinvest (2013) and the Vienna Institute for International Economic Studies¹³ suggest that Kosovo is in the same bracket (34.4 %).

Based on 34 studies using MIMIC and currency models, Schneider¹⁴ outlines six factors that influence the shadow economy with a combined influence of between 78 % and 98 %, according to the models. Typically,

⁹ Schneider, F., Buehn, A., Montenegro, Claudio E. (2010). *Shadow economies all over the world: new estimates for 162 countries from 1999 to 2007*. Policy Research working paper; no. WPS 5356. Washington, DC: World Bank.

¹⁰ Schneider, F., Krstić, G., Arsić, M. and Ranđelović, S. (2015). What Is the Extent of the Shadow Economy in Serbia? In *Formalizing the Shadow Economy in Serbia* (pp. 47-75). Springer International Publishing.

¹¹ Schneider, F. (2013). Size and Progression of the Shadow Economies of Turkey and Other OECD Countries from 2003 to 2013; Some New Facts. *Ekonomi-tek-International Economics Journal*, 2(2), pp. 83-116.

¹² Schneider, F., Buehn, A. and Montenegro, Claudio E. (2010). *New Estimates for the Shadow Economies all over the World*.

¹³ Christie, E., Holzner, M. (2004). Household Tax Compliance and the Shadow Economy in Central and Southeastern Europe, *wiiw Balkan Observatory Working Papers 38*, The Vienna Institute for International Economic Studies, wiiw.

¹⁴ Ibid.

increases in taxes and social security contributions increase the shadow economy. This factor is responsible for between 35 % and 52 % of variation of the variable dependent. The majority of companies studied by World Bank Enterprise Surveys in Eastern Europe and Central Asia are mostly concerned with tax rates when asked about their biggest obstacle (17.8 %). Montenegro (38 %), Romania (43 %) and Turkey (37.4 %) are far ahead of the SEE average (19.5 %) and wider ECA average (19.5 %), and Serbia (16.1 %) is below the regional average, but higher than the world average (12.1 %).

The second explanatory factor according to Schneider is tax morale, accounting for between 22 % and 25 % of influence. Tax morale itself is linked to trust in institutions and expectations of what others are doing (Riinvest Institute, 2013).¹⁵ Hidden economy practices are themselves reinforcing reasons to hide. When most of your competitors are not paying VAT on sales, profit tax and social security, if you pay all of these you may be uncompetitive and thrown out of the market. Firms in Macedonia (30.1 %), Bulgaria (28.7 %), Kosovo (26 %) and Albania (18.6 %) chose informal sector practices as the single greatest obstacle, far more than tax rates (more than 4 times higher in the case of Kosovo) within SEE, ECA and world-wide.

The quality of institutions is responsible for 10 % to 17 % of variation in the shadow economy across countries (Schneider, *ibid*). This is especially the case for Albania (more companies see the tax administration itself as an obstacle, rather than taxes), but also for Bulgaria (where taxes are among the lowest in rates and least in number) and Bosnia and Herzegovina (where tax complexity is enormous due to the complex composition of the state itself, conflicting institutions and political instability). There is even a significant difference in taxes paid on wages in Republika Srpska (56 % on net salary) and the Federation of Bosnia and Herzegovina (73 %).

Other factors – specific labour market regulations, public sector services and transfers – account for between 5 % and 9 % (Schneider, *ibid*) of the shadow economy variation and have a cross-impact effect (when families are not receiving adequate public services such as education, health care, social security, and even ordinary security, people are more prone to engage in the hidden economy and resort to emigrant safety nets or nepotism in public administration). Tax evasion can be viewed as a psychological tax contract between citizens and tax authorities, influenced by factors such as education, geography, age, etc. (Frey and Feld, 2002).¹⁶

Research into the consequences of the shadow economy and tax evasion, on the other hand, reveals its harmful effects on the level of certainty in the economy, insufficient financing of public goods and services, social exclusion, unfair competition and corruption. The complexity of the phenomenon of tax evasion thus becomes even greater in societies with

¹⁵ Riinvest Institute, (2013). *To Pay or Not to Pay. A Business Perspective of Informality in Kosovo*.

¹⁶ Feld, L. and Frey, B. (2007). *Tax Evasion, Tax Amnesties and the Psychological Tax Contract*.

TABLE 4. SELECTED DEVELOPMENT INDICATORS

	GDP (current mil USD) 2015	GDP annual growth % (2015)	Employment to population ratio, 15+, total (%) (Modelled ILO estimate) 2014	Unemployment, total (% of total labour force) (Modelled ILO estimate) 2014	Personal remittances, received (% of GDP) 2015	Account with a financial institution (% of population 15+) 2014	Tax payments (numbers) 2015	Significant decrease in number of taxes paid by businesses since 2011
TUR	718,221	3.98	44.80	9.20	0.19	56.51	11	no
ROM	177,954	3.74	52.80	7.00	1.65	60.79	14	yes
ALB	11,456	2.56	46.30	16.10	9.14	37.99	34	moderate
BIH	15,995	3.16	32.70	27.90	11.08	52.69	45	moderate
HRV	48,732	1.64	42.70	16.70	4.33	86.03	19	yes
BGR	48,953	2.97	47.20	11.60	2.97	62.99	14	no
KSV	6,386	3.62	28.40	...	16.72	47.80	32	no
MKD	10,086	3.67	39.90	27.90	3.04	71.80	7	yes
MNE	3,993	3.37	40.40	19.10	9.55	59.83	17	yes
SRB	36,513	0.73	40.90	22.20	9.23	83.09	42	yes

Source: World Bank.

weak institutions, such as those in the Western Balkans. Consequently, countering tax evasion in the region is important not only in order to impose fairness in the tax system and the economy by ensuring fair competition, but also to maintain a stable economic atmosphere and protect society's most vulnerable groups. Tax revenue is also necessary to assure democracy and successful law enforcement.

In terms of policies, governments usually produce detailed strategies to combat the hidden economy, with hundreds of small measures which only work if the government functions well and is coordinated. However, this is usually not the case, so these strategies are used only to report to international institutions. A government's non-compliance with its own strategies is usually not penalised by voters at elections, and there are no administrative sanctions for bad coordination between agencies. In practice, governments try to simplify administrative regulations and taxes, and organize promotion/awareness campaigns of the negative effects of the hidden economy, tax evasion, contraband, etc. (Kosovo, Montenegro, Bulgaria). In the last five years (2011 – 2015), several SEE countries, such as Romania, Croatia, Macedonia, Montenegro and Serbia, have reduced significantly the tax burden on companies, measured by the number of taxes they have to pay/administer. Others, like Bosnia and Herzegovina, despite moderate changes in the tax regime, have not been able to break through the toughest barriers, in this case, the social security system and labour-related taxation. Montenegro organized a campaign "Na sva zona siva zona" ("Grey areas in all areas"), aimed at increasing the readiness

of consumers/employees to report cases of hidden economy. Yet, the campaign itself is a sign of weak strategic thinking and inter-institutional cooperation between the Tax Administration and Administration for Inspection Affairs.

Probably the most interesting practice recently employed by institutions to tackle the hidden economy is Kosovo's Tax Administration campaign (launched in 2015), whereby the VAT portion of customers' fiscal receipts is reimbursed. Registered customers are eligible to collect receipts and take them to the authorities in order to have the value added tax reimbursed. The aim of this campaign is primarily to increase awareness about the importance of fiscal compliance, and secondly to encourage consumers to put pressure on businesses to issue fiscal receipts. This ongoing activity is considered highly successful by the government, which claims there has been an evident rise in the number of fiscal coupons collected by the authorities after the campaign launch, compared to before it.¹⁷ A similar activity is being performed by the National Revenue Agency in Bulgaria, which organizes a lottery involving tax receipts, where the expected benefits clearly outperform the costs of collecting receipts. However, the success in Kosovo appears less straightforward, since there is no measurement of the effect the campaign has had on increasing the actual fiscal compliance of businesses (as opposed to how many more receipts are collected). Neither is it obvious whether the rise in the number of coupons collected offsets the costs of reimbursement.

Kosovo's Ministry of Finance has also revealed plans for creating reward policies for businesses that comply with national fiscal policies within the newly-established Credit Guarantee Fund. The independent institutional framework for the Credit Guarantee Fund was set up at the end of 2015, and its general role consists of easing access to finance for businesses, as well as improving liquidity in the market by assuming up to 50 percent of credit risks. The Fund allows access to businesses with a better record of financial reporting and fiscal compliance. Similarly, a reward system for businesses with a good track record will also apply within other governmental policies under implementation, including subsidizing wages and interest rates.¹⁸

Among the more significant institutional changes in Kosovo has been the establishment of the Tax and Customs Agency, which brings together two formerly separate governmental agencies (Tax Authority and Customs). The aim of this organizational merger is to maintain consolidated, effective activity in fighting the hidden economy.¹⁹ The new agency aims to be the only body that coordinates both customs and sales taxes, in order to track imports from the moment they enter the market to the point of sale. Other countries have planned improved coordination and enhanced promotion strategies, but there is no clear benchmark for evaluating the results.

¹⁷ Kosovo Tax Administration, (2015). *Application for Fiscal Coupons*.

¹⁸ Koha, (2015). *Rreth 450 milionë euro humbje nga ekonomia e paligjshme*.

¹⁹ Koha, (2016). *Themelohet Agjencia për Tatime dhe Doganë të Kosovës*.

TABLE 5. GREATEST OBSTACLES TO FIRMS (SHARE OF FIRMS)

	All	ECA	ALB	BGR	BIH	KSV	MKD	MNE	ROU	SRB	TUR
Access to finance	15.7	13.5	14.3	5.2	15.5	16.3	21.5	9.1	10.4	9.7	8.9
Access to land	3.5	2.5	6.6	0.9	0.9	2.0	1.3	1.2	2.3	0.9	0.6
Business licensing and permits	2.6	2.0	1.4	1.7	3.9	1.4	0.4	0.4	1.3	1.3	2.0
Corruption	7.2	7.9	7.0	13.3	8.1	10.9	1.6	1.2	4.7	11.7	3.6
Courts	1.1	1.4	0.3	4.8	3.4	1.5	5.1	0.2	0.5	4.5	0.1
Crime, theft and disorder	4.0	1.3	1.6	4.3	1.9	2.4	1.1	2.5	1.9	1.3	1.0
Customs and trade regulations	3.6	3.4	1.1	0.5	7.9	9.4	2.0	9.1	0.5	3.3	0.2
Electricity	9.5	5.7	15.0	3.4	1.6	7.8	6.6	2.6	0.9	0.2	4.6
Inadequately educated workforce	7.3	5.8	2.1	5.0	2.0	7.0	6.8	2.7	6.3	6.1	1.6
Labour regulations	3.2	1.8	0.1	5.6	6.8	0.4	0.7	4.3	0.7	0.1	1.5
Political instability	11.6	13.5	5.3	14.6	31.4	4.0	10.2	6.9	11.3	28.7	11.5
Practices of the informal sector	12.4	15.9	18.6	28.7	4.3	26.0	30.1	18.0	8.1	10.6	20.2
Tax administration	3.4	5.2	12.9	4.0	1.3	4.3	2.7	2.6	5.1	5.2	1.9
Tax rates	12.1	17.8	10.8	8.0	8.2	5.5	8.7	38.0	43.0	16.1	37.4
Transportation	2.8	2.2	3.0	0.0	2.9	1.0	1.2	1.0	3.1	0.4	4.8

Source: World Bank Enterprise Surveys, 2013.

Most countries view electronic transactions as a powerful instrument in countering sales underreporting. They support this by setting threshold limits for businesses to operate point-of-sale terminals, pay employees electronically and even pay pensions and security allowances electronically, banning cash exchanges over a certain limit and subsequently lowering such limits (Romania and Bulgaria). The cost of cash for banks and businesses is increasing, so they offer discounts for card payments (cash-back of 0.5 – 1 % on credit card purchases), and run lotteries (usually organized by Visa). Although many central banks in the Western Balkans do not publish regular statistics on card payments, a good model for developing the financial infrastructure is the share of population aged 15 or over who have an account with a financial institution. Another is the distribution of ATMs (per capita and geographically).

Albania and Kosovo have both the lowest levels of financial accounts (less than 50 %) and ATM distribution (less than 35 and 37 respectively

per 100,000 people). The leader in that respect is Croatia, where 86 % of the population have financial accounts (closely followed by Serbia, 83 %, and Macedonia, 72 %) and a density of 117 ATMs per 100,000 people (followed by Bulgaria, 91, and Turkey, 78 ATMs) and 75 ATMs per 1,000 km² (followed by Turkey, 57, and Bulgaria, 52). The data suggest that in some countries (like Serbia) ATMs might relinquish density to POS uptake, as their prevalence is virtually everywhere. In countries like Bosnia and Herzegovina and Macedonia, ATM density is continuing to grow slowly.

TABLE 6. DISTRIBUTION OF ATMs IN SOUTHEAST EUROPE

Average ATMs per	ALB	BGR	BIH	HRV	MKD	MNE	ROU	SRB	TUR	UVK	Total
2004											
1,000 km ²	3.39	16.12					14.30		17.61		12.86
100,000 adults	4.22	26.17					18.32		28.51		19.31
2005											
1,000 km ²	7.48	20.98		41.23	6.17	5.20	18.93	9.57	19.28	9.37	15.36
100,000 adults	9.24	34.10		61.63	9.64	14.28	24.28	13.86	30.63	8.06	22.86
2006											
1,000 km ²	11.28	33.20	9.61	47.19	11.68	9.52	26.24	15.41	21.46	10.65	19.62
100,000 adults	13.81	54.12	15.16	70.35	18.11	26.05	33.74	22.30	33.49	9.09	29.62
2007											
1,000 km ²	15.80	40.65	12.79	53.52	20.97	14.72	32.42	23.71	24.42	14.24	25.32
100,000 adults	19.24	67.54	20.10	79.80	32.01	40.22	42.25	34.30	37.48	12.05	38.50
2008											
1,000 km ²	23.43	47.79	17.60	59.72	30.16	19.55	40.22	28.52	28.52	22.04	31.76
100,000 adults	28.37	79.98	27.63	89.17	45.69	53.28	53.37	41.27	43.06	18.52	48.03
2009											
1,000 km ²	27.04	52.14	26.46	64.35	32.99	22.23	42.17	31.13	31.12	31.14	36.08
100,000 adults	32.56	87.84	41.51	96.26	49.60	60.38	56.55	45.09	46.17	25.94	54.19

TABLE 6. DISTRIBUTION OF ATMs IN SOUTHEAST EUROPE (CONTINUED)

Average ATMs per	ALB	BGR	BIH	HRV	MKD	MNE	ROU	SRB	TUR	UVK	Total
2010											
1,000 km ²	28.14	53.36	21.45	67.80	34.46	23.87	43.91	32.67	35.87	38.12	37.96
100,000 adults	33.68	90.59	33.55	101.61	51.48	64.60	59.28	47.35	52.21	31.51	56.59
2011											
1,000 km ²	29.38	54.85	23.48	71.03	34.73	24.68	47.82	32.36	41.14	42.25	40.17
100,000 adults	34.91	93.88	36.73	109.91	51.58	66.60	64.91	47.15	58.95	34.62	59.93
2012											
1,000 km ²	30.04	54.02	25.08	72.96	33.78	26.02	47.77	31.84	45.10	44.36	41.10
100,000 adults	35.44	93.10	39.15	113.07	49.92	69.95	65.04	46.52	63.64	36.07	61.19
2013											
1,000 km ²	30.00	53.99	26.72	73.68	36.88	26.84	46.83	30.56	52.12	45.56	42.32
100,000 adults	35.19	93.66	41.58	114.19	54.28	71.84	63.92	44.77	72.44	36.78	62.87
2014											
1,000 km ²	29.60	52.03	27.85	75.45	38.03	26.69	47.60	30.09	56.74	45.74	42.98
100,000 adults	34.56	90.89	43.26	117.16	55.77	71.16	65.14	44.20	77.66	36.82	63.66
Total per 1,000 km ²	21.42	43.56	21.23	62.69	27.98	19.93	37.11	26.59	33.94	30.35	32.65
Total per 100,000 adults	25.57	73.81	33.18	95.31	41.81	53.84	49.71	38.68	49.48	24.95	48.82

Source: IMF, *Financial Access Surveys 2005 – 2015*.

Often, governments try to legitimize simple revenue maximisation strategies (imposing minimum thresholds on social security, and mandatory health security thresholds even for the unemployed and those living abroad) as measures to tackle the hidden economy. In effect, these attempt to minimize the tax gap and government losses, but they do not deal with the causes of tax and social security avoidance, and are often at the expense of the poorer population (those who are really unemployed, for instance, who cannot enjoy the full benefits of health care anyway). Sometimes, such measures are counter-productive. In Turkey, various fiscal measures undertaken after the 2008 crisis to overcome the hidden employment

burden actually made matters worse.²⁰ The measures included a 4 % reduction in social security premiums, with further reductions granted to young people (under 30 years of age) and women, reduced work time, less tax reduction, increased benefits for the unemployed, passive employment measures, etc. Yet Turkish organisations (i.e. the Turkish Confederation of Employer Associations) were very critical and suggested that the situation had actually become worse, with unregistered workers and withheld social security.

National statistical institutes might be subject to different, conflicting pressures regarding the level of unobserved economy in their GDP. In time of recession, there may be moves from the government to show that the economy is not doing badly (at the expense of the unobserved economy), or, if the government wants to borrow money but is hesitant or bound to macroeconomic ratios, it might push NSIs to depict the unobserved economy as larger than it is, so as to stay within allowed margins of debt to GDP. At the same time, factors that decrease a government's motivation to increase GDP through a higher share of unobserved economy may include obligatory payments to international organisations (including the European Union), which are calculated on the basis of GDP, or political pressure to fund education, the military or other sectors from a fixed percentage of GDP, when governments have other priorities. Last, but not least, increasing GDP through imputations is only possible if tax revenues show some sort of growth, including growth relative to officially reported economic indicators. Otherwise, political opponents will express heavy criticism that the government is not doing enough to tackle the hidden economy.

²⁰ [Yeldan, E. \(2011\). Macroeconomics of Growth and Employment: the Case of Turkey, *Employment Working Paper Np 108, ILO.*](#)

CHAPTER II: SELDI HIDDEN ECONOMY SURVEY RESULTS

Despite the existence of various studies on hidden employment, there is no recent comparable data for the Western Balkans, so SELDI has filled this gap through a set of national representative surveys, conducted in nine countries on a sample of 9,340 people.²¹ As a benchmark for the study, we will use ILO data (available through the World Bank) for the informal economy, which by definition is smaller than the hidden economy. Employment in the informal economy (as a percentage of total non-agricultural employment) basically includes all jobs in unregistered and/or small-scale private, unincorporated enterprises that produce goods or services meant for sale or barter. Self-employed street vendors, taxi drivers and home-based workers are all considered enterprises, regardless of the size of their operation. However, agricultural and related activities, households producing goods exclusively for their own use (e.g. subsistence farming, domestic housework, care work, and employment of paid domestic workers), and volunteer services rendered to the community are excluded. According to this definition, Turkey had informal employment of between 30.6 % in 2009 and 17.2 % in 2014 (a constant decline through years). Albania had 43 % in 2014, Macedonia 12.3 % in 2010, and Serbia has fluctuating informal employment between 5.3 % (the lowest in 2013 since 2010) and 6.6 % (the highest in 2014 since 2010). However, Turkstat's Labour Surveys²² suggest a stable level of informal employment of 44 % to 46 % of total employment in the period 2004 – 2010.

SELDI employs a broader definition of the hidden economy to be measured. A person is counted as being engaged in the hidden economy if they participate in at least one of six hiding practices:

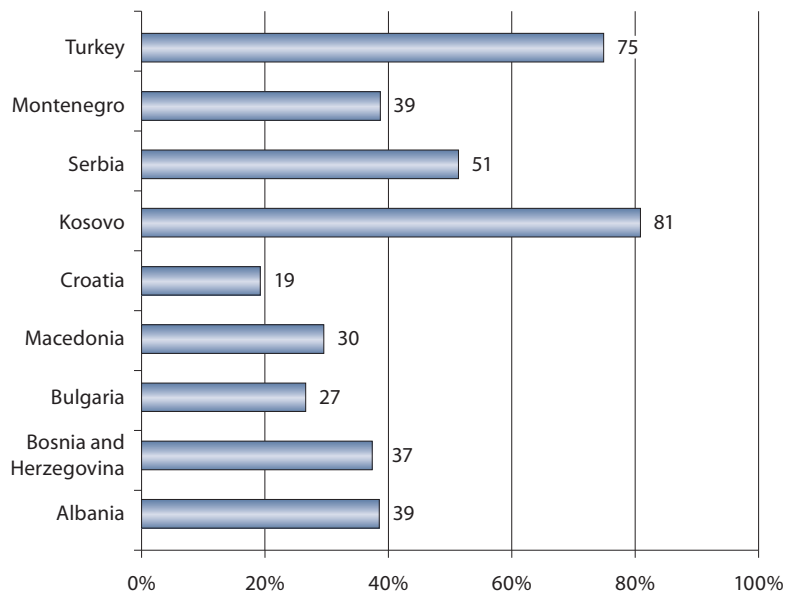
- No written contract with the employer at the main job
- Actual remuneration received in the previous month was higher than the one written in the contract with the main employer, based on a verbal agreement
- No social security is paid on the main job
- The base for the social security paid is the minimum wage, even if the actual salary is higher
- The base for the social security paid is the amount written in the contract and not the actual received, which is higher;
- There is no health insurance on the main job.

In some countries, some of these hypotheses are not possible if there is a labour contract (mandatory social and health security). In others, tax au-

²¹ Sample sizes are as following: Albania (1,050), Bosnia and Herzegovina (1,007), Bulgaria (1,008), Macedonia (1,001), Croatia (955), Kosovo (1,000), Serbia (1,061), Montenegro (1,040) and Turkey (1,219). Field research was conducted in January and February 2016 by professional interviewers. More information on the methodology applied is available on request from the SELDI secretariat.

²² [ILO, \(2011\). *Employment Working Paper No. 108*.](#)

FIGURE 3. EMPLOYED IN THE HIDDEN SECTOR, SELDI 2016
(% OF THOSE EMPLOYED IN A MAIN PAID JOB)



Source: SELDI Hidden Economy Survey, 2016.

thorities have different degrees of ability to control whether a particular part-time contract should involve payments of social and health security if the contracted wage does not exceed a certain threshold. This leaves ample room for discrepancies and hiding social and health security, even if income is declared and income tax paid. However, the definition does not include cases of social and health security avoidance, for example, through cash advances on a monthly basis and a longer contract on a multi-monthly basis in order to keep below the minimum amount of income on which security is due. Neither does it include other legal ways of reducing tax payments in relation to labour provided. The Hidden Employment Index represents

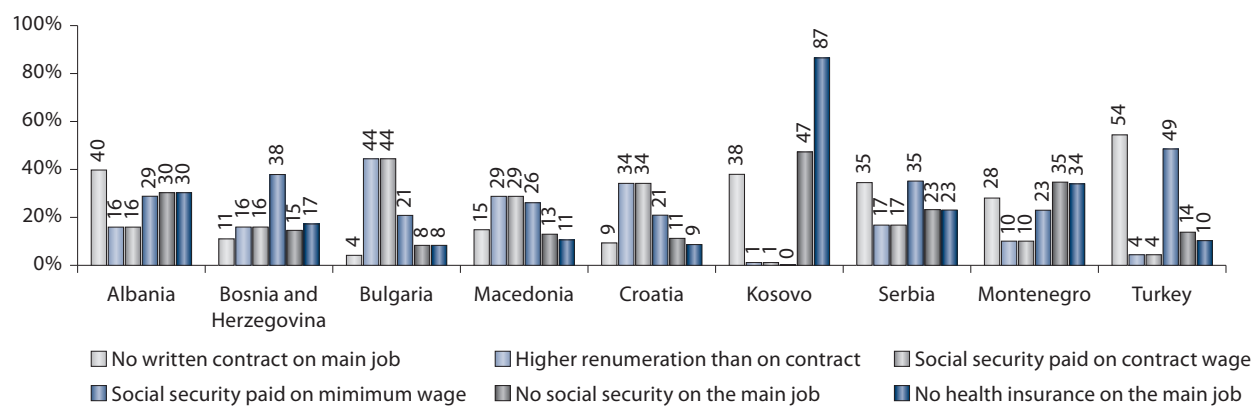
the share of respondents who are engaged in a main paid activity and who hide something, through at least one of the means listed above.

Besides the enormous difference in levels of hiding, (in Croatia it is as low as 19 % and in Kosovo as high as 81 %), different countries have different patterns of hiding, and therefore different problems to resolve. More than half of all hidden Turkish employment has no formal contract. The major reason is social security evasion. If there is a contract, an employee must be reported to the social security system. Similarly, more than a third of those in hidden employment in Serbia, Kosovo and Albania do not possess labour contracts. However, Bulgaria resolved the issue long ago by a combination of mandatory contract registration and subsequent inspections, and enjoys a low rate of only 1 % of those employed and 4 % of those in hidden employment being without labour contracts.

Virtually all Kosovars in hidden employment hide health security completely (87 %). Kosovar citizens are very dissatisfied by access to health (especially in rural areas, where even getting to medical centres is a problem), the quality of health services, and prevailing corruption.²³ Other countries where there are severe problems with health care funding through dedicated taxes are Montenegro and Albania, where every third person in hidden employment does not pay any health and social security at all. Bulgaria is relatively better off in this respect, although

²³ Uka, F. (2013). *Satisfaction with Health care Services and Perceptions on Presence of Corruption*, UNDP.

FIGURE 4. PREVALENCE OF DIFFERENT TYPES OF HIDDEN EMPLOYMENT IN SOUTHEAST EUROPE (% OF THOSE EMPLOYED IN A MAIN PAID JOB)



Source: SELDI Hidden Economy Survey, 2016.

the amounts received are not enough to provide quality health care services for all.

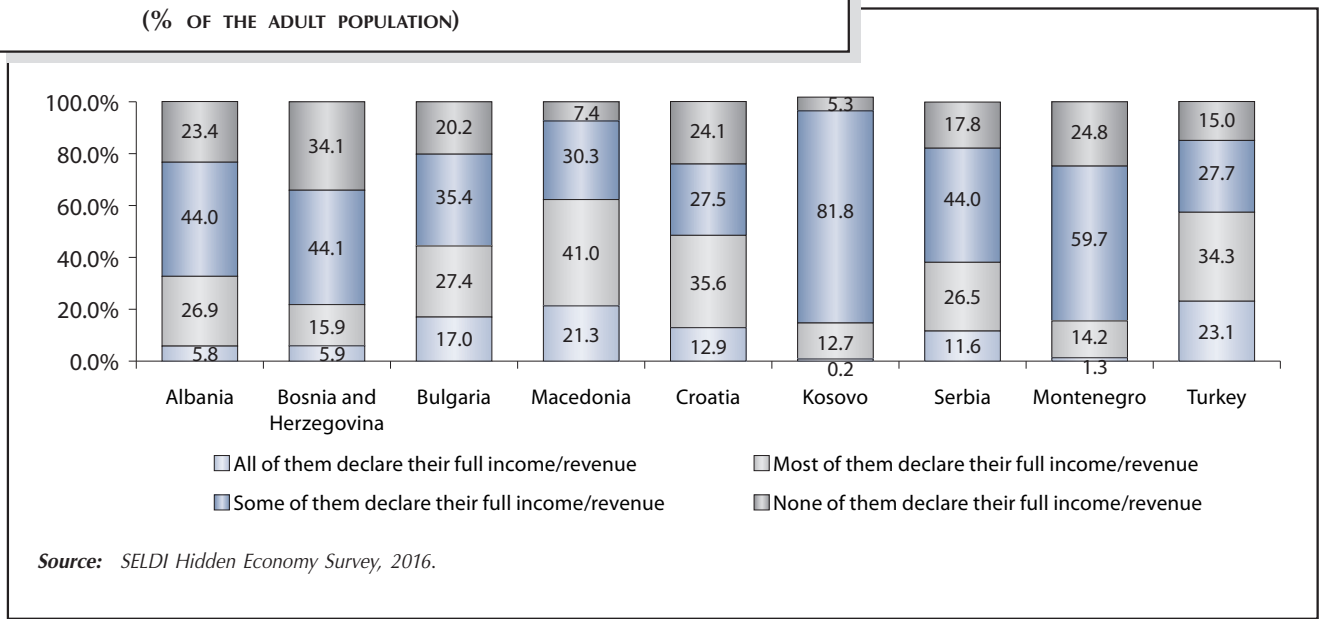
Besides the lack of labour contracts (therefore no social security), Turkey’s main problem in terms of hidden employment is hiding (underreporting and paying) social security. Almost half of all Turks working in the hidden economy pay social security on the minimum wage and save on their actual salary difference. The same problem is observed in Serbia and Bosnia and Herzegovina, where between 35 % and 38 % of those in the hidden economy pay social security on the minimum wage and save on the salary difference.

Being part of hidden employment is sometimes a matter of choice, but more often it is a reinforcing social network and creates a specific tax morale. People employed in the hidden economy in Southeast Europe are slightly younger (2 years on average, yet statistically significant), predominantly male (62 %) and tend to know other people who hide (statistically significant). The age difference is due to young people (under 30 years of age) in hidden employment, who outnumber those in formal workplaces.

Hidden employment links people and companies in different ways. Hiddenness does not influence the perception of the extent to which extent the companies in a person’s social circle (through workers, former workers, friends, owners, business partners or consumers) hide revenues. However, hiddenness entails tighter social networks with people who also hide, and this is valid across the whole region. This finding has important policy implications, as often policy measures seem designed for individual transactions (employment or revenue reporting) and do not reflect the social embeddedness of the phenomenon.

This is not a surprising discovery, as hiding employment in firms is not random. If present, it applies either to the whole firm or to a relatively

FIGURE 5. SHARE OF PEOPLE DECLARING THEIR FULL INCOME (% OF THE ADULT POPULATION)



Source: SELDI Hidden Economy Survey, 2016.

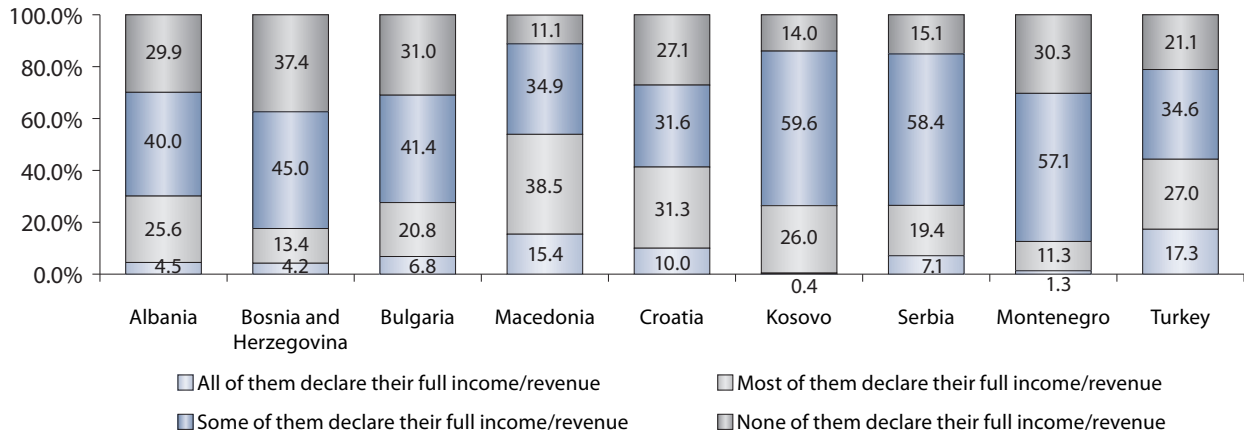
independent team, to prevent leakages and enforce the collective morale of self-protection against the inspection authorities. The same applies if the economic unit is completely unregistered (teams in agriculture, street vendors, suitcase traders/smugglers, home repair and construction teams, night-club entertainers, etc.). Quite often it also applies throughout sectors, not just firms and competitors can exert peer pressure not only by pricing, but through social pressure and even threats to business for those more compliant than they are. This can be observed in sectors such as car repair services, usually working as a cluster of five, six or more workshops renting space from one landlord (a former public enterprise) and offering complementary services (general repairs, tyre repairs, bodywork repairs, electrical systems and alarms, engine/computer diagnostics and repair, car washes, etc). Inspections of similar cases are often made simultaneously, achieving economies of scale. If one place produces perfect documents and reports significantly higher revenue, this gives leverage to inspectors to ask for higher bribes from those less compliant.

Although significant variations exist across countries, as a rule, people favour people over firms in declaring income/revenue. The only exception is Kosovo, due to the extremely high level of hidden employment (81 % reported participation in the hidden economy). Another factor accounts for this difference. About half of all registered businesses in Kosovo are self-employed persons²⁴ who may refer to their hiding as individual, and so the business population would be halved.

Kosovo and Serbia have the smallest gap between self-reported hiding and the prevalence of hiding in social circles, while Croatia and Montenegro have the widest difference. One explanation of the gap might be social stratification and the Gini Index. The higher the Gini Index, the higher the gap (Croatia and Montenegro have Gini indexes higher than Kosovo

²⁴ KOSME, (2014). *Report on SMEs in Kosovo*.

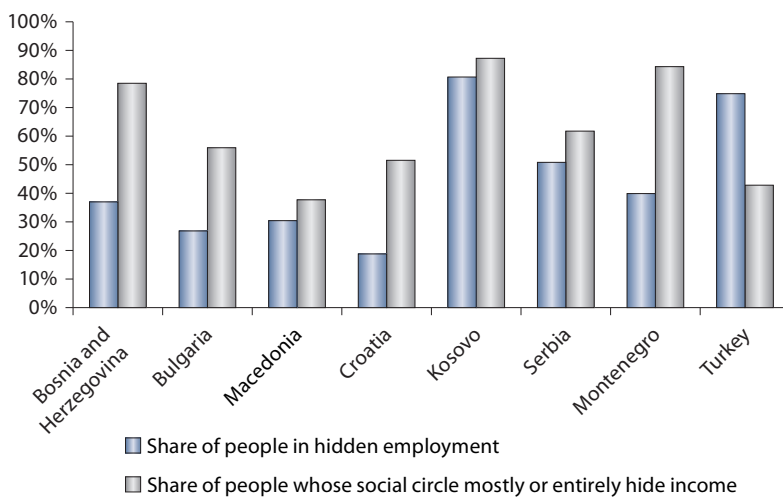
FIGURE 6. SHARE OF COMPANIES DECLARING THEIR FULL INCOME/REVENUE



Source: SELDI Hidden Economy Survey, 2016.

and Serbia). At the other extreme, Turkey has a reverse difference – more people self-report in the hidden economy than their perception about their social circle indicates. Stratification has different network patterns and countries with similar levels of income diversification may have different level of social connectedness, or atomization. Croatia has a much more inter-linked society than Macedonia, thus lowering the perceived gap. The social embeddedness of hidden employment can also be seen through the lens of unemployment. About 62 % of unemployed people tend to know others who hide their income, so the chances of them starting wholly or partly hidden work are higher than for those already in work.

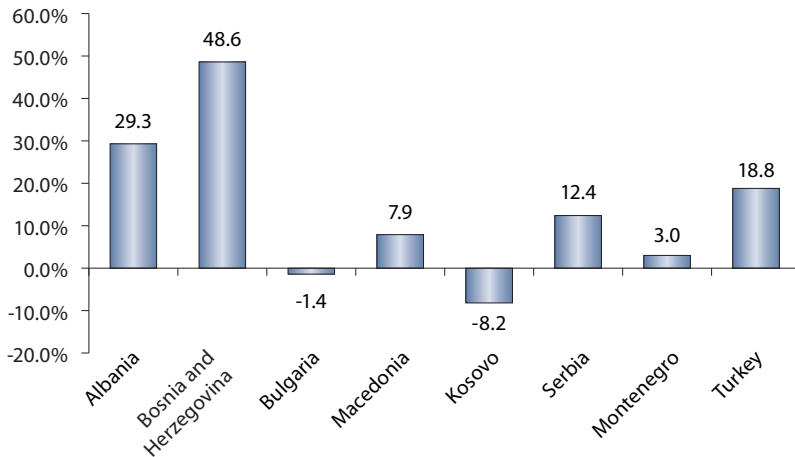
FIGURE 7. SOCIAL EMBEDDEDNESS OF HIDDEN EMPLOYMENT (% OF THE ADULT POPULATION)



Source: SELDI Hidden Economy Survey, 2016.

The SELDI survey revealed that people earn more in the formal sector than in the hidden one, despite widespread belief in the opposite. The premium is as high as almost half again in Bosnia and Herzegovina and almost a third in Albania. Surprisingly, in Bulgaria and Kosovo the premium is negative, yet in Bulgaria the difference is not statistically significant. This finding once again suggests that staying in the hidden economy is not entirely a matter of free choice (nobody would voluntarily work for lower wages, all things being equal). Higher pay and more formal workplaces are linked to educational background and skills, as ad-

FIGURE 8. WAGE PREMIUM IN THE FORMAL ECONOMY OVER THE HIDDEN ECONOMY



Source: SELDI Hidden Economy Survey, 2016.

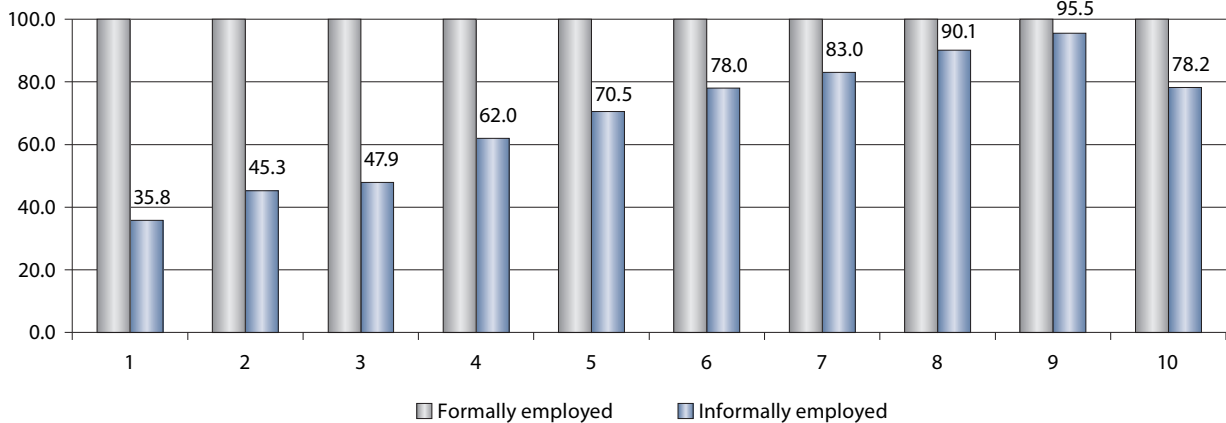
vanced graduates (masters) are more often found in the formal economy.

This finding is perfectly in line with a more detailed study comparing income in formal and informal employment per decile groups in Montenegro.²⁵ The lowest decile in the informal economy on average earns 36 % of the average income of the lowest decile in the formal economy. As deciles move up, the gap lowers, but informal economy income never tops the formal one.

People who are part of the hidden economy statistically work more (longer) than those

in the formal one, are engaged more often and longer in work at home and on private premises, and are more relaxed (not judgmental) towards morale in society (they do not believe that there is a serious moral crisis in society). Yet, their subjective feeling of happiness is slightly lower than the country average, though this does not affect subjective self-positioning in the social hierarchy. The only exception is Macedonia, where hidden employment significantly hinders self-esteem in terms of one's place in society.

FIGURE 9. DIFFERENCES BETWEEN WAGE LEVELS OF FORMALLY AND INFORMALLY EMPLOYED IN MONTENEGRO BY DECILE GROUP, 2014 (%)



Source: IPSOS (2014), *Informal Employment and the Grey Economy in Montenegro 2014*.

²⁵ UNDP, (2016). *National Human Development Report for Montenegro, Informal Work: from Challenges to Solutions*.

If about half the civilian labour force (as in the case of Turkey but also Bosnia and Herzegovina) stays outside, or at the margins of the social security system for 15 years, a new morale is already built in to the next generation. Trust in institutions in such families is detrimentally low, and in certain cases, is transformed into active distrust and opposition, also fuelled by feelings of affiliation to another country or nation (Albanians in Macedonia, Serbs in Bosnia and Herzegovina, Kurds in Turkey). This can lead to a situation where large groups of people simply refuse obedience to formal rules, to the extent that they drive cars without official plates (in towns such as Tetovo, Macedonia) and the local police do not sanction them. In such cases, payments of decentralized taxes (that go back to the community) are prioritized over payments of centralized taxes (that siphon money to the centre and a rival ethnic group).

The same pattern is observed and still present in Turkish villages and towns in Bulgaria (especially those in the mountains), where the local authorities tolerate hiding of revenues (due to the central tax authorities) and even hiring in the shadows, but require direct monetary contributions or assistance in kind for municipal projects (pavements, roads, children's playgrounds, school repairs, and so on).

In-depth longitudinal studies of informal work in Montenegro have shown that 19 % of people in hidden employment have worked for 15 years or more in the same place.²⁶ The average time-span in the hidden economy for those in totally informal work is 9.7 years and for those partially hiding it is 7.5 years. There are no similar longitudinal studies for other Western Balkan countries, but anecdotal evidence from all confirms long periods in the shadows of the economy.

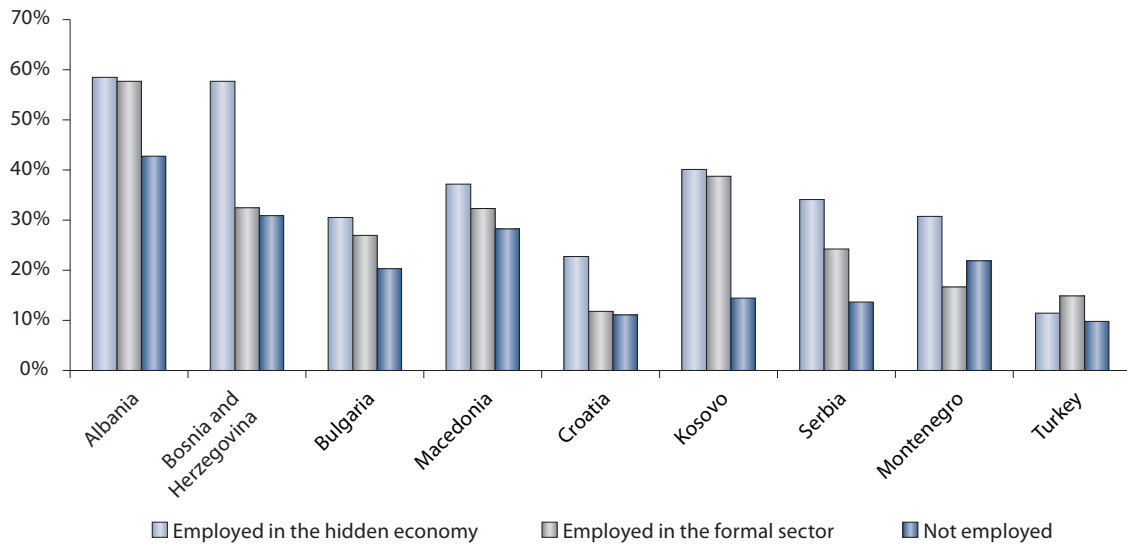
It is not surprising that those in hidden employment are more often subject to corruption pressure – both because of work-related (inspections that reveal irregularities or corruption initiated by a business) and home-related incidents (access to health, access to finance and access to education require social and health security to be paid, and high wages to be put on record, etc.).

According to the SELDI hidden economy survey, 34 % of those in hiding experienced corruption pressure, compared to 29 % of those in the formal sector. For various reasons, the unemployed are least likely to be asked for bribes – only 22 % of them experienced corruption pressure in 2015.

In terms of different SELDI countries, the corruption pressure gap between those employed in the hidden and formal economies has not been observed statistically in Albania, Kosovo and Turkey (surprisingly, corruption pressure on those in the hidden economy is lower than on those in the formal sector). It is possible that extreme values of corruption pressure in Albania and hidden employment in Kosovo and Turkey mask the phenomenon. Another explanation may be that some of

²⁶ UNDP, (2016). *National Human Development Report for Montenegro, informal work: from challenges to solutions*.

FIGURE 10. CORRUPTION PRESSURE (SHARE OF THOSE IN DIFFERENT EMPLOYMENT SITUATIONS, % OF THE ADULT POPULATION)



Source: SELDI Corruption Monitoring System, 2016.

those in formal employment in Turkey (public administration employment accounts for about 15 %) exercise corruption pressure themselves. In Bosnia and Herzegovina, however, the corruption pressure gap between the two groups is more than 25 %. Significant differences are found also in Montenegro (14 % difference in corruption pressure), Croatia (11 % difference), and Serbia (10 % difference) suggesting a deep divide in the way people get things done.

The SELDI survey results, combined with the SELDI partners' deep knowledge of how local societies function, provide an indispensable framework for policy makers to design evidence-based policies, rather than simply copy-pasting tools from different social and business contexts.

A key message from the survey and analysis relates to the social and market embeddedness of the hidden economy, which requires sequencing of policy measures and the overall enforcement of the rule of law in society. A recent study by Williams, Perez and Kadir showed that firms which started unregistered and spent a longer period operating unregistered had significantly higher subsequent annual sales, employment and productivity growth rates, compared to those that registered from the outset.²⁷ So, strict control on start-ups may be detrimental to development.

Approaches which help formalize clusters of companies relying on a complex nexus of social relationships, including informal investment through

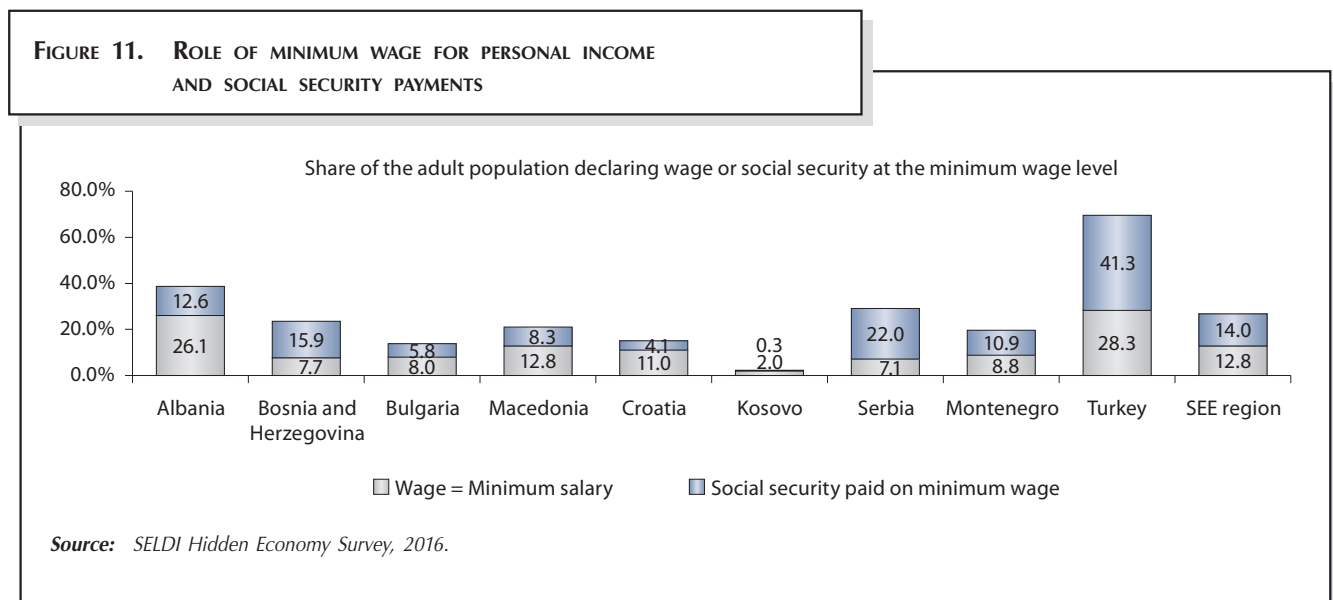
²⁷ Williams, C.C., Martinez-Perez, A. and Kadir, A.M. (2016). *Informal Entrepreneurship in Developing Economies: the Impacts of Starting-Up Unregistered on Firm Performance. Entrepreneurship Theory and Practice.*

remittances (as in Macedonia, Kosovo and Bosnia and Herzegovina) might be more effective than labour and tax inspectors conducting raids (which only serve to create corruption revenue for them and make hidden businesses and employees poorer).

Another important finding from the survey is that minimum wages make economic policy sense (besides being a threshold for the collection of revenues from those having formal contracts) in only two countries, Albania and Turkey, where respectively 26 % and 28 % of those employed receive them, and a total of 39 % and 70 % of social security is paid on that basis.

In all other countries, the share of employees who receive the minimum wage is between 2 % (Kosovo) and 11 % (Croatia). Only in Serbia (22 %) is there a significant number of employees who receive higher salaries than the minimum wage, but for tax, social and health security purposes, report the minimum wage as their income level. In many cases, governments tie specific prices (for public services) and salaries (public servants and public officials) proportionally to minimum wages, and thus by increasing the minimum wage, they increase public revenue and (tacitly) spend more on public administration.

Montenegro’s Human Development Report 2016²⁸ confirms the hypothesis that stricter enforcement of the minimum wage for informal workers may be quite a burden on the self-employed (the majority of the lowest decile groups), due to the associated costs they would be obliged to pay to the government.



Policy makers should study income levels carefully, especially for the poorest 20 % of employees, who earn between 5 % (Romania and Macedonia) and 9 % (Kosovo and Albania) of the income earned by

²⁸ UNDP, (2016). *National Human Development Report for Montenegro, informal work: from challenges to solutions.*

all those employed for each of the SELDI countries. Increasing the minimum wage for these lower income people might entail a negative welfare change, because of the increased costs of public or regulated private services as general practitioners (provided there are no waivers or subsidies), even if employers bear additional costs at their own expense.

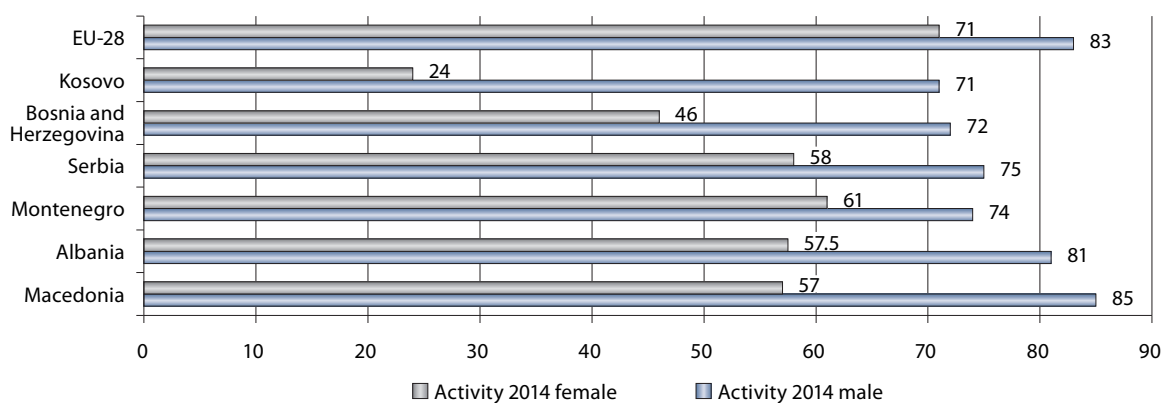
CHAPTER III: HIDDEN EMPLOYMENT

3.1. General Labour Market Conditions

Countries in the region have enjoyed stable 15+ labour force participation rates since 2000 (the lowest being Turkey, with 31 %, and the highest Bulgaria, with 47 % in 2014). The spread in Western Balkan countries varies from 38 % (Bosnia and Herzegovina) to 44 % (Montenegro). Italy and Greece fall within the same bracket. The range and dynamics in the employment to population ratio is greater, as Romania, Albania and Serbia have experienced decline in employment since 2000, whereas Macedonia and Bulgaria have grown and the rest remained stable, with slightly fluctuations around the time of the 2008 crisis.

A striking difference in the region is represented by extremely low economic activity rates (EAR) and employment for women (aged 20-64). In Kosovo EAR for women is as low as 24 % while employment is only 14 %. Bosnia is ranked second worst with 46 % EAR and 32 % employment. These gender imbalances can be explained by patriarchal attitudes in society which prevail in the region, and also to a lesser extent in other countries.

FIGURE 12. ECONOMIC ACTIVITY RATES BY GENDER (%)



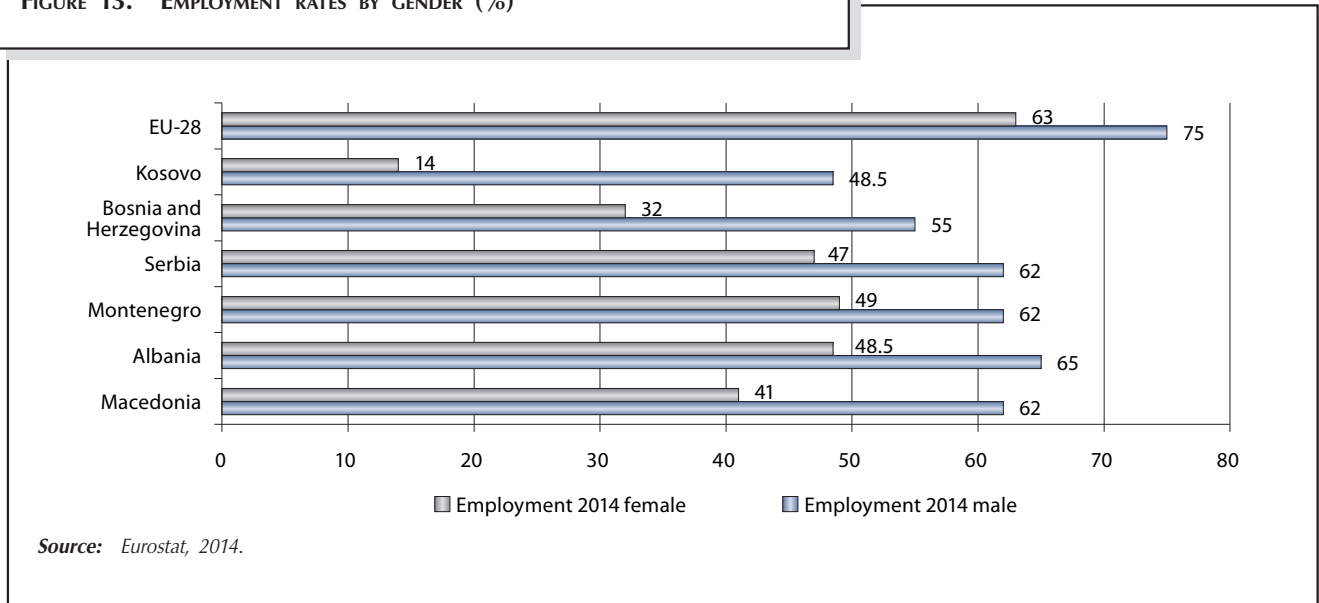
Source: Eurostat, 2014.

However, the positive news from the perspective of the hidden economy is that women constitute only 38 % of the hidden employment base in the region (not-weighted average, SELDI survey 2016). The only two exceptions are Bulgaria, where women constitute 56 % of hidden employment, and Turkey. Although survey data from Turkey suggest 77 % of hidden employment is male, more detailed data from TESSF suggests a higher rate of non-registered women (48.1 %) than men (28.7 %). In the agricultural sector, this ratio is even worse – 93.8 % and 70.5 % respectively. The reasons are related to women's employment

status. The female labour force participation rate is very low in Turkey compared to OECD countries and even the Western Balkans. Women are likely to be employed in part-time positions. According to Turkish law, part-time workers can benefit from social security services by making premium payments themselves. The social security system in Turkey is Bismarckian, meaning that the working status of a man provides his family with social insurance. On the one hand, being registered is important for men in Turkey, since it affects the whole family, but on the other hand, this situation may dissuade family members from registering with the system.

In all other cases, there are fewer female hidden workers than male workers. However, there may be a slight seasonal bias in the survey, as those temporarily employed in the hidden economy in agriculture (mostly women) may have responded, as they are unemployed. This is certainly the case in Turkey, because of the sample size and incomplete coverage of rural areas. Most of the existing research into developing economies claims that hidden (informal) employment provides greater opportunities for women than for men²⁹ and gender-tailors proposals for handling hidden economy problems. This study argues that while there is an obvious need to provide a decent framework for careers for women, especially young mothers, this should not be part of the anti-hidden economy agenda.

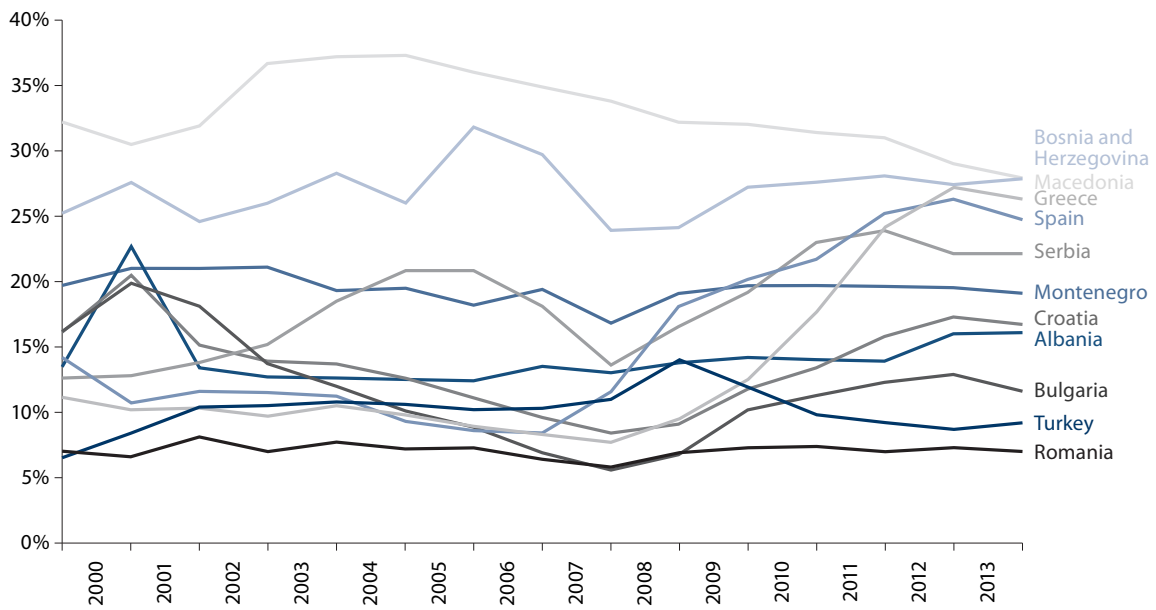
FIGURE 13. EMPLOYMENT RATES BY GENDER (%)



Unemployment in the region is a serious source of all kind of problems and on average is higher than in the EU28 countries. Yet since 2012, Spain and Greece have had higher unemployment than Serbia, Montenegro, Croatia, Albania, Bulgaria, Turkey and Romania. Bosnia and Herzegovina and Macedonia are just 1.5 percentage points higher.

²⁹ Chen, M.A., Vanek, J. and Carr, M. (2004). *Mainstreaming informal employment and gender in poverty reduction: a handbook for policy-makers and other stakeholders*. Commonwealth Secretariat.

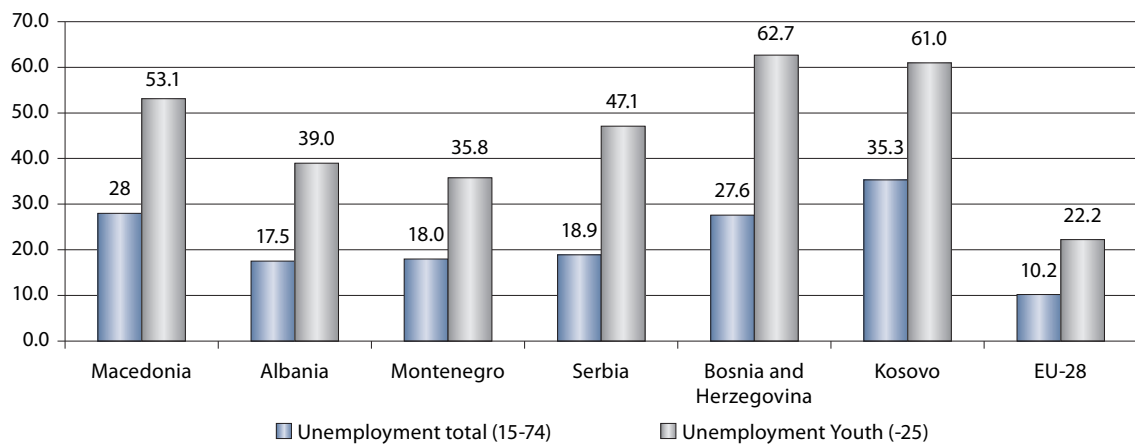
FIGURE 14. UNEMPLOYMENT RATES (2000 – 2014)



Source: World Bank, 2016. Years correspond to the left ordinate.

Far more trouble is created by long-term and youth unemployment in each of these countries. Bosnia and Herzegovina and Kosovo have higher youth unemployment rates than Greece, and are comparable with Spain, the two most troubled EU countries. The most severe problem in Bosnia is that long-term unemployment is 90 %, while in other Western Balkan countries it is between 70 % and 80 %, which means that non-youth unemployed are practically excluded from the economy.

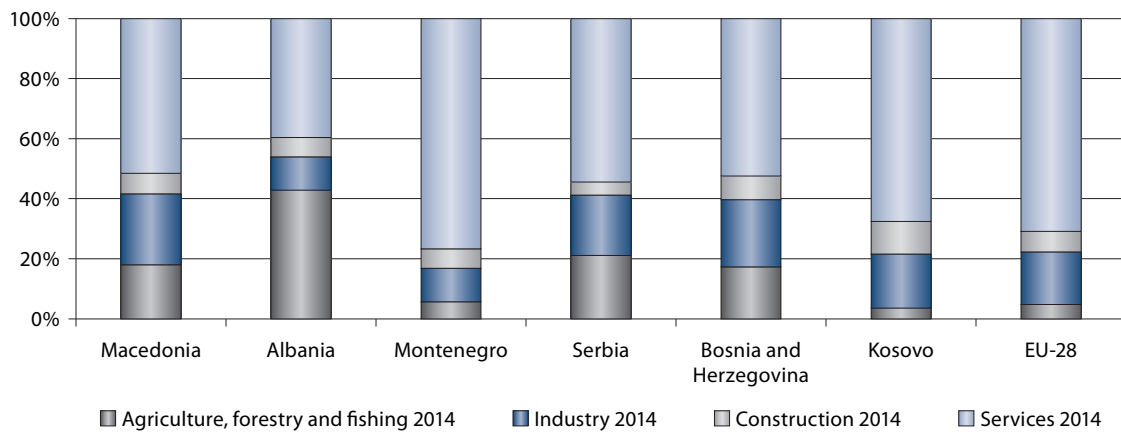
FIGURE 15. UNEMPLOYMENT RATES, GENERAL AND YOUTH (%)



Source: Eurostat.

The structure of employment varies significantly across the region. Although this is the official structure of the economy, there is no known research that argues that the hidden economy is powerful enough to change the structure of the overall economy, certainly not the employment structure. For many years, statistical institutes in the region have been estimating employment in agriculture (for example, through labour force surveys) rather than using self-reporting institutions. Through the process of adjusting GDP to the non-observed economy, statistical institutes adjust labour statistics as well. So, to a certain extent, the structure of the economy as presented by them reflects the whole economy, not that only officially reported.

FIGURE 16. STRUCTURE OF EMPLOYMENT BY INDUSTRY, 2014



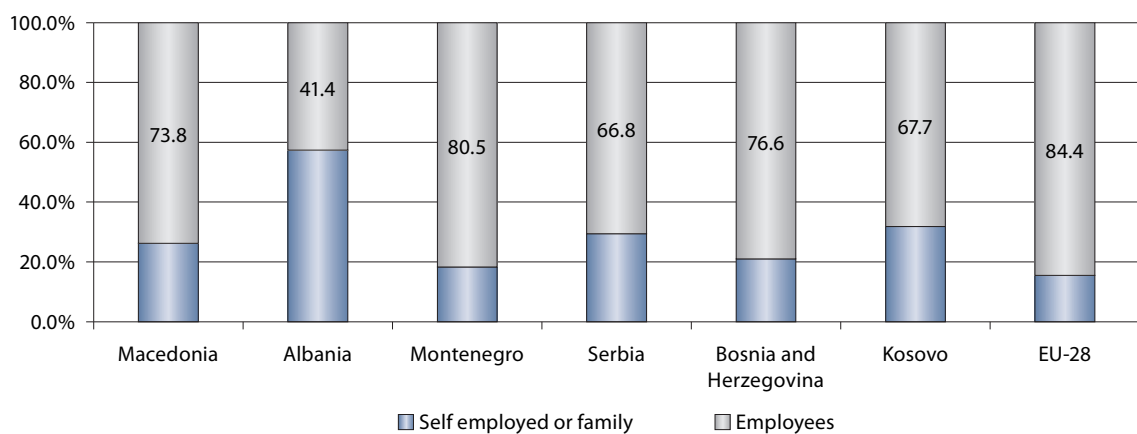
Source: Eurostat.

Montenegro's structure of employment, among all the Western Balkan countries, resembles the EU28 to the highest degree. More than 76 % of employees work in services, but this can probably be explained by the importance of the tourism industry. At the other extreme, its neighbour Albania has the lowest share of services, at just below 40 %. By contrast, the share of employment in agriculture, fishing and forestry is much higher in Albania than in any other country in the region (or the EU28), at 42.7 %. Proportions in industry are comparable, at about 15-20 % (with exceptions in Montenegro and Albania, at around 11 %). Construction, which hides a lot of employment and revenue everywhere, is a thin industry, at about 5-7 % (with the exception of Kosovo, at 11 %).

Most employed are wage earners, with large discrepancies between countries and compared to the EU28. The distinction between wage earners (typical employment) and non-wage earners (self-employed, agricultural workers) is important in designing policy measures, as hiding in these cases is subject to different stimuli and institutional settings. Montenegro's rate of 80.5 %, the highest among the Western Balkan

countries, is below the EU average of 85 % and Bulgaria's high rate of 87.5 % but is higher than Italy, Romania and Greece. The outlier in the region is Albania, with just 41.4 %, due to high rates of family-based and agrarian employment. This is the only country in the Western Balkans that has a lower rate of wage earners than Greece. Turkey experienced the highest growth between 2000 (below 50 %) and 2014 (above 65 %). Romania and Croatia also grew, but at around 10 %. The only country that experienced decline was Serbia – there was rapid decline from 2006 to 2008, with subsequent slight improvement by 2014.

FIGURE 17. EMPLOYMENT BY PROFESSIONAL STATUS, 2014



Source: Eurostat.

Although child employment, almost entirely in the hidden economy, is generally believed to be a problem in African and Asian countries, the data suggest that countries in Southeast Europe are not immune to this problem. The issue usually stays outside of the main perimeter of hidden economy research, but it has a dramatic, long-term impact on the labour market (especially in Turkey, where many working children do not attend school). As a rule, despite the potentially positive effects of stimulating an entrepreneurial spirit early, child employment prevents children from receiving education and qualifications, dooming them to lower level workplaces in the future. While the severe problem in 2000 in Albania (with more than 35 % of children above 7 years old working) has been reduced to a level of 5 %, comparable to the situation in Turkey, two other countries, Macedonia and Serbia, are the subjects of mounting concern, with more than 15 % child employment. Although the vast majority is family related and seasonal (agriculture), it still requires a rapid reaction from policy makers. Although data is not available for EU countries, the issue is present also in Bulgaria and Romania, especially within minority families (the Roma population in both countries and the Turkish population in Bulgaria).

FIGURE 18. CHILD EMPLOYMENT DYNAMICS
(EMPLOYMENT OF CHILDREN 7 – 14 YEARS)



Source: World Bank.

3.2. Different Forms of Hidden Employment

The informal economy, in general, usually takes place in small companies or individually, with little growth potential, the use of labour-intensive production methods, and employing workers with low skills, and therefore involves low capital.³⁰ Most informal employees in general, and the self-employed, work independently, or have very few informal companies, so informality is a way to reduce labour costs.

A typical example is Montenegro. The self-employed account for 70 % of the total number of informal employees, of whom more than half are employed in agriculture. Among informal employees, the highest participation rates are among the young and the old, while those in middle age are more represented in the formal economy. When qualifications are lower, the likelihood is greater that a worker will be engaged in the informal economy. A considerable number of beneficiaries of poverty and other social protection programmes work in the informal economy, thus accruing double benefits.³¹

A recent survey of 73 countries showed that in low income countries and developing countries in Europe and Central Asia, employee wages in the informal economy are not lower than in the formal economy. As country income grows, wages in the informal sector lag behind.³² In Serbia, before the 2008 crisis, there was a significant difference in favour of employees in the formal sector, but it was significantly reduced during the crisis. In addition, employees in the formal sector are concentrated

³⁰ C. Miheš (ed.), (2011). *A comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova and Montenegro*, ILO.

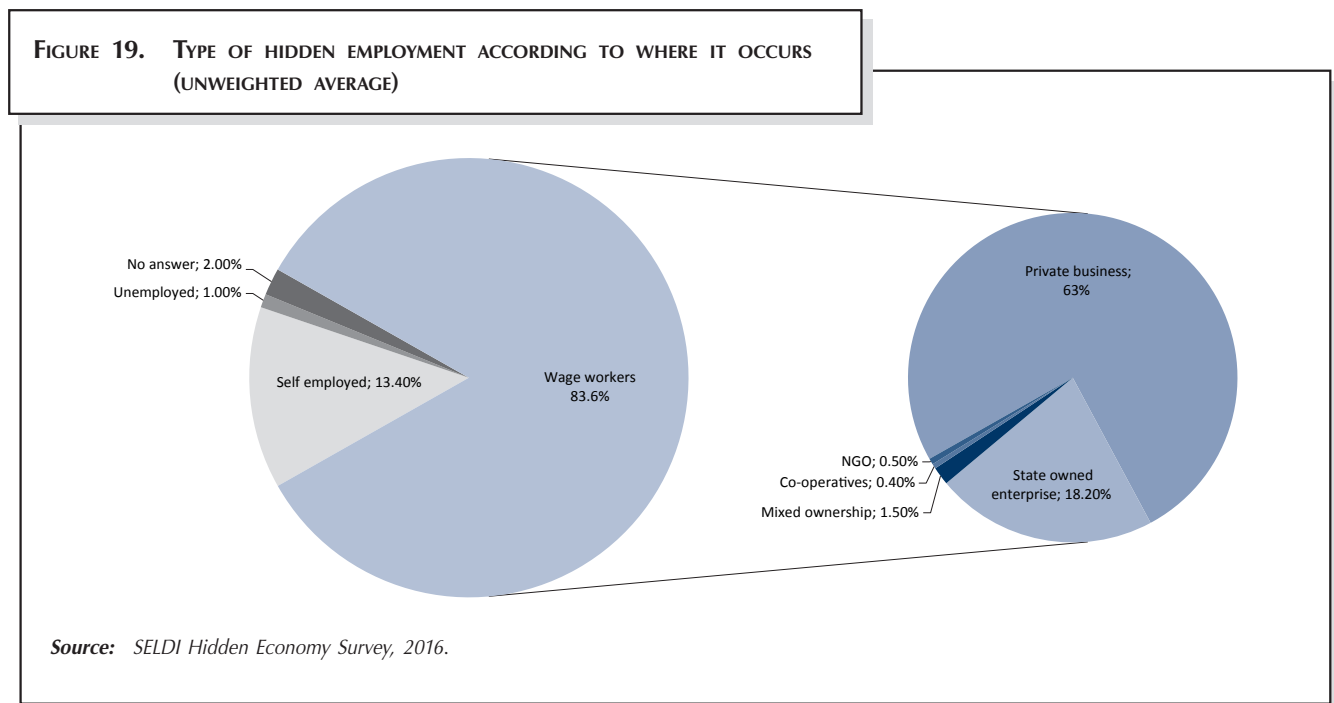
³¹ Ministry of Labour and Social Protection, Montenegro (2015). *A Report According to Human Measures – the Informal Economy: Overcoming Exclusion and Marginalization*.

³² T. H. Gindling, N. Mossaad and D. Newhouse. (2016). *Earnings Premiums and Penalties for Self-Employment and Informal Employees around the World*, IZA, Discussion Paper No. 9723, p. 19.

in sectors where wages are higher, and they have more qualifications and longer working hours than those in the informal sector, which form the main reasons for differences in earnings.³³

Informal self-employment represents a small share of the overall hidden economy, according to the SELDI survey. The not-weighted average is 13.4 %, and is as low as 3 % in Bosnia and Herzegovina and 4 % in Macedonia, up to a high of 20 % in Albania and Kosovo. The vast majority in hidden employment are wage earners (84 % on average), and of these, people in the private sector naturally take the lead. The survey found a distinctive characteristic of hidden employment not usually mentioned in the literature. Between 10 % (Albania and Turkey) and 31 % (Kosovo) of total hidden employment actually occurs in state-owned enterprises. In Bosnia and Herzegovina, this share is 21 %, but an additional 14 % occurs in enterprises where there is joint state and private ownership.

There are many state-owned enterprises in Bosnia and Herzegovina which have been partially privatized or are in line for privatization, and which fail to pay benefits to their employees. Management is obliged to keep employees on the roll due to privatization contracts or for political reasons, while no adequate restructuring and rehabilitation of enterprises has occurred. As a result, employees occasionally receive advance payments in cash, but no social or health security is paid. The same model has been widely applied in similar cases in other countries, including Bulgaria (problematic state military factories).



The problem deserves the special attention of all governments in the region, as even EU countries like Croatia and Bulgaria have experienced

³³ N-H. Blunch, (2015). *Bound To Lose, Bound To Win? The Financial Crisis and the Informal-Formal Sector Earnings Gap in Serbia*, IZA, Discussion Paper No. 9231, p. 28.

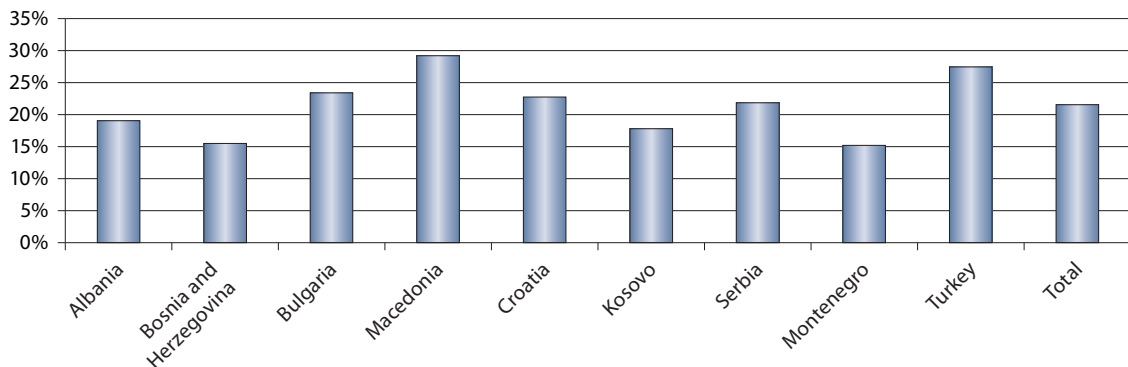
the same problem, with 11 % and 20 % respectively of hidden employment. This sends an important signal to the entire economy that governments tolerate the hidden economy in all places and forms.

Chapter 2 outlined the high perception of hidden economy in the region. On average, only 11.5 % of the population believe “All the people they know declare full income in their tax declarations”, while 19.6 % believe that none report full income. In order to obtain a single measure of the perception of the widespread nature of the phenomenon of hiding income, the weighted average of all answers was taken (per country). For “All” the weight was 1, “Most” – 0.66, “Some” – 0.33 and “None” – 0. Based on this new construction, perception is highest (the index is lowest) in Montenegro and Bosnia, while it is lowest (the index is highest) in Macedonia and Turkey.

Although concerns may emerge regarding the applicability of such questions in relation to specific tax systems in the region, they are indicative of the availability of unreported income. If employees work only with labour contracts, they may not be required to file and report their income. Further, if they receive untraceable income/payments (not reported as expenses, without documentation, or bank traces) it is awkward to report these in tax declarations, and they may not have everything necessary to report them (e.g. the identification number of the company, and sometimes even the name of the person authorising payment). So, whether or not it actually makes sense to report income, information that is partially or fully withheld is an indication of hidden economy.

Of course, the survey and index do not differentiate between the amounts hidden, but prior experience with questions demanding specific figures shows an extremely high non-response rate.

FIGURE 20. PERCEPTION OF UNDERREPORTING OF INCOME BY INDIVIDUALS (% OF THE ADULT POPULATION)



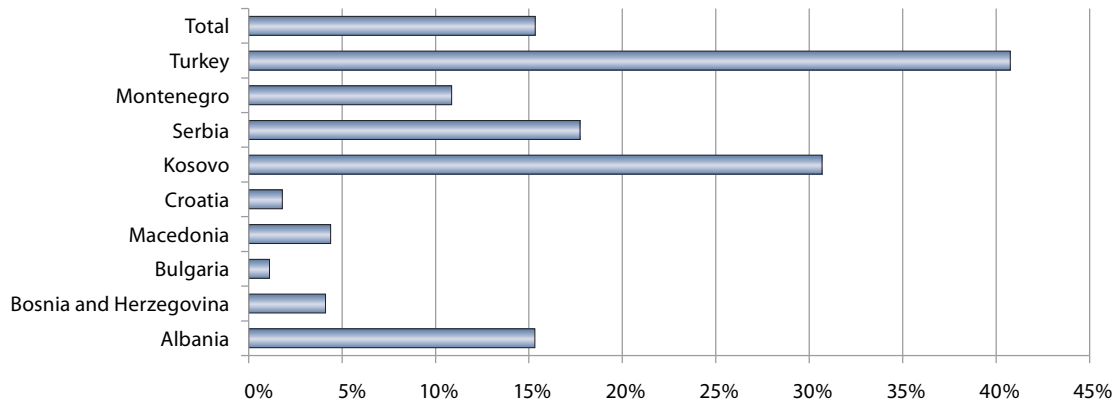
Source: SELDI Hidden Economy Survey, 2016.

Lack of written contracts, though studied in the Labour Force Surveys, is not reported routinely in country reports, and sometimes reports

are not available at all on the dedicated web page of the International Labour Organisation³⁴. The latest available LFS data for Montenegro (Q1 2016³⁵) suggest there are only 4 % of contract-less wage earners (SELDI survey data – 11 %). Serbia and Macedonia provide data for informal employment (including self-employment) and non-contract work, and the most comprehensive data is for Macedonia (with time-series).

There is a strong variation across the region regarding how many people work without contracts. Croatia, Macedonia, Bulgaria and Bosnia have low values (below 5 %), moderate problems exist in Albania, Serbia and Montenegro (15 %, 17 % and 11 % respectively), which are around the regional average (15 %), but Turkey (41 %) and Kosovo (31 %) are problematic countries.

FIGURE 21. SHARE OF PEOPLE WHO DO NOT HAVE A WRITTEN CONTRACT WITH THEIR PRIMARY EMPLOYER (% OF THOSE EMPLOYED IN A MAIN PAID JOB)



Source: SELDI Hidden Economy Survey, 2016.

The Labour Force Survey (LFS) data for Macedonia suggests an important age and gender gap in hidden employment. Women in informal employment account for between 34 % and 37 % of all informal employment and the largest population age-brackets are youth (15 to 24 years old) and pensioners (over 65 years old). In the last five years (2011 – 2015), total employment has been rising and informal employment decreasing.

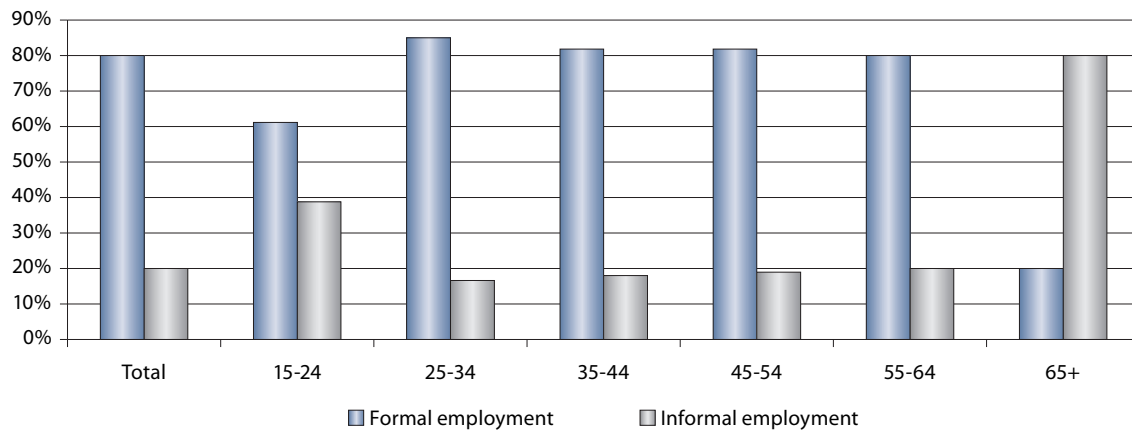
Lack of contracts is not just a symptom of hidden labour and tax evasion. It also indicates inefficient labour markets, a lack of protection, and no trust in the judicial system. Employees without contracts, or on incomplete contracts, often work significantly longer hours (including night shifts, weekends and holidays) for no additional compensation, do not use sick leave and are locked in their workplaces. When workers

³⁴ [Webpage of the International Labour Organisation.](#)

³⁵ [Labour Force Survey data for Montenegro \(Q1 2016\).](#)

decide to leave (change job), they often forfeit the previous month's salary, or receive only the amount officially written in the contract.

FIGURE 22. FORMAL AND INFORMAL EMPLOYMENT BY AGE GROUP IN MACEDONIA, 2015 (STRUCTURE)



Source: Labour Force Survey 2015, State Statistical Office of Macedonia, May 2016.

Estimates based on discrepancies in employment statistics and statistics for contributions suggest that about 11 % of employees in Kosovo work without a valid employment contract. In the opinion of employers in Kosovo, informal employment is triple that figure. The largest percentage is in agriculture, industry, health services and social work etc. According to a survey of employers in Serbia (companies and entrepreneurs) only 1.9 % of employees in their enterprises work without a contract, and only 3.8 % of workers have contracts, but receive some earnings without paying taxes and contributions. This obviously non-transparent result is a great contrast to the evaluation by the same respondents about the behaviour of other employers in the same sector: then it was estimated that 23.9 % of workers had no contracts and that 24.7 % had an employment contract, but received part of their salaries in cash (without taxes and contributions). If we add these two figures together, it turns out that almost half the employees in the formal sector belong to the informal economy, although there is probably an overlap between the two categories.³⁶

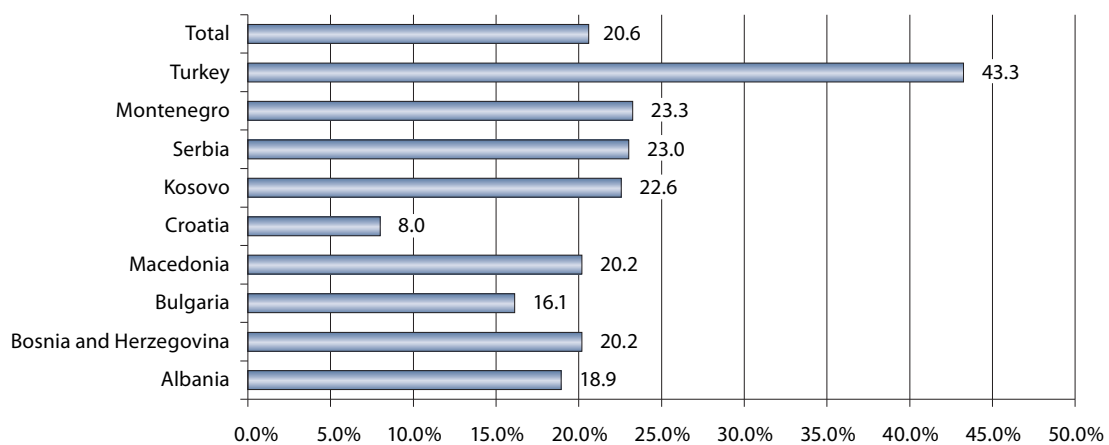
According to the SELDI survey, on average 20 % of wage earners with contracts receive higher salaries (not bonuses) than those written in contracts, with the aim of saving money both for employers and workers at the expense of government revenues. The outliers here are Turkey, with over 40 %, and Croatia, with just 8 %. An earlier study in Macedonia confirmed similar findings – the practice of combined payment of wages in the formal sector, including part in cash (envelope payments) or through short-term service contracts is well developed, so

³⁶ Foundation for the Advancement of Economics (FREN), (2013). *The shadow economy in Serbia: New findings and recommendations for reform*, pp. 70-78.

that it is estimated that one-third of employees are paid according to this mode.³⁷

It is important to distinguish different employment types (self-employed, wage earners, business owners and people on managerial contracts) as their hiding patterns (tax evasion and/or avoidance) are different. For instance, managers may have formal contracts at higher monthly rates for social and health security, but for a reduced time (e.g. an hour per day) and sign additional contracts with reduced taxes on the total amount as if self-employed. In certain cases, managers formally receive larger amounts of money as a proof to tax authorities that they have enough income to afford a certain life-style, but use the money to pay workers envelope wages. Another way of hiding taxes is to claim company expenses, which are in fact personal, and fully accounted for in the books as transactions. Sometimes this method leads to significant budget losses of up to 50 % or more (VAT refund as a company expense plus saved taxes and benefits). Policy makers should study in detail budget losses from different ways of hiding by different groups of people, and compare the expected benefits with the cost of enforcing higher compliance.

FIGURE 23. SHARE OF WAGE EARNERS, WHO RECEIVED HIGHER REMUNERATION THAN IN CONTRACTS (% OF THOSE EMPLOYED IN A MAIN PAID JOB)

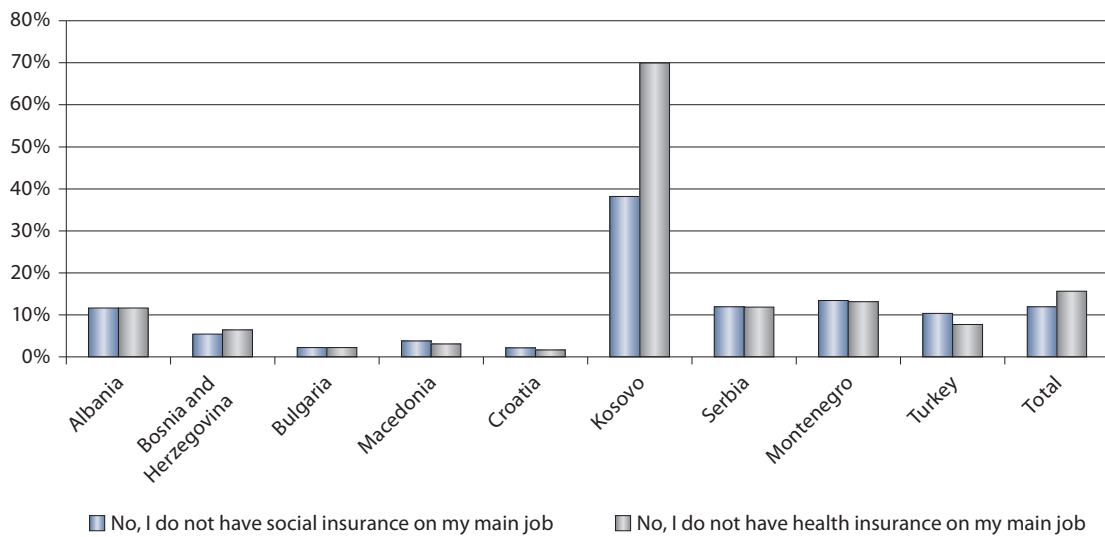


Source: SELDI Hidden Economy Survey, 2016.

On average (not-weighted, whole sample), around 12 % of employees do not have social security and 16 % do not have health insurance on their main job. Kosovo stands out with extremely high rates (38 % and 70 % respectively) due to different pension and health insurance systems. Bulgaria, Macedonia and Croatia show marginal non-compliance below 4 %, again mainly for regulatory reasons (tying wage payments to social and health security and income tax payments). However, in the case of Bulgaria, the banks were important drivers of labour

³⁷ CSD and CRPM, (2014). *Hit and Miss – The Dynamics of Undeclared Labour in Macedonia*, Policy Brief No. 31, p. 11.

FIGURE 24. SHARE OF PEOPLE WITHOUT SOCIAL OR HEALTH SECURITY ON MAIN JOB (% OF THOSE EMPLOYED IN A MAIN PAID JOB)



Source: SELDI Hidden Economy Survey, 2016.

legalisation, as they required formal contracts and social and health security paid at reasonable levels paid in order to grant loans in the early 2000s. An important factor that prevents many SMEs from offering full-fledged labour contracts to employees is the rigidity of labour regulations (especially in Albania, notoriously known for low labour market freedom). As a number of empirical studies have shown,³⁸ rigid labour legislation encourages hidden employment.

The basis for pension and health insurance is in many cases lower than the actual remuneration, attributed to taxes and contributions, but there may be a path dependence factor as well, as in many countries rates are not at all high. Kosovo is again a significant exception. Turkey has an exceptionally high number of people who report having a lower reported pension/health insurance basis, although the tax wedge in Turkey is not exceptionally high at about 37.5 % (Bosnia and Herzegovina, Serbia and Romania have higher social security and the tax wedge is about the same size in Croatia).³⁹ Yet, the overall tax burden in Turkey (sum of personal and corporate taxes, VAT and social security) is the second largest after Croatia in the countries in the study and more than double that of Kosovo. Non-payment of social security contributions usually leads to the loss of the right to social insurance, i.e. pension, health and unemployment insurance,⁴⁰ so workers in the hidden sector are forced to pay for private health services and save for periods of illness or job loss. The opportunity

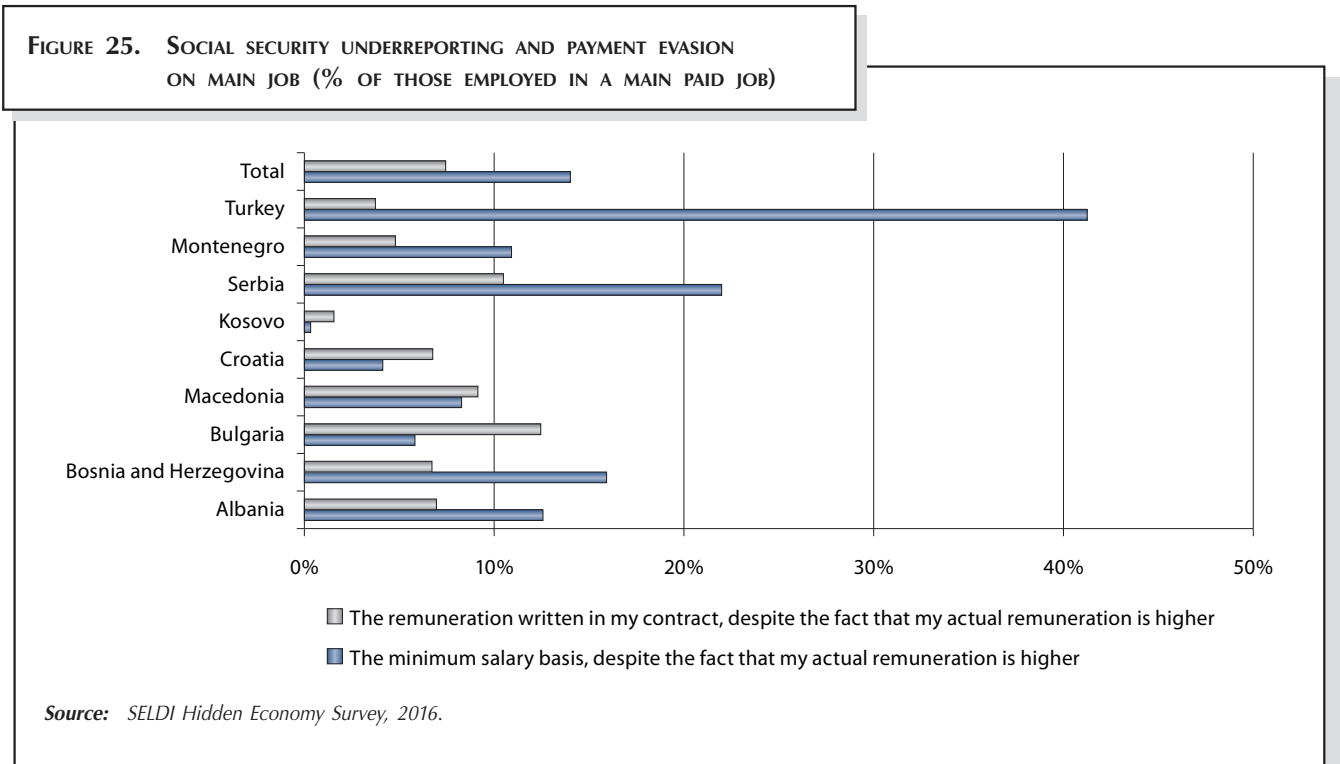
³⁸ S. Djankov and R. Ramalho, (2012). *Employment laws in developing countries*, Journal of Comparative Economics 37:1, 2009; H. Lehmann and A. Muravyev: *Labour Market Institutions and Informality in Transition and Latin American Countries*, University of Bologna – School of Economics, Working Paper DSE N° 854.

³⁹ OECD, (2016). *Taxing Wages*.

⁴⁰ Some health care is usually provided independently of social insurance (children, the elderly etc.).

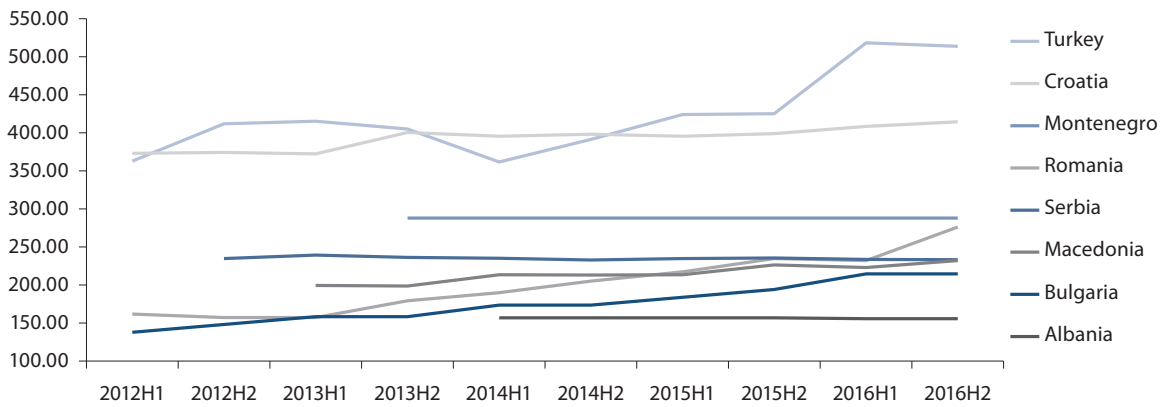
cost of non-payment is lower when pensions and unemployment benefits are low, pension insurance is insecure,⁴¹ unemployment periods are shorter and public health care is inefficient.⁴²

Personal income tax varies from as low as 9 % (flat) in Montenegro to 47.2 % (highest bracket⁴³ in a progressive tax system, on monthly incomes over EUR 1,200) in Croatia. Personal income tax in Albania is also progressive, but the highest threshold is rather low (about EUR 80 per month). All other countries apply flat rates (minimum non-taxable threshold lines may apply). The data shed doubt on expectations that high rates drive hiding, as Croatia, with the highest tax rates, has the lowest hiding rates, while Kosovo, with lowest tax rates, has the highest hiding rates. This contradiction has been pointed out earlier, comparing Nordic countries with South or global South countries, but this time the comparison comes from two very close countries, which were part of the same federation until 25 years ago. A similar comparison of the Czech and Slovak Republics was carried out by Hanousek and Palda⁴⁴ based on a similar population survey in 2000. Czechs evade more and to a greater extent than Slovaks, although taxes in Slovakia stayed higher than in the Czech Republic after their separation. The study attributes the difference to other factors such as income, tax morale and satisfaction with public services.



⁴¹ For instance, in Serbia pensions were nominally reduced by 10+% in 2015.
⁴² For instance, in Serbia and Bulgaria (with the exception of limited treatment) people have to pay for dental services.
⁴³ The lowest rate in Croatia is 12 % and the most widely applied to incomes of between EUR 300 and EUR 1200 is 25 %.
⁴⁴ Hanousek, J. and Palda, F. (2003). Why people evade taxes in the Czech and Slovak Republics: A tale of twins. *The Informal Economy in the EU Accession Countries: Size, Scope, Trends and Challenges to the Process of EU Enlargement*. Sofia: CSD, pp. 139-174.

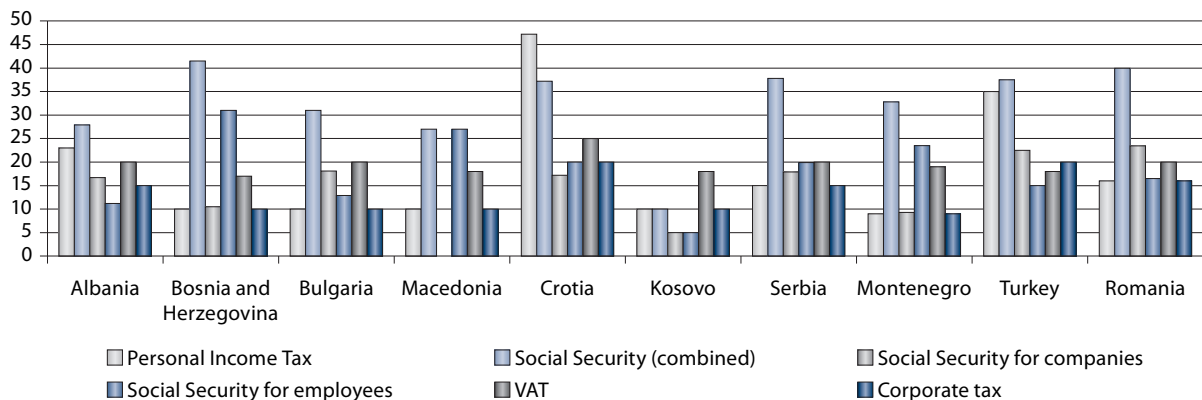
FIGURE 26. MINIMUM WAGE DYNAMICS (2012 – 2016 MEASURED AT THE BEGINNING OF EACH HALF-YEAR) (EUR)



Source: Eurostat, 2016.

In Serbia, the ratio of the minimum to the average wage was 50.1 % in February 2016, which is very high in international comparisons. This level had already been reached by 2012, during parliamentary elections. It was a government concession to the unions in order to ensure political support for the ruling coalition, which was certainly a form of corruption or abuse of government authority in order to acquire political benefit. The over-high minimum wage inevitably had negative consequences. It resulted in a reduction in the demand for low-skilled labour and led to the spread of non-compliance with the Minimum Wage Act. The former effect led to a decline in formal and an increase in hidden employment, while the latter led to violations of legal regulations and moral decay.

FIGURE 27. SELECTED TAX RATES FOR SOUTHEAST EUROPE, 2015 (%)



Source: Trading Economics, tradingeconomics.com

The high minimum wage and accompanying high minimum base for social contributions in Serbia, combined with means-tested benefits aimed at poor households, prevent low earning workers in the hidden economy from finding an economic rationale for legalising their work. If they decide to do so, they must give up a significant amount of their salaries to move into the formal sector. So, it is unlikely that the value of the newly-acquired social security transfers and other similar benefits, such as protective labour legislation, will overcome these high implicit costs.⁴⁵

⁴⁵ J. Koettl, (2010). *Does Formal Work Pay in Serbia? The Role of Labour Taxes and Social Benefit Design in Providing Disincentives for Formal Work*, Technical Note, World Bank, p. 9.

CHAPTER IV: TAX COMPLIANCE AND TAX AVOIDANCE

Ever since taxes were invented to fund government operations, people and firms have looked for ways to avoid paying them wholly or partially, mainly because the expected marginal usefulness of public goods and services provided and consumed, minus the cost of the risk of being caught in noncompliance, is lower than the marginal alternative cost of private gain/benefit. This is the microeconomic approach to understanding tax compliance, avoidance and evasion. The behaviourist explanation looks at institutional design, social routine and expectations. Revenue researchers try to measure the tax gap,⁴⁶ which is the difference between the amounts due, if all individuals and companies are compliant with the law and its spirit, and those actually paid. There are various methodologies to assess the tax gap and its components, such as the gross tax gap (based on voluntary compliance) and net tax gap (accounting for the cost of enforcing all micro-payments in an economic value added chain).

The only available, though poorly documented and academically doubtful tax gap estimate (for the fiscal years 2011 and 2012) based on Schneider's Shadow Economy estimates for the Western Balkan countries, was made by Harremi.⁴⁷ A subsequent consultancy report by AL-Tax Centre from Albania,⁴⁸ which resembles the former in methodology, but with no direct reference to it, presented its second tax gap assessments in the region for the fiscal year 2013. Macedonia tops the group with a gross tax gap of 29.2 % of GDP, but due to differences in the cost of enforcement and possibly the tax refund system, three countries are at the top in terms of net tax gaps – Macedonia, Montenegro and Kosovo, with 25.9 % of GDP.

More thoroughly executed estimates are available for the VAT gap covering the EU-26 countries (EU-28 without Cyprus and Croatia)⁴⁹ and the FISCALIS report (14 countries).⁵⁰ The total EU-26 VAT gap for the period 2000 – 2011 was estimated at 1.2 % of GDP, while the average (non-adjusted arithmetic mean) was 1.6 %. The highest country average for the period was Romania with 5.4 %, rising to 7.9 % at the end of period. Bulgaria was performing relatively well with 1.8 % and 1.6 %, significantly lower than Greece with 3 % and 4.7 %.

Next best to detailed assessments of overall (net and gross) and specific (per type of) tax gaps and the underlying sociology of tax avoidance are

⁴⁶ [European Commission, \(2016\). *The Concept of Tax Gaps. Report on VAT Tax Gap Estimations.*](#)

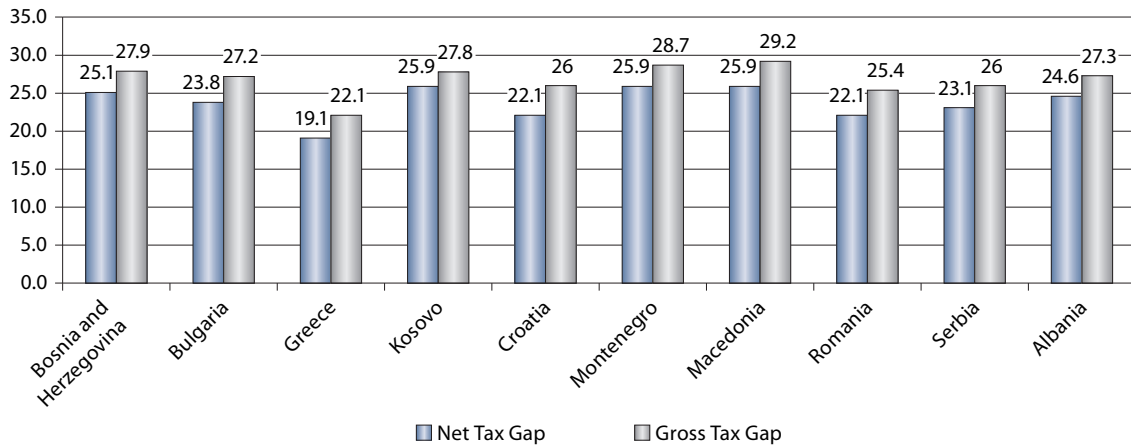
⁴⁷ Harremi, M., (2014). A simple analysis of the tax gap Balkan region. *Mediterranean Journal of Social Sciences*, 5(19), p. 365.

⁴⁸ [AL-Tax Centre \(Albanian Taxation Association\), \(2014\).](#)

⁴⁹ [European Commission, TAXUD, \(2013\). *Study to quantify and analyse the VAT Gap in the EU-27 Member States.*](#)

⁵⁰ [European Commission, \(2016\). *The Concept of Tax Gaps. Report on VAT Tax Gap Estimations.*](#)

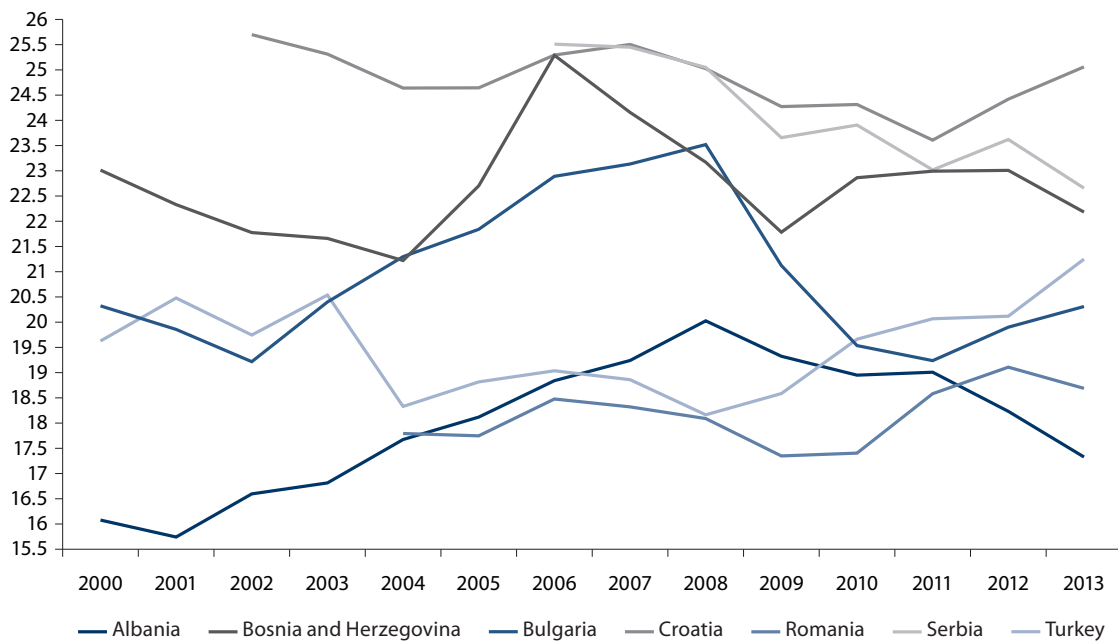
FIGURE 28. TAX GAP ESTIMATES (2013)
(% OF TAXES OWED TO THE GOVERNMENT)



Source: AL-Tax Centre, Albania.

time series of contributions of different taxes controlled according to the size of the economy through GDP. These data provide meaningful insights into setting policy preferences for sequencing enforcement measures, in order to balance costs and benefits.

FIGURE 29. TAX REVENUE AS A PERCENTAGE OF GDP



Source: World Revenue Longitudinal Data (World) (07/13/2015).

Total tax revenues in the analysed countries in Southeast Europe ranged between 17.5 % and 25.5 % of GDP, which is the bracket for the Czech Republic, Greece, Germany, the Netherlands, Portugal, Spain and the United States, with France the next highest (26 %-28 %). However, the relative proportion of different taxes suggests a diverging pattern between Southeast European countries and the rest, with society paying relatively more than business. This may be due to higher tax gaps on personal income and social security in relation to the VAT gap (which is the conclusion from comparing the Bulgarian net tax gap of 23.8 % according to AI Tax and its less than 2 % VAT tax gap according to the Fiscalis report), but also because companies are better prepared to avoid taxes, while individuals mostly evade them.

Tax evasion, which is “the unlawful and intentional non-payment or avoidance of tax owed” differs significantly from *tax avoidance* which consists of “using legal means to reduce the amount of taxes owed” (Green, 2008).⁵¹ Through avoidance, entities try to reduce taxes paid without changing the economic activity, by arranging it differently, for instance, changing the legal status of a business ‘from a C corporation to an S corporation’ while keeping the recorded economic activity (Slemrod and Yitzhaki, 2002).⁵² Another example is charging corporate accounts for personal luxury purchases (houses as offices, top end cars as company cars with VAT refunds) and so on. Thus, the distinguishing factor between *tax evasion* and *tax avoidance* is legality, and it is hard to draw a clear line dividing the two, as detailed investigation is needed in order to judge whether purchases are genuine restructuring and other transactions, or avoidance mechanisms.

4.1. Business perspectives

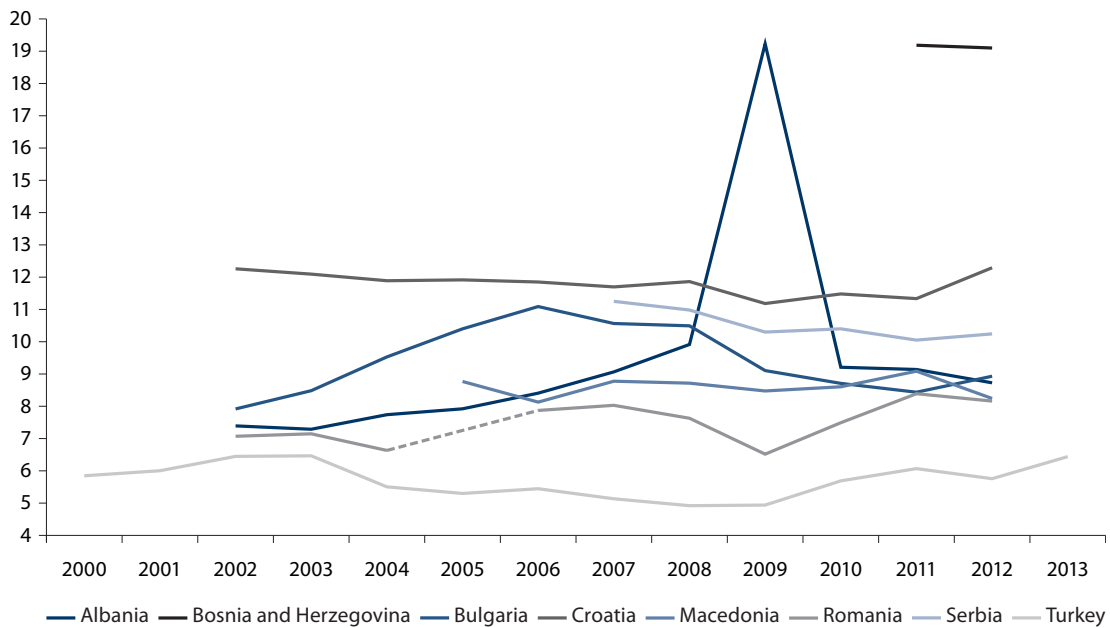
VAT is an important factor in overall tax revenues in all countries whose tax systems include VAT. In Bosnia and Herzegovina, as much as 83 % of tax revenues in 2011 and 2012 were due to VAT, and in Albania and Croatia, VAT accounts for half of revenues. Turkey’s government depends less on VAT, which contributed only 28.6 % in 2012. VAT rates are between 17 % and 20 % across the analysed countries except for Croatia, where it is 25 %. Reduced rates of VAT apply in many countries (5 % in Macedonia, 7 % in Montenegro, 10 % in Croatia and Serbia, 9 % in Bulgaria, and down to 0 % for specific groups of products and services and/or depending on the origin of financing).

VAT-related losses occur either through conventional, non-organised tax evasion (not issuing taxable receipts, underreporting sales of actual products and services, or overvaluing spending on inputs) or through more organised abuse of the system involving fictitious transactions with absent or insolvent traders (i.e. carousel fraud). The former involves one (i.e. retail without tax receipts) or a maximum of two parties (business to business, when manipulating the amount on invoices) during transactions.

⁵¹ Green, Stuart P. (2009). What Is Wrong with Tax Evasion? *Houston Business and Tax Law Journal*, Forthcoming.

⁵² Slemrod, Joel, and Shlomo Yitzhaki, (2002). Tax Avoidance, Evasion, and Administration in *Handbook of Public Economics*, ed. Alan J. Auerbach and Martin S. Feldstein. Volume 3, pp. 1423-70. Amsterdam: Elsevier B.V.

FIGURE 30. VAT REVENUE AS A PERCENTAGE OF GDP

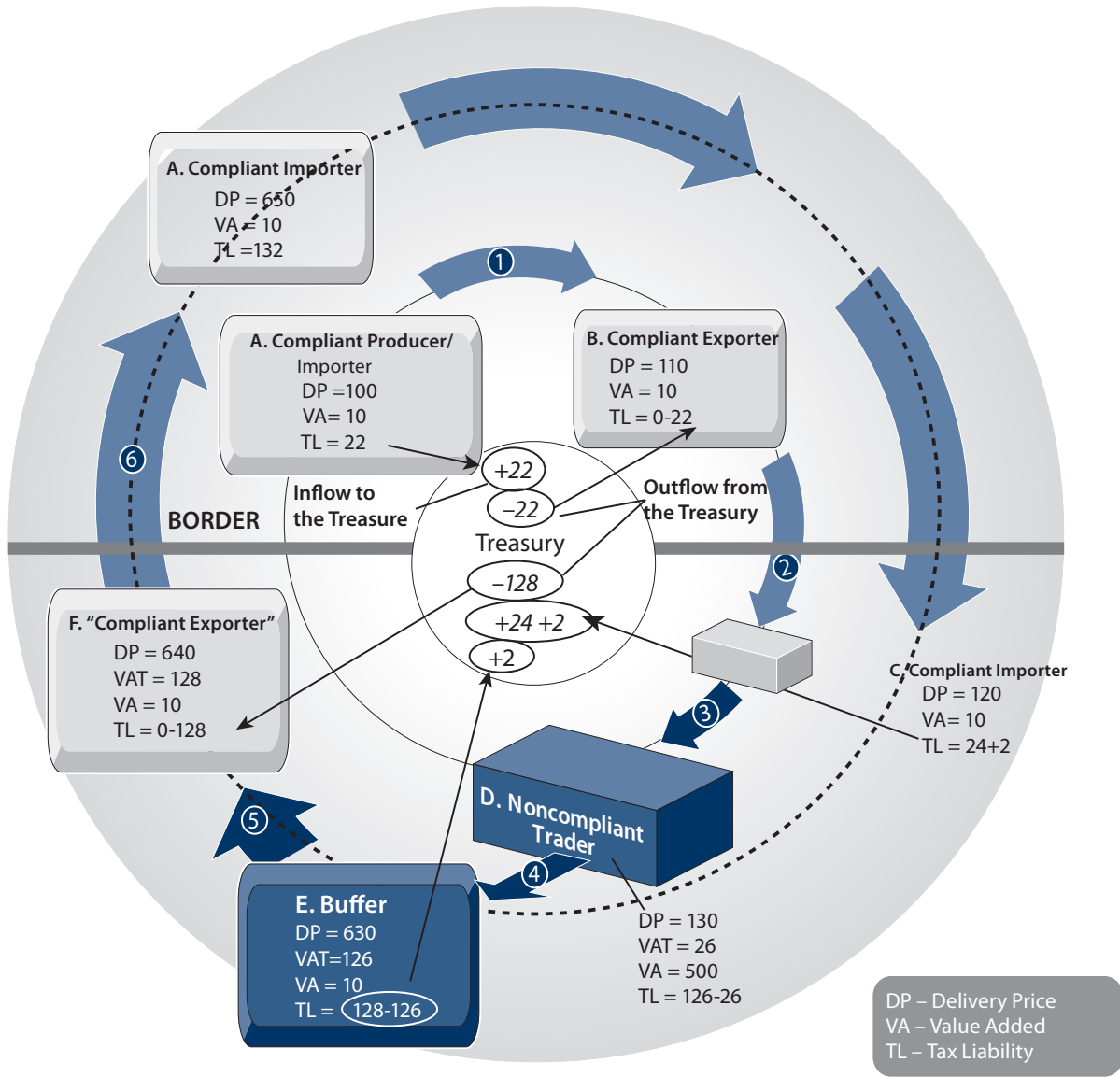


Source: World Revenue Longitudinal Data (World) (07/13/2015).

The latter involves complex networks including real businesses (i.e. real producers, logistical companies, accountants’ offices) and zero assets companies owned by poor, uneducated or even convicted people, among whom multistage paper transactions are made. From a fiscal perspective, the former does not pay taxes to the treasury, while the second actually results in a net cash outflow from the treasury. VAT evasion happens often and on a small transaction base, while siphoning VAT credit is rarer, but involves significant amounts. Evasion usually happens without the knowledge of tax authorities and there is extremely low probability of getting caught on the spot, or a low to moderate probability of being traced through surprise inspections. Fines or bribes paid are significantly less than the usual benefits of withholding taxes. Carousel fraud, on the other hand, relies on internal collaborators from the tax authorities and customs administration (fictitious exports), who deliberately exercise low control, which is hard to prove without surveillance and special operations. When fraud is detected after a significant time, the judicial system is unable to penalize the real organisers and the treasury cannot recoup any losses.

VAT evasion is widespread in all Western Balkan countries where an owner is self-employed, works in a company and knows the clients, for example hairdressing, home decoration, building contractors working for private customers, car repairs, green/fruit markets, house-keeping and child-minding, private language and music lessons, and private tutoring. Small grocery shops can buy from wholesale traders or deliver to pitch traders without proper invoices and VAT, and sell without keeping any

FIGURE 31. CAROUSEL TAX FRAUD MODEL



Source: CSD, *Corruption and Tax Compliance, Challenges to Tax Policy and Administration*, 2005.

records. Often the physical products bought this way come from fictitious exports – the goods are exported on paper and the VAT redeemed through someone in the chain. Sometimes, of course, the customer is aware that the sale is being made without VAT, and may share in some of the ‘gains’. In many Balkan countries, especially in Bulgaria and Albania most recently, businesses are required by tax authorities to ask customers to take receipts when leaving stores, the threat being that both will be penalised if inspection discovers non-compliance. Riinvest (2013) results show that large companies tend to evade less, while smaller firms are more prone to evasive behaviour. This correlation is in line with general theoretical expectations and previous empirical investigation conducted

in the field (see for instance Nurtegin, 2008),⁵³ given the presence of two important factors. First, larger firms are usually more consolidated, so they have fewer intentions of gaining competitive advantages by engaging in risky illegal activities. Second, given the limited resources of tax administrations, and the need to optimize these resources in line with maximizing tax revenues, tax officers usually target larger firms, where the bulk of taxes are collected.

Hiding sales is far more prompted by hiding VAT, as it is higher and due quicker than tax on profit. Small firms are also usually tighter on cash. If thresholds for mandatory registration exist (as in Macedonia – around EUR 16,000, Bulgaria – EUR 25,000 and Serbia – around EUR 65,000), small entrepreneurs tend to operate more than one legal company, one not registered for VAT, so they can always issue invoices without VAT. However, hiding some sales has another important purpose – guaranteeing cash for ‘envelope’ wages, which is a widespread practice, as shown by data from the previous two chapters. Although there are more options to find this cash, claiming false invoices or purchases for personal use formally paid the owner or management, then used to provide ‘envelope’ wages, the most widely used mechanism is to pay hidden wages through hidden revenues from unreported sales. Of course, all these actions lead to reductions in paying profit tax, but this is a secondary effect rather than the main aim (if the profit tax rate is sufficiently low). Moreover, in some countries (Albania, Bosnia and Herzegovina, Bulgaria, Montenegro) it is cheaper and easier for small entrepreneurs (depending on earnings) to pay the profit tax and take the profit, rather than receiving a salary (due to the requirement of paying monthly social security payments).

According to the CRPM/CSD report *Monitoring the Hidden Economy in Macedonia: Trends and Policy Options*,⁵⁴ less than half (46.7 %) the respondents reported always receiving receipts when buying groceries, while a third of businesses reported that ‘manipulating VAT’ and ‘employing accounting tricks in order to pay lower taxes happened in their sectors.’⁵⁵

In Albania, according to a survey among 400 businesses by the Albanian National Business Forum, the most frequent hidden economy practices are paying employees in cash and having employees without contracts (National Business Forum, 2016).⁵⁶ Even more alarming is the fact that 10 % of companies believe that most other companies are siphoning off VAT, and 26 % evaluate this practice as occurring “often”. The fact that 14 % of companies believe that others ‘always’ or ‘often’ import goods illegally indicates substantial problems with the customs administration. The survey seemed to provide legitimacy for government intervention against the hidden economy in 2015, targeting mainly unregistered businesses

⁵³ Nurtegin, Kanybek D, (2008). Determinants of Business Tax Compliance, *Journal of Economic Analysis & Policy*, Berlin.

⁵⁴ Releva, A. Shurkov, E. (2014). *Monitoring the Hidden Economy in Macedonia: Trends and Policy Options*. Centre for Research and Policy Making, Skopje.

⁵⁵ Shurkov, E., Mickova, R.A. (2014). *Hunting the Shadows – Tax Evasion Dynamics in Macedonia*. Policy Brief No. 33. Centre for Research and Policy Making: Skopje.

⁵⁶ [National Business Forum, \(2016\). National Business Forum Perspectives on the Issue of Informality in Albania.](#)

and unregistered employees as the most widespread manifestations of hidden economy.

FIGURE 32. FREQUENCY OF DIFFERENT TYPES OF HIDING BEHAVIOUR BY ALBANIAN FIRMS (%)



Source: National Business Forum (2016).

Recognising the problem of the hidden economy, the government of Albania undertook energetic actions in late 2015 (see box). It is expected that the programme will continue in 2016 with initiatives to strengthen the administrative capacities of tax-related institutions, including planning a reform with tax devices and electronic tax processes (e-taxing). From a sectoral point of view, the government will target evasion of excise duties. Albanian excise revenues as a share of GDP (less than 3 %) were the smallest among the SELDI countries in 2002 – 2007 and 2010 – 2012 (just ahead of Bosnia and Herzegovina, which has deteriorated since 2004).

BOX 1. COMBATING THE HIDDEN ECONOMY LEADS TO SKYROCKET START-UPS AND INCREASED EMPLOYMENT

The government of Albania (partnered by the Ministry of Finance and the Ministry of Economic Development, Trade, Tourism and Entrepreneurship) launched a complex initiative against the hidden economy in September 2015. It had immediate positive effects, but national experts doubt its long-term effect, as it does not target the corrupt nexus of politicians and businesses.^{57,58,59} Persistent campaigns

⁵⁷ Bota Sot, (2015).

⁵⁸ Gazeta Shqiptare, (2015).

⁵⁹ Scan TV, (2015).

Box 1. COMBATING THE HIDDEN ECONOMY LEADS TO SKYROCKET START-UPS AND INCREASED EMPLOYMENT (CONTINUED)

were conducted over a period of more than five months, and included business inspections, penalties, and administrative and punitive measures for businesses and clients in order to reduce informal practices and the hidden economy. The General Tax Directorate increased inspections significantly in registered businesses and identified unregistered businesses. The campaign was announced two months before the field visits took place, and all unregistered businesses were invited to the National Registration Centre, as fully-fledged undeclared business activities would be subject to higher fines and penalties. By September 2015, the number of registered businesses in the National Registration Centre was 830 % higher than in September 2014.⁶⁰ There was a parallel overall increase of 137 %⁶¹ in the number of registered employees in the social and health insurance system for the year 2015. By November 2015, the General Tax Directorate had performed 103,000 inspections using 500 groups of inspectors.⁶² Yet the government was surprised to find these actions did not stimulate an increase in budget revenues. The process was not welcomed by businesses and civil society, as it seemed mostly focused on micro and small businesses, which composed only 5-10 % of GDP.^{63,64} Businesses were subject to repeated inspections, sometimes just fishing for bribes. The Tax Directorate presented several criteria under which the risk analysis was conducted and businesses selected for inspections. It is still not clear whether algorithms were applied from the beginning only in Tirana or throughout the country. High penalties and tough administrative measures were issued to businesses, upsetting many people.

Source: Albanian Centre for Economic Research.

Excise goods, especially tobacco and alcohol, along with some of the trading infrastructure (duty free shops) constitute a major risk not just to public health, but also to the health of the state financial system. In 2011, Bulgaria's excise duties contributed 26 % to tax revenues. Bulgaria, Serbia and Turkey have more than 5 % of GDP in excise revenue. One illustration of excise goods contributing significantly to the hidden economy is tobacco. Serbia, through following the trend in all countries to increase tobacco excise tax, experienced a significant increase in tobacco-smuggling in 2013. In June 2016, the police seized 100 kg of cut tobacco⁶⁵ in Ruma, while in the town of Novi Sad alone, more than 4 tonnes of cut tobacco were seized during 2015.⁶⁶ In Macedonia, around 1,500 tonnes were confiscated in the first five months of 2015, an increase of almost 10 times since 2014.⁶⁷ Countries like Albania, Bosnia and Herzegovina, Kosovo and Macedonia, where similar smoking patterns are found as in Bulgaria and Serbia, are seriously underperforming in terms of excise duty collections on tobacco and other goods, and need immediate reform to increase them. Furthermore, according to the

⁶⁰ Shekulli, MoF, (2015). *Results of the Action against Informality*.

⁶¹ Monitor.al, (2015).

⁶² Shqiptarja.com, (2015).

⁶³ Gazeta Shqip, (2015). *The Informal Economy and Development*.

⁶⁴ Gazeta Shqiptar, Ballkan Web, (2015). *The Fiscal Pyramid and the Four Benefiting Channels of the Big Businesses*.

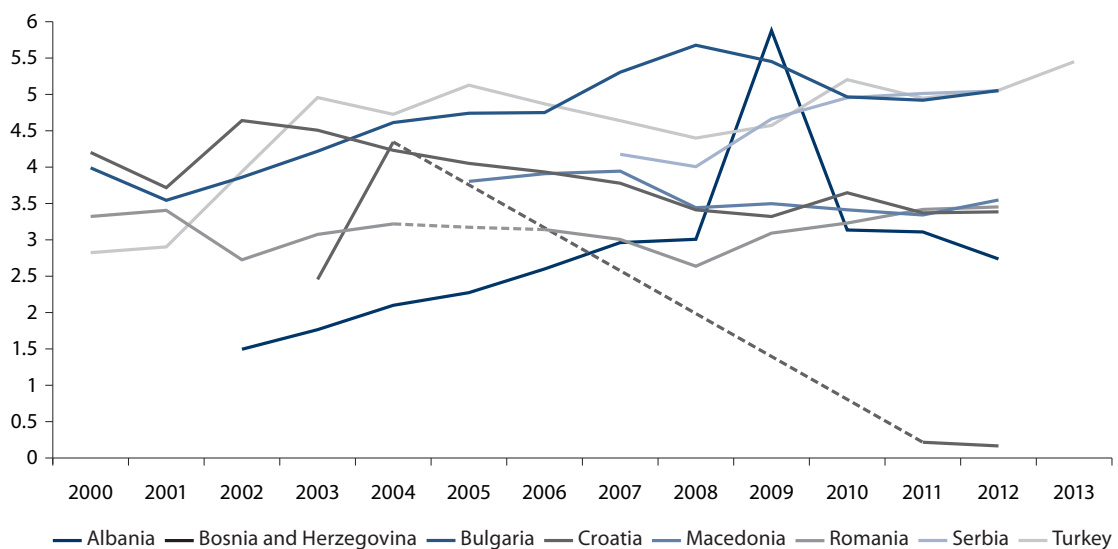
⁶⁵ Kurir, AKCIJA U RUMI: Zaplenjeno 100 kilograma duvana, 17.06.2016.

⁶⁶ 021, Šverc duvana "cveta" u Novom Sadu i drugim gradovima Vojvodine, 25.12.2015.

⁶⁷ Independent, (2015). *Roads of Tobacco Smugglers Went through Serbia and Croatia*.

tobacco industry, there is an important route to Europe through these countries, so it does not just affect their internal market. The problem with tobacco-smuggling is more than uncollected revenue. Organised crime networks learn quickly that networks which can smuggle packs of cigarettes can make higher returns on investment by smuggling heroin and cocaine. This is exactly what has happened in Montenegro.⁶⁸ Today, smuggling channels are even more pernicious, as they may be involved in human trafficking and arms smuggling, leading to imports of terrorism in Europe.

FIGURE 33. EXCISE TAX REVENUE AS A PERCENTAGE OF GDP



Source: World Revenue Longitudinal Data (World) (07/13/2015).

4.2. Corruption practices and efficiency of control

There is an obvious correlation between corruption, tax evasion and fraud, where causation works in both directions. The overall level of corruption in a country affects the individual’s readiness to engage in illegal behaviour such as tax evasion. Slemrod (2003)⁶⁹ shows that tax evasion is affected by the individual’s perceptions of government behaviour and performance. A variety of factors are considered to contribute directly to corruption in tax and customs administrations. These include the degree of discretion given to tax and customs officials, complexity of tax procedures, lack of monitoring, commitment of political leadership to fight corruption, and the overall environment in the public sector.

Tax and customs officers are usually assigned to a particular geographical area of operations. To a particular taxpayer (company), the tax/customs

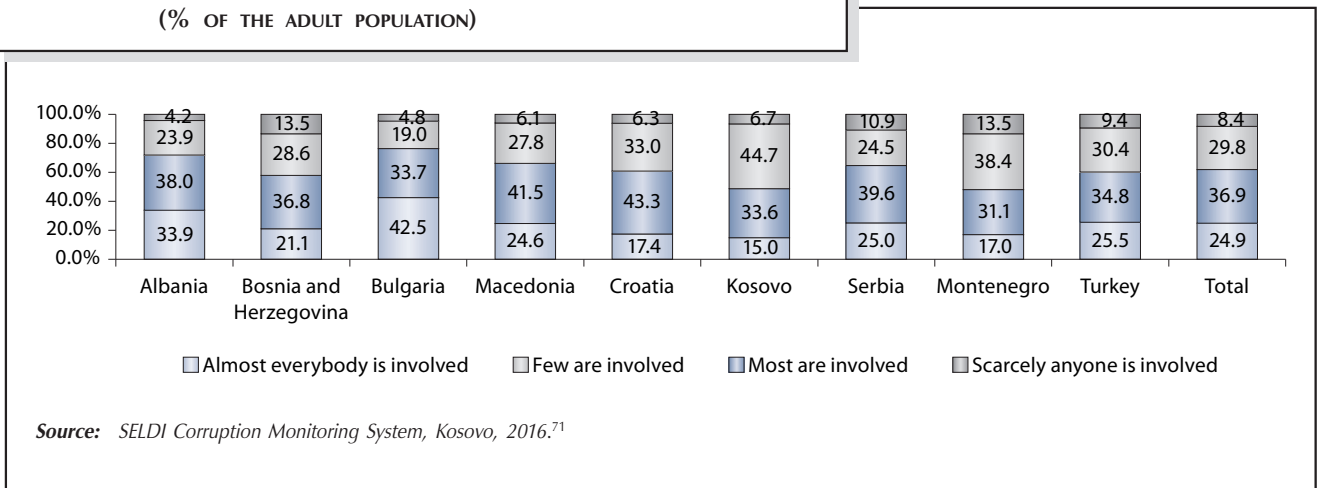
⁶⁸ European Parliament, (2012). *New Trends in the Expansion of Western Balkan Organized Crime*.

⁶⁹ Slemrod, Joel, (2003). *The Role of Misconceptions in Support for Regressive Tax Reform*.

officer is the tax/customs department. Full discretion gives tax/customs officers the opportunity to create relationships with companies (taxpayers) that often end in corrupt acts. According to Fjeldstad (2005),⁷⁰ the greater the discretion of the tax/customs officer, the greater the scope to interpret tax rules to the client’s benefit in return for various favours. Cases exist in Bulgaria where whole teams of custom officers at border crossing points have been arrested and dismissed for corruption. Despite the discovery of large amounts of unexplained cash, and huge discrepancies between these officers’ income and property, or that of their family members, the judiciary has never able to sentence a whole organised group effectively.

A total of 25 % of all citizens of SELDI countries think almost all tax officers are involved in corruption, and 37 % think that most are involved. Kosovo seems the most optimistic in terms of corruption in tax administration. Customs officers are generally assessed similarly to tax authorities, with the exceptions of Albania and Bulgaria, where people are far more concerned with corruption in the customs administration.

FIGURE 34. CORRUPTION PERCEPTION OF TAX AUTHORITY (% OF THE ADULT POPULATION)



However, due to a lack of resources (mainly human resources), it is difficult to monitor tax/customs officers and hold them accountable for their actions. The absence of monitoring increases the likelihood of tax/customs officers being involved in corrupt practices. In a recent study conducted by Riinvest (2013) in Kosovo, almost 63 % of companies were certain that if they decided to evade taxes they could do so easily without getting caught, presumably relying on bribing the tax officer doing the inspection. The situation is very similar in other Balkan countries.

The tax literature acknowledges that there is a positive impact of fine rates on tax compliance (i.e. the harsher the penalties, the higher the risk of illegal behaviour). Understandably, high fines may backfire if businesses consider penalties unreasonable; they also make corruption more likely, as is often the case with heavy regulation.

⁷⁰ Fjeldstad, Odd-Helge, (2005). *Corruption in Tax Administration: Lessons from Institutional Reforms in Uganda*.

⁷¹ SELDI, (2016). [Corruption Monitoring System survey data](#).

Over the course of 2013, Croatia increased its monitoring of cash transactions by introducing online cash registers (the ‘fiscalisation project’), which had an obvious effect in terms of higher tax levels collected compared to 2012 (as a share of GDP). In January 2014, a simplified tax return form was introduced, replacing the previous five forms, and allowing real-time information on tax payments to be sent directly to the tax administration (European Commission Report, 2014).⁷² Lastly, following the passing of a new Tax Administration Act in December 2014, the structure of regional and local offices was rationalised. With this new structure, there are now six instead of the previous twenty regional offices and the Large Taxpayers Office is separate office, with the number of local offices reduced from 124 to 54 (OECD, 2015).⁷³

In Macedonia, data from reports from the Public Revenue Office’s hot-line for violations showed that tax evasion and non-issuance of cash register receipts were the leading types (78 % of all reports). Since 2014, Macedonia has also applied a measure that establishes direct connections between fiscal cash registers that gather transaction data in real time at the point-of-sale, and the Public Revenue Office (CRPM and CSD, 2014).

While Bulgaria (currently and in the past), Croatia and Macedonia (recently) and Albania (planned) focus on technology, Montenegro and Kosovo focus on raising awareness about public finance and tax compliance through various campaigns. While campaigns may be of some value, they can only be complementary measures. Even technology cannot achieve much if a tax administration does not plan and implement effective inspections and monitoring of data provided. The capacity of the control system, including its ability to perform due risk analyses and profiling samples for inspection, is well substantiated by data in Turkey, and similar calculations have been already performed for Bulgaria.⁷⁴

The Tax Auditing Service (TAS) in Turkey is badly understaffed (a total of 9,205 people, or 0.6 per 1,000 population at the end of 2015) while this figure is 1.3 for France and 1.5 for the United Kingdom. Thus, the TAS can perform only a limited number of inspections and investigations, and companies know that the probability of getting caught randomly is minimal, so they are more prone to under-report or over-report their accounts in order to minimize their tax burden. Moreover, there are many not registered businesses, as shown earlier in the report.

The tax investigation results indicate that the difference between the true base and declared base is approximately 46.7 billion TL and the total tax to reinvestigate amounts to 9.8 billion TL. The total penalties due to be paid by tax evaders is 18.8 billion TL. The biggest discrepancy between the declared base and true base is in VAT (Value Added Tax), followed by corporate tax. The mathematically estimated penalty is just EUR 2,265, so rationally, if a person is hiding more, they should be prepared for the risk. Unless the TAS (and other tax authorities in Southeast Europe)

⁷² [European Commission, \(2014\). *Convergence Report*.](#)

⁷³ [OECD, \(2015\). *Tax Administration 2015 – Comparative information on OECD and other advanced and emerging economies*.](#)

⁷⁴ [CSD, \(2005\). *Corruption and Tax Compliance, Challenges to Tax Policy and Administration*.](#)

implements sound risk assessment, published and known to evaders, tax payers are not likely to change their attitudes and tendency to evade. A further pro-evasion characteristic of the policy environment is that very often, tax amnesty laws are passed, enabling taxpayers to restructure previous tax debts (the latest is ACT 6552, dated 11 September 2014). Debt is rescheduled after default interest and penalties are written off within the scope of this law. Such amnesties create a negative effect, since those who abide by the tax laws feel that evaders gain unfairly.

TABLE 7. TAX INVESTIGATION OF TAX PAYERS IN TURKEY

Years	Number of tax payers*	Number of taxpayers investigated	Investigation ratio
2013	2,460,281	71,352	2.90%
2014	2,472,658	55,284	2.24%
2015	2,527,084	58,676	2.32%

* Income and corporate tax.

Source: VDK Faaliyet Raporu 2015 Table 19.

**TABLE 8. TAX INVESTIGATION RESULTS WITH REGARD TO TAX TYPE
(1000 TL = EUR 304.3)**

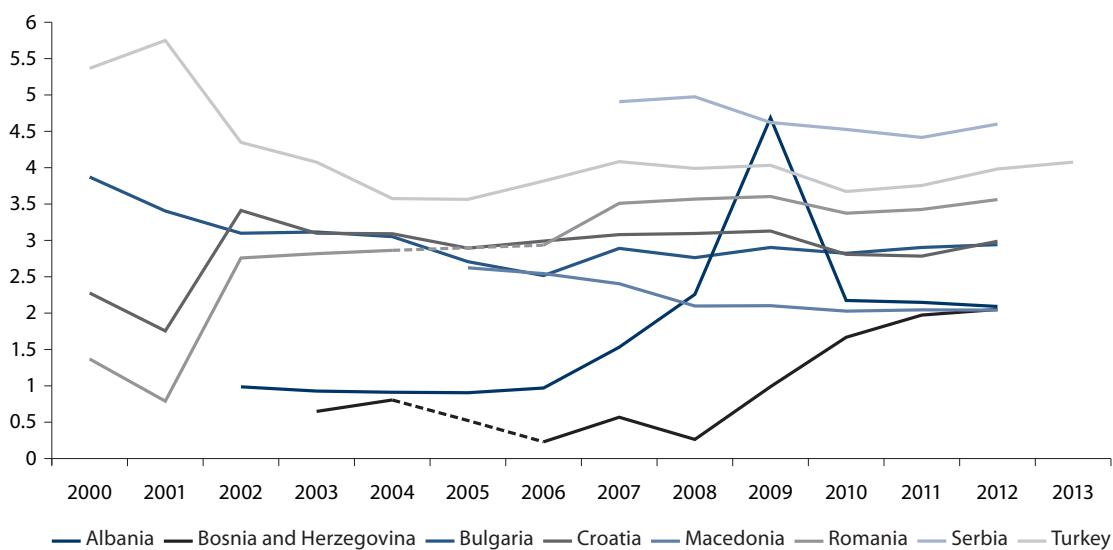
Tax type	Base Difference (TL)	Tax amount to reinvestigate (TL)	Penalty (TL)
Corporate tax	5,721,126,300	882,807,654	1,539,588,634
Corporate tax (transitory)	8,247,413,332	688,885,406	988,481,872
Income tax	477,830,515	146,704,285	267,338,801
Income tax (transitory)	728,880,855	59,758,994	83,018,947
VAT	7,277,771,008	5,227,813,584	11,601,867,902
Bank and insurance tran. tax	3,060,606,206	155,262,020	185,344,151
Excise tax	361,759,435	1,261,294,944	2,584,748,238
Stamp duty	11,158,719,400	46,451,701	48,127,689
Income tax (withheld)	3,594,105,473	418,115,608	475,060,192
Corporate tax (withheld)	570,998,366	63,369,042	92,038,347
Other taxes	5,550,770,223	853,536,745	977,467,856
Total	46,749,981,122	9,803,999,983	18,843,082,627

Source: VDK Faaliyet Raporu 2015 Table 20.

4.3. Citizens' Perspectives

The country with the highest share of revenues from income tax as a share of GDP is Denmark (26.37 % in 2013 – an all-time high since 1990). It has a fairly complicated tax system, with gross tax at 8 % applied to all income without a threshold. Then, progressive rates (5.83 % and 15 % apply with the minimum threshold untaxed), and flat local income tax rates (23 %-28 %) are applied accumulatively. Until recently there was an additional health tax at a declining rate, which will be abolished in 2019. Various allowances apply to determine taxable income, including commuting costs and participation in trade unions. In some cases, taxes can rise to as much as 57 % of gross income. Moreover, VAT is at the rate of 25 %. Yet, despite all these high nominal and effective tax rates, and the complexity of the tax system, Danish citizens seem to be paying sufficient taxes. The VAT gap of 1.1 % of GDP is lower than the EU-26 average.⁷⁵ Obviously, Danes receive public services for their money, which they value (the carrot) and their tax enforcement system is very effective (the stick).

FIGURE 35. PERSONAL INCOME TAX REVENUE AS A SHARE OF GDP



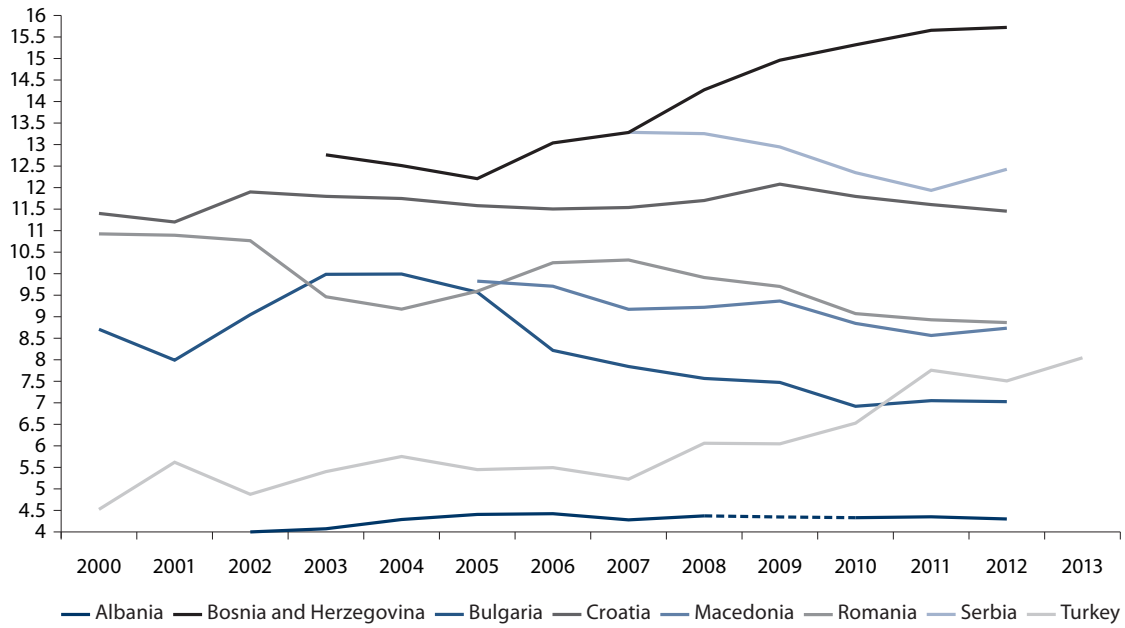
Source: World Revenue Longitudinal Data (World) (07/13/2015).

People in Southwest Europe paid between 2.05 % (Macedonia and Bosnia and Herzegovina) and 4.61 % (Serbia) in personal income tax as a share of GDP in 2012. On average, this is just 3 %, four times less than Lithuania and Italy and half that of Portugal. Based only on this data, it could be argued that there is significant under-reporting of income (salaries or self-employed earnings) and related to that, social security. While the difference between countries in income tax terms is only 2.56 %, social security systems differ substantially. The lowest level

⁷⁵ European Commission, TAXUD (2013), *Study to Quantify and Analyse the VAT Gap in the EU-27 Member States*.

of funding is in Albania (around 4 % of GDP) and the highest in Bosnia and Herzegovina (around 16 % of GDP). The country ranking corresponds well to the social security rates paid by those in employment – 11.2 % in Albania and up to 31 % in Bosnia and Herzegovina on taxable income.

FIGURE 36. SOCIAL SECURITY CONTRIBUTIONS AS A SHARE OF GDP



Source: World Revenue Longitudinal Data (World) (07/13/2015).

CHAPTER V: THE BUSINESS ENVIRONMENT

The density of businesses compared to OECD countries is relatively high, 10 times higher on average (2.08 for the six countries, compared with 0.27 in 2012 and 0.20 in 2013). Bosnia and Herzegovina and Kosovo are at the bottom, while Macedonia, Montenegro and Albania are at the top. The increased ratio for Albania in 2015 is due to mass outreach by the Albanian government and aggressive inspections for legalisation compliance. Albania and Kosovo have fallen in the “Doing Business” 2016 ranking, an aggregate assessment of the business environment, while Bosnia and Herzegovina, Montenegro, Macedonia and Serbia have improved their positions. Deterioration, or improvement, was due to public-private institutional interplay.

TABLE 9. DATA ON BUSINESS ACTIVITY IN SEE COUNTRIES

Country/ Indicator	ALB		BiH		KSV		MKD		MNE		SRB	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
Population	2,894,475	2,886,026	3,843,126	3,843,126	1,823,149	-	2,067,471 ⁷⁶	-	620,029 ⁷⁷	620,029 ⁷⁸	7,129,428	-
No. of legal entities/ companies	112,537 ⁷⁹	152,288	60,983 ⁸⁰	34,586 ⁸¹	31,921 ⁸²	-	67,545 ⁸³	70,139 ⁸⁴	23,308 ⁸⁵	25,955 ⁸⁶	86,996 ⁸⁷	-
No. of new businesses ^{88,89}	17,377	-	2,192	-	9,404	9,833	7,161	-	2,901	2,647	8,021	-
No. of companies/ 100 citizens	3.89	5.27	1.59	0.9	1.75	-	3.26	-	3.75	4.18	-	-

Source: National Statistical Offices.

⁷⁶ Republic of Macedonia, State Statistical Office (2016).

⁷⁷ MONSTAT, (2011 census).

⁷⁸ MONSTAT, (2011 census).

⁷⁹ INSTAT, (2014).

⁸⁰ Statistical Agency of Bosnia and Herzegovina, (2014).

⁸¹ Statistical Agency of Bosnia and Herzegovina, (2015).

⁸² Kosovo Agency of Statistics, “The results of the structural study on businesses”, (2014).

⁸³ Republic of Macedonia, State Statistical Office.

⁸⁴ Republic of Macedonia, State Statistical Office.

⁸⁵ MONSTAT, (2014).

⁸⁶ MONSTAT, (2015).

⁸⁷ Institute for Statistics of FB&H, (2014).

⁸⁸ Statistical Report on Businesses in Kosovo T4, (2015).

⁸⁹ Republic of Macedonia, State Statistical Office.

The main obstacle that firms in Southeast Europe face persistently is still competition from the hidden sector.⁹⁰ This issue seems to be the major concern for businesses operating in Albania, Kosovo and Macedonia, while the main problem in Bosnia and Herzegovina and Serbia is political instability, and in Montenegro, tax rates. The easiest place to start (register) a business in SEE is Macedonia, which is second in the world according to the indicator *low number of procedures, short time and low cost*.⁹¹ In 2016, Macedonia further simplified the procedure by introducing *compulsory online registration* carried out by certified agents.⁹² Montenegro seems quite advanced in raising credit (seventh in the world) although this position seems rather artificial, as it measures mainly banking interest rates, while start-ups in advanced economies rely on other forms of riskier crediting not available in Montenegro, or in the Western Balkans.

TABLE 10. DOING BUSINESS RANKING OF SEE COUNTRIES

Indicator	Ease of Starting a Business			Raising Credit			
	Country/Year	2016	2015	Change in Rank	2016	2015	Change in Rank
Albania		58	54	-4	42	36	-6
Montenegro		59	55	-4	7	6	-1
Kosovo		47	40	-7	28	24	-4
Macedonia		2	2	0	42	36	-6
Bosnia-Herzegovina		175	165	-10	42	36	-6
Serbia		65	62	-3	59	52	-7
Turkey*		79	90	11	82	78	-4

* Data for Turkey refers to 2017 and 2016.

Source: *Doing Business, 2015 – 2016*.

Kosovo holds 47th position in the ranking for starting a business, and 42nd in raising credit.⁹³ Albania, Montenegro and Serbia are placed not much differently, and apply a similar number of procedures (5 or 6) taking up to 10 days. The most difficult country in the region in which to register a business is **Bosnia and Herzegovina**, which is 175th of 189 countries in the world. This placement is due to the *high number of procedures* (12), *long procedural time* (67 days), *costs* (14.8 % of income per capital), and a *high minimum capital* (28 % of income per capita). The situation concerning credit seems slightly different, as Albania, Macedonia and Bosnia and Herzegovina rank together in 42nd position. **Serbia** has the

⁹⁰ EBRD, (2012 – 2014). *Business Environment and Enterprise Performance Survey (BEEPS)*.

⁹¹ The process consists of only one procedure, lasts one day and costs 0.1 % of income per capita.

⁹² *Doing Business, (2016). Business Reforms for Starting a Business*.

⁹³ Kosovo applies 5 procedures for starting a business, taking 11 days and costing 1.1 % of income per capita.

worst performance, with the highest loan interest in the region, almost twice as high as the interest lending rates in SEE countries.⁹⁴

Almost all SEE countries have deteriorated since 2015 in the relatively low performance of the indicators discussed, due to unease in public-private dialogue, corruption and the overall impact of the financial crisis. The business environment is strongly influenced by the relationship between the private sector and the government. As a result of path-dependence from before the 1990s, all Western Balkan countries have serious problems with economic freedom⁹⁵ and regulations designed in favour of particular state capture. High political instability always transforms into lower economic freedom and regulatory performance, as in the case of Bosnia and Herzegovina. In Serbia the lack of *institutional capacities and the wrong strategic directions* in relation to the private sector have led to *intrusions in the business environment*. So, improved public administration would lead to better control and a decrease in state intervention⁹⁶ in final products for consumption, or financial restructuring of firms. Macedonia, Albania and Montenegro enjoy relatively better ranks.

TABLE 11. ECONOMIC FREEDOM RANKINGS IN THE SEE REGION

Country	ALB	BIH	KSV	MKD	MNE	SRB
Ranking	59	108	84	47	65	77

Source: The Heritage Foundation, 2016.

Several independent studies confirm the high level of interventionism in SEE countries. In Macedonia, a survey on the hidden economy showed that more than 60 % of respondents partially/completely agreed that there was *large scale state interventionism in the activities of private businesses*.⁹⁷ In Albania, state intervention in the first years of democracy was seen by experts as one of the biggest issues.⁹⁸ Even today, state intervention instruments, or state-related causes such as *high tax levels* (for larger businesses), *corruption among government officials*, *tax inspections* etc., are considered *incentives for the hidden economy*.⁹⁹ Interventionism is also seen in the operations of state-owned enterprises, in the way they are run

⁹⁴ World Bank, Lending interest rate (%).

⁹⁵ The Heritage Foundation, (2016). *The Index of Economic Freedom Country Rankings*.

⁹⁶ OECD, (2013). *Serbia Assessment Report*.

⁹⁷ Centre for Research and Policy Making (CRPM) and Center for the Study of Democracy (CSD), (2015). *Monitoring the Hidden Economy in Macedonia: Trends and Policy Options*.

⁹⁸ Sybi Hida, *Albania: The Future Path to Sustainable Development*.

⁹⁹ In the National Business Study in Albania, 2015 the following interventions are seen by the business as burdens to operating fully transparently: "Tax rates for larger revenue businesses" 71 % of the surveyed businesses saw these as a very severe/major obstacle; "Corruption among government officials" for 63 % of the businesses and "Tax Inspection" for 55 %. Less delicate issues are: "Compliance with environmental requirements", "Compliance with safety and health requirements" and "Business licensing and permits".

as businesses and privatised, sold to close political allies below market value. A surprising fact found earlier in the report is the high level of hidden employment found everywhere in the region within state-owned enterprises.

According to the World Bank, in Albania the *business climate has been a priority* and its progress is viewed within the legal and regulatory framework for business.¹⁰⁰ Despite the fact that each individual change must be assessed positively, the overall high rate of regulatory change has a negative effect on perceptions of stability and trust. If businesses are not consulted in the policy-making cycle, they oppose change, even when it is relatively positive (e.g. Albania and Serbia). In Serbia, the main worries of business are *frequent legal changes, uneven implementation of laws and difficult contract enforcement*, which burden business operations.¹⁰¹ Legal and regulatory changes are proposed and implemented by the government *with little prior and post consultation*. Bosnia and Herzegovina is trapped in a constitutional set-up of competing authorities. Fiscal space needs to be increased by the government, but in continuous contact with regulatory changes related to the rule of law and fight against corruption. According to the latest Progress Report for the country (2015) BIH has taken several steps forward, but still faces a lack of institutional capacity and has a poor track record.¹⁰²

In Montenegro, several reforms have been undertaken, resulting in improving the country's ranking in the competitiveness or ease-of-doing-business index. The private sector appears to face an easier, improved business climate. Nevertheless, along with *fiscal consolidation*, the business environment remains a challenge and with it the regulatory framework for businesses. *Licensing, contract enforcement, access to credit and cumbersome tax administration procedures are today still the main obstacles for the business community*.¹⁰³ Since 2011, Kosovo has actively *improved the legal framework in the matter of the business environment*, with the aim of creating a well-functioning market economy. As a young economy, Kosovo still faces great challenges ahead and according to the Progress Report for 2015, despite *progress made on the legal rules governing business, their implementation has remained insufficient*.¹⁰⁴ Macedonia has gone through a reform process and currently the legal system is under substantial reform. Nevertheless this *reform appears inefficient*, lacking in adequate resources, and sometimes *subject to political pressures and corruption*.¹⁰⁵ Macedonia has recently adopted a new law, which is a step forward in enhancing the business environment through easier, faster procedures.

The concept of *State Capture* is defined similarly by the European

¹⁰⁰ World Bank, (2015). *Albania: World Bank Group Partnership Program Snapshot*.

¹⁰¹ European Commission, (2015). *FYR of Macedonia 2015 Report*.

¹⁰² European Commission, (2015). *Bosnia and Herzegovina 2015 Report*.

¹⁰³ European Commission, (2015). *Montenegro 2015 Report*.

¹⁰⁴ European Commission, (2015). *Kosovo 2015 Report*.

¹⁰⁵ Dimireva, I. (2010). *FYR of Macedonia Investment Climate*.

5.1. State Capture

Commission and the World Bank: efforts by firms to shape state laws, policies, and regulations to their own advantage through illicit, non-transparent provision of private gains to public officials, including behaviour such as private purchase of legislative votes, executive decrees, court decisions and illicit political party funding (the last is the most frequent phenomenon).^{106,107,108} It is considered to be present in the region, as the *corruption risk* throughout many years has been high.¹⁰⁹

In Albania, state capture is considered a serious concern, mainly because of control over the procurement system, privatisation and economic monopolies in strategic sectors of the economy.¹¹⁰ Few investigations have been conducted by prosecutors, and almost no investigative studies made, while mainly media articles raise doubts about state involvement in the market functioning of these companies.¹¹¹ Serbia resembles Albania in this respect. The country faces continuing suspicious practices, such as the overnight agreement within the big parties on the Constitution Proposal, which happened without public debate or the inclusion of other Parliament members.¹¹² Suspicious state capture cases for investigation in Serbia include the conversion of *state-owned companies* into 'party property', the involvement of businesses in decision-making by *buying political influence*, ensuring their monopolies to keep high prices, through favourable laws and *various privileges*. State capture cases in Montenegro seem to be found particularly in the privatisation of state-owned enterprises.¹¹³ *Regulation and laws* regarding the *privatisation* process have been influenced by *private interest*, drafted for the specific profits of interest groups.

State capture is semi-legitimized in Macedonia through regulations designed to give absolute authority to institutions in decision-making and administering fines, and providing authorities with the power to *silence and imprison political opponents* and *take control over companies* or *economic sectors*.¹¹⁴ In a study dedicated to the hidden economy, 90 % of Macedonian businesses declared that influence is high on the

government by powerful business groups which aim to protect private

¹⁰⁶ Hellman, J. and Kaufmann, D., International Monetary Fund (IMF), (2001). *Confronting the Challenge of State Capture in Transition Economies*.

¹⁰⁷ World Bank, state capture definition.

¹⁰⁸ Transparency International, (2014). *Anti-Corruption Helpdesk, State Capture: An Overview*.

¹⁰⁹ The Corruption Perception Index ranked Bosnia and Herzegovina in 73rd position among 177 countries, with a more favourable ranking than Albania (88) and Kosovo (103) but a less favourable one than Montenegro (61), Macedonia (66), and Serbia (71). Transparency International, (2015). *Corruption Perception Index (CPI)*.

¹¹⁰ Transparency International Albania (ITA), (2013).

¹¹¹ It is worth noting that 45 % of companies in Albania that operate in the oil sector came from offshore registrations. The leading company in this area in Albania owes the state budget 350 million USD for 3 years and has been able to evade this liability through overstating expenses.

¹¹² Parliament Members never received the proposal for Constitutional Changes nor had a chance to debate it. Centre for European Policy Studies (CEPS), (2007). *State Capture and Widespread Corruption in Serbia*.

¹¹³ Council of Europe, (2015). *Basic Anti-corruption Concepts, A Training Manual*.

¹¹⁴ European Policy Institute (EPI) and Institute of Social Sciences and Humanities, (2015).

economic interests in Macedonia.¹¹⁵

In Bosnia and Herzegovina too, enterprise managers consider *policy and regulatory aspects of state capture the biggest problem for businesses*.¹¹⁶ Close interaction between politicians and oligarchies, whose private interests overrule those of the public, has created an extensive degree of state capture in Bosnia and Herzegovina.¹¹⁷ Kosovo, as the newest country in the region, has higher risks in terms of state capture than other SEE countries. The judiciary, customs administration and other public authorities are all affected by corruption, and companies regularly pay bribes to public officials. Also, during procurement processes, companies are required to give gifts and facilitation payments for public tenders.¹¹⁸

The markets in Southeast Europe tend to be controlled by oligopolies, either naturally, or through control of the respective state institutions which exercise significant non-market power over independent competition. For instance, tycoons in Serbia have their own '*representatives*' in the most important *executive authorities*, favouring them and *protecting their interests*.¹¹⁹

TABLE 12. COMPETITIVENESS RANKING OF SEE COUNTRIES

Country	ALB	BIH	KSV	MKD	MNE	SRB
Ranking	93	111	-	60	70	94

Source: World Economic Forum, *Global Competitiveness Index, 2015 – 2016*.¹²⁰

Bosnia and Herzegovina is in a less favourable position, where businesses consider *monopolies as the most serious obstacle* in the business environment.¹²¹ Examples of monopolist practices in Bosnia and Herzegovina are banks operating on the banking market. These entities seem to earn their total and interest revenues through a monopoly or perfectly collusive oligopoly.¹²² In Montenegro, some companies in construction have created an oligopoly and have advantageous access to relevant information.¹²³ The respective antitrust commissions in the region have been captured by oligopolies and monopolies, are extremely ineffective, or simply do

¹¹⁵ Centre for Research and Policy Making (CRPM) and Center for the Study of Democracy (CSD), (2015). *Monitoring the Hidden Economy in Macedonia: Trends and Policy Options*.

¹¹⁶ World Bank, Bosnia and Herzegovina, *Diagnostic Survey of Corruption*.

¹¹⁷ SELDI, (2014). *Corruption Assessment Report: Bosnia and Herzegovina*.

¹¹⁸ Business Anticorruption Portal, (2015). *Kosovo Snapshot*.

¹¹⁹ International Communications Partners, (2013). *The Struggle against Monopoly*.

¹²⁰ World Economic Forum, (2015 – 2016). *Global Competitiveness Index*.

¹²¹ World Bank, Bosnia and Herzegovina Diagnostic Surveys of Corruption.

¹²² DeniMemić, (2015). *Banking Competition and Efficiency: Empirical Analysis on the Bosnia and Herzegovina Using Panzar-Rosse Model*.

¹²³ Boban Melovic and Mijat Jovicic, (2013). *Public Procurement as Determinant of Competitiveness of the Construction Sector in Montenegro*.

not work.

TABLE 13. NUMBER OF INVESTIGATIONS/DECISIONS ON ABUSE OF A DOMINANT POSITION (MONOPOLY) IN THE MARKET FROM THE COMPETITION SUTHORITY, 2012 – 2015

	ALB ¹²⁴	BIH ¹²⁵	KSV ¹²⁶	MKD ¹²⁷	MNE ¹²⁸	SRB ¹²⁹
2015	3	0	-	-	0	-
2014	3	0	4	4 ¹³⁰	0	-
2013	0	0	0	3 ¹³¹	0	-
2012	2	1	0	6 ¹³²	3	5

Source: Competition Authority Institutions in respective SEE countries.¹³³

In the OECD Country Survey Report, Turkey's business sector is defined as "highly segmented, ranging from a myriad of micro, informal, low productivity firms to a small core of modern, high-productivity enterprises". Five types of firm are distinguished according to their size and institutionalization level. Their qualities regarding human/physical capital and management, openness to world production and capital markets, and access to labour markets, also differ.

The five types are:¹³⁴

1. Micro-enterprises (which represent about 45 % of total business sector employment outside agriculture)
2. Small- and medium-sized businesses (about 35 % of employment)
3. Large family firms (about 15 % of employment)
4. Institutionalized corporations listed on the stock exchange (no more than 3 % of employment)
5. "Skilled Stars" (sophisticated start-ups representing less than 1 % of employment)

The first two types (SMEs) operate potentially in the hidden economy. Large and incorporated firms generally meet the conditions of regular operations. SMEs constitute 99.8 % of the total number of enterprises,

¹²⁴ Competition Authority Annual Report (2015).

¹²⁵ [Council of Competition Bosnia and Herzegovina.](#)

¹²⁶ [Kosovo Competition Authority.](#)

¹²⁷ [The Commission for Protection of Competition.](#)

¹²⁸ [Agency for Protection of Competition of Montenegro.](#)

¹²⁹ [Commission for Protection of Competition of the Republic of Serbia.](#)

¹³⁰ [Commission for Protection of Competition of the Republic of Macedonia.](#)

¹³¹ [The Commission for Protection of Competition of Republic of Macedonia.](#)

¹³² [The Commission for Protection of Competition of Republic of Macedonia.](#)

¹³³ [Competition Authority, Annual Report 2014, Albania, Commission for Protection of Competition, \(2012\), Annual Report for 2012, Serbia, Agency for Protection of Competition, Decisions 2012, Montenegro.](#)

¹³⁴ [OECD, \(2014\). Economic Surveys Turkey.](#)

employ 74.2 % of all employees, and produce 52.8 % of total value added (at factor cost). In particular, micro-size firms (1-5 employees) constitute the segment where hidden employment is highest (approximately 70 % of their employees are not registered). Hidden employment diminishes as the size of the firm grows. The productivity difference between small and large firms is enormous. Productivity (as measured by the value added per person employed) is lower in SMEs. They mostly use low-level technology. Turkey has the biggest labour productivity gap between the largest and smallest enterprise classes among the OECD countries (2010, OECD).

It is fair to say that there is a negative correlation between firms' productivity and regularity. For low-productive, non-incorporated small firms, it is difficult to satisfy regularity conditions. Some micro-sized and small firms are legally exempted from income tax duties, and they compose the informal sector as defined by Schneider; "The sector where both the output produced and production and distribution process are legal. The informal sector is predominant in developing countries where small firms produce a large share of economic added value". In less developed countries, informal activities are deeply engrained in society. There are socio-economic and political reasons for this:

- In the informal sector, productivity is generally lower than in the formal sector. Many activities would not be carried out if they were fully declared and taxed.
- Small firms can conceal their activities better, so they tend to stay small.
- The government collects the majority of taxes from sales taxes, which are easy to collect administratively.

5.2. Public-Private Cooperation and Trust in Law Enforcement

Business satisfaction with laws and procedures is mostly assessed according to the following aspects: ease in obtaining information on laws and procedures; interpretation of laws and procedures; preliminary private sector consultations about new laws; and the efficiency of the court system.

Bosnia and Herzegovina is characterized by a complex legal framework, non-transparent business procedures and a weak judicial system. Furthermore, it has a multi-tiered legal framework that is often considered duplicating and contradictory. Laws are not always introduced transparently. Given overlapping jurisdictions and the lack of a central source of information, it is difficult for businesses to keep up to date with new regulations.¹³⁵ Among deficiencies in the legal and business environment are the costly, complex procedure of businesses getting onto the market, operations there and exiting the market.¹³⁶ Regarding court decisions, it is commonly believed that political interference exists in the judicial system and that there are a large number of unresolved

¹³⁵ U.S. Department Of State, (2015). *Investment Climate Statement – Bosnia and Herzegovina*.

¹³⁶ European Commission, (2015). *Bosnia and Herzegovina Progress Report*.

cases.¹³⁷ More than four-fifths of businesses (81.4 %) think that the court system is not secure, and more than three-fifths of enterprises (63.3 %) do not consider the court system to be fair, impartial and free from corruption.¹³⁸ Overall, half the businesses (51 %) in Bosnia and Herzegovina agree that laws and regulations can be passed, while one-third (32 %) think they are consistent and predictable. In spite of this, only 6 % of enterprises are satisfied with how the government consults and involves the private sector in the process of drafting new laws.¹³⁹

In the area of laws and procedures, **Montenegro** has drawn-out procedures and an inefficient court system, in which cases are left pending for years.¹⁴⁰ In recent years, Montenegro has adopted 20 new business laws which have brought significant clarification into the legislative environment.¹⁴¹ Regarding laws, public consultation must be strengthened further, since the relevant stakeholders often enter the process too late.¹⁴² Concerning the court system, in 2014 there were some improvements by which the decisions of appeal courts, which are currently available, contributed to greater certainty in legal proceedings.¹⁴³ However, nearly half the businesses in Montenegro (45.3 %) consider court systems to be quick, while half (50.6 %) think the court system is fair, impartial and not subject to corruption.¹⁴⁴ To sum up, more than three-fifths of enterprises think information on laws and procedures is easy to obtain, and two-fifths (40 %) think laws are consistent and predictable. Only 13 % of businesses are satisfied with government consultations with the private sector about new laws and procedures.¹⁴⁵

In **Albania**, as is the case in all SEE countries, laws are usually approved without giving the business community time to comment or have its suggestions reflected in the final version.¹⁴⁶ According to recent studies,¹⁴⁷ approximately two-fifths of businesses (41 %) consider the application of laws to be unfavourable, while less than one-fifth consider it favourable. The business community also has little confidence in regular legal procedures for resolving problems.¹⁴⁸ The main concerns regarding civil courts are the time cases take, and the fact that Albanian authorities often do not enforce their decisions.¹⁴⁹ Almost three-fifths of businesses (58 %) do not consider the court system quick enough, while just over one-third (36 %) consider it fair, impartial and not subject to corruption. In conclusion, three-fifths of businesses (58 %) declare that information on laws and procedures is easily obtained, and almost half (45 %)

¹³⁷ EBRD, (2010). *Commercial Laws of Bosnia and Herzegovina, an Assessment*.

¹³⁸ EBRD, (2012 – 2014). *Business Environment and Enterprise Performance Survey (BEEPS)*.

¹³⁹ Regional Cooperation Council, Balkan Barometer, (2015). *Business Opinion Survey*.

¹⁴⁰ Amcham, (2010). *Business Challenges in Montenegro*.

¹⁴¹ U.S. Department of State, (2014). *Investment Climate Statement in Montenegro*.

¹⁴² European Commission, (2015). *Montenegro 2015 Report*.

¹⁴³ EBRD, (2014). *Commercial Laws in Montenegro, an Assessment by the EBRD*.

¹⁴⁴ EBRD, (2012 – 2014). *Business Environment and Enterprise Performance Survey (BEEPS)*.

¹⁴⁵ Regional Cooperation Council, Balkan Barometer, (2015). *Business Opinion Survey*.

¹⁴⁶ U.S Department of State, (2015). *Albania Investment Climate Statement*.

¹⁴⁷ Amcham, (2014 – 2015). *Business Index, Albania*.

¹⁴⁸ National Business Forum (NBF), (2016). *National Business Forum Perspectives on the Issue of Informality in Albania*.

¹⁴⁹ U.S Department of State, (2015). *Albania Investment Climate Statement*.

think their interpretation as consistent and predictable. In Albania, one-fifth (21 %) of businesses are satisfied with the degree to which the government consults private enterprises about laws and procedures.¹⁵⁰

The transparency of legislative changes and procedures, especially public procurement procedures, is an ongoing issue in **Serbia**¹⁵¹ and a focus of the country's reform process. The government has focused in recent years on improving the legislative and regulatory framework,¹⁵² with the main aim of improving the business climate, in order to build a competitive country in the region. Only 16 % of Serbian enterprises are agreed on the fact that finding the relevant legal information for businesses is easy, and 37 % have stated that they tend to agree (Balkan Barometer). Similar levels of satisfaction are given in regard to interpreting laws and procedures. Realistic time-frames are needed for the business community and other stakeholders to provide comments/suggestions, in order to enable a high quality review and consultation process on draft laws.¹⁵³ The rulings of commercial courts have improved slightly since 2012,¹⁵⁴ but there is still a huge backlog of cases, which must be resolved if trust in the judicial system is to improve. In response to a BEEPS 2012 – 2014 question about whether the court system was quick enough, 50 % of respondents strongly disagreed and 38 % tended to disagree. High levels of disagreements were seen also in regards to fairness, the incorruptibility of the courts, and their ability to enforce rulings.¹⁵⁵

On the ease of getting information on laws and procedures, enterprises in **Kosovo** express better average satisfaction than the rest of the region, at 0.2 points higher [the SEE average is 3.4 (out of 5), Kosovo is 3.6].¹⁵⁶ A similar pattern, with a slightly decreasing satisfaction level, is shown in regard to the interpretation of laws and procedures. By 2011, Kosovo local advocacy groups had managed to press for a law on access to public documents,¹⁵⁷ but there is a current need for minimum standards of public consultation.¹⁵⁸ Similarly to Serbia, Kosovo needs to provide public consultation with stakeholders. Weak reasoning, a need for capacity building, and improvement of the current fragmented, or lack of specific business-related legislation are characteristics related to the current functioning of the judicial system in relation to the business environment.¹⁵⁹ All the above factors, combined with many non-finalized cases, indicate low trust in court institutions, with 62 % of responding businesses disagreeing with the fact that courts in the country are fast, and around 40 % thinking that the courts are unfair, corrupt, and unable to enforce decisions.¹⁶⁰

¹⁵⁰ [Regional Cooperation Council, Balkan Barometer, \(2015\). *Business Opinion Survey*.](#)

¹⁵¹ [Partnership for Transparency Fund, \(2015\). *Transparent Public Procurement in Serbia*.](#)

¹⁵² Serbia Snapshot 2015.

¹⁵³ [European Commission, \(2015\). *Serbia Report*.](#)

¹⁵⁴ Commercial Laws of Serbia, EBRD.

¹⁵⁵ [EBRD, \(2012 – 2014\). *Business Environment and Enterprise Performance Survey \(BEEPS\)*.](#)

¹⁵⁶ Balkan Barometer.

¹⁵⁷ [Kosovo Law on Access to Public Documents, \(2010\).](#)

¹⁵⁸ [European Commission, \(2015\). *Kosovo 2015 Report*, SWD\(2015\) 215 final.](#)

¹⁵⁹ [Ibid.](#)

¹⁶⁰ [EBRD, \(2012 – 2014\). *Business Environment and Enterprise Performance Survey \(BEEPS\)*.](#)

Macedonia presents a better situation in the general perception of businesses, laws and procedures, compared with the other countries in the region. Business perceptions in Macedonia on the ease of getting information is higher than in the region, with 69 % of respondents strongly agreeing or tending to agree with the statement,¹⁶¹ but at the same time, in a study on the hidden economy in Macedonia, only one-third of the respondents were partially satisfied with the quality and provisions of laws and administrative procedures affecting businesses. Since 2006, Macedonia has had an act on access to public information¹⁶², but public consultations are often inadequate and public participation inconsistent.¹⁶³ Online platform consultations are also inadequate and publishing draft laws prior to approval by Parliament has decreased somewhat¹⁶⁴ in recent years, along with the time provided for feedback and answers to possible inquiries on public documents. Judicial actions still require improvement, as administrative courts require further capacity building; follow-up procedures need to be enforced along with contracts.

Satisfaction with laws and procedures is certainly related to frequent, non-consulted, non-notified changes in legislation and procedural regulation related to businesses. According to the Balkan Barometer, the *uncertainty of regulatory* policies is considered an issue in South East Europe. Businesses do not consider themselves part of the process, and three out of five businesses are dissatisfied with the level of engagement in drafting and consulting laws in their country. The table below shows changes in the main laws related to doing business in the region, organized as legislation related to taxes, customs, employment and reporting.

The most frequently changed law **in Albania** is that on income tax, and it should be noted that changes have been significant. The tax on profit was increased in 2013 from 10 % to 15 %, putting Albania in a disadvantageous situation compared with the SEE countries. The most important changes in local taxes have been made recently, with an increase in education tax and public spaces tax on businesses. Macedonia and Montenegro also show several changes in their legislation. Macedonia is in top place for changes to the Social and Health Insurance Act, Labour Code Act, Act on Entrepreneurs and Commercial Companies and almost all the other listed type of legislation. Montenegro resembles Albania in regard to the Local Taxes Act, as the main legislation changed between 2012 and 2015.

The volatility of regulations and their unpredictability, without a real analysis of their impact in the business environment, is considered of high concern in the region. Thus, in order to increase revenue collections, it is easier for governments to increase taxes than to increase the base for tax collection, by changing regulations during the tax year without any consultation, thereby damaging business plans in specific and the business environment in general.

¹⁶¹ [Regional Cooperation Council, \(2015\). Balkan Barometer.](#)

¹⁶² Country Laws EBRD.

¹⁶³ European Commission (2015). Progress Report 2015 for FYR of Macedonia.

¹⁶⁴ Ibid.

TABLE 14. FREQUENCY OF CHANGES IN ACTS IN SOUTH EAST EUROPE, 2012 – 2015

	ALB	BIH	MKD	MNE ¹⁶⁵
Local Taxes Act	4 ¹⁶⁶	0	2 ¹⁶⁷	6 ¹⁶⁸
Social and Health Insurance Act	3 ¹⁶⁹	0	12; ¹⁷⁰ 19 ¹⁷¹	3 ^{172,173}
VAT Act	1 ¹⁷⁴	0	7 ¹⁷⁵	2 ¹⁷⁶
Income Tax Act	10 ¹⁷⁷	0	6; ¹⁷⁸ 1 ¹⁷⁹	5 ¹⁸⁰
Excise Tax Act	1 ¹⁸¹	0	7 ¹⁸²	4 ¹⁸³
Licenses, Authorizations and Permits Act	1 ¹⁸⁴	0		
Customs Code Act	1 ¹⁸⁵	0	6; ¹⁸⁶ 5 ¹⁸⁷	2 ¹⁸⁸

¹⁶⁵ In MNE there are two acts regulating social and health insurance; the Act on Health Insurance (the new act was passed in 2016) and the Act on Social and Child Protection (it has been changed three times).

¹⁶⁶ [Për Sistemin e Taksave Vendore, Nr. 9632, 30.10.2006.](#)

¹⁶⁷ Act on Financing Units of Local Self-Government "Official Gazette of the Republic of Macedonia" No. 47/11 and 192/15.

¹⁶⁸ [List of Laws in Montenegro.](#)

¹⁶⁹ [Act on Social Securities of the Republic of Albania, \(1993\).](#)

¹⁷⁰ Act on Contributions for Mandatory Social Insurance, "Official Gazette of the Republic of Macedonia" No. 44/12, 15/13, 91/13, 170/13, 97/14, 113/13, 180/14, 188/14, 20/15, 48/15, 129/2015 and 217/2015.

¹⁷¹ Act on Health Insurance, "Official Gazette of the Republic of Macedonia" No. 26/2012, 16/2013, 91/2013, 187/2013, 43/2014, 44/2014, 97/2014, 112/2014, 113/2014, 188/2014, 20/2015, 61/2015, 61/2015, 98/2015, 129/2015, 150/2015, 154/2015, 192/2015 and 217/2015.

¹⁷² Act on Social and Child Protection.

¹⁷³ In MNE there are two acts regulating social and health insurance; the Act on Health Insurance (the new act was passed in 2016) and the Act on Social and Child Protection (it has been changed three times).

¹⁷⁴ [Act on Value Added Tax of Republic of Albania, \(2014\).](#)

¹⁷⁵ Act on Value Added Tax, "Official Gazette of the Republic of Macedonia" No. 155/12, 12/14, 112/14, 130/14, 15/15, 129/15 and 225/15.

¹⁷⁶ Act on VAT ("Sl. list RCG", No. 65/2001, 12/2002 – amendments, 38/2002, 72/2002, 21/2003, 76/2005, 4/2006 – amendments and "Sl. list CG", No. 16/2007, 40/2011 – other, 29/2013 i 9/2015).

¹⁷⁷ [Act on the Income Tax of Republic of Albania, \(1998\).](#)

¹⁷⁸ Act on Personal Income Tax, "Official Gazette of the Republic of Macedonia" No. 166/12, 187/13, 13/14, 116/15, 129/15 and 199/15.

¹⁷⁹ Act on Profit Tax, "Official Gazette of the Republic of Macedonia" No. 129/15.

¹⁸⁰ Income Tax Act ("Sl. list RCG", No. 65/2001, 12/2002 – amendments, 37/2004, 29/2005 – other, 78/2006 and 4/2007 – amendments and "Sl. list CG", No. 86/2009, 40/2011 – other, 14/2012, 6/2013, 62/2013, 60/2014 i 79/2015).

¹⁸¹ [Act on the Excise Duties of Republic of Albania, \(2002\).](#)

¹⁸² Excise Act, "Official Gazette of the Republic of Macedonia" No. 82/13, 43/14, 167/14, 188/14, 129/15, 154/15 and 192/15.

¹⁸³ Excise Tax Act ("Sl. list RCG", No. 65/2001, 12/2002 – amendments and 76/2005 and "Sl. list CG", No. 76/2008, 50/2009, 78/2010, 40/2011 – other, 61/2011, 28/2012, 38/2013, 45/2014 and 8/2015 – other).

¹⁸⁴ [Act on Licenses, Authorizations and Permits in the Republic of Albania, \(2009\).](#)

TABLE 14. FREQUENCY OF CHANGES IN ACTS IN SOUTH EAST EUROPE, 2012 – 2015 (CONTINUED)

	ALB	BIH	MKD	MNE ¹⁶⁵
Labour Code Act	1 ¹⁸⁹	1 ¹⁹⁰	11 ¹⁹¹	3 ¹⁹²
Bankruptcy Act	-	0	5 ¹⁹³	0 ¹⁹⁴
Competition Act	-	0	1, ¹⁹⁵ 0 ¹⁹⁶	0 ¹⁹⁷
Act on Entrepreneurs and Commercial Companies	-	2 ¹⁹⁸	10 ¹⁹⁹	0 ²⁰⁰

Source: Official Journals of SEE Countries (2012, 2015).

Businesses are generally worried by the levels of taxes, as they affect their activity directly or indirectly. In 2013, the surveyed businesses (34 %) admitted that changes made with regard to business revenues had a negative impact on their businesses, while only 10 % considered the changes had a positive impact.

The highest dissatisfaction with legal changes affecting revenues is seen in Bosnia and Herzegovina (19 % – changes were very negative, 19 % – changes were negative), Serbia (9 % – changes were very negative, 27 % – changes were negative) and Montenegro (5 % – changes were very negative, 26 % – changes were negative).²⁰¹ These answers are also related to the methodology of sampling in the study, but this does

¹⁸⁵ [Act on the Customs Code of the Republic of Albania, \(2014\).](#)

¹⁸⁶ Customs Code Act, "Official Gazette of the Republic of Macedonia" No. 11/12, 171/12, 187/13, 129/15, 154/15 and 192/15.

¹⁸⁷ Customs Tariff Act "Official Gazette of the Republic of Macedonia" No. 11/12, 93/13, 44/15, 81/15 and 192/15.

¹⁸⁸ Customs Act "Sl. list RCG", No. 7/2002, 38/2002, 72/2002, 21/2003, 31/2003 – decision US, 29/2005 and 66/2006 and "Sl. list CG", No. 21/2008, 40/2011 – other, 39/2011 – other, 28/2012 – other 62/2013.

¹⁸⁹ [Official Bulletin of the Republic of Albania, No. 220, \(2015\).](#)

¹⁹⁰ [Labour Law of the Federation of BiH, Official Gazette of the Federation of Bosnia and Herzegovina, No. 26/16 of 04.04.2016.](#)

¹⁹¹ Labour Relations Act, "Official Gazette of the Republic of Macedonia" No. 11/12, 39/12, 13/13, 25/13, 170/13, 187/13, 113/14, 20/15, 33/15, 72/15 and 129/15.

¹⁹² Labour Act ("Sl. list CG", No. 49/2008, 26/2009 – amendments, 88/2009 – other, 26/2010 – other, 59/2011, 66/2012, 31/2014 and 53/2014 – other).

¹⁹³ Bankruptcy Act, "Official Gazette of the Republic of Macedonia" No. 79/13, 164/13, 29/14, 98/15 and 192/15.

¹⁹⁴ Bankruptcy Act ("Sl. list CG", No. 1/2011).

¹⁹⁵ Protection of Competition Act, "Official Gazette of the Republic of Macedonia" No. 41/14.

¹⁹⁶ Act Against Unfair Competition, "Official Gazette of the Republic of Macedonia" No. 80/1999.

¹⁹⁷ Act on Protection of Competition ("Sl. list CG", No. 44/2012).

¹⁹⁸ [Federation of BiH, \(2015\), Law on the Companies.](#)

¹⁹⁹ Commercial Companies Act, "Official Gazette of the Republic of Macedonia" No. 166/12, 70/13, 119/13, 120/13, 187/13, 38/14, 41/14, 138/14, 88/15 and 192/15.

²⁰⁰ Companies Act ("Sl. list RCG", No. 6/2002 and "Sl. list CG", No. 17/2007, 80/2008, 40/2010 – other, 36/2011 and 40/2011 – other).

²⁰¹ [Regional Cooperation Council, Balkan Barometer, \(2015\). Business Opinion Survey.](#)

not undermine the fact that businesses see tax rates as a major burden on their activities.

5.3. Satisfaction with Public Officials/ Administration

Public administration reform in **Bosnia and Herzegovina** is in the early stages, with the aim of improving service delivery levels. Furthermore, Bosnia and Herzegovina is among the last countries in the region to have adopted legislation regarding e-business.²⁰² Since the country has a good ICT infrastructure, the lack of appropriate legislation is a constraint that must be resolved for the development of an efficient electronic system.²⁰³ Regarding the perception by Bosnian businesses of public officials, in an UNODC study, 10.4 % of businesses declared they had paid bribes to public officials in the 12 months prior to the survey.²⁰⁴ In addition, more than one-third of businesses (35 %) in Bosnia and Herzegovina considered it normal for their sector to pay additional payments to public officials in order to “get things done”.²⁰⁵

Montenegro has implemented an e-government strategy, but user satisfaction with public officials has not yet been measured regularly. The central government portal provides 80 e-services through 25 public institutions, but these unfortunately consist mostly of basic services, rather than full electronic procedures.²⁰⁶ Regarding satisfaction with public officials in Montenegro, businesses expressed themselves satisfied with the effectiveness of the Tax Authority as a consequence of the newly-implemented electronic reporting system, which has improved transparency and the efficiency of bureaucratic processes.²⁰⁷ On the other hand, businesses in Montenegro declared that during interactions with public officials, bribes were requested in 44 % of cases, mainly by customs officers, tax/revenues and inspection officials.²⁰⁸

The low efficiency of state administration has been identified and considered in the past as a major constraint by the World Economic Forum and as an urgent issue by businesses **in Albania** (88 %).^{209, 210} Business are still dissatisfied with public officials and about two-thirds of them (63 %) consider corruption among public officials (bribes) as an obstacle to operating completely transparently. In Albania, businesses claim that public officials must understand that their role is to serve the business community,²¹¹ among others, guaranteeing them improved quality of service and adequate treatment. In order to improve the current

²⁰² [European Commission, \(2015\). *Bosnia and Herzegovina Country Report*.](#)

²⁰³ [Zvezdan Stojanovic, \(2014\). *Perspective for E-Business in Bosnia and Herzegovina*.](#)

²⁰⁴ [UNODC, \(2013\). *Business, Corruption and Crime in Bosnia and Herzegovina: The Impact of Bribery and Other Crime on Private Enterprise*.](#)

²⁰⁵ [Regional Cooperation Council, Balkan Barometer, \(2015\). *Business Opinion Survey*.](#)

²⁰⁶ [European Commission, \(2015\). *Montenegro Report*.](#)

²⁰⁷ [AmCham, \(2012\). *AmCham Montenegro Business Climate Report*.](#)

²⁰⁸ [UNODC, \(2013\). *Business, Corruption and Crime in Montenegro: The Impact of Bribery and Other Crime on Private Enterprise*.](#)

²⁰⁹ [Business Albania, \(2011\). *Identifying problems and obstacles encountered by businesses in Albania and determining ways to remove them*.](#)

²¹⁰ [World Bank, \(2011\). *Governance in Albania: A Way Forward for Competitiveness, Growth and European Integration*.](#)

²¹¹ [AmCham, *Business Index 2014 – 2015, Albania*.](#)

situation, objectives have been set for the development of electronic governance and delivery of interactive public services for businesses, known as 'one-stop-shops', by establishing several ICT systems that include taxation, customs etc.²¹²

In terms of public administration, Macedonia has made some moderate improvements to service delivery for businesses and citizens. The number of services provided through e-governance platforms is considered to be limited, but one-stop-shop options have been developed widely in the country especially for businesses.²¹³ There is mixed assessment of G2B relationships, as almost one-third are partly satisfied, while one-third are completely dissatisfied. On the other hand, only 23 % of businesses are completely confident that they do not need to make additional "gifts" to have procedures finalized by public administration.²¹⁴

Kosovo identifies the politicization of public administration as a major concern²¹⁵ which may jeopardise planned public administration reform. Kosovo lacks an act on general administrative procedures, which makes further advances in e-governance strategies implementation difficult. Since 2008, an active strategy on e-governance²¹⁶ has been available, improvements have been made over the years, and finalization of procedures in most cases is possible through the platforms.

Serbia has made good progress through its adopted action plan for public administration reform.²¹⁷ A relevant integrity plan in public services and an act on public administrative procedures are also being adopted. E-governance requires the further efforts of the government of Serbia, in terms of transparency, e-services etc, as currently e-governance and one-stop-shops have been presented randomly and insufficiently widely. According to the progress report on the country, satisfaction with public officials is not being measured continuously. In a study on businesses, corruption and crime, business representatives perceived public utilities officials, police officers and municipal and local officers as those with the highest prevalence of bribery and corruption.²¹⁸

²¹² [Albanian Digital Agenda Strategy 2015 – 2020.](#)

²¹³ European Commission, (2015). *Progress Report of FYR of Macedonia.*

²¹⁴ Balkan Barometer.

²¹⁵ European Commission, (2015). *Progress Report for Kosovo.*

²¹⁶ [Ministry of Public Services, Republic of Kosovo, \(2008\). Electronic Government Strategy 2009 – 2015.](#)

²¹⁷ [European Commission, \(2015\). Serbia Report, SWD\(2015\) 211 final.](#)

²¹⁸ [UNODC, \(2013\). Business, Corruption and Crime in Serbia: The Impact of Bribery and Other Crime on Private Enterprise.](#)

CONCLUSIONS AND POLICY RECOMMENDATIONS

The **hidden economy in SEE remains wide-spread**, perpetuates informality, which is linked to corruption, and denotes a substantial gap between formal and informal institutions. This gap is due both to underdeveloped formal market institutions, and also to the lack of coherent enforcement of rules, often related to corruption. Those engaged in the hidden economy are more likely to face corruption pressure than the rest of the population throughout the region.

The immense diversity of the scale of the phenomenon (19 % in Croatia and 81 % in Kosovo), its prevailing patterns (no written contracts in Turkey, non-payment of health care contributions in Kosovo, envelope wages in Macedonia and Bulgaria, non-formalised business in Albania) and statistical estimation of the hidden economy in GDP across Southeast European countries leads to the conclusion that any successful counter-measures would require **tailor-made policies and sequencing of reforms**.

Working in the **hidden economy in SEE is often socially embedded**, culturally and educationally predetermined, and not simply a matter of a rational choice maximising personal benefit. In that respect, an effective anti-hidden economy policy should not be purely economic or fiscal, but a comprehensive social policy.

Working entirely in the formal sector, as compared to the hidden economy, means earning significantly higher wages in Bosnia and Herzegovina, Albania and Turkey, slightly higher wages in Macedonia, Serbia and Montenegro and about the same or slightly lower in Kosovo and Bulgaria. However, the sustained high-levels of the hidden economy in SEE, coupled with systemic petty corruption, low trust in public institutions and, in some cases, ambiguous national identity, has resulted in **changes in tax morale** and lower revenues for governments in the region.

Based on these conclusions, we could provide the following **policy recommendations**:

- All **National Statistical Institutes** should implement carefully the Eurostat/OECD methodology for **non-observed economy adjustments to GDP** and publish timely and comprehensive descriptions of imputations by non-exhaustiveness type and economic sector. Use **mirror statistics** to calibrate international trade statistics and proxy contraband and trade-related tax evasion.
- **Prioritize and sequence reforms on tax gap areas** which have **the strongest negative social impact** (for example, health care security evasion in Kosovo, non-existent labour contracts in Turkey, and excise duty evasion in Bosnia and Herzegovina and Albania). Businesses and

citizens should be **widely consulted** on these areas, so that society at large will feel **engaged** in needed reforms and raise their trust in institutions. So far, even policies which are appropriate in principle have provoked resistance by businesses and civil society, as top-down driven (e.g. in Albania and Serbia).

- Design policies to **target formalization of the whole economic value chain** (or significant parts of it) and **clusters of economic actors and relationships**, as opposed to focusing on case-by-case legalisation, by increasing penalties and control of non-compliance. Working in the hidden economy in SEE is often socially embedded, culturally and educationally predetermined, and not simply a matter of a rational choice maximising personal utility. Hence, an effective anti-hidden economy policy would not be purely economic or fiscal, but a comprehensive social policy.
- In countries where remittances are an important source of investment in the hidden economy (e.g. Macedonia, Kosovo and Bosnia and Herzegovina), design schemes to **reduce the cost of transferring remittances**, and **match domestic entrepreneurship development schemes and foreign donor programs**, offering special incentives for legalising workers abroad. Remittances often link the hidden economy in Southeast Europe with the hidden economy in EU Member States (where the senders frequently work). So, countries have incentives to resolve this problem in partnership.
- **Rely more on technology** (electronic payments, cash registers with fiscal memories linked in real time to revenue agencies, electronic filing of tax forms, points of single contact, etc.), automation and algorithms (risk profiling and sampling for inspections), and less on personal judgement.
- Conduct **regular tax gap assessments** (including per type of tax), following a common methodology and adjust policies according to findings. Cross-check hypotheses with statistical assessments of the size of the hidden economy and independent, survey-based analyses of characteristics.
- Policies tackling the hidden economy should be linked to those **countering corruption and improving law enforcement**, while taking note of the need to embed them all in the overall economic growth strategy of the country. Countries in **SEE need to double their annual average real GDP per capita growth rates at least**, if they are to achieve and sustain lasting governance change.