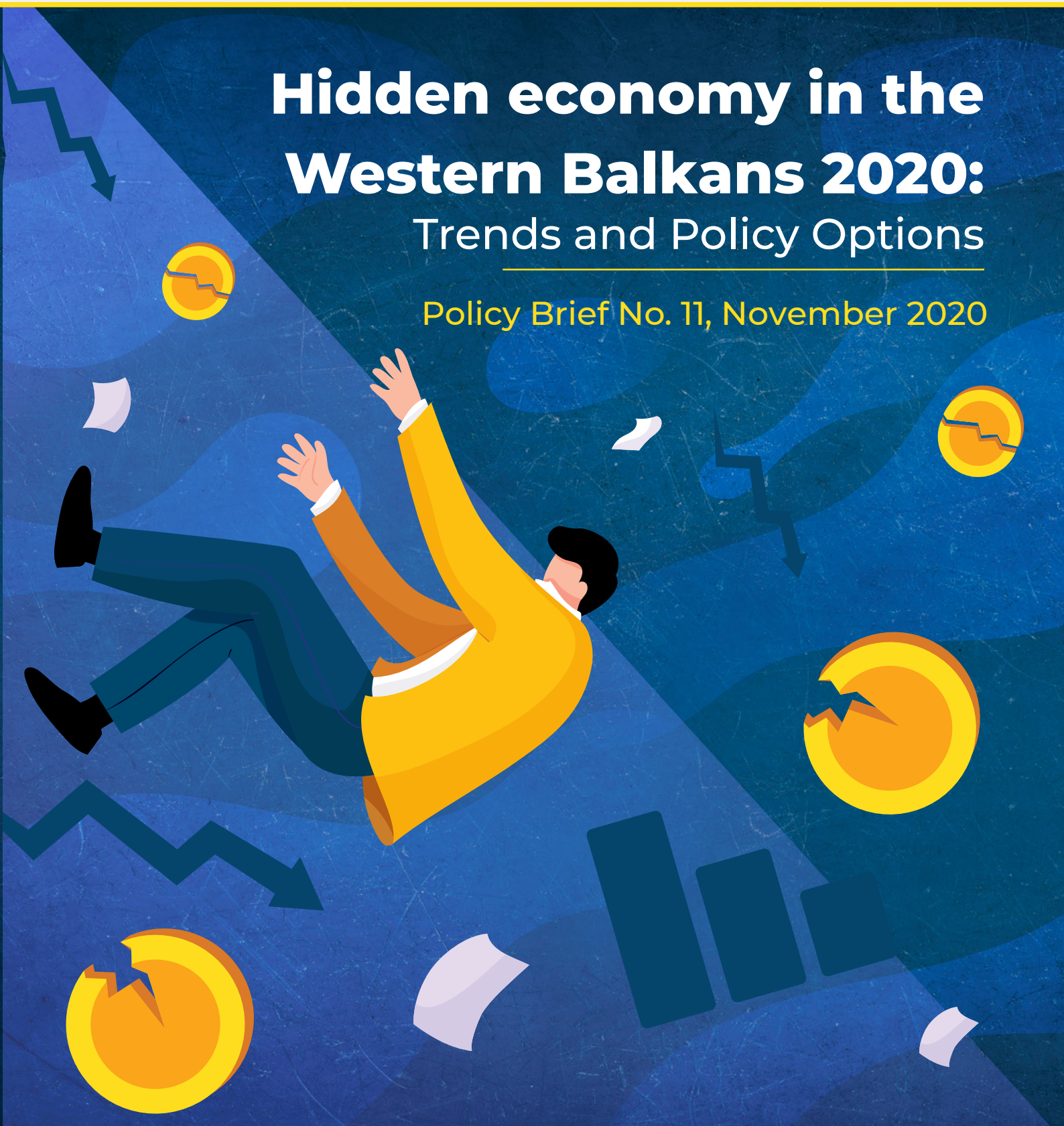


# Hidden economy in the Western Balkans 2020: Trends and Policy Options

Policy Brief No. 11, November 2020





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## KEY POINTS:

# Hidden economy in the Western Balkans 2020:

## Trends and Policy Options

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- The quality of the business environment and reduction of **the hidden economy is a crucial dimension for the fulfilment of the Copenhagen economic criteria** and the eventual accession of the Western Balkan countries to the EU. It is therefore imperative that the new investment and economic competitiveness programme of the European Commission for the Western Balkans addresses the hidden economy in the region.
- The **COVID-19 pandemic bared the problems of high informality in the Western Balkans**. The crisis put further pressure on people working undeclared. It brought to light the lack of healthcare coverage of undeclared workers and the many businesses operating in the informal sector in the region. These will not be able to fully benefit from the government measures and/or the IPA funds for post-Covid economic recovery.
- According to the SELDI Hidden Economy Monitoring System between 2016 and 2019 **hidden employment has increased** in five out of the six Western Balkans countries by a factor of between 2.4% and 12.4%. Serbia is the only country which has seen a decline in hidden employment during that period (by 5.7%). Kosovo\* remains the country with the highest hidden employment in the region – some 83% of its employed have some form of informality in their employment relations.
- In parallel to the overall increase in hidden employment, there is an ongoing process of transformation in the undeclared work's manifestations in the Western Balkans. The share of workers without a labour contract has declined. Yet, the share of those not declaring their full actual remuneration and social security payments has increased, in comparison to previous years.
- The national governments need to achieve the most efficient policy mix between incentive, preventive and punitive measures, and **promote the transition from the informal to the formal sector** through various policies such as flexible types of labour contracts, use of vouchers, amnesties or tax reductions.
- The European Commission and the Council could also **promote in-depth reforms** through the IPA funds or during the assessments of the 2019-2021 Economic Reform Programmes (ERP). An initiative similar to the European Platform tackling undeclared work, focusing on the Western Balkans could help the region reduce the most negative consequences of undeclared work.

\* The designation "Kosovo" is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.



## INTRODUCTION: THE LINKS BETWEEN HIDDEN ECONOMY AND CORRUPTION

**The hidden economy<sup>1</sup> is closely linked to corruption.** Empirical studies show that they fuel each other - a one-point rise in the index of corruption, is associated with an increase in the level of hidden economy (in percent of GDP) by 0.253% points<sup>2</sup>. These are millions and billions of unaccounted for cash flows, which support corrupt payments, distort competition and provide links to the illegal or black economy. Both phenomena are based on similar principles such as circumvention of regulations and non-payment of taxes. They undermine democratic governance and the rule of law, negatively affecting economic development. The hidden economy and corruption are both a result and a symptom of bad governance.

The **negative effects** of the hidden economy are numerous – low funding and quality of public services, no healthcare and pension coverage, maternity or annual leave. Informal practices also breed unfair competition and corruption, hamper regular enterprises from growing and innovating, and create problems with regard to access to finance. Informality leads ultimately to wage and purchasing power reduction and

eventual losses of state revenues.<sup>3</sup> The European Commission (2019) adds to the adverse effects of informality the increasing job insecurity and the lower safety at work. In the Business Environment and Enterprise Performance Survey (BEEPS V) 66% of Kosovar enterprises state that a major obstacle to regular business activities is informal competition (the average in all surveyed countries from the Western Balkans is 39%).<sup>4</sup> As a result reputable investors (from the EU) are unwilling to enter the region, whereas the size and persistence of informality attracts risky investors (from third/non-EU countries) who have an exploitative rationale towards the local economy.<sup>5</sup> The worst outcome could be the entry of corrosive capital in the region, which then undermines the countries' further integration into the European Union.<sup>6</sup>

## THE COVID-19 IMPACT

The **COVID-19 pandemic** has shed a new light on the seriousness of the problem of informality in the Western Balkans. *First*, the governments imposed universal lockdowns and emergency situations that have created rapid, although most probably temporary, spike in unemployment, thus increasing the risk of people seeking alternative (undeclared) work options in the services or the agriculture sectors. As

<sup>1</sup> SELDI has chosen the use of the term "hidden" economy to denote that the intent of the business entities and workers involved in it are to deliberately try to hide some or all of their economic activity. It typically involves the hiding of both legal (grey economy) and illegal (black economy) activities. Yet, the most common definitions, including the one used by the European Commission, refer to the hidden economy as informal or undeclared economy, and define it as economic activities, which are legal in their nature but are fully or partially undeclared to the public authorities for the purpose of avoiding taxes or other regulations. We use in this and other SELDI papers the works "hidden", "undeclared", "grey", "informal", etc. interchangeably.

<sup>2</sup> Borlea, S., Achim, M. (2017), Corruption, Shadow Economy and Economic Growth: An Empirical Survey across the European Union Countries.

<sup>3</sup> OECD/ETF/EU/EBRD (2019), SME Policy Index: Western Balkans and Turkey 2019: Assessing the Implementation of the Small Business Act for Europe, SME Policy Index, OECD Publishing, Paris, p. 602.

<sup>4</sup> European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107.

<sup>5</sup> Peci, B. (2019), [Informal economy: the devil on Kosovo's shoulder](#), Prishtina Insight.

<sup>6</sup> Vladimirov, M., et al (2018), [Russian Economic Footprint in the Balkans. Corruption and State Capture Risks](#), Sofia: Center for the Study of Democracy.

the pandemic became global, people from the region working abroad, who became unemployed in their host countries, returned to their countries of origins. This is likely to further burden local social security and healthcare systems, while slowing or even pushing down wage growth. Thus, the post-epidemic recovery of the labour market and the economy might be slower, especially in a situation of lowered exports, remittances and FDI.

by the Sovereign guarantee fund in order to pay wages for all their (non-declared) employees. In Bosnia and Herzegovina, the fully undeclared employees will not be able to access the government subsidised grant schemes for 40 000 employees for whom the government will cover the personal income tax and social security contributions of EUR 120 per month for the period March - May 2020. Similarly, in North Macedonia and Montenegro, the firms in the informal

**Table 1. Expected economic impact form COVID-19 and EU financial support**

	Forecasts of unemployment rates (%)		Projections of annual change in real GDP (%)			Financial support of the EU to Western Balkans (EUR million)	
	2019 (actual)	2021	2019 (actual)	2020	2021	Immediate support for the health sector	Support for the social and economic recovery
<b>Albania</b>	11.6	14.5	2.2	-5	8	4	46.7
<b>BiH</b>	32.75	35.5	2.7	-5	3.5	7	73.5
<b>Kosovo*</b>	25.9	33	4	-5	7.5	5	63
<b>North Macedonia</b>	16.6	19	3.6	-4	7	4	62
<b>Montenegro</b>	15.35	18	3.6	-9	6.5	3	50
<b>Serbia</b>	9.7	13.9	4.2	-3	7.5	15	78.4

**Sources:** Forecasts of unemployment rates: Trading economics (April 2020). Forecasts; Projections of annual change in real GDP: IMF. (April 2020). World Economic Outlook; Financial support of the EU to Western Balkans: European Commission (April 2020). EU response to the coronavirus pandemic in the Western Balkans

Second, the enterprises employing undeclared workers will not be able to benefit from the emergency and recovery **government measures, IPA funds** or the EUR 38 million in immediate **EU support** for the Western Balkans<sup>7</sup>. For example, in Albania the irregular workers from the recently closed small businesses or the self-employed working undeclared will not be able to request the provided by the government minimum salaries, doubled unemployment benefits or social assistance layouts. They will also not be able to take credits covered

economy will not be able to receive in full the subsidy on social security contributions for maintaining employment throughout the crisis (or the 3-month deferment in the case of Serbia). In North Macedonia they will also not be able to prove the full extent of their financial losses (in case the turnover is already partially unreported), in order to obtain a loan from the Development Bank<sup>8</sup>. However, some of these schemes if smartly designed and enacted could potentially lead to a decrease of undeclared work and regularization. For example, the gov-

<sup>7</sup> European Commission (March 2020), [EU mobilises immediate support for its Western Balkans partners to tackle coronavirus](#).

<sup>8</sup> [Development Bank of North Macedonia](#).

ernment support scheme in Montenegro providing 70 % of the gross minimum wage of newly employed workers in SMEs for six months, if these workers are registered as unemployed, could lead to the declaration of employment that would otherwise have remained hidden<sup>9</sup>.

*Third*, the lack of **healthcare coverage** of the fully undeclared workers poses a serious threat to their health and the general public during the COVID-19 crisis. According to SELDI's Hidden Economy Monitoring System, Kosovo\* is the most affected country in the region in this respect, with 60% of the **employed in a main job** claiming to have no healthcare insurance. An additional issue of concern presents the fact that on average the SELDI data shows that every tenth employed in the region has **no social security coverage**. The situation is again the worst in Kosovo\* (24% of the employed have no social security coverage).

The low healthcare coverage in the region raises legitimate expectations for further **scrutiny and reform of the healthcare system**, once the pandemic is over. While lockdowns have averted disaster, the region has been seen as a late hot-spot for a second wave of Covid-19 spreading, and there are many worrying signs that need to be addressed. Especially these need to be analysed in relation to the high **corruption<sup>10</sup> and state capture risks<sup>11</sup>** and the inefficient budget spending in the sector throughout the region. In the case of

healthcare hidden economy and corruption have had a very malign influence, because they have diverged necessary public resources, leaving the most vulnerable people without proper health care and protection. This has provided further justification for governments to impose emergency measures, which have had an adverse effect on democratic governance in the Western Balkans.<sup>12</sup>

### Key hidden economy trends 2020

The European Commission notes that there still no reliable methods for measuring informality in a consistent and continuous manner in the region.<sup>13</sup> The International Labour Organisation (2019) reiterates the absence of fresh and reliable quantitative data about the levels of informality, for example in Montenegro.<sup>14</sup> *SELDI's Hidden Economy Monitoring System*,<sup>15</sup> which is closely related to the *Corruption Monitoring System*<sup>16</sup>, fills this gap by providing detailed survey data on the overall size, different aspects and the dynamics of the hidden economy in the region. The current edition of the system focuses on hidden employment (undeclared work) trends and characteristics.

The SELDI data shows that hidden employment remains very prevalent in the region. Between 2016 and 2019 the **hidden employment index has increased** in five out of the six Western Balkans countries by a factor of between 2.4% (in Montenegro) and 12.4% (in North Macedonia). Serbia is

9 IMF (April 2020), [Policy responses to COVID-19](#); OECD (April 2020). [Key country policy responses](#).

10 SELDI (2019), [Policy Brief 9: Corruption in the Western Balkans: Trends and Policy Options](#).

11 SELDI (2020), Policy Brief 10: State Capture Assessment Diagnostics in the Western Balkans 2020: Risks and Policy Options (upcoming).

12 European Western Balkans/SELDI (31 March 2020), [COVID-19 pandemic as a threat to the rule of law in the Western Balkans](#).

13 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, pp. 51, 61.

14 ILO (2019), Decent Work Country Programme 2019-2021. Montenegro, International Labour Organization Decent Work Technical Support Team and Country Office for Central and Eastern Europe, pp. 4, 26.

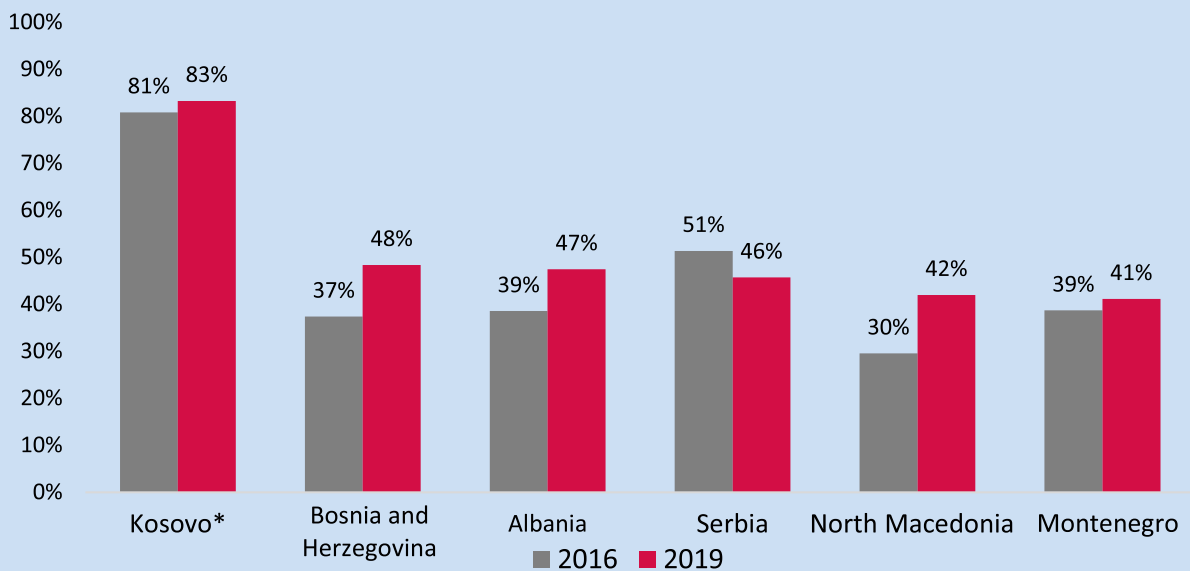
15 CSD (2016), [Hidden Economy Indexes in Bulgaria 2002-2015: Results and Methodological Notes](#).

16 SELDI (2017), [Sustainable Policy Impact through State-of-the-Art Research and Advocacy](#).

the only country which shows a decline in the hidden employment levels since 2016 (by 5.7%). Kosovo\* remains the country with the highest hidden employment share.

gaged in a main job) who indicated their participation in at least one of these five practices. Understanding the hidden employment dynamics requires zooming in on

**Figure 1. Hidden employment index 2016-2019**



**Source:** SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020.

The *Hidden Employment Index* reflects the existence of any of five practices common in the hidden economy:

- Working without a written contract with the employer;
- The “official” remuneration written in the contract is lower than the wage actually paid to the employee, as agreed upon verbally between the two parties;
- The employee has no social security coverage;
- The base for the social security contributions paid is the amount written in the contract, and not the higher amount actually received;
- There is no health insurance on the main job.

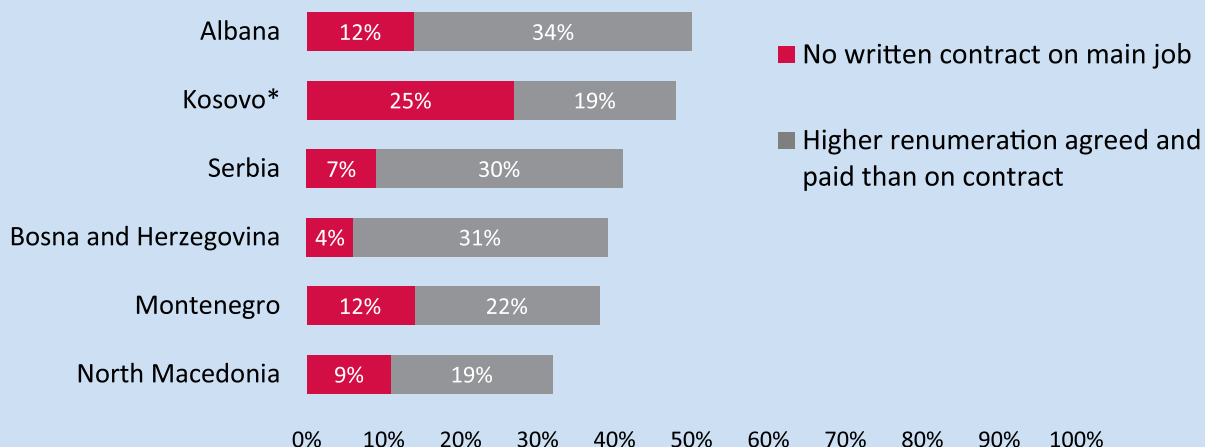
The *Hidden Employment Index* represents the percentage of respondents (of all en-

gaged in a main job) who indicated their participation in at least one of these five practices, taking place in the region.

*First, working without an employment contract or receiving higher remuneration* than claimed in the employment contract both reflect the presence of hidden employment. While the share of those who work without any contract is highest in Kosovo\* (25%), when the practice of hiding the actual wage is added, Albania comes first with nearly half (46%) of all respondents engaged in a main job reporting either having no contract at all, or receiving some part of their salary unofficially (cash in hand or in an envelope). This shows that while the nature of the contractual agreement (or its lack thereof) varies between countries, all of them have high shares of undeclared work, with even the lowest percentage in North Macedonia (27%) exceeding a quarter of all employed in a main job.



**Figure 2. Workers without written contract on the main job or receiving higher than the declared remuneration (2019, in %)**



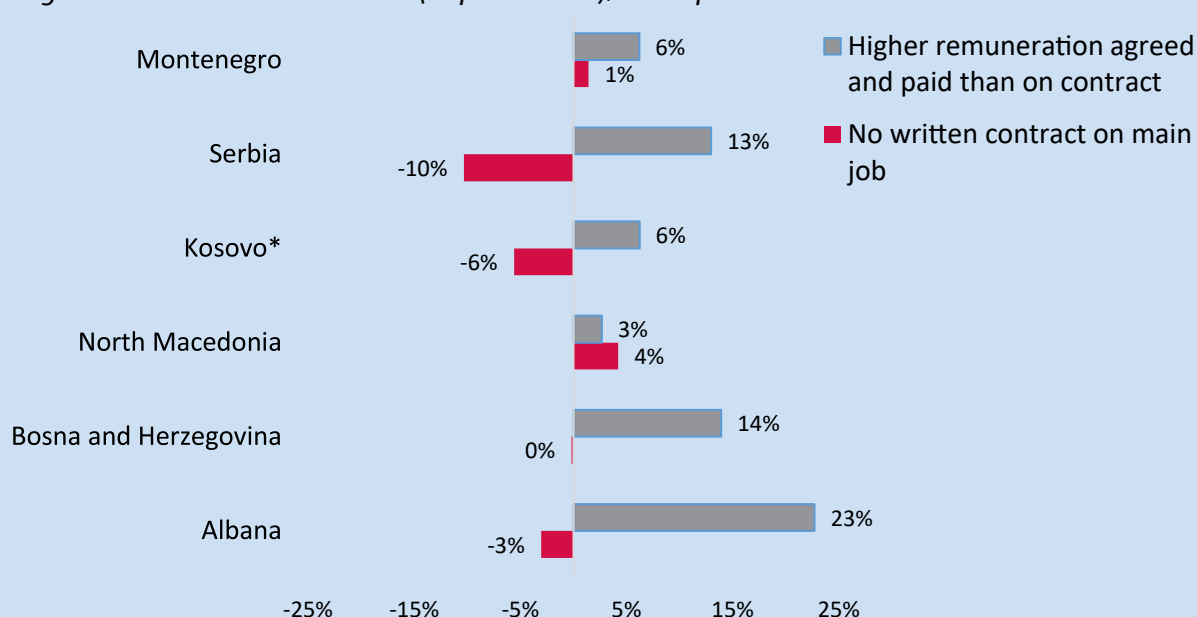
**Source:** SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020.

Observing the trend over time (Figure 3 below) shows that in most countries where the percentage of “no contract” cases declined since 2016 there was an equal (Kosovo\*) or even larger (Serbia, Albania, BiH) increase in the cases of payment of higher remuneration than the one declared in the official contract. This trend of transforming employment re-

lations without any contract to partially declared work can be expected to continue across the region. This is due to the fact that in the second scenario the hidden employment is both easier to hide and more favourable for the employees who can receive at least some health and social security coverage.

**Figure 3. Workers without written contract on the main job or receiving higher than the declared remuneration (% change 2019-2016)**

*Negative numbers show decline (improvement), while positive numbers show increase.*

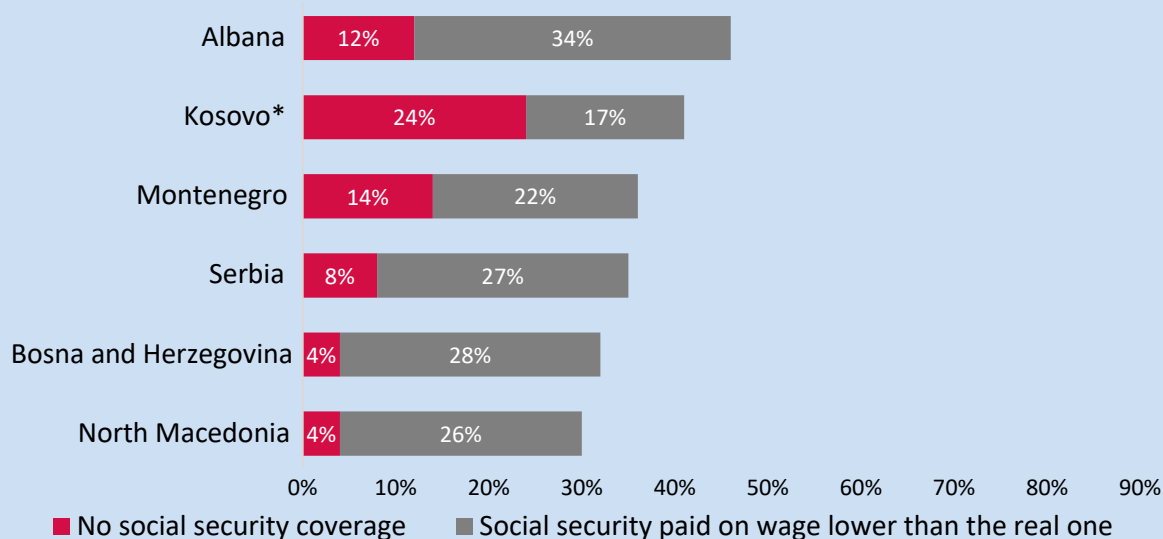


**Source:** SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020.

*Second, social security related hidden employment practices* encompass employees who either do not pay any social security contributions, or pay them, but on the lower officially declared basis than the real one actually received. The survey results on these practices naturally mirror the undeclared work indicators, as social security coverage is closely linked to the labour contract.<sup>17</sup> Changes in the hidden practices in social security coverage since 2016 also follow the

*Third, the percentage of workers who have no healthcare insurance* paid is of critical importance in the context of the Covid-19 crisis and one of the worst effects of the hidden employment practices in the region (considered by many a type of employment victimisation). This issue affects directly the individuals as well as indirectly the whole society through diminishing further the already scarce public finances for public healthcare services.

**Figure 4. Hidden practices in social security coverage (2019, in %)**



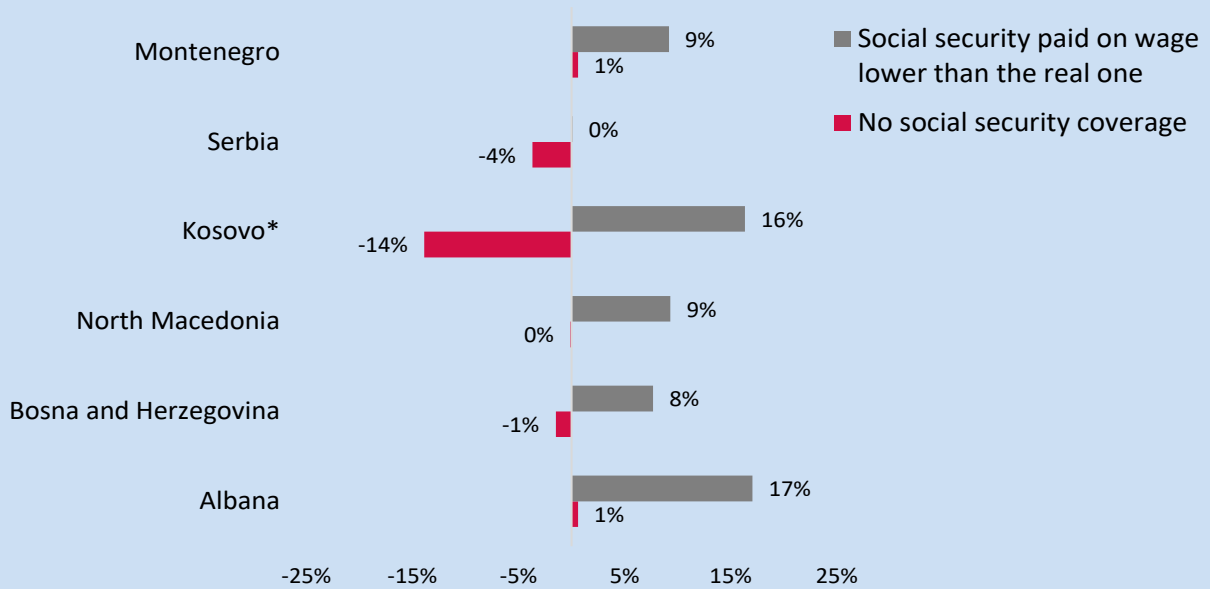
Source: SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020

same pattern as with the undeclared work practices: small or no decline in the percentage of cases without any social security coverage is accompanied by large increases in the cases where social security is paid on declared wages lower than the actual received (see Figure 5 below). Serbia is the only exception with 4% decline in the cases without any social security coverage and no significant increase in the cases where social security is paid on wage lower than the actual one. All other countries show large increases (between 8% and 17% of the respondents engaged in a main job) in the latter practices.

As mentioned above, the situation in Kosovo\* is the worst of all six countries, according to the 2019 results. Still, it should be noted that the country has achieved a considerable progress compared to 2016, when the percentage of cases with no health insurance coverage was 10% higher. There is also some progress observed in Serbia (-4%) and BiH (-2%) which confirms the overall conclusion that the increase of the hidden employment in the region comes in parallel to a transformation of fully undeclared work to a partially (under) declared one.

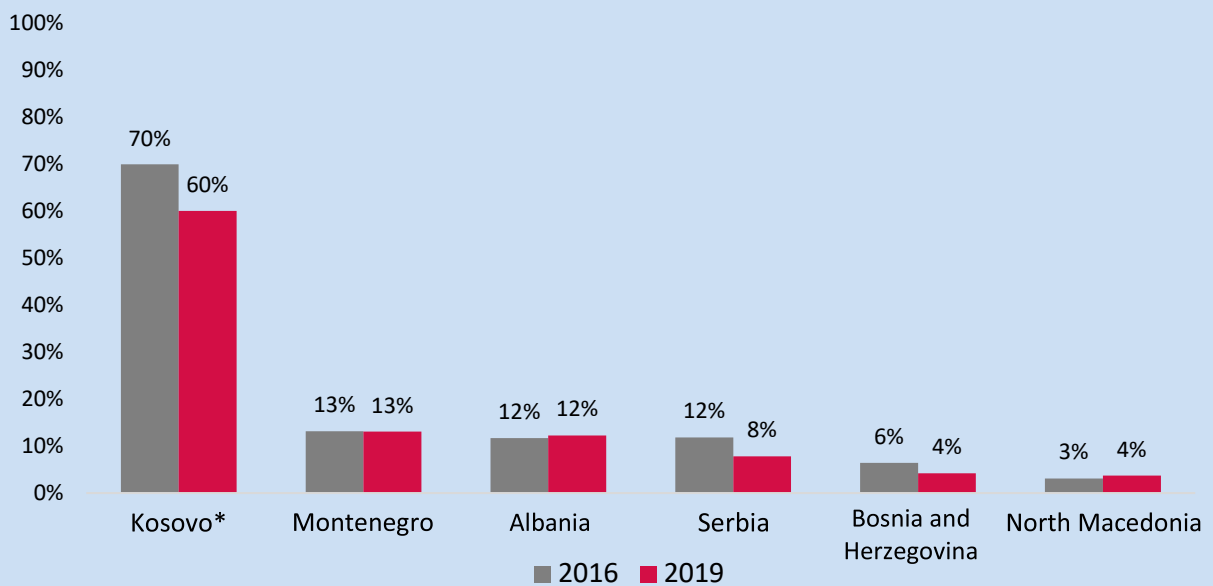
<sup>17</sup> These two aspects are not always identical, since local regulations could leave room for discrepancies.

**Figure 5. Trends in social security coverage (% change 2019-2016)**



Source: SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020

**Figure 6. Workers with no health insurance coverage on the main job 2016-2019, % of all engaged in a main job**



Source: SELDI Corruption Monitoring System / Hidden Economy Monitoring System, 2020.

## The causes of informality

The informality in the Western Balkans could be attributed to a plethora of **causes**<sup>18</sup>, such as:

- low tax morale;
- high levels of unemployment (in particular among the youth and long-term unemployed);
- weak business environment and very high poverty levels;
- lack of trust in the state and the public institutions, and high perceptions of corruption;
- high taxation and para-fiscal costs, in parallel to excessively coercive tax policy;
- insufficient inspections and audits;
- low quality of education and healthcare systems;
- red-tape, burdensome severance payment system, frequent changes of legislation and delays of VAT refunds.

High tolerance towards tax and social security evasion has been cultivated in the Western Balkans due to **the perception that tax authorities and in general the public system are corrupt**. According to 45.7% of the businesses in North Macedonia and 72.9% in Albania, corruption is the most important factor for the existence of the hidden economy.<sup>19/20</sup> This leads to the conviction that taxes are not properly used

for high-quality public services<sup>21</sup>. The *Open Budget Survey 2019* confirms that the general public in the region lack accessible information on the ways **their governments raise and spend the national budgets**.

For example, in Montenegro, the *Programme for the Reform of Public Financial Management 2016-2020* was marked by a relatively poor degree of implementation<sup>22</sup>. The key mechanism for ensuring efficient and lawful spending of citizens' money – budgetary inspection, has been dysfunctional for many years. As a result, ten NGOs submitted in mid-June 2019 a joint e-petition proposing a change in the Government policy on the publication of the reports on the work of the Commission for Housing Policy and the Commission for Distribution of Budgetary Reserve Funds<sup>23</sup>. NGOs also advocate for more transparency on the financing of large infrastructure projects, such as the Bar-Boljare Highway<sup>24</sup>. In contrast, the key issue in Albania seems to be the lack of trust of citizens in the private financial institutions. One of the primary reasons for such distrust is the memory of the losses suffered by many Albanians from investing in firms around 1997, later exposed as financial pyramids (Ponzi schemes). Thus, the banking sector development process has been slow, especially in rural areas, although the use of electronic payments is expanding. According to the Bank of Albania<sup>25</sup>, 'paper' credit transfers

18 SELDI (2016), [Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe](#); and SELDI (2016), [Hidden Economy and Good Governance in Southeast Europe Regional Assessment Report](#).

19 CRPM, IDM, Democracy for Development (2018), [Monitoring the Hidden Economy in Macedonia, Albania and Kosovo](#).

20 Williams, CC and B Kosta (2019), Evaluating institutional theories of informal sector entrepreneurship: Some lessons from Albania. *Journal of Developmental Entrepreneurship*, 24(2), doi.org/10.1142/S1084946719500092.

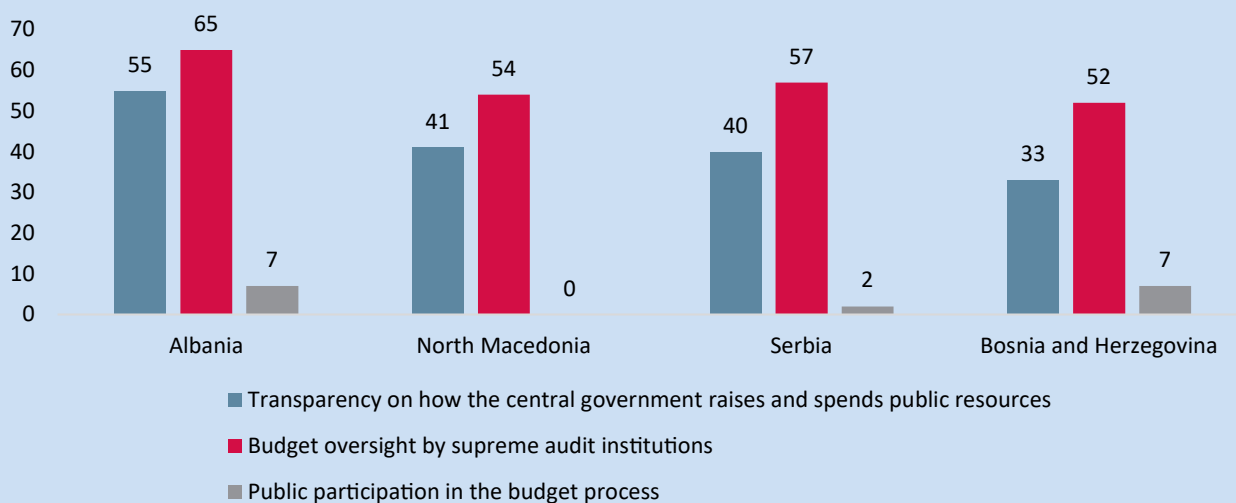
21 Kosta, B. and C. C. Williams (2018), Diagnostic report on undeclared work in Albania. Sarajevo: Regional Cooperation Council.

22 Ministry of Finance (June 2019), [Annual Report on implementation of the Action Plan for Implementation of the 2016-2020 PFM Reform Programme, for the period January - December 2018](#).

23 Institute Alternative (12 July 2019), [Government of Montenegro puts private interests ahead of the interest of public to know](#).

24 MANS (October 2018), [Tajni putevi novca: Izveštaj o izgradnji auto-puta](#).

25 Bank of Albania (2018), [2018 Report](#).

**Figure 7. Transparency of budget spending in 2019 (on a scale from 0 to 100)**

Source: Open Budget Survey (OBS), 2020.

shrank from 90% in 2008 to 38% in 2018. However, it is worth pointing out that the circulation of currency outside the banking system remains high.

Another major force driving informality in the region is the level of **taxation and perceived tax injustice**. Corporate tax rates in the Western Balkans are comparatively low, with the highest in Serbia and Albania of only 15%.<sup>26</sup> Yet the overall tax burden on employment is considered high, provided the very low sophistication of the tax system, the lack of tax breaks, and the very low level of employment. In addition, taxpayers perceive the system as unjust and slated against the poorest strata, as infamous regional oligarchs are seen as untouchables for the poor performing rule of law systems. In Montenegro, there is no progressive taxation, but 39% of the gross salary is deducted for social security and health care benefits, national and local taxes. The so-

cial security contribution rate is 37.05% in Serbia, which is second only to the level in Bosnia and Herzegovina (41.5%).<sup>27</sup> These high rates of social security contributions coupled with the very low level of wages and perceived unemployment benefits, creates high incentives for evasion. For a long time, the Association of Employers of the Federation of BiH has been requesting changes to a number of laws that would reduce taxes and contributions, and thus - increase and regularise workers' salaries. They advocate for these changes due to the shortage of labour, and the observed labour migration towards more developed countries in Europe<sup>28</sup>. Similarly, the high tax wedge for social groups with low income in North Macedonia results in their difficult transition from social assistance to formal employment status.

The **(para)fiscal burdens**<sup>29</sup> also present considerable obstacle to formalisation. These include the costly regulations re-

26 Trading Economics (2019), [List of Countries by Corporate Tax Rate](#).

27 Trading Economics (2019), [Social Security Rate](#).

28 Focus.ba (9 September 2019), [How I worked "in the black": Whether you want it or not, there is always someone else](#).

29 The most common examples of para-fiscal burdens in Montenegro are the following: taxes related to business advertising; taxes paid for road usage; tourist taxes; taxes for utilising a commercial property; administrative taxes; taxes for using temporarily the public land; and business start-up charges.



lated to the method of calculating salaries and the burdensome severance/firing payments in Montenegro.<sup>30</sup> The same factors are at play in Bosnia and Herzegovina, where para-fiscal fees (e.g. excise duties) are widely implemented at municipal and cantonal level. The outcome is dis-incentivising the establishment of new companies

and pushing existing ones towards operation into the hidden economy.<sup>31</sup> Employers in North Macedonia have also repeatedly called for more flexibility in the labour legislation, mainly related to the termination of contracts, as well as decreasing the occupational health and safety-related financial burdens.

### Box 1. Hidden economy in Bosnia and Herzegovina

Bosnia and Herzegovina presents a special case of hidden economy in the region. The country has a complex administrative and political framework with fragmented governmental and public structure. This forces companies to comply with different procedures within different parts of the country. It also hinders the efforts of designing and implementing necessary universal social and labour market policies, consequently blocking progress towards curbing informality.<sup>32</sup> Due to the large number of budget users (ministries, agencies, cantons, municipalities and cities), the share of public expenditure in BiH remains very high, despite continuous pledges and measures to restrict it. As a result, the role of the state in the economy is still disproportionate, absorbing substantial resources to fund inefficient public enterprises and social security system. The regulatory environment is confusing, with incompatible provisions of both old and new laws coexisting, whereas regulation is not consistent across the whole national territory.<sup>33</sup> A distinctive type of informality, which has developed after the collapse of the socialist regime and during the 1992-1995 civil war, and that still dominates the economy, is the so-called "network marketing" (e.g. provision of undeclared paid services such as children and elders' care and home-cleaning).<sup>34</sup> In addition, two more factors aggravate the hidden economy situation in BiH and put the country in a league of its own. Some 70% of the unemployed youth in the country are long-term unemployed.<sup>35</sup> The national economy suffers from persistent current account deficit, which has led to the extended reliance on remittances from diaspora (which account for more than 10% of GDP), further depressing labour supply motivation.<sup>36</sup>

30 Bejaković, P. and Stefanov, R. (2019), Characteristics of Undeclared Work in Service Sector in Countries of South East Europe, Zagreb International Review of Economics & Business, Vol. 22, No. 1, p. 122.

31 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, p. 183.

32 ILO (2019), [About the ILO in Bosnia and Herzegovina](#).

33 Bejaković, P. and Stefanov, R. (2019), "Characteristics of Undeclared Work in Service Sector in Countries of South East Europe", Zagreb International Review of Economics & Business, Vol. 22, No. 1, pp. 116-117.

34 Efendic, N., Pasovic, E. and Efendic, A. S. (2018), Understanding the Informal Economy in Practice – Evidence from Bosnia and Herzegovina, Financial Internet Quarterly 'e-Finanse', vol. 14.

35 World Bank Group & The Vienna Institute for International Economic Studies (2019), Western Balkans Labour Trend Markets 2019, p. XII.

36 Efendic, N., Pasovic, E. and Efendic, A. S. (2018), Understanding the Informal Economy in Practice – Evidence from Bosnia and Herzegovina, Financial Internet Quarterly 'e-Finanse', vol. 14, no. 4, p. 80.

## Vulnerable sectors

The sector most affected by hidden economy in the region is **agriculture**. This is particularly true for Albania, Serbia and Bosnia and Herzegovina. **Real estate, wholesale trade** and **construction** follow.<sup>37</sup> Other sectors that face serious problems are the services sectors (in particular, restaurants, hotels, transport and trade). The banking sector, which is 90% foreign-owned, is also negatively influenced by informality, as it cannot rely on a well-established system of asset valuation and hence remains under-utilised.<sup>38</sup> Some country specifics exist. In **Albania**, additional affected sectors are the footwear and garment industry, mining and manufacturing.<sup>39</sup> The fashion sector<sup>40</sup>, which has significant impact on employment and the economy in the country, features substantial levels of informality. While, it can be seen across the region, it is very prevalent in Albania to see a plethora of informal vendors selling fish on sidewalks, or pick-up vehicles which are used as stores.<sup>41</sup> Illustrative examples from **Kosovo\*** concern call centres that employ persons without a contract, or construction workers who rotate every day on different

construction sites (some studies suggest that 77.1% of the employees in the construction sector in the country are unregistered).<sup>42</sup> In **North Macedonia**, envelope wages are found primarily in the construction industry. However frequent incidents can also be traced in agriculture, hotels, cafes and restaurants.<sup>43</sup>

In **Montenegro**, besides the wide-spread practice of envelope wages, there are many cases of under-reporting of the number of employees.<sup>44</sup> It is noticeable that around 2/3 of informal activities do not take place in companies or firms, but are rather related to “door-to-door” vendors, domestic work, family farms, and open markets.<sup>45</sup>

Four out of five persons working in the agriculture in **Bosnia and Herzegovina** do so without declaring their activities.<sup>46</sup> Private tutoring<sup>47</sup> and unregistered tourist guides<sup>48</sup> become ever more popular. In **Serbia**, outside agriculture where unpaid family workers dominate, the construction industry is adversely affected by incidents of envelope wages; a trend also observed in food preparation and other services.<sup>49</sup>

37 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, p. 218.

38 OECD/ETF/EU/EBRD (2019), SME Policy Index: Western Balkans and Turkey 2019: Assessing the Implementation of the Small Business Act for Europe, SME Policy Index, OECD Publishing, Paris, p. 601.

39 Williams, C. C. and B. Kosta (2019), Evaluating institutional theories of informal sector entrepreneurship: Some lessons from Albania. *Journal of Developmental Entrepreneurship*, 24(2), doi.org/10.1142/S1084946719500092.

40 Processing industries of textile, garments and footwear manufacturing, where the partial, or fully finished products are almost always exported to other countries.

41 Tirana Times (2019), [Informal economy still at concerning levels](#).

42 Peci, B. (2019), [Informal economy: the devil on Kosovo's shoulder](#), Prishtina Insight.

43 Williams, C. C. and Bezeredi, S. (2017), Illegitimate Economic Practices in FYR Macedonia. Findings from a representative survey of 2,014 citizens, GREY Working Paper No. 10, p. 46.

44 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, p. 61.

45 Katnic, M. and Williams, C. C. (2018), Diagnostic Report on Undeclared Work in Montenegro, Employment and Social Affairs Platform, pp. 24-26.

46 Pasovic, E. and Efendic, A. S. (2018), Informal Economy in Bosnia and Herzegovina – an Empirical Investigation, *South East European Journal of Economics and Business*, Volume 13 (2), p. 116.

47 Bejaković, P. and Stefanov, R. (2019), Characteristics of Undeclared Work in Service Sector in Countries of South East Europe, *Zagreb International Review of Economics & Business*, Vol. 22, No. 1, p. 117.

48 Efendic, N., Pasovic, E. and Efendic, A. S. (2018), Understanding the Informal Economy in Practice – Evidence from Bosnia and Herzegovina, *Financial Internet Quarterly 'e-Finanse'*, vol. 14, no. 4, p. 85.

49 Bejaković, P. and Stefanov, R. (2019), Characteristics of Undeclared Work in Service Sector in Countries of South East Europe, *Zagreb International Review of Economics & Business*, Vol. 22.

## National policies and measures to tackle the hidden economy

The governments of the Western Balkan countries have all undertaken measures aimed at tackling informality, but not all of them can be characterised as comprehensive, consistent, nor fully efficient. Nonetheless, some positive developments can be recognised.

### Strategies and Action Plans

Adopting strategies and action plans for tackling the hidden economy, under the auspices and recommendations of the International Labour Organization (Montenegro, North Macedonia) or the International Monetary Fund (Albania) are common steps the national policy-makers undertake. In particular, the Serbian *National Programme for Countering the Grey Economy* from 2015, could be among the contributing factors explaining why **Serbia** is the only country in the region, which according to the SELDI data has registered a decline in the share of hidden employment between 2016 and 2019. It is also worth noting that the updated Action Plan has been designed with the assistance of private sector partners and contains around 80 specific measures against informality.<sup>50</sup>

Similarly, the government of **Kosovo\*** adopted for the first time a *Strategy and Action Plan for the prevention and fight against informal economy* in 2014. A legal framework was developed to that end, with special attention being paid to money laundering practices.<sup>51</sup> The Strategy and Action Plan for 2019-2022 were adopted in May

2019, and are considered the most serious initiative to date for combating informality. **Albania** is working closely with the IMF to develop a revenue mobilisation strategy, which will, among others, address informality and tax evasion. The draft strategy is expected to be completed by June 2020<sup>52</sup>.

Yet, stakeholders have also often criticised strategic documents for tackling the hidden economy in the region. For example, the **Albanian** business community and economic experts reasoned that the primary task of the national Action Plan had been to increase the collection of governmental revenues, rather than a genuine transition from informal to formal economy.<sup>53</sup> In **North Macedonia**, the *Strategy for the Formalisation of the Informal Economy (2018-2022)* envisages as responsible for its implementation the Ministry of Labour and Social Policy, along with the State Labour Inspectorate, the Ministry of Economy, the Ministry of Finance, the Employment Agency, the Public Revenue Office, and the Customs Office. Yet, some critics note that only a loose cooperation exists between these bodies, with no common databases or jointly agreed targets.<sup>54</sup> **Montenegro** has been trying to implement various new strategies for combating informality, as a follow up to the 2013 national tripartite *Enabling Environment for Sustainable Enterprises* and the *Action Plan for combating the grey economy* adopted in June 2017. However, the European Commission has warned that the measures concerning social policy and employment are not well advanced, neither

50 International Monetary Fund (2018), Republic of Serbia. Request for a 30-Month Policy Coordination Instrument—Press Release; Staff Report; and Statement by the Executive Director for Republic of Serbia, IMF Country Report No. 18/237, pp. 18-19.

51 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, p. 218.

52 Ministry of Finance, Republic of Albania (2020), [Economic Reform Programme 2020-2022](#), p. 8.

53 Kosta, B. (2018), [Emerging from the Darkness: Albania's Informal Economy](#), PROSPERCSIS.

54 Blazevski, N. M. (2018), Policy Brief on Undeclared work in The Former Yugoslav Republic of Macedonia - evidence and policy recommendations, Regional Cooperation Council, pp. 6-7.

are effective in dealing with the root problems of labour market.<sup>55</sup> According to the OECD, **Bosnia and Herzegovina** has not devised coherent strategies on the issue of informal economy.<sup>56</sup>

### **Tax reforms**

Another common measure for tackling informality in the Western Balkans has been to alter the taxation regime. For example, Montenegro implemented a two-percentage point reduction in employers' health insurance contributions in 2019. North Macedonia attempted to re-introduce progressive taxation as of January 2019, but has revoked the decision and returned to flat personal income tax as from January 2020. In the Federation of Bosnia and Herzegovina and Republika Srpska in BiH the labour tax burden has been lowered in 2019. Reform of the tax administration is also foreseen in the Serbian Action Plan for tackling the informal economy.

### **Inspections and fines**

In Serbia, the Action Plan for 2018-2019 placed as a top priority the qualitative upgrade of inspections, through the use of better IT systems and coordination among authorities. Heavier fines were introduced, as well as punitive measures against tax evasion. According to the National Alliance for Economic Development, the intensity of inspection operations and the expected penalties altered the perceptions of businesses towards informality. In 2012 the

expected probability of being detected and punished was 14.5%, whereas by 2017 it grew to around 24%.<sup>57</sup> Similar increase of inspections is observed in North Macedonia and Albania. In Kosovo, a reform of the inspection system is foreseen for 2020.<sup>58</sup> The European Commission however has criticised countries in the region, noting that they often focus almost exclusively on inspections and controls, rather than on providing incentives to businesses for formalising their activities.<sup>59</sup>

### **Fiscal cash registers**

Western Balkan countries try to deal with informality also by introducing the newest technologies for tracing payments and transactions. Kosovo\* installed a fiscal cash register under its 2014-2018 Plan. A two-stage plan for fiscalisation was also initiated in Albania at the beginning of 2020. It is expected that by 1 September 2020 small businesses (with annual turnover up to ALL 8 million/EUR 64,944) will introduce fiscalisation procedures, followed by all businesses from 1 January 2021<sup>60</sup>. Montenegro will launch a system for issuing fiscal invoices electronically. If successful, the measure is expected to result in a more effective monitoring of goods and services transactions in real time, thus restricting informality.<sup>61</sup> The initial plan however has been postponed until 2021, upon the request of the Chamber of Commerce and business associations. In Bosnia and Herzegovina, the government introduced the

55 European Commission (2019), 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo, Institutional paper 107, p. 52.

56 OECD/ETF/EU/EBRD (2019), SME Policy Index: Western Balkans and Turkey 2019: Assessing the Implementation of the Small Business Act for Europe, SME Policy Index, OECD Publishing, Paris, p. 550.

57 National Alliance for Economic Development (2017), Shadow Economy in Serbia in 2017. Key findings and recommendations, p. 3.

58 OECD/ETF/EU/EBRD (2019), SME Policy Index: Western Balkans and Turkey 2019: Assessing the Implementation of the Small Business Act for Europe, SME Policy Index, OECD Publishing, Paris, p. 621.

59 European Commission (2019), Economic Reform Programme of Albania (2019-2021), Commission Assessment, SWD, p. 22.

60 Law No. 84/2019, On Invoice and Circulation Monitoring System.

61 European Bank for Reconstruction and Development (2017), Strategy for Montenegro, Document, p. 13.



obligatory submission of VAT declaration in electronic format on 1 January 2019.<sup>62</sup> It remains to be seen whether these efforts will produce fruitful results in the quest for formalisation.

**Removing fiscal and administrative burdens**  
**Bosnia and Herzegovina** has taken steps towards removing the fiscal burdens firms face. The central government has attempted to simplify the registration process for firms by introducing online platforms and one-stop-shops. The **Federation of Bosnia and Herzegovina**, has made some proposals concerning the decrease of contributions and the tax burden imposed on low-income earners. **Republika Srpska** adopted in 2017 the Law on Tax System, and a year later it amended the Law on Income Tax. These two initiatives aim to reduce administrative burdens on the companies, thus facilitating formalisation.<sup>63</sup> The **Kosovo\*** Strategy and Action Plan for 2019-2022 also seek to simplify the legislative framework and introduce a regulatory impact assessment system.<sup>64</sup>

### **Awareness raising and transparency of budget spending**

The understanding of the negative impact of the hidden economy and the benefits of operating legally are promoted through various awareness raising campaigns. These campaigns sometimes include lotteries such as the “Take a Receipt and Win” in Serbia, as well as returning part of the paid VAT and “My VAT” cash prizes lottery in North Macedonia. Another example of awareness raising is the face-to-face meetings with small busi-

ness representatives, which the Albanian General Directorate of Taxation initiated in 2017, in order to encourage formalisation, offer assistance and promote the new ad hoc call centre.<sup>65</sup> However, local experts have argued that medium and large companies, concessionaries and their subcontractors, need also be contacted, not just the small businesses. Albania and North Macedonia adopted additional measures aimed to promote the transparency and accountability of public spending (as a factor influencing corruption perceptions of the citizens). These included the adoption of the Public Finance Management Reform Programmes (for 2018-2021 in North Macedonia and for 2014-2020 in Albania, currently revised for the period 2019-2022), as well as the Law on Reporting and Recording of Liabilities (in force since 19 May 2018 in North Macedonia). Furthermore, the Ministry of Finance of North Macedonia started preparing a “Citizens’ Budget<sup>66</sup>” which interprets the key information contained in the State Budget for the benefit of ordinary citizens, and maintains the portal “Open Finances<sup>67</sup>”. In addition, the Albanian Ministry of Finance and Economy maintain the online portal “Local Finances<sup>68</sup>” with data from the 61 municipalities as a means for monitoring the use of public funds.

62 Ibid, p. 177.

63 OECD/ETF/EU/EBRD (2019), SME Policy Index: Western Balkans and Turkey 2019: Assessing the Implementation of the Small Business Act for Europe, SME Policy Index, OECD Publishing, Paris, p. 550.

64 Peci, B. (2019), [Informal economy: the devil on Kosovo's shoulder](#), Prishtina Insight.

65 Williams, C. C. and Kosta, B. (2018), Diagnostic Report on undeclared work in Albania, Employment and Social Affairs Platform, p. 59.

66 [Ministry of Finance, Republic of North Macedonia](#) (2017, 2018).

67 Ministry of Finance, Republic of North Macedonia (2020), [Open Finances](#).

68 Ministry of Finance and Economy, Republic of Albania, [online portal “Local Finance”](#).



## Policy recommendations

The area of business environment and reduction of the hidden economy is a critical dimension for the fulfilment of the **Copenhagen economic criteria** and the eventual accession of the Western Balkan countries to the EU. In particular, the functioning of the domestic market and its capacity to endure the pressures within the EU single market are among the key issues assessed by each candidate in its **Economic Reform Programme (ERP)**<sup>69</sup>, submitted on an annual basis to the European Commission. They also fall within the “fundamentals first” approach to EU enlargement. In each country’s ERP there is a special section devoted to the tackling of the hidden economy. The efficiency of the measures against the hidden economy also plays an essential role under **negotiation Chapter 2: Freedom of movement for workers**, which requires, among others, the setting up of a mechanism to coordinate national social security provisions for insured persons and their family members moving within the EU. **Chapter 19: Social policy and employment** sets minimum standards in the areas of labour law, and foresees EU level standards in the areas of employment policy, social inclusion and social protection. These are all factors that will influence the level and dynamics of undeclared work in the region upon accession. Other negotiation chapters that benefit from the regularisation of the business operations are: Chapter 3: Right of establishment and freedom to provide services; Chapter 4: Free movement of capital; Chapter 6: Company law; Chapter 8: Competition policy; Chapter 16: Taxation, Chapter 28: Consumer and health protection, and others.

The results of the SELDI *Hidden Economy Monitoring System* verify that policy-makers have taken steps to introduce the obliga-

tory use of written labour contracts on the main job across the Western Balkans. However, the effectiveness of their efforts has remained low, as the overall hidden economy levels in the region continue to rise. This is due to the multiple alternative ways of evading the payment of health and social security contributions, such as under-declaring the amount of the received actual salary, or non-declaring secondary or part-time jobs.

In order to tackle the informal economy, the **national governments** need to achieve the most efficient balance between preventive and punitive measures. *First*, they need to **identify the real incentives** for engaging in informal business activities, and implement reforms for improving the business environment, the tax policy and the quality of the public services (education, healthcare, pensions, etc.). *Second*, the governments should consider **the continuous use of a mix of measures**, such as awareness campaigns, the introduction of flexible types of labour contracts, use of vouchers, amnesties or tax reductions to promote the transition from the informal to the formal sector. And *third*, the random repressive monitoring and inspections of numerous small and micro-companies should be replaced with **targeted inspections** at key risk companies, sectors and locations. The latter would require consolidation of national registers, use of data-mining systems and redflags, and collaboration among all relevant national and cross-border public authorities. The development of e-Government services and the encouragement of electronic payments would also have a beneficial effect on formalising the economy.

The **European Commission and the Council** could also promote more in-depth reforms and decrease hidden economy levels through the provision of stronger messages, and more concrete and practical solu-

tions in the Assessments of the Economic Reform Programmes (ERP)<sup>70</sup>, as well as in the annual Joint Conclusions and policy guidance<sup>71</sup>. The (potential) candidate countries could benefit from the legal and procedural know-how of the Member States in applying efficient measures. This could be achieved through best practice exchange visits, as well as adoption of some of the measures identified in the virtual library of the European Platform tackling undeclared work<sup>72</sup>, as well as in the practice of Eurofound<sup>73</sup> and the International Labour Organization (ILO). The region could benefit from setting up a similar regional platform tackling undeclared work, in preparation for joining ELA upon accession. The

countries should also be more pro-active in utilising the available funding opportunities (European Social Fund, IPA, etc.) for strengthening their business operations, labour and tax legislation and procedures, and the quality of governance. In particular, Western Balkan countries need investment in soft skills capacities for their labour, tax and other inspectorates tackling informality. For example, the European Social Fund has supported the restructuring of the Employment Service Agency in North Macedonia in 2012-2013; IPA funded initiative has been developed for increasing the capacity of the Serbian National Employment Service and Ministry of Labour, Employment and Social Policy<sup>74</sup>, etc.





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