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CAUSES, CONSEQUENCES AND POSSIBLE WAYS FOR COMBATING UNDECLARED ECONOMY IN MACEDONIA

Abstract

The “grey” economy has a serious impact on the micro and macroeconomic performance of the country. High levels of grey economy negatively affect the competitiveness of the formal firms due to unfair competition on the domestic market and regulatory burden. They also deter foreign direct investments, which contributes to lower capital inflows and productivity in the country.

This paper attempts to locate causes, consequences, scope and to estimate the level of grey economy in the Republic of Macedonia, as well as possible ways for combating grey economy in Republic of Macedonia and understand the basic characteristics of the Macedonian case in order to present well-grounded policy recommendations.

The main finding (conclusion) of the paper is the fact that the grey economy in The Republic of Macedonia is a multifaceted phenomenon and the most efficient manner to remove the causes for the occurrence and presence of the grey economy is the improvement of the institutional frame in the country. There is a need for directly focused Government measures that would precipitate the integration of the grey economy in the formal sector, once the right conditions are put in place. The recommendations that this paper promotes will head exactly in that direction.

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Introduction

The “grey” economy has a serious impact on the macroeconomic performance of the country. High levels of grey economy negatively affect the competitiveness of the formal firms due to unfair competition on the domestic market and regulatory burden. They also deter foreign direct investments, which contributes to lower capital inflows and productivity in the country. The grey economy directly affects other aspects of social life, such as level of crime, rule of law, social conflict, political instability, etc.

This paper attempts to locate causes, consequences and the scope of grey economy in Republic of Macedonia, as well as to estimate the level of grey economy in the Republic of Macedonia and understand the basic characteristics of the Macedonian case in order to present well-grounded policy recommendations.

The research is based on several methodologies: qualitative, descriptive, statistic, and comparative. Some study findings and recommendations come out from the survey that was carried out on a sample of 1200 respondents.

During preparing this text a substantial amount of domestic and foreign research was consulted, but the analysis is mainly based on the author’s own research because the grey economy has been his analytical preoccupation for a longer period of time.

The main finding of the paper is that the most efficient manner to remove the causes for the occurrence and presence of the grey economy is improvement of the institutional frame in the country. This means improvement of the relations between the government and the economy. The recommendations that this paper promotes will head exactly in that direction.

1. DEFINITION OF GREY ECONOMY

What is grey economy?

There are various definitions that determine grey economy. It seems that the most dominant and most precise definition is the one which brings the grey economy in a tight connection with the officially measured GDP: *It encompasses all the unregistered production activities (the ones that create added value), which ought to be a part of the national production.*²

In order to determine the size of the grey economy as correctly as possible, as well as its rate in the GDP, we should bear in mind that: 1) we are talking about the added value, not about all the transactions which take part in the informal sector (for example, the capital revenues are not added value); and 2) the grey economy is not the same as tax evasion (nonpayment of or avoiding to pay taxes), because, paid or unpaid, the taxes represent a transfer, not an expense in the economic sense of the word.

2. SIZE, CAUSES AND CONSEQUENCES OF GREY ECONOMY

In the Republic of Macedonia there is a widely spread opinion that the grey economy (in different periods) has amounted between 40 and 50% of the GDP. The establishment of the “flat” profit personal tax and the “flat” personal income tax in 2007, the intensive fiscalization during the payment in the retail trade, as well as the more and more intensive usage of payment cards for execution of the payment function of money, created the possibility for the grey economy in 2007 to note downward tendency. According to the last (2011) research of the Ministry of economy, the grey economy in the Republic of Macedonia during 2011 was around 30%. In the meantime, the Government of Republic of Macedonia took series of measurements in different fields of socio-economic matters, which caused a decrease of the scope of the grey economy in the country. According to the State Statistical Office, the scope of grey economy in 2013/2014 fell down to approximately 20% of the GDP.

² Frey S. Bruno, Schneider Friedrich, *Informal and Underground Economy*, International Encyclopedia of Social and Behavioral Science, Amsterdam,: Elsevier Science Publishing Company, 2000, p. 2

The existence of still high amount of the grey economy has a direct negative influence on the main economic indicators, categories and instruments for macroeconomic regulation. In addition, three basic problems that the grey economy imposes can be located:

a. *The number of unemployed and socially endangered persons* is analyzed according to the official data from the State Statistical Office. However, their official number does not show what is the number of people that are involved in any kind of unregistered activities and get an appropriate compensation, which, also, is not registered anywhere.

b. The second problem is conceived in the *high sum of evaded tax*, which the participants in the grey economy do not pay. That restricts the fiscal policy in the enhancement of its mechanisms for further tax facilitation of the economic subjects, lower public debt and enhancement of its development component, which would result with GDP incensement and incensement of the number of employed persons, reduction of the number of unemployed persons and social security users, and further reduction of the grey economy in the country.

c. The third problem (which was highly manifested in the Republic of Macedonia for a longer period of time in the past) is the fact that the grey economy, if we could put it like that, points to an *“unhealthy” relationship between the Government and the citizens of the Republic of Macedonia*. The citizens (tax payers) manifest(ed) the disaffection of their economic-social status by transferring to the grey economy, thus enhancing the previously mentioned problems.

The causes which condition and stimulate the grey economy are different. The *unemployment* has the strongest influence on its development. In the period from 1992 to 2010 the number of unemployed persons in the Republic of Macedonia almost doubled (from 180.000 to 321.000 citizens), causing high unemployment rate of around 31%. In the meantime, as a result of various measurements undertaken by the Government of Republic of Macedonia, the number of unemployed people started to decrease and the unemployment rate fell down to 24,6% by 31.12.2015.

The jobs that were previously lost and the lack of more energetic measures of the central government for the creation of new jobs forced those persons to enter the grey economy. That statement confirms the results of the

performed survey³, according to which the major part of the citizens think that the biggest problem they face is unemployment and poverty (73% of the interviewed) and that inability to satisfy their existential needs has the highest influence on the appearance of the grey economy (29%) and the bad economic situation in the country (27%).

In the past 25 years Macedonian economy has faced a strong development of the private sector and the small and medium size enterprises, with a parallel adoption of incorrect and often confusing *solutions in the economic legislative*, which highly influenced the accelerating size and dynamics of the grey economy in the country.

The over burdening with taxes and contributions was one of the main instigators of the grey economy for a longer period of time. This was happening especially until 2007, during the progressive calculation of the personal income tax, when three tax rates were used (15%, 18% and 24%), depending on the amount of the realized income. In that tax system, the increased personal incomes mean an automatically increased tax burdening (the action of a so-called fiscal drug). The easiest way to avoid this is to report a lower realized income or executing an unregistered activity which does not require tax payment. Aware of those consequences, the Government of the Republic of Macedonia accessed the determination of a so-called flat profit tax and a flat personal income tax in 2007 and 2008, with the parallel reduction of their rates to 12% in 2007, and to 10% in 2008. The effect from those measures is already being felt: the tax payers are more aware on tax ethics, the fluctuation of means in the budget is amazingly getting higher, and the grey economy notes downwards values.

The next more significant cause for the strong presence of the grey economy is the *too emphasized administrative regulation of the "business"*. The establishment of one-stop-shop system and the cutting-down on time for company registration to a maximum of one day, as well as the implementation of the concept of the government for the so-called "Regulatory guillotine" are all directed to the overcoming of that situation, with already visible effects in the domain of the transfer of the informal into formal economy.

³ Conducted for the purpose of USAID project "Measuring the Grey Economy in Macedonia and drafting Policy Proposals for Its Integration in the Formal Sector", January 2008, Skopje

3. SCOPE OF THE GREY ECONOMY

There are numerous causes for the different approaches of identification of the grey economy. That helps determine the size of the eroded taxes and how fast and strong the market forces act and by that, how the size and structure of the GDP in the country is determined.

According to the internationally recognized system of national accounts known as standard SNA-93, the grey economy in the Republic of Macedonia can be located in the following areas⁴:

- 1) **Underground production:** Execution of permitted activities which are being hidden from the public institutions with the aim to avoid tax or social security contributions payment. Those activities are highly present in the Republic of Macedonia, and mostly, they are present in the execution of activities from wholesale and retail, real estate trade, property rental, hotel and restaurant work, execution of craftwork etc.
- 2) **Deliberate misreporting.** There is existence of misreporting of incomes or reporting higher expenses than the ones that really took place, with the purpose of avoiding or decreasing the amount that should be paid based on taxes, customs or social security contributions. The most common cases of this kind of grey economy in the Republic of Macedonia are reporting of lower salaries than the real ones (one part through a bank, and the other part in cash), hiring unregistered employees (the biggest part or 22% of the interviewed pointed out that this is the area where the grey economy is most present), execution of unregistered sales in trade, showing higher expenses than the real ones, not registering the total sales in the accounting books (smaller incomes), etc.
- 3) **Unregistered units:** The informal sector, usually, consists of small production units (mostly family units). They are not registered in the Central Register because they are not requested to do that with the appropriate legislative. Mostly they are established in the area of agriculture, construction, wall painting, service providing, households with small domestic production, tailors, etc.;
- 4) **Intentionally not registered units:** Having the aim to avoid the payment of different kinds of payments, such as taxes, contributions,

⁴ United Nations Economic Commission for Europe, *Non-observed economy in national accounts (Survey of national practices)*, United Nations, Geneva, 2003, p 2-4.

expenses for protection during work, etc., some enterprises or individuals intentionally do not register themselves in the Central Register or they do not register some part of their activity in order to realize the same purpose. In that case, their whole production or a certain significant part of it, is not registered (reported) and becomes a component of the grey economy. This group of the grey economy covers the unregistered mechanic workshops, print houses, transporters of goods and passengers, carpenters, shoe cleaners, technical support workers, grocery shops, etc.

- 5) **Performing activities which the companies are not registered for:** In some cases the companies which are registered to perform a certain activity do not engage their selves in it, instead, they perform another activity which is not registered and for which they do not pay the appropriate fees based on taxes, customs, etc. In that way, a company can be registered as a healthcare club or a massage club, and work as a bordello; or a certain night club can perform unregistered gambling activities and not pay any kind of taxes for them;
- 6) **Other uncovered activities:** Very common, and with a significant influence on the grey economy size, are the activities which are defined as tips, payment of salaries and other contributions for the employees in cash, production of certain products for one's own needs, giving lectures for training of pupils and students, money extortion, sale of all kinds of small goods on the car – fairs, street sellers of different products, goods bought abroad for which the customs tax has not been paid, etc.

Besides this kind of analytical classification of the resources of the grey economy in the Republic of Macedonia, for the statistical needs of the country, and at the same time for the formulation and implementation of the measurements of the macroeconomic policy of the country, an important issue is the distribution of that phenomenon through sectors. Generally, the grey economy is mostly notable in the trade, industry, agriculture, foreign trade and tourism.

4. MEASUREMENT OF THE SIZE THE GREY ECONOMY IN THE REPUBLIC OF MACEDONIA

Measuring the grey economy is not a simple thing. It is especially hard in the countries in transition, such as the Republic of Macedonia, where the major part of the market activities are performed by the numerous new small and medium size enterprises and traders – individuals, where this measurement is much harder to be accomplished than in big enterprises.

In theoretical analyzes and in statistical practices different methods for the measurement of the grey economy are used. Generally, there are three⁵ approaches in order to realize that purpose.

4.1. Direct approach

The most simple, and at the same time, most unsafe way to measure the size of the grey economy is performing survey research among the economic subjects where that phenomenon is supposed to be present. The different surveys of that kind refer to the many difficulties for the estimation of the size of the grey economy. Therefore, a part of the interviewed enterprises or individuals avoid giving answers or give incomplete answers to the questions asked. The surveys do not always cover all of the possible participants in the grey economy, and the numbers that figure are too approximate.

Another direct way to measure the grey economy size is to *control the tax refund or the payment of social security contributions* that the Public Revenue Office executes. In that case the total work of the enterprises is controlled and their real values are discovered. The weakness of that system for measurement of the grey economy is conceived in its stringency to solely tax or contributions (un)payment. Since the tax evasion has a redistributive character, its measurement has a small relevance for the „grey” economy measurement in its definition given in the chapter two of this paper.

Therefore, those two methods do not encompass all the grey activities and cannot measure the development of the grey economy for a longer period of time. But those two direct methods can be very useful while providing information for the activities that are comprised with the term grey economy and for the structure of the persons that are active participants in that phenomenon.

⁵ See more in Frey S. Bruno S., Schneider Friedrich, 2000, p. 3-6

4.2. Indirect approach (measurement of differences)

The definition and different modalities of the grey economy presence refer to the possibilities for its measurement through the identification of the differences that occur between the official and unofficial statistical indicators and in different markets:

a. The persons who work in the informal sector usually spend more than their officially reported income. In countries with a strongly developed IT and record-keeping system, it is possible to confirm that difference on individual's level and on aggregate level. But, in the Republic of Macedonia where this kind of record-keeping is just now starting to be established, it is very hard to find those differences.

b. The next field of measuring is the labor market. The frequent surveys made by State Statistical Office show that the number of unemployed (end of September 2015) in the country is 243.230 persons, while the number of reported persons in Agency for Employment, who are seeking for jobs, was 117.736. That means a big number of persons have provided unofficial working engagement such as self-employment, or are employed by other employers where they get financial payment in cash which is not registered in other places.

c. The newest approach to grey economy measurement through the system for measuring differences is perceived in the differences of the inputs, and especially in the measurement of the differences of electric energy consumption.⁶ The meaning of this approach is in the calculation how much electric energy would be normally spent for the production of the national income. The surplus of spent electric energy indirectly leads to a calculation of the production in the grey economy. The advantage of that approach is that it employs easily accessible and quite accurate indicators. On the other hand, its weakness is perceived in the fact that not all activities that the grey economy covers use electric energy.

A general problem of all the previously mentioned approaches for measurement of the differences as a base for measurement of the grey economy is that we must presume that in a certain year the country did not have grey economy. Otherwise, how could we determine the appropriate differences in its expenses?

⁶ Ott Katarina, *The Underground Economy in Croatia*, Institute of Public Finance, 2002, Zagreb, Republic of Croatia, p. 9

4.3. Estimation of the tax evasion

The size of the grey economy can be measured up to a certain level by estimation of the extent of tax evasion.⁷ The increase of burdening of the economic subjects with taxes and social security contributions will probably lead to a tax evasion increase. The reverse relation, of course, is always valid. The reduction of the rates of profit tax and personal income tax, as well as of a part of the social security contributions during 2007 and 2008, contributed to a significant decrease of the tax evasion in the Republic of Macedonia, which is manifested with a high increase of incomes in the central budget, bringing it to a level of unplanned and unwanted surplus in certain periods of that year. Those realizations, are, probably the reason for the major part of the citizens (38% of the ones participating in the survey) to positively evaluate the activities of the current Government of the Republic of Macedonia in the direction of grey economy reduction. However, during the implementation of that approach, we should always have in mind the fact that tax evasion can be caused by and be a result of the inadequate legal frame, administrative barriers, low quality public services, incredibility of the judicial system, etc.

5. RECOMMENDATIONS FOR REDUCTION OF THE SIZE OF THE GREY ECONOMY AND ITS TRANSFER INTO THE FORMAL ECONOMY

The previous analysis confirmed that the grey economy represents a challenge, but also a serious risk for the macroeconomic planning and regulation. That imposes the following dilemma during the determination of the activities of the institutions in charge for the reduction of the presence of that phenomenon: a) Increase of the punishments for the participants in the grey economy; b) Determination and tolerance of the optimal size of the grey economy that has a net present price for the economic policy of the country; c) Undertaking no actions and leaving the grey economy develop by itself; d) Abandoning or modifying the policy that generates grey economy. The final solution seems to be the most acceptable in theory and in practice.

a. Since the objective is to reduce the presence of the grey economy in the country, the main recommendation of this research is to direct the

⁷ Ibid, p. 13

activities and measures primarily to stopping and removing the causes, and afterwards punishing the consequences of that phenomenon. It is necessary to broaden the awareness of all the participants in the economic sector for the sake of respect for the regularity and the defined rules of the game, in the direction of enhancement of the institutional frame, judicial arrangement, the moral values and the stimulators of the economic functions in the country.

b. The multi-dimension of the issue, empirically confirmed with the research results, emphasizes the necessity for the government and its institutions to create a different approach for the creation, affirmation and implementation of the economic reforms, with the purpose of restoring the trust of the citizens to the institutions as components of consistent, responsible and non-compromising country.

c. The most efficient manner to remove the causes for the occurrence and presence of the grey economy is improvement of the institutional frame in the country. In order to realize that purpose, the government must improve the laws and remaining regulatory solutions more intensively than the way it is done up to now in certain areas of the economy: introducing high punishments if unregistered employees are found working in the corresponding trade company; the possibilities for usage of the payment instruments such as cash, assignation, compensation etc. (known as “payment with calculation”) to be eliminated, in the case when the transaction account of the economic subject is blocked, and with that the possibility of payment of the obligations based on taxes and social security contributions by using those instruments in order to avoid (completely or partially) to be eliminated as well; implementation with an enhanced intensity of the current project “regulatory guillotine”, further enhancement of the regulation of the cash payments and consumptions through intensifying the fiscalization process everywhere possible, and obviously very necessary (for example on the green markets); permanent regulation wherever possible of the additional jobs of persons who, besides the regular one, have additional professional engagements (like the case of the medical doctors); capacity building of the Customs Service with the purpose of stopping further forms of grey economy on the big scale as it was in the previous period; energetic implementation in practice of the Law for prevention of money laundering; enhancement of the controlling measures and punishments against the persons who act in unregistered (unreported) forms, but also punishments against the inspectors and custodians, who ease the previously mentioned deviant phenomenon, etc.

e. In the upcoming period there must be a feeling established in the general public that the tax system is stable and that the tax burdening gets lower and lower, as a result of already reduced rates for certain taxes.

f. There is no analysis of the grey economy which does not confirm that its reduction is possible by increasing the country's capacity for increase of the extent and quality of the public services. That imposes the need of organizational enhancement, efficiency, qualification and collaboration between the separate authorities and bodies of the central government, reduction of the influence of the central government to economy, rationalization of the public consumption, improvement of the public sector quality, cutting down of public administration, etc.

g. To all of these measures and activities for fighting the grey economy, the general impression of the establishment of a lasting and sustainable economic growth of the country must be added, and with that, the reduction of unemployment, the improvement of the standard of living and the increase of the tax ethics of the population, which will lead to a drastic reduction of the currently still high rate of grey economy in the Republic of Macedonia.

h. The analysis and the results from the field survey showed⁸ that the unreported and unregistered jobs are the main source of grey economy in the Republic of Macedonia. That means that the recommendations and measures for grey economy reduction which are mentioned in this research, as well as other research of the economic policy, should primarily be oriented in that direction.

i. The following forms of action could significantly locate and extend the coverage of the grey economy, together with the usage of appropriate preventive – instructional and punishment measures in order to reduce the presence of the grey economy in the country:

- Enhancement of the controls in the activities (areas) that this research locates as most intensive, regarding the presence of grey economy;
- Based on the indicators obtained with the previously mentioned procedures, the institutions in-charge should execute a theoretical calculation of the size of the value added tax that the subjects obligated by law should pay to the central budget. Based on that, they should have to make approximate estimations for the size of the newly created value in the country and for the areas where that value is created but officially not presented and where in the future

⁸ Bogov, D., *Hidden economy in F.Y.R. of Macedonia and its treatment in the statistical office*, Statistical Office of Republic of Macedonia, 2002.

the measures should be directed (control and punishment measures) in order to fight for maintaining and enhancing the current aggressive campaign of the central government through the public information means on the consequences from the great presence of the grey economy; The statistical system for calculation of GDP should be widening by adding elements that will increase its coverage and with that its authenticity. In that direction, the official statistics, should also import new approaches in that function. The usage of the approach for the spent electric energy, even though is not all-embracing and completely competent, would be a good method for location and evaluation of the major part of the grey economy;

- The further activities of the statistical and controlling institutions should, as much as possible, locate and estimate the amounts of the payments in cash and in kind production for their own needs, size of the tips which become a routine in Macedonian economy etc.

Conclusions

The grey economy represents a significant part of the Macedonian economy. There are different reasons that cause and stimulate grey economy. The strongest influence comes from the high unemployment in the country, confusing legal decisions, great administrative business regulation, intensive private business sector development and other.

Because of its high value, grey economy is challenging and serious danger for macroeconomic planning and regulation. Knowing that the on going Government of the Republic of Macedonia has identified grey economy as one of the important areas that require action.

But, what the program of the Government lacks is direct measures. Namely, the planned activities would indirectly affect grey economy activities and put in place conditions for its integration into the formal sector. However, there is a need for directly focused measures that would precipitate the integration of the grey economy in the formal sector, once the right conditions are put in place. The recommendations of this research are exactly in that direction. The main recommendation is directed towards activities and measures of the authorities for preventing and removing the reasons of the appearance of grey economy and punishing the consequences of this national

economy “evil”. The government has to increase the speed for redefining (changing) its role on the market. Finally, there is a need for widening the awareness of all business players for the need of respecting the regularity and playing according to the rules, as well as for enforcing the institutional framework, legal order, moral values and the motivators of the country’s functional economy.

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