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A·U·K

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Fighting Informal Economy: Informal Labor

An Honors Society Project

Presented to

The Academic Faculty

By

Lumbardh Zagragja

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Executive Summary

The first and main goal of project is to find how much does the budget of the government of Kosovo lose and how much pension contributions are forgone as a result of labor informality. Secondary goals of the project to find out the challenges of fighting labor informality and implications that arise from undeclared labor.

Losses from the government budget were calculated by using three different approaches. First approach takes into consideration the total number of workers that is generated by the Labor Force Survey and the total number of declared workers at the Kosovo Saving Pensions Fund. It was found that Kosovo budget loses between 2 and 4.6 million euros annually, while pension contributions forgone as a result of labor informality are between 11 and 18.3 million euros annually.

The second approach also refers to the total number of active workers that was found by the Labor Force Survey. The total number of undeclared workers is found based on the labor informality percentage that was found by the Riinvest report “To Pay or Not To Pay”. Calculations from this approach yielded that Kosovo government budget losses between 4.2 and 9.4 million euros in unpaid taxes. While the pension contributions forgone as a result of labor informality are between 22.5 million euros and 37.5 million euros annually.

Lastly, the third approach uses information on inspections from the Executive Agency of Labor Inspectorate. This approach compares the total number of inspected workers with the number of workers who were legalized. It was found that, using this approach, the Kosovo government budget loses between 1 and 2.3 million euros annually in unpaid taxes. While pension contributions forgone as a result of labor informality are between 5.4 and 9.1 million euros annually.

The study finds that main challenges of fighting labor informality are poor business planning, lack of collaboration between relevant institutions, and lack of capacities in the side of the Executive Agency of Labor Inspectorate.

Chapter 1: Background on informal economy: informal labor

Living in a developing country usually means that you will encounter informal economy almost every day. This is a phenomenon that is widely spread in most developing countries, sometimes even making up the majority of economic sector. The International Labor Organization defines informal economy as “all economic activities by workers and economic units that are - in law or in practice - not covered or insufficiently covered by formal arrangements” (“Resource Guide on the Informal Economy” 2014). Although there is substantial literature on informal economy, considering that the lives of billions of people are affected directly by this phenomenon there is arguably still much room for progress in our understanding of informal economy and its effects which would allow us to identify ways to fight it.

The implications of informality pose problems that are greatly relevant from socio-political as well as economic viewpoint. On the whole, economic informality implies a range of economic costs on any state, thereby jeopardizing social stability. First of all, economic informality hinders economic growth by limiting funds of governments and their ability to provide public goods. Second, informality serves as an incentive to firms to operate at a lower level and stay small, resulting in missed opportunities to grow and create jobs (Zeka 2013). Third, it causes inequities in the market where honest tax payers are disadvantaged to tax evaders, therefore, offering further incentives for tax evasion. Lastly, informality promotes unfair competition where formal sector carries the burden. It must also be noted that the informal labor has important implications on the well-being of workers (Zeka 2013). Workers that are employed in the informal sector either are under-employed in the sense that they work less than they are ready to, or have to work more to obtain a minimum wage. Second, these workers do not benefit from their pensions contributions because of their under-declared or undeclared work and generally lower salaries. Long term costs for the state are significant because these workers will be a burden when they retire (Zeka 2013).

So who works in informal economy? What are the main characteristics of employees and employers in the informal sector? Firms who operate in informal economy are typically characterized by small capital and operations. Staying small lowers the probability of being caught by tax authorities, which works as a mechanism that halts development of firms working in informal sector; and thus the development of their workers. Consequently, firms operating in

informal sector have a smaller capital-labor ratio. Little capital to work with and the lack of development strategy and prosperity repel high-productivity workers who are attracted to formal firms while low-productivity workers subside to the informal sector (Blades 2011).

Views of informal economy have evolved over time. In the beginning of the second half of the 20th century it was believed that informal economy was a fading phenomenon. It was believed that with the industrialization of economies and global development would imply that informal economy would make no more sense economically. However, researchers have been appalled to find out that actually the levels of informal economy, globally speaking, are increasing (Hussain 2011). The table below shows percentages of workers in three main continents with developing countries where informal economy is mostly spread. What must be paid attention to in this table is the high percentage of informal workforce of new jobs created. In Africa for example, out of 100 new jobs created 93 are in the informal sector (Chen 2001). The table also shows non-agricultural employment and urban employment. The reason why these two categories are chosen is because agricultural employment although informal is not considered to have the effects that other forms of informal employment have. That is mainly because usually families in rural areas are self-employed in agriculture and they only work in subsistence level (Chen 2001).

Informal Workforce as share of	Latin America and Caribbean	Africa	Asia
Non-agricultural employment	57%	78%	45-85%
Urban Employment	40%	61%	40-60%
New jobs	83%	93%	NA

Table 1. *Percentage of Informal Workforce in Latin America and Caribbean, Africa, and Asia (Chen 2001).*

As mentioned earlier, the view of informal economy has changed in recent decades. The table below summarizes some of the key differences between the old view on informal economy and the modern one. The main difference seems to be the major scope of informal economy that is recognized in the new view. It is no longer isolated in particular regions, industries, and occupations. Informal economy it has rather become a custom way of doing business in many

segments of economy. Another important takeaway from the table below is the fact that we no longer see informal economy as isolated in terms of goods and services produced. The new view considers that people employed in informal economy produce goods and services for the formal economy. This new relationship gives researchers a lot to think about when indexing for the impact of informal economy in economic growth and general welfare (Hussain 2011).

Evolving Perceptions of The Informal Economy	
The Old View	The New View
The informal sector is the traditional economy that will wither away with modern industrial growth.	The informal economy is here to stay and is expanding with industrial growth
It is only marginally productive	It is a major provider of employment, goods and services for lower end income groups, and contributes a significant share of GDP.
It exists separately from the formal economy	It produces for, trades with, distributes for and provides services for the formal economy
It represents a reserve pool of reserve labor	Much of the recent rise in informal employment is due to the decline in formal employment and informalization of employment relationships.
It is composed mostly of street traders and other small producers	It includes a wide range of informal relationships.
Informal workers run illegal and unregistered enterprises to avoid regulation and taxes	Informal workers are self-employed people producing legal goods through irregular and unregulated means.
Informal work is composed mostly of survival activities, and thus is not a subject for economic policy	Survival activities exist as well as stable enterprises and dynamic growing businesses.

Table 2. Differences between new and old view of economic informality (Source: Hussain 2011).

Consequences of informal economy

Nations' policy makers and even international financial institutions have spent and continue to spend a great deal of efforts and money into fighting informal economy. However, should we take for granted that the existence of informality is necessarily a bad thing? As the

matter of fact a study conducted by Stephen Graham Saunders of University of Johannesburg in Western Africa shows that with the increase of informal economy, the formal economy increases as well (Saunders 2005). Nevertheless, there are substantial drawbacks from having an economy that suffers from informality. First of all, an increasing informality in the economy must serve as an indication of people's dissatisfaction with tax policies. If people feel overburdened with taxes and requirements that they have to comply with, then they will choose an "exit option" which is to operate in the informal economy (Schneider 2000). This also means that people will not voice their concerns through different channels such as media or protests. Consequently, there is the risk of a vicious cycle to get in place where informal economy would keep increasing together with budget deficits (Schneider 2000). Another consequence of a developed informal economy is the effect that it has on other indicators such as unemployment rates, income, consumption and so forth. If politicians are to base their policy drafting in unreliable indicators, the effects of such policies would multiply the bad effects of informal economy. The effects of informal economy on the formal economy must also be considered. A developing informal economy may attract investment and resources (foreign and domestic) away from the formal economy. However, studies suggest that two thirds of income that is earned through informal economy is spent in the formal one, thus proposing that a developing informal economy may also have positive effects on the formal economy (Schneider 2000).

What causes informal economy?

To understand how to fight informal economy we must pay attention to what are the main causes. In the International Labor Organization report main causes of informal economy are generally identified. Identifying causes must start at regulations and legislation that tell us whether an activity is formal or informal. Three types of regulations must be considered. First, commercial regulations which foresee the establishment of private businesses. Second, laws that regulate property rights which affects the enterprise's ability to convert assets into productive capital. Third, labor legislation which regulates contracts and employment affairs ("Decent Work and the Informal Economy" 2002). What is imperative regarding these laws is whether they provide incentives for companies and workers to become or stay formal or

informal. The report recalls that more emphasis must be put on the analysis from the perspective of the worker or the enterprise that operates in the informal economy and try to understand what is the motivation behind such operations ("Decent Work and the Informal Economy" 2002).

Another cause of informal economy is the pattern of economic growth. It is not uncommon for developing countries to have more workers entering the workforce than there are new jobs created. Besides other reasons, this often happens because countries are focused on attracting foreign investment, thereby ignoring the agricultural sector. The movement towards high-tech industries requires for high-skilled workers. On the other hand, low skilled workers who are not able to find a job in the formal economy are forced to enter the informal economy (Arias 2007).

The underlying factor, however, for causing informal economy is poverty. First and foremost, it must be mentioned that there are many jobs in the informal sector where a great deal of knowledge and skill is involved. Being in the formal sector does not mean escaping poverty either. However, on average, income from informal economy is much lower than from the formal one (Arias 2007). Being poor means that you have to accept even unattractive and low paid jobs in the informal economy. At the heart of this issue stands the rural agricultural sector which usually comprises the largest share of informality within an economy. That is why policy makers who try to fight poverty and informality at the same time must focus most of their efforts into agricultural sector in rural areas (Arias 2007).

The informal economy is very often a product of trends in demography of a country. As previously mentioned, the development of informal economy is closely related to the surplus labor that enters the market. Therefore, it is very important to gain background information on a country's labor force size, skills and knowledge of workers that enter the market, migration and urbanization etc. ("Decent Work and the Informal Economy" 2002). Another important factor is female participation in the labor force. In most parts of the world, female participation has increased faster than men participation in the labor market. Necessity or choice is pushing more and more women to enter the labor force. Usually for the informal economy this means

that women will get the most low-paid and low skilled jobs either because they lack access to education or training or simply because they face employment discrimination ("Decent Work and the Informal Economy" 2002).

Chapter II: Background information on the Informal Economy in Kosovo

As a developing country, Kosovo shares the same characteristics with regards to informal economy with other countries that are at the same stage of development. Unfortunately, only estimates exist for the severity of informal economy of Kosovo. However, these estimates foresee that informality is a crucial component of the economy of Kosovo. Experience from other transition countries tells us that the formalization of economy is in positive relation to the democracy and establishment of regulatory institutions of the country (Krasniqi 2012). Therefore, fighting informal economy must come from a package of measures that aim overall development in terms of democracy, rule of law, and regulatory institutions.

The table below provides some of the key differences of formal and informal economy. In the first category we have ease of access by consumers which is easier in the informal economy- some argue that this is one of the reasons why informal economy takes place to begin with (Krasniqi 2012). The existence of informal economy is usually only possible at the small/micro level because at the large or medium level the surveillance of competent authorities is more rigid. An important distinction between formal and informal economy is the level of skills that are employed in each sector. From the table below we understand that formal sector employs workers that have mostly formal education while the informal sector is usually occupied with workers who gain their skills by experience (Krasniqi 2012).

Category	Formal Economy	Informal Economy
Ease of access by consumers	Difficult	Easy
Sources of Resources	External	Personal/family/informal financial markets
Scale of operation	Large/medium	Small/micro
Ownership	Corporate	Family/self
Technology	Capital-intensive	Labor-intensive
Skills	Formal education	By experience/ apprenticeship /self-taught
Social legislation (Labor code)	Protected	Low/ absence of protection
Market	Wide access	Limited access

Table 3. *Distinguishing Formal and Informal Economy (Source: Krasniqi 2012)*

The unemployment rate in Kosovo is estimated to be at 30%. However, the number of people employed in the informal sector is significant and it changes the unemployment indicators (Adrian 2001). Kosovo's labor market is characterized by some special features in comparison to neighboring and other developing countries. Most data show that one third of Kosovo's population is below the age of 16 while around 50% are estimated to be below the age of 24. This puts a great pressure in creation of jobs which cannot match the incoming entry of workers (Aleance of Kosovar Business 2007). It must be mentioned that the unemployment data varies depending on the source. The unreliability of data has been an ongoing issue in the after-war Kosovo, which has made the picture very unclear and thus affecting policy drafting.

While data access and reliability have been a problem in the after war Kosovo, World Bank has provided the following data on the informal labor in Kosovo which helps us see a better picture of the recent situation. The table below categorizes labor informality in Kosovo in three panels (by gender and area, by age group, and by education level). Panel A looks at the informality by categorization of gender and area. We can see that just as more men are employed in the formal sector than women, the same is true for the informal sector as well where 35% of all men employed are in the informal sector compared to 18% women. As expected, labor informality is more present in rural than urban areas with 38% and 24%, respectfully.

Panel A (total by gender and area)	Total	Male	Female	Urban	Rural
Employees	67%	63%	85%	73%	62%
Temporary	65%	65%	67%	71%	59%
Without a contract	13%	14%	70%	12%	13%
Self-employed with employees	9%	10%	3%	10%	7%
Self-employed with no employees	15%	18%	6%	12%	19%
Unpaid family workers	31%	35%	18%	24%	38%
Informal	31%	35%	18%	24%	38%
Panel B (by age group)	15-24	25-34	35-54	55-64	

Employees	65%	67%	67%	74%	
Temporary	70%	67%	64%	62%	
Without a contract	31%	16%	9%	5%	
Self-employed with employees	3%	8%	10%	7%	
Self-employed with no employees	12%	15%	17%	13%	
Unpaid family workers	19%	10%	7%	6%	
Informal	50%	35%	28%	21%	
Panel C (by education level)	Lsec	Usec voc	Usec gen	Tertiary	
Employees	45%	66%	70%	89%	
Temporary	71%	62%	60%	74%	
Without a contract	26%	16%	1%	2%	
Self-employed with employees	8%	9%	8%	7%	
Self-employed with no employees	25%	17%	14%	3%	
Unpaid family workers	21%	7%	8%	1%	
Informal	57%	33%	27%	4%	

Table 3. *Informal Workers (Percentage) (2008)*(source: World Bank: Kosovo-Unlocking Growth Potential: Strategies, Policies, Actions)

Panel B, categorizes informal workers by age group. Age and tendency to work in informal sector are negatively related, where with the increase in age percentage of informal workers decreases. The highest informality occurs for ages between 15-24 at around 50%. Workers who belong to this age group hold unstable jobs and are more vulnerable, therefore, more likely to succumb to working informally (Krasniqi 2012). Panel C categorizes informal labor by education level. As expected, education and tendency to work in the informal sector are negatively related. With the increase in level of education workers are more inclined to work in the formal sector. This change is significant from one level education to the next, where 57% of workers with lower secondary education work in the informal sector as opposed to just 4% of workers with tertiary education (Krasniqi 2012).

A more recent study has been carried out by the Friedrich Ebert Stiftung (FES) Office in Prishtina, the Kosovo Foundation for Open Society (KFOS), and Riinvest Institute for Research and Development. To answer one of the most important questions in our report, how big is labor informality in Kosovo, “To Pay or Not To Pay” Report is based on survey of 600 randomly chosen companies. The level of labor informality is considered to be at 37% (Zeka 2013). This figure is in line with prior estimations of the size of informality in Kosovo such as that in UNDP’s Kosovo Human Development Report of 2012 where labor informality is considered to be between 30 – 40 percent.

Expectedly, the sector with most undeclared workers is agriculture where only 30% of workers are declared. While the sector with the lowest level of undeclared workers is education with only 17.5% (Zeka 2013).

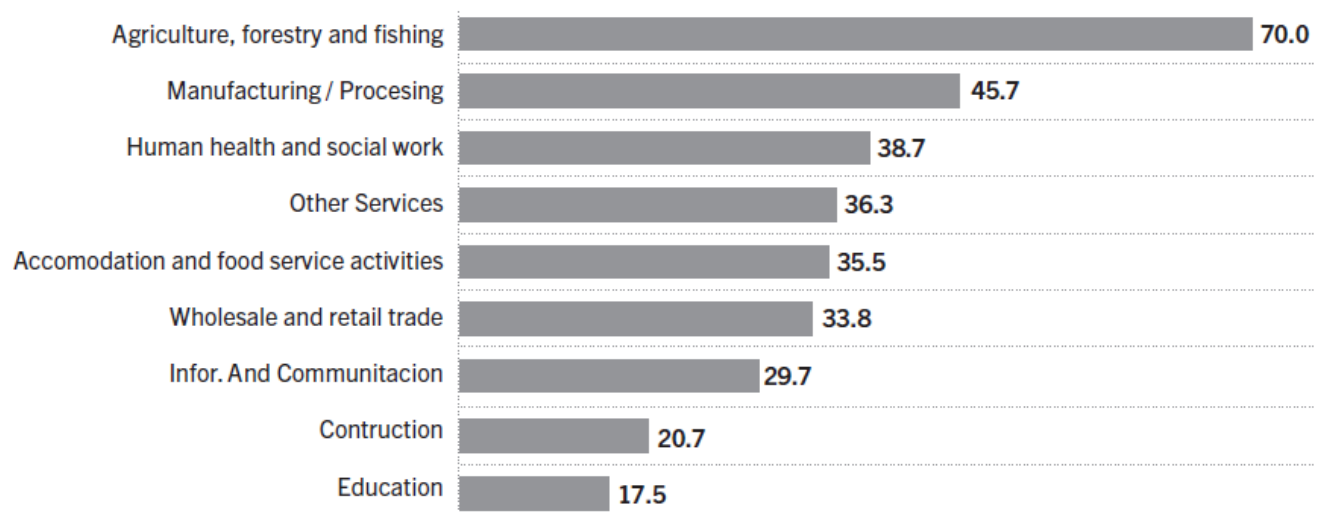


Figure 1. *Labor evaded for tax purposes in different sectors (in percentages)(Source: To pay or not to pay report 2013)*

There are two main views that explain the development of informality. The first suggests that hefty start-up costs, inelastic labor registration, ineffective tax system, high registration charges and corruption are the main factors that give way to the rise of informal economy. The second view proposes that the main reason why entrepreneurs operate in the informal economy is the lack of constrains from goods and services which are only available in the formal sector. In other words, so long as constrains and incentives do not justify operating

in the formal sector, entrepreneurs will choose informal economy (Johnson et.al.,1998; Loayza, 1996; Montiel et.al.,1993). These views are not mutually exclusive, and as such they both apply to the informal economy of Kosovo. Recognizing this, efforts have been made into facilitating registration procedures for small and medium enterprises. A project financed by the World Bank has established Business Centers which have eased the steps for registration and have provided authorities with a valuable digital database of businesses operating in Kosovo. The World Bank has further suggested that attempts to move from informal economy towards the formal should focus on these main areas (Kristina 2005):

- Reduce the requirements for business permits, licenses and approvals
- Restructuring of administrative processes
- Enforcing uniform taxes
- Improving access to capital

On the other hand, the Alliance of Kosovar Business (AKS) suggests that there are four main policies that the Government of Kosovo should follow which would have an impact on the informality of the economy (Alliance of Kosovar Business 2007):

- Macroeconomic policies (macroeconomic stability, inflation control, economic growth, employment policies, business environment);
- Financial regulatory policies (system of taxes, fees, social insurances, pensions, fines, etc.);
- Labor norms and law and
- Social protection policies

In general, the main effects of informal economy in Kosovo are on:

Monetary indicators: Informal activities tend to be carried out in cash thus increasing the need of money circulation (Gianni 2007).

Participation in the labor market and duration of working hours: If the number of employees and working hours in the informal economy increase, the rate of employees and working hours in formal economy will decrease (Gianni 2007).

Official statistics of production: Growth of informal economy is associated with less credible statistics and lower figures compared to the official rate of the economic growth (Gianni 2007).

Economic growth: There are two opposite streamlines concerning the effect of informal economy on economic growth: The first is that the decrease of informal economy influences on the economic growth negatively since less taxes are paid and, thus, less government expenditure. And the second is that formal economy is more competing and efficient than the informal economy; in this way it stimulates the economic growth (Gianni 2007).

Public expenditures: On the conditions of high-rate informal economy lead to an increase of the informal economy itself, and in a vicious circle, to an increase of taxes to meet the public expenditure needs (Gianni 2007).

Chapter 3: Methodology and Results

Goals of the project

The main goal of this project is to determine how much does the budget of Kosovo lose in revenues from the unpaid taxes of informal workers; and what is the value of pension contributions that is not being accumulated as a result of the labor informality. The second goal of the project is to analyze the causes and implications of labor informality from an economic and social point of view. Lastly, this project will try to determine which are the main implications and challenges in fighting informal labor.

The following section will be allocated to calculation of losses in budget revenues and pension contributions. This will be achieved through three different approaches:

- First approach will take into consideration the total number of workers as stated by the Labor Force Survey and the total number of pension contributors in the Kosovo Pension Saving Trust; the difference of which is expected to tell use the number of undeclared workers
- Second approach will use the indicator of informal labor that was found in the study conducted by Riinvest & co. and compare that with the total number of workers found by the Labor Force Survey.
- Third approach is to use the information on inspections by the Executive Agency of Labor Inspectorate and the number of undeclared workers that were caught during these inspections to tell us a percentage of undeclared workers among inspected subjects. This will be multiplied by the total number of workers as stated in the Labor Force Survey.

Methodology

Findings of this project are based on reports, surveys, and internal information of relevant institutions that deal with the issue of undeclared workers. For the purposes of this project, interviews, surveys and data was extracted from institutions such as: Kosovo Agency of Statistics, Riinvest Intitute, Kosovo Foundation for Open Society, Friedrich Evert Stiftung, Executive Agency of Labor Inspectorate and Department of Labor and Employment within the Ministry of Labor and Social Welfare, Kosovo Saving

Pension Trust. The Labor Force Survey that was conducted by the Kosovo Agency of Statistics is a very crucial component for our calculations as it is used in all three approaches of calculations of losses of government budget revenues as a result of labor informality. This survey found the total number of active working people in Kosovo. It must be stated that for the purpose of calculations a very important assumption was made. It is assumed

“that subjects surveyed would declare themselves as employed, even if they worked in the informal sector. That means that they would have no interest in hiding the fact that they are working, because nowhere in the survey was there any question or indication regarding their status as declared or undeclared workers.”

This assumption was supported by carriers of this survey who were interviewed (Expert from the Kosovo Agency of Statistics, personal communication, January 12, 2015). Riinvest Institute in cooperation with Kosovo Foundation for Open Society and Friedrich Evert Stiftung, conducted a report on tax evasion and labor informality in Kosovo. This study found that 37% of total employed workforce is not declared (Zeka 2013). The second approach of calculating the government budget revenue losses as a result of labor informality uses this percentage to find the total number of informal workers. The Executive Agency of Labor Inspectorate was able to provide us with information regarding the number of total workers inspected and total number of undeclared workers who were legalized as a result of these inspections. The third approach will use this percentage to determine the number of undeclared workers.

Difficulties

One of the main difficulties of the project was the obtaining of qualitative data (i.e. interviews). People who were responsible in relevant institutions to our project were sometimes reluctant to provide their own opinions on a number of issues with the fear of contradicting the findings that their institutions have had publicized.

Possible sources of error

Main sources of possible errors are in the third approach. The third approach uses data from the Executive Agency of Labor Inspectorate which may be subject to bias as it happens in many public institutions. This bias is suspected because of the lack of capacities of public institutions, such as Executive Agency of Labor Inspectorate, to be fully capable of catching undeclared workers, as well as possibility of corruption which has been prevalent in Kosovo.

Limitations

Main limitation is the lack of any information regarding the average salary in the informal sector. Therefore, we will have to make assumptions and take into consideration three different scenarios to project possible losses in budget revenue as a result of labor informality.

Chapter 4: Results

First Approach

The first goal of the project is to determine the budget revenue losses that occur as a result of undeclared workers in the form of unpaid income tax. We will use the same approach to also calculate the lost or unpaid pension contributions by the employer and the employee. The first approach has the least potential for errors and limitations.

Our calculations start by looking at the total number of active workers for year 2013. Calculations will be based on this year since most of the data used was not available for year 2014. For year 2013 the Kosovo Agency of Statistics found that there are 338,364 employed people from the age of 15 to 64 (Labor Force Survey 2013). On the other hand, active contributors to the Kosovo Saving Pension Trust for year 2013 were 277,267 (Annual Report 2013). This number is considered to be the total number of declared workers. When we subtract the number of declared workers from the number of total workers in the economy we conclude that 18.05% of all workers are undeclared to tax authorities and, therefore, do not contribute to their pension fund. This 18.05% translates into 61,097 workers who constitute the total number of informal labor in Kosovo.

For the first goal of the project, we are limited because we do not have information on the average salary in the informal sector. Therefore, for purposes of calculation another assumption is made that

“the average monthly salary for undeclared workers is lower than the overall average salary, because undeclared workers typically occupy jobs that are paid less than those in the formal sector.”

Calculations are based on three scenarios of potential average salaries in the informal sector, which will give an approximation of how much revenues are lost from the budget as a result of undeclared workers. Three scenarios of average monthly

salaries are 150 euros, 200 euros and 250 euros. The table below summarizes the results:

Average Salary	Tax on income per worker	Total Budget Loss	Pension Contribution Employer	Pension Contribution Employee	Total Pension Contributions Lost
150	2.80	2,052,859.20	7.5	7.5	10,997,460.00
200	4.40	3,225,921.60	10	10	14,663,280.00
250	6.30	4,618,933.20	12.50	12.50	18,329,100.00

Table 4. *Government revenue and pension contribution losses as a result of undeclared workers (Source: author's calculations)*

For each of the average salaries above, the taxable portion was calculated according to the law on personal income in Kosovo. The first hypothetical average salary is taxed with 4% on the amount from 80 to 150 euros (since 0-80 euros is not taxed). The same logic is followed in other hypothetical average salaries in other scenarios. That amount is then multiplied by the number of informal workers as was found by the first approach, and then multiplied with twelve months of the year to find annual losses in budget revenues.

The pension scheme in Kosovo is regulated as 5% employee contribution and 5% employer contribution. This is applicable to the whole of the wage and not only a part of it as it is with taxation. The result is multiplied with the number of total undeclared workers as found by the first approach and then multiplied with twelve months to find annual losses in pension contributions.

The Second Approach

The second approach to find budget and pension contribution losses as a result of undeclared workers uses the percentage of undeclared work which was taken from the Riinvest Institute study “To pay or not to pay”. The study relied on a survey conducted on 600 companies in Kosovo, which is considered to be statistically representative of all companies registered in the Tax Administration of Kosovo. It was revealed that “on average, 37% of the total employed workforce is not legally declared”(Zeka 2013). The question that was asked to measure the level of labor informality for purposes of tax evasion is as follows:

“What percentage of the total labor force of a typical firm in your area of activity would you estimate is reported to the tax authorities, bearing in mind difficulties with complying with taxes and other regulations?”(Zeka 2013)

After answering this question, later in the survey, subjects were asked directly about the number of full time employees in their firms that are not declared. Both techniques generated the same result of 37% of undeclared workers, which adds robustness to these results. For the purposes of this project, this finding has enough credibility to use it for calculations of budget and pension contribution losses as a result of undeclared workers.

According to the finding of the Labor Force Survey conducted by the Kosovo Agency of Statistics, there are 338,364 active workers in Kosovo. Same as in the first approach, the assumption here is:

“that subjects surveyed would declare themselves as employed, even if they worked in the informal sector. That means that they would have no interest in hiding the fact that they are working, because nowhere in the survey was there any question or indication regarding their status as declared or undeclared workers.”

According to the report by Riinvest Institute, 37% of all workers (338,364) are undeclared to tax authorities(125,195). The table below summarizes the losses in budget revenues and pension contributions.

Average Salary	Tax on income per worker	Total Budget Loss	Pension Contribution Employer	Pension Contribution Employee	Total Pension Contributions Lost
150	2.80	4,206,552.00	7.5	7.5	22,535,100.00
200	4.40	6,610,296.00	10	10	30,046,800.00
250	6.30	9,464,742.00	12.50	12.50	37,558,500.00

Table 5. *Government revenue and pension contribution losses as a result of undeclared workers (Source: author's calculations)*

The calculations for the table above are similar to the previous approach. The number of undeclared workers is the only variable that changes in this approach. The Riinvest Institute finding suggest a much larger number of undeclared workers which results in larger losses from budget revenues as well as pension contributions.

The third approach

The third approach is based on information from the Executive Agency of Labor Inspectorate. It takes into account the number of total inspections that were completed in year 2013 and the number of undeclared workers that were caught and then declared to tax authorities.

The total number of subjects (firms) inspected in 2013 was 5,627 (Expert from Executive Agency of Labor Inspectorate, personal communication, Jan 16, 2015). Out of the 5,627 firms inspected, 289 firms were not registered to the tax authorities and thus were legalized. This let's us know that, in difference from the second approach, this approach also includes firms that were not registered to tax authorities. In all 5627 firms inspected, there were a total of 37,518 workers. During inspections 3,371 workers were legalized, meaning that they were undeclared (Expert from Executive Agency of Labor Inspectorate, personal communication, Jan 16, 2015). According to this calculation, approximately 9% of all workers were undeclared (30,453). This approach gives us a larger pool of data then the second approach on which to base our findings. We will use the same total number of workers from the Labor Force Survey to determine the total number of undeclared workers and then calculate losses from the budget as well as

pension contributions from all hypothetical average salaries that we assume are prevalent in the informal sector.

Average Salary	Tax on income per worker	Total Budget Loss	Pension Contribution Employer	Pension Contribution Employee	Total Pension Contributions Lost
150	2.80	1,023,220.80	7.5	7.5	5,481,540.00
200	4.40	1,607,918.40	10	10	7,308,720.00
250	6.30	2,302,246.80	12.50	12.50	9,135,900.00
300	9.60	3,508,185.60	15.00	15.00	10,963,080.00

Table 6 . *Government revenue and pension contribution losses as a result of undeclared workers (Source: author's calculations)*

The calculations on the table above are also similar to those in the first and second approach. The only variable that changes is the number of undeclared workers. The numbers are significantly different in all three approaches as the number of undeclared workers differs based on calculations. The next chapter will analyze some of the strengths and drawbacks of methods used for these calculations, possible sources of errors and provide possible explanations for the large disparities between each approach used.

Chapter 5: Analysis and Discussion

Goal of the project

This project aims to find the annual losses in budget revenue and pension contributions that result from undeclared workers (i.e. informal labor). To achieve that goal, three approaches were used to find the number of undeclared workers. Calculations from these three approaches revealed a great deal of discrepancy between one another, providing ground for further research on the issue. In this chapter we will discuss what the results from each of the approaches mean. Later we will discuss some of the reasons we see this discrepancy between the results. And finally discuss some of the implications and challenges of informality in Kosovo.

As it was stated in the previous chapter, the first approach used data from the Labor Force Survey conducted by the Kosovo Agency of Statistics and Kosovo Saving Pension Trust. The Labor Force Survey has found that there are 338,364 workers in Kosovo. We use this number in all three approaches as the total number of workers, which included declared and undeclared workers. The most reliable source of information to understand how many workers are declared is the Kosovo Saving Pension Trust, where there are 277,267 active contributors (i.e. declared workers)(Annual Report 2013). Since there is no information on the average salary in the informal sector, three hypothetical average salaries were considered: 150 euros, 200 euros, and 250 euros. The underlying assumption for taking these average salaries is that the average salary in the informal sector is by default lower than that in the formal sector. We do not know how much lower it is, therefore, we were limited to taking three possible average salaries for the purpose of calculating the losses from the budget and pension contributions.

The first approach reveals 18% labor informality in Kosovo, or about 61,097 undeclared workers. This percentage is well under the average of labor informality in South-Eastern Europe which is at 25% (Hazans 2011). With this number of undeclared workers, Kosovo budget is predicted to lose from 2 to 4.6 million euros annually in unpaid taxes. Additionally, non-contribution to pension savings range from 11 to 18.3 million euros annually. In interpreting these results and looking at what they mean for

Kosovo's budget and economy, we must bear in mind that a minimal level of labor informality is always expected to occur. That means that for a portion of the labor informality, there is nothing the government, the economy or individual businesses can do to make sure that it is completely formalized. Many European countries suffer from labor informality such as Ireland and Greece at one third of their labor force working in informality, Austria (20%) and UK (13%), while Lithuania has one of the lowest levels of labor informality still at 6.4% (Hazans 2011).

How reliable are the findings of the first approach and what are some of the potential sources of error? Experts from the Kosovo Agency of Statistics offer some more information on how the survey was carried out and some problems associated with it. One important factor for the Labor Force Survey conducted in Kosovo is that they had a very good reach to people in rural areas. According to experts who carried out the survey, even workers employed in the agricultural sector and subsistence level were counted as active workers (Expert from the Kosovo Agency of Statistics, personal communication, January 16, 2015). This is imperative for our calculations because the true number of all workers is a crucial part of calculating the number of undeclared workers. On the other hand, KAS experts also revealed that potential errors may occur in finding the total number of active workers when some of the surveyed subjects were inclined to declare themselves as unemployed in the hope that KAS agents will help them somehow. Although it was made very clear to all surveyed subjects that this survey is for statistical purposes only, there is a chance that some of them may have declared themselves as unemployed even if they were working. However, KAS experts were still very confident in the findings of the Labor Force Survey and they stated that this potential source of error is not high enough to effectively impact the results (Expert from the Kosovo Agency of Statistics, personal communication, January 16, 2015).

The second approach also uses the total number of active workers stated by the Labor Force Survey. It is based on the percentage of informal labor that was stated in the study carried out by Friedrich Ebert Stiftung (FES) Office in Prishtina, the Kosovo Foundation for Open Society (KFOS), and Riinvest Institute for Research and Development. This survey concluded that 37% of workers in Kosovo are not declared

(Zeka 2012). The main strengths behind this survey that makes this indicator reliable are the two methods used to generate this number. Firm owners were firstly asked to state the perceived labor informality prevalent in their sector, and then they were asked directly about the number of full time employees that work in their firms and are not declared. Averaging out all responses generated the same number of 37% of undeclared workers. According to calculations based on the second approach there are 125,195 undeclared workers in Kosovo. Our calculations yielded that there the Kosovo government budget losses from 4 to 9.4 million euros annually as a result of undeclared labor. As for pension contributions there are 22.5 to 37.5 million euros lost annually. A possible problem with this approach is the reliability of the data in which the calculations are based, namely the Riinvest report. There is a tendency by non-governmental organizations, such as Riinvest, to publicize reports which describe the situation in Kosovo worse than it is, in order for there to be the need of conducting such projects in the future . While this may be considered as a valid concern by some, we do not have sufficient evidence in Kosovo or the region to support such a claim.

The third approach uses data from the Executive Agency of Labor Inspectorate. Calculations are based on the number of inspected firms and workers and the number of workers that were legalized (i.e. declared) as a result of these inspections. For year 2013 there were a total of 5,627 firms inspected, out of which 289 firms were not registered and therefore, legalized as a result of inspection. On all firms there was a total of 37,518 workers, out of which 3,371 workers were legalized (meaning they were undeclared before the inspection)(Expert from the Executive Agency of Labor Inspectorate, personal communication, January 17, 2015). Our calculations reveal that using this method of measuring the number of undeclared workers, there are 30,453 undeclared workers or roughly 9% of entire labor force. Using this approach we find that the budget of Kosovo suffers from 1 to 2.3 million euros annually as a result of undeclared workers. While there are 5.4 to 9.1 million euros lost in pension contributions each year. This approach has a high potential for error because it is based almost entirely on the capability of the EALI to catch undeclared workers and legalize them. Experts from this agency revealed that the agency does not have sufficient capacities to fight labor informality properly. Additionally, they blamed the lack of

cooperation between relevant institutions to provide necessary information that would facilitate the combat against labor informality. The total number of inspectors in Kosovo is 50 inspectors, which according to EALI experts is in compliance with international standards (Expert from the Executive Agency of Labor Inspectorate, January 17, 2015). However, the economic, social and political situation in Kosovo calls for a greater number of inspectors. The ratio 1 inspector for every 1000 firms may be fitting for countries which have already have established institutions and a relatively high level of rule of law. However, for Kosovo this number of inspectors is considered to be inefficient (Expert from the Executive Agency of Labor Inspectorate, January 17, 2015). On the other side, while some argue that non-governmental organizations make the situation to appear worse than it actually is, their governmental counterparts such as EALI may make the situation to appear better than it is because that is the interest of the government. However, that remains only conjecture.

What are the main challenges of fighting informality and consequences of it?

So far in this project we have discussed labor informality as a negative phenomenon and our focus has been the loss of budget revenues and pension contributions. However, secondary and tertiary goals of the project are also challenges of fighting informality and some of the main implications associated with it. Main challenges of fighting informality reside in businesses' incapability of paying all the taxes, inadequate capacities for inspection and control, unqualified labor force etc. Some of the implications with labor informality in Kosovo are the effects of involuntary legalization of workers, forgone pension contributions and unsecure future, market distortions, trade off between better conditions for existing workers and opportunities for employment for the unemployed etc.

We will refer once again to the report "to pay or not to pay" by the Riinvest Institute which found that 62.7% of respondents declared that it is relatively easy to evade taxes if they decided to do so (Zeka 2012; Expert from Riinvest Institute, personal communication, January 18, 2015). According to Riinvest expert, this is a very concerning figure that proves incapability of tax authorities and labor inspectorate to effectively fight tax evasion and labor informality. This takes us to the intrinsic incentives

of not evading taxes, or what is called tax morale. Tax morale is the incentive of people to pay taxes not because of possible penalties but rather the element of “civic virtue”. This study finds that Kosovo business owners are generally characterized by very low tax morale (Expert from Riinvest Institute, personal communication, January 18, 2015). Another alarming figure is that around 40% of business owners surveyed justify evading taxes. There is a historic background that may be a possible explanation for such high level of justifying tax evasion which goes back to communism days where evading taxes was considered to be a patriotic act (Expert from Riinvest Institute, personal communication, January 18, 2015).

According to the expert from the Executive Agency of Labor Inspectorate, main challenges of fighting informal labor start from businesses’ poor planning and financing. (Expert from the Executive Agency of Labor Inspectorate, personal communication, January 17, 2015). Business owners already face a inadequate environment of doing business but their planning is also such that forces them to cut expenses wherever they can, and often that means not declaring workers with the intention of evading taxes (Expert from the Executive Agency of Labor Inspectorate, personal communication, January 17, 2015). It is in the best long term interest of every business, however, to declare their workers since this prompts a higher motivation, lower stress and higher levels of identifying oneself with the business. Nevertheless, there is also fault on the side of the EALI in fighting effectively informal labor. Factors that impede the attempts of controlling and legalizing undeclared workers are the lack of collaboration between relevant institutions and lack of access to firms (Expert from the Executive Agency of Labor Inspectorate, personal communication, January 17, 2015). The expert from EALI let’s us know that sometimes they have difficulty finding the address of registered firms. Other times it is not entirely clear whether businesses are still active or not. This creates confusion and is very time and resource consuming.

But how big of a problem is labor informality? Many developed European countries continue to have relatively high levels of labor informality (Hazans 2011). Despite the losses in budget revenues, the first implication is the forgone contribution to pension’s fund. This creates a group of workers who will need assistance either from

future generations or the state to provide for them when they retire. But a bigger problem is market distortion that is created as a result of tax evasion (i.e. undeclared workers). The number one business barrier in Kosovo, according to business owners, is unfair competition which is caused by tax evasion and informality (Zeka 2013). This creates problems for businesses to grow and has a much larger effect on the long term economic development than the forgone taxes and pension contributions. After all, one way to think about labor informality is to compare it with a tax cut. Ignoring for the moment all the safety hazards, job security and so on, by not declaring workers there is more money on the hands of consumers. At the end of the day that money is still being spent in this economy for the most part. However, the Riinvest expert argues, the implications of undeclared workers (i.e. tax evasion) is felt more by market distortions that are created than by the forgone taxes and pension contributions. (Expert from Riinvest institute, personal communication, January 18, 2015).

Another way to look at labor informality is as a tradeoff between improving the conditions of existing workers, thereby, also increasing tax revenues and pension contributions on one side, and decreasing the number of active workers. This trade off exists because if current businesses who have undeclared workers, are forced to declare all of their workers and have full compliance with the law, they are very likely to lay off some of their workers. There is a number of variables that play a part in making such a policy decision; however, this tradeoff is definitely a key factor when we talk about fighting informality in general.

Chapter 6: Recommendations and Conclusions

The main goal of this project has been to determine how much does the government budget lose from the unpaid taxes of undeclared workers and, simultaneously, how much is forgone in pension contributions. This was done through three approaches which generated significantly different results.

The first recommendation is for further research to be conducted on the degree of labor informality in Kosovo. For effective battling of informality, we have to be sufficiently familiar with its degree and profile. Further, research should be conducted to find the average wage in the informal sector which would help determine how much taxes and pension contributions are forgone as a result of undeclared workers.

The second recommendation is for the government to increase capacities of the Executive Agency of Labor Inspectorate and foster inter-institutional collaboration and update of information on Kosovar businesses. It was found that one of the main challenges for fighting labor informality is the lack of capacities of the EALI, especially the number of inspector. The 50 inspectors that are currently hired to inspect labor conditions in Kosovo, are not sufficient to effectively fight labor informality; therefore, more inspectors should be hired.

Business planning and poor environment for doing business are also found to be some of the main causes of labor informality. It is recommended therefore, that besides general improvement of the business environment through micro and macro policies, special focus to be paid to business planning skills. Specialization programs, workshops, and incentives to participate in trainings for entrepreneurs and business leaders are some of the suggested policies that should be followed in order to improve business planning.

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Appendix A: Interview with experts from the Kosovo Agency of Statistics

1. Can you tell us more about the Labor Force Survey?

The Labor Force Survey was conducted on 600 families, 150 families for each quarter. It provides very detailed information on the labor force and its main characteristics. We are very proud of it and we have to say that it has been used as reliable basis for many other studies in Kosovo.

2. The Survey does not include any information on the distinction between the declared and not declared workers. Do you have any suggestion or personal opinion on the level of labor informality?

I would not take the liberty to expand on that. Our study was not concerned with that and I don't think I should make further comments on that. There are responsible institutions and agencies that deal with that.

3. I plan to use the number of total workers that was found from the survey and subtract from it the number of declared workers in the KPST to find the total number of undeclared workers. I want to get your personal opinion on it.

Yeah that seems fairly accurate. I know some people in the Trust that can help you with that if you have problem accessing that sort of data. I think you should also take into consideration the number that was declared at Tax Administration and compare them.

4. Do you think the number of active contributors at KPST is not reliable for this sort of calculation?

No, no I'm just saying that you may use also the number from TAK to support your calculations but I think it should be very straightforward the number of active contributors at the Trust. Not very difficult to find and I don't think there is any catch there.

5. Do you agree with the assumption that workers who are not declared to tax authorities would declare themselves as active workers in the survey?

Yes. Again the survey is really not concerned with that and we made no indication that we have anything to do with that sort of stuff. The only problem may be that some people may have said that they don't work even if they did because they think we will find them jobs. We try to tell them that we are only gathering information of statistics but maybe sometimes they are not convinced.

6. Do you think that may have a significant impact on the result of the survey?

No, not really.

Appendix B: Interview with expert from Riinvest Institute

1. Since you are one of the experts who drafted the report “To pay or not to pay”, how comfortable are you with the 37% of informal labor that was found?

Very, actually. I think the fact that we got the same result from asking firm owners directly about the number of informal workers not declared in their firms and from asking them about the perceived labor informality in their sector gives a great deal of reliability to these data.

2. So you don't see possible reluctance from firm owners to state the number of undeclared workers in their firms as a problem?

Well that is why we also had the other approach. The other approach is not subject to such reluctance.

3. But this one is?

Yes, but we would say that there was reluctance if we got a lower number. But we didn't, so I don't see any reason to believe that they were reluctant to give us an honest answer.

4. I would like to ask for your personal opinion on what you think is the biggest contributor to the labor informality?

I can give you my personal opinion but it will not be different from what the report says because I formed my opinion based on what the numbers say. That is why I work in this institute.

5. Well I searched the literature and very few authors dedicate labor informality to lack of capacity of authorities. And in the report you dedicate most of informality to that.

Well, we do because about 60% of people thought that it was relatively easy to evade taxes. That number is of huge concern.

6. So you think that the probability of getting caught evading taxes is the main problem?

Well yes. I like to speak with numbers because they are more exact. I don't like to make statements that are based on intuition. In the report we have specified the audit rate and the fine rate to be very important factors.

7. Which one do you think is more important?

You can see here that the audit rate looks to be more important. Meaning that the frequency of inspections is more important than the fine rate.

8. While I was exploring literature on informality elsewhere in Europe I saw that there are many European countries who also have relatively high informality. It made me think that maybe this is not that big of a problem. How do you feel about that?

I don't like to make statements that are not based on numbers but I think that the main problem with informality is not the forgone taxes but rather the market distortion that is created. After all, you can argue that individuals who keep the money for themselves and do not pay taxes use that money better than the state would. This is not a justification but when you have such an incapable government such as ours that becomes increasingly more common sense to people.

9. Would you suggest that the effect of forgone taxes is rather insignificant?

I cannot say that without having any numbers but you have to ask yourself what services the government is providing that would convince people that their money is put to good use.

10. But our tax rates are some of the lowest in the region and actually as far as I know in all of Europe. So do you think that that is justifiable?

I'm not suggesting there is a legitimate reason for evading taxes but you have to look at it from the average citizen perspective.

11. With this labor informality that we have, do you think we should really invest time and money into fighting it and ensuring that taxes are paid and that workers get their pension contributions and have security in their jobs?

I think that it comes to a tradeoff between investing money into fighting informality now, or pay assistance to these people who will not have pension contributions in the future.

12. But we really do not have much to make ourselves competitive in the international market, maybe we shouldn't care so much about working conditions and we should sort of "justify the means" to develop our economy?

It is difficult for me to make that sort of statement. But we are in a very odd middle where we do not have abundance of labor like some Asian countries do, and we do not have skilled labor like western countries. So maybe in some sense it is not in our best interest to fight for the best labor working conditions. Look what happened with law on maternity leave. It is pretty much making women much less employable.

Appendix C: Interview with expert from the Executive Agency of Labor Inspectorate

1. How many inspector are there in the Agency?

50.

2. In the whole Kosovo?

Yes.

3. Do you think that is enough? It seems such a low number of inspectors?

Well, that is actually in compliance with international standards which require one inspector to cover one thousand businesses but Kosovo is a developing country that has a very different background from the developed countries.

4. What do you mean?

In developed countries this number is sufficient because they have well established institutions and a long tradition of making business and industrialization came to them way before us.

5. How many inspections did you complete last year?

Let me get in my computer. In 2013, there were 5,627 firms inspected. 289 of them were legalized. In all of these firms there were 37,518 workers out of which 3,371 were legalized. You can find the percentage from that by dividing them.

6. Thank you so much for that. Do you think the existing law covers you well in doing your job? Do you see any loopholes that unable you to do your job properly?

I think it can always get better but I don't see it as a problem. It is more the practical side of the issue that is a problem

7. My next question was going to be, what do you think are the main challenges of your agency for fighting labor informality?

I think that the main challenges rely on the side of businesses. There is a lack of culture of doing businesses. We try to convince owners that it is in their interest

to declare their workers because an undeclared worker experiences more stress in the job. A stressed worker performs worse . But on the other side we also find that involuntary legalization of workers from our side has negative effects. That is because businesses are not built on solid business plans and business owners cannot afford to declare all their workers. Sometimes this may even result in laying off of workers. But it is also the workers who are not prepared. They generally do not have the right qualifications and skills to make themselves more employable and to make themselves more powerful in negotiating a formal contract. They know that if they insist in being declared they will be fired so they stay undeclared.

8. Are there any other challenges that you as an agency face?

Yes. We have problems with access to businesses. There is a lack of collaboration between relevant institutions. For example we don't know when businesses are active or passive. Someone opened a business and they just left it there. We sometimes don't have the correct address of a business. That makes it almost impossible for us to inspect that business.