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Tackling the informal economy in Moldova: An assessment of the options

Abstract

This article presents a structured compilation of the major findings of surveys, articles and reports into the realities of the informal economy in Moldova. Comparative lessons are drawn from actions taken to address aspects of the informal economy in other European countries, with particular attention paid to what has been done in the immediate region of south-east Europe. The author looks firstly at the comparative size of the informal economy in Moldova and its major sectoral and occupational characteristics before examining the major drivers of informality. After considering the implications of the informal economy for the state and for workers, the article turns to the measures which Moldova might take in response. These are varied and many incorporate a scale of investment which Moldova – typically a poor country beset by many problems – may find difficult to access, not least in the time of the pandemic. Others, however, are low-cost measures where the primary barrier is likely to be the existence of the political will to tackle the issues that arise, not least at government level.

Keywords: *informal economy, Moldova, corruption, public service, tax wedge, governance, institutional trust*

State of the informal economy in Moldova

Definitions of the informal economy

A broad definition of the informal economy is rooted in the work of Philip Smith (1994: 18). He defines it as 'market based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP'. Friedrich Schneider (2014: 4), however, uses a narrower definition of the shadow economy to encompass all market-based legal production of goods and services but which are deliberately concealed from the public authorities for one or more of the following reasons:

- to avoid payment of income, value added and other taxes
- to avoid payment of social security contributions
- to avoid having to meet certain legal labour standards such as minimum wages, maximum working hours, safety standards, etc.
- to avoid complying with certain administrative obligations such as completing statistical questionnaires or other administrative forms.

Such a definition therefore includes undeclared work and undeclared salaries but excludes illegal activities of a criminal nature such as drug dealing. The European Commission defines undeclared work as:

> Any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account the differences in the regulatory system of Member States. (European Commission 2007: 2)

A typical characteristic of informal economic activities is that they involve only two partners (e.g. the worker and the employer) whereas formal economic activities always involve three partners (those two plus the state).

Approaches to estimating the size of the informal economy

Measuring the extent of the informal economy is tantamount to trying to know the unknown. Here, one can identify two types: direct methods; and indirect ones. Between the direct methods which are often used we can distinguish sample surveys based on voluntary replies by individuals and tax auditing reports (microeconomic methods). Indirect methods use macroeconomic data such as the discrepancy between the official labour force and the actual one or that between national expenditure and national income in national accounts (Schneider 2002: 33-44).

Statistica Moldovei (National Bureau of Statistics; SM) is of the opinion that Schneider's macroeconomic model (based on the MIMIC method: multiple indicators, multiple causes) yields exaggerated results. Therefore, SM uses both the system of national accounts (recommended by the UN in 1993) and the recommendations included in the manual produced by the Department of Statistics and Sociology of the Republic of Moldova in 2003 (ILO 2016).

Size of the informal economy

If one looks at the available international data, one may say that the informal economy is a worldwide phenomenon. If so, it is also true that the level of informal activities varies significantly from country to country.

In 1999-2000 the average size of the informal economy (as a percentage of GDP) in the 23 transition countries was 38 per cent – over twice the average size in OECD countries (18 per cent) (Schneider 2002). By 2007, however, the average size of the informal economy in transition countries had decreased by more than four percentage points to 33.7 per cent of GDP (Schneider 2012: 17). By 2012, Schneider (2012) had observed a further decrease in most (new) EU countries; and the same story is true as of an updated estimate – incorporating a new methodology – for 2015: Bulgaria is still at the top of the EU ranking, at 29.6 per cent (falling to 19.2 per cent on an adjusted basis), followed – in terms of south-east European countries – by Croatia (26.5/17.2 per cent), Romania (26.3/17.1 per cent), Estonia (24.6/16.0 per cent), Lithuania (23.8/15.5 per cent) and Slovenia and Hungary (both 22.4/14.6 per cent).

In Moldova, the shadow economy stood at 43.8 per cent in 2006 (Medina and Schneider 2018), although this represents a drop on the figure recorded for 2000 (45.1 per cent). In 2011, this had fallen slightly more sharply, to a still-substantial 41.1 per cent of GDP while, for 2015, it had fallen to 39.7 per cent. Across the period from 1991 to 2015, the figures averages out at 43.4 per cent (Medina and Schneider 2018). According to SM's own figures, the non-observed economy in Moldova decreased significantly up to 2007, followed by a slight increase to 23.1 per cent of

GDP in 2013 (ILO 2016). As of 2013, 32.5 per cent of the total employed population in Moldova had an informal job compared to 38 per cent in 2003.

Whilst undeclared employment has decreased in Moldova, certainly in enterprises in the formal sector, companies have started to look for new ways to save on labour costs. The number of companies that now employ workers in a partly formal (often on the basis of the minimum salary) and partly informal way has been on the increase (ILO 2016). Indeed, according to a study by the Moldovan Ministry of Labour, some 57 per cent of the employed population do not declare their full salary (ILO 2016).

SM and the German Economic Team Moldova (GET Moldova 2014: 3) estimate that, for employees working in the formal sector, between 30 and 50 per cent of salary (on average 40 per cent) is paid in an envelope. For employees in informal enterprises, self-employment and family members in informal employment, wage payment is assumed to be completely informal. The total amount of undeclared wages adds up to 31.1 per cent of the national wage sum (the ILO (2016) estimated that the share in 2010 to be 29.6 per cent, implying a figure of 13 per cent of GDP).

This means that the phenomenon of the under-declaration of salary is more widespread in Moldova than informal employment. The payment of such 'envelope wages' is quite common in east-central Europe: a Eurobarometer survey on undeclared work in the EU had earlier revealed that 68 per cent of all interviewed employees in these countries received envelope wages whereas in continental Europe the figure was 14 per cent and only 6 per cent in the Nordic countries (Eurofound 2008: 13). The same survey also showed that, in countries such as Bulgaria, Latvia, Lithuania, Poland and Romania, envelope wages then amounted to an average of about one-half of formal wages; and, in the Czech Republic, Estonia, Hungary, Slovakia and Slovenia, to an average of around one quarter.

Where do we find informality in Moldova?

The informal economy is highly concentrated: according to the 2013 Labour Force Survey, 68.7 per cent of informal jobs were situated in the agricultural sector (quoted in GET Moldova 2014) although the relative number of informal jobs (as a percentage of total jobs in the sector) decreased in nearly all sectors other than in agriculture and construction. In 2013, 73.8 per cent of jobs in agriculture and 61.7 per cent of those in construction were informal; in all other sectors the share was below 20 per cent, falling to a low of 0.2 per cent in public administration, education, health and social work.

In the same year, the share of the non-observed economy in terms of gross added value by sector was highest in agriculture (close to 60 per cent), followed by hotels and restaurants (over 40 per cent), construction (around 36 per cent), wholesale and retail trade (30 per cent), manufacturing (around 18 per cent) and transport and communications (around 13 per cent) (ILO 2016, on the basis of SM data).

Agricultural employment counted for 51 per cent of all employment in 2001; by 2013, this figure had fallen to only 29 per cent (Kraan et al. 2010; GET Moldova 2014: 17). Over the 2006-2013 period, employment in agriculture decreased by one-fifth due partly to the diminishing share of the sector overall (agriculture's contribu-

tion to GDP decreased from 22 per cent in 2003 to 18 per cent in 2007 (Kraan et al. 2010)) as well as to its modernisation (ILO 2016). Another reason is probably also the decreasing status and attractiveness of farming jobs, combined with the poor income perspective of the average Moldovan farm (as a result of agricultural plots being too small). This has led to an exodus from the industry and an orientation towards other more lucrative (informal) jobs such as in construction. The number of formal jobs in agriculture decreased by 36.4 per cent over the 2006-2013 period while the number of informal jobs fell by only 12 per cent which may indicate that farming is increasingly considered as a secondary informal occupation, mainly performed for domestic family consumption.

In construction, the 2013 Labour Force Survey revealed a remarkable phenomenon: in the midst of the financial and economic crisis, both formal and informal employment in the sector boomed: formal employment increased by 31.4 per cent in the space of two years while informal employment grew by 16.3 per cent. However, from 2009 formal employment fell drastically, by 36.6 per cent by 2013, while informal employment lost only 7.8 per cent in that same time span. This may indicate a certain consolidation of informal employment in construction, combined with a more or less structural loss of formal employment and, perhaps also, a switch from formal to informal employment.

A case study by the ILO (2016) in the construction sector of Moldova reveals a high turnover of workers as well as a shortage of high- and medium-skilled workers. The main reasons indicated by employers are the (seasonal) migration of construction workers abroad (e.g. to Russia) because of the higher wages offered by foreign companies and the movement towards better-paid and more flexible jobs in the sector within Moldova, often offered by households for repair work in older buildings or for finishing jobs in newly-built apartments sold as unfinished by formal construction companies. These repair and finishing jobs are mostly carried out by self-employed workers. The 2013 Labour Force Survey reveals that 30 per cent of such workers would like to change their current informal job for more regular and secure formal work on the basis of a contract if they could earn more income through longer hours.

Who are informal workers?

The majority of informal employment (72 per cent) is represented by self-employed workers in informal sector enterprises.

Gender

In 2013, the share of informal employment in total employment was 34.7 per cent for men compared to 27.1 per cent for women. Some 78 per cent of employed women contributed to the social security fund compared to only 71 per cent of men (ILO 2016, based on SM data).

Age

SM data show that informal employment occurs across all age groups but that it is particularly pronounced amongst young people (the 15-24 cohort), where around 37 per cent of employees work informally, and amongst people aged 65 and older, where 60 per cent of those who are still active are informal (ILO 2016).

Area of residence

Informal employment is widespread in rural areas where 46.4 per cent of active workers are in the informal economy; in urban areas only 13.5 per cent of the employed had an informal job (ILO 2016).

Company size and type

Informal employment is most common in medium-sized companies (20-99 workers) and in small ones (5-19 workers) which often work below the radar of tax inspectors. In big companies and in foreign-owned enterprises, undeclared work and wages is rather uncommon. GET Moldova (2014: 5) sees two reasons for this: first, the perception and attitude of illegal employment is different for foreign companies; and second, since the share of labour costs is smaller, the need to cut labour costs in order to exist in the market is not so pressing.

Informal employment is also strongly present in sectors and companies with seasonal work (GET Moldova 2014: 5).

Another aspect of the problem is that, in those sectors/companies in which goods and services are mainly paid for in cash, the chance of informal employment occurring is bigger than in those sectors/companies in which payments are predominantly made via electronic transfer (bank cards, bank transfers) (GET Moldova 2014: 5). GET Moldova concludes here that the most important factor increasing the likelihood of informal employment is the use of cash payments which occurs mainly in agriculture, construction, services (hotels, restaurants, retail, hairdressing, wholesale trade) and transport (taxis) (GET Moldova 2014: 5).

Qualifications and level of education

Some two-thirds of all informal jobs are found in elementary occupations. Craft and related trade workers, and service and sales workers, respectively represent 10.8 per cent and 11.1 per cent of the informal workforce. Even so, high-skilled people are not absent in the informal work statistics: 0.9 per cent of all informal workers are managers or professionals. Amongst skilled agricultural workers, the relative number of informal workers is over three times higher than the number of formal workers (ILO 2016, based on SM data).

It is not a surprise that informal employment also goes hand-in-hand in Moldova with low levels of education: 59 per cent of all informal jobs are held by people with only primary or secondary general education. Remarkably, however, 26 per cent of informal workers are vocational school graduates which the ILO explains by pointing to the deteriorating quality of the vocational education system and the broken link between the demand for labour and its supply from the education system.

Employment status

Eurofound shows that, in east-central Europe, 84 per cent of all employees who receive envelope wages receive that money in respect of regular work while 43 per cent receive it for overtime or extra work (Eurofound 2008: 13).

More recently Eurofound (2013: 7) has demonstrated that, in east-central Europe, 62 per cent of all undeclared work is conducted by people who are formally employed; those who are officially unemployed are responsible for 17 per cent of undeclared work. Formally employed workers earn 67 per cent of undeclared income while the unemployed accounted for only 17 per cent. The average hourly undeclared wage of the formally employed was 59 per cent higher than that of the unemployed. Eurofound concludes that, in countries which pursue active labour market policies and which provide unemployment benefits on a larger scale and at a higher level in relation to average salary, the unemployed are less forced into undeclared work in order to make a living. This does, however, beg the question as to why formal workers and companies are so keen on informality.

Cash payments as a pre-requisite for informality

One important question is how informal employment and envelope wages are financed. A basic rule is that, for the informal economy to operate easily, a lot of cash is required. Formal employment without cash is possible; but informal employment is impossible without cash.

Goliaš (2013: 7) refers to a study by the World Bank which establishes a strong negative correlation between the frequency of electronic payments and the shadow economy: the size of the shadow economy is bigger in countries where people are less likely to make payments by electronic means. GET Moldova (2016: 1) reports that the number of non-cash transactions per capita in Moldova is 1.8 compared to 11.5 in Romania. Furthermore the amount of cash in circulation in Moldova amounts to 15.6 per cent of GDP compared to 5.6 per cent in Romania.

GET Moldova (2014: 6) reports three examples of the influence of cash in the system: overstating of invoices, whereby the purchaser obtains goods or services and receives additionally part of the invoice in cash; running a small business on the side in which payments are made in cash – e.g. a car wash; smuggling goods for sale or illegally importing 'grey cash'. Oana-Carmen Ravas illustrates in her paper how the state tax service discovered irregularities in the tourism business where operators and travel agencies did not always reflect the actual amount of transactions in their accounts and several agencies did not reflect objectively the wages they paid.

Main drivers of the informal economy

Before effective measures against the informal economy can be developed, it is important to understand the rationale for this behaviour.

It is clear at the outset that the general socio-economic situation and the fragmentation of the labour market, as well as the high level of (youth) unemployment and of poverty, have an important impact on the level and the nature of the informal economy. If regular and decent jobs are scarce and unemployment benefits are low or non-

existent (e.g. for school-leavers), people tend to accept each job offered at whatever price and under whatever conditions, albeit that it might be located in the informal economy. The same can be said about people in poverty and who have few relevant qualifications: poverty can drive them into informal employment as a means of survival.

At the same time, people who do have the right qualifications and who are strongly solicited by the market can put their conditions forward to employers or customers and bargain not only on the basis of a high salary or price but also on a substantial 'envelope', especially when the risk of being caught by the tax inspectorate is low and the rule of law is weak.

The reasons for under-declaration, or for not declaring their real wage or employment, may well be entirely different for poor people on low incomes, especially in rural areas where well-paid jobs are scarce, and for people on high wages. For people in poorly-paid jobs, the satisfaction of immediate needs (food, rent, electricity, etc.) prevails over future safety (pensions, etc.) and therefore they work on an informal, undeclared basis (ILO 2016). People on higher wages, on the other hand, are more driven by their evaluation of the balance between the taxes they (should) pay and what they get in return from the state. If their conclusion is negative, their behaviour will be similar.

Research reports and the position papers of the social partners of Moldova report, besides references to the general economic situation, several specific determinants set out in the following sections. It is important to point out that these are frequently inter-related and mutually reinforcing. This means that, in order to reverse the situation, action is needed in different fields and at all levels.

Low quality of public goods and services

The ILO report (2016) considers, on the basis largely of the results of a national representative survey conducted for the Expert-Grup study (2014), that corruption and the efficiency of governance in terms of the quality of public services have the most significant impact on the quantity of undeclared work. One of the triggers for accepting envelope wages in Moldova is general dissatisfaction with the quality of public services given the level of taxation. Dissatisfaction is especially expressed concerning the quality of roads (77 per cent), the system of social protection (72 per cent), the functioning of public institutions (55.9 per cent), health care (55.7 per cent) and the education system (38.8 per cent). A direct correlation was found between dissatisfaction with social protection, public institutions and roads and a justification for the under-declaration of wages and income.

One year prior to pension reforms, Ravas wrote in particular connection with the position on pensions saving that:

> Reduced confidence in the sustainability of the pension system increases the likelihood of acceptance of informal wages because employees do not perceive the current system as being fair and no one able to guarantee a level proportional to the size of pension contributions. (Ravas 2015: 156-157)

Low level of transparency of budgetary spending

The ILO (2016) refers to the many reports of the Moldovan Court of Accounts which highlight budgetary resources often being used inefficiently and in a non-transparent way. The Expert-Grup survey (2014) also shows that only 11.4 per cent of the population considers themselves to be highly informed about how public money is being spent whilst 79.4 per cent consider themselves to be poorly informed. More people in this second category consider the under-declaration of salaries to be justifiable compared with well-informed people.

Low tax morale

The third main driver of the informal economy to which the ILO report (2016) refers is widespread tolerance of tax evasion.

Confederația Națională a Patronatului din Republica Moldova (the National Confederation of Employers of Moldova; CNPM) (2015: 7) argues that multiple surveys show Moldova to have low tax morale. The majority of Moldovan workers have very low satisfaction with public services and a very low trust in public institutions. According to the Expert-Grup survey (2014), the level of tax morality in Moldova is lower than in other central and eastern European countries. This is explained by weak institutions, a widespread perception of corruption and low confidence in the pension and budgetary system.

Mistrust in governments has several reasons, some already mentioned, while others include: a weak rule of law; a lack of fairness in the tax system (flat-rate taxes); lack of accountability in the tax inspectorate; and increasing inequality.

A too-heavy burden of taxation

For the World Bank (Packard *et al*. 2012) the equation is simple: high taxes on labour (the 'tax wedge' i.e. the difference between total labour costs and net take-home pay), and especially on low earnings, are a key cause of the shadow economy in central and eastern Europe. Leibfritz (2011) confirms the general approach: relatively low formal salaries, together with relatively high taxes on labour, lead to the under-declaration of wages of the sort in which part is paid in cash and/or to the false declaration of workers as self-employed (as this means lower taxes).

However, looking at the situation in practice, it appears that what might be true for low wage earners in central and eastern Europe, and in Moldova in particular, cannot be generalised across all wage levels and for all countries. If high labour taxes (and a high tax wedge) did indeed lead to high levels of an informal economy, then we should find a high level of informality in countries such as Belgium, Austria, Germany and France which, according to the OECD (2016: 61), have the highest marginal tax wedges on labour income for single workers on average pay (respectively 66.3 per cent, 60.5 per cent, 60.2 per cent and 59.3 per cent). However, these countries have low levels of informality: Austria has the lowest level, with only 7.6 per cent, followed by France (10.8 per cent), Germany (13.3 per cent) and Belgium (16.8 per cent). Hungary is an exception, with a relatively high marginal tax wedge of 49 per cent and a relatively high level of informal economy (22.5 per cent). Fur-

thermore in Bulgaria we find completely the opposite situation: a very low average tax wedge (33.6 per cent) and the highest level of informality (31.9 per cent).

Our conclusion is that, generally speaking, higher tax wedges do not necessarily lead to higher levels of the informal economy and lower tax wedges are no guarantee of a low level of informality; other factors and parameters seem to play a more important role. Indeed, the study by Johnson et al. (1998) comes to the conclusion that it is not higher taxes *per se* that increase the size of the informal economy but governments' ineffective and discretionary application of the tax system and regulations. In the western Balkans we could witness the same phenomenon – that tax reductions do not lead to a reduction in the informal economy – following the introduction of flat-rate taxes.

The ILO report (2016) suggests that entrepreneurs perceiving the fiscal burden in Moldova to be high and a constraint may be explained by low labour productivity in the private sector: GDP per person employed in Moldova in 2016 was indeed only 15.2 per cent of the EU average. Likewise in Bulgaria, GDP per person employed is low: 50.4 per cent of the EU average. In contrast all countries with a high tax wedge also have high labour productivity (in terms of GDP per person employed): Belgium is 124 per cent of the EU average; France 114.9 per cent; Austria 112.4 per cent; and Germany 109.5 per cent (World Bank and ILOSTAT databases).

According to Goliaš (2013: 14-17), the 'formalisation tax rate' (FTR) and the marginal effective tax rate (METR) offer better information on the motivation of people than the simple tax wedge. The FTR is defined as the share of informal income that an informal worker has to give up in order to formalise their position. The study by Packard et al. for the World Bank (2012) shows that post-communist countries have the highest FTR for lower wage earners. Goliaš explains that this means low-earning people in these countries face the biggest financial barrier to entering the formal labour market. In Bulgaria, single people without children who earn less than the minimum wage in the informal sector have to give up between 50 and 70 per cent of their income to formalise. For a single person earning 10 per cent of the average wage, the opportunity cost in Romania is almost 70 per cent and in Serbia it is even 80 per cent.

The marginal effective tax rate (METR) measures at a given wage level how much of an additional euro earned in formal gross wages is taxed, be it in labour tax or in the form of the withdrawal of benefits.

The World Bank study (Packard *et al*. 2012) shows that the new EU member states have very high METRs (mostly 100 per cent) at low wage levels. In the Czech Republic and in Slovenia, people who earn less than 20 per cent of the average wage lose 100 per cent of each additional euro earned in formal income by way of higher taxes and the withdrawal of social assistance.

The levels of both FTR and METR have a strongly significant positive correlation with the probability that a worker will work on an informal basis. High FTRs and METRs mean high disincentives for workers to formalise.

Weak link between social contributions and social benefits

Before the reform of the pension system (December 2016) there was major dissatisfaction in Moldova about the weak link between social contributions and the level of pension (GET Moldova 2014: 9). This dissatisfaction worked as a disincentive to formalise and to pay contributions on the basis of the real salary. The reform establishes a direct link between contributions and benefits and is thus a major incentive for workers to declare their full wage since their future pension will be in line with what they have declared.

As to health insurance, Packard et al. (2012) argue that this segment of social protection has the highest influence on the motivation of the workers to formalise or to stay in the informal economy. Whereas for the employer the reduction of overall labour costs constitutes the major reason to pay envelope wages (GET Moldova 2014: 7), the employee's rationale is different: he or she will seek a higher net salary but be more cautious because realising that, in the case of illness, he or she might fall without any income.

Poor quality of public institutions and of regulations

The image of weak institutions is mentioned in several publications dealing with the role of state bodies in Moldova (ILO 2016; GET Moldova 2014: 9; Schneider 2015: 10).

The ILO report believes that the lower level of tax morality in Moldova compared to other countries of central and eastern Europe is the result of weak institutions and a widespread perception of corruption. The Gallup Worldview Survey, quoted by Goliaš (2013: 8), points out that the confidence of the people of Moldova in the government is only 24 per cent, in the judicial system 27 per cent and in the police 36 per cent. At the same time, corruption in government is perceived by 81 per cent while corruption is frequently listed as the most problematic factor in doing business in Moldova. Goliaš (2013: 6, 7) also reports, on the basis of data from Packard et al. (2012), a strong negative correlation between government effectiveness and the shadow economy, the latter being bigger in countries with weak governance, weak institutional credibility and weak control of corruption.

In Moldova, the chance of being caught in the case of informal employment is small given that there are too few labour inspectors, that labour inspections are poorly targeted and that the procedure is totally inefficient since inspections have to be announced to the employer five days in advance (in contravention of ILO rules) and may take place only once a year in a company (ILO 2016). Even if an employer is fined, the amount of the financial penalty is too low to make much of an impression. Furthermore Schneider (2015: 11) argues that fines and punishment do not exert a negative influence on the shadow economy; whilst a subjectively perceived risk of detection does.

Another major problem in Moldova is that the fiscal regulatory framework is ambiguous and fiscal administration complicated, undermining the efficiency of the relevant institutions. The ILO report (2016) highlights, on the basis of the Expert- Grup study (2014), that the responsibilities of the key institutions dealing with tax collec-

tion, especially the tax inspectorate and the customs service, overlap in many cases and that coordination between the agencies is poor.

Two in three firms created after 2005 consider that fiscal administration, regulations and procedures are a constraint on enterprise development (ILO 2016): Moldovan firms need to complete 21 fiscal declarations (and payments) per year, the highest number in the region. In Latvia and Estonia the number is only seven while it is 13 in Bulgaria and 14 in Romania. Heavy bureaucracy, coupled with poor regulatory quality and government inefficiency, can also be found in construction and in the trade and transportation sector (which are both significantly exposed to the informal economy). In order to obtain a construction permit in Moldova, 27 procedures and 247 days are required. For exports, nine documents have to be collected while an import procedure requires eleven (ILO 2016).

The National Human Development Report (UNDP 2014) indicates that reforms launched by the government aimed at enhancing the business environment, had only produced one-half of the expected results. Meanwhile the ILO points also to other factors contributing weakness in Moldova such as weak competition policies, a weak rule of law, unequal access to fair justice and a lack of independence in the judicial system (ILO 2016).

Schneider (2015: 10) asserts that, in general, it is not so much the number of regulations that is driving employers towards the informal economy but the complexity and discretionary application of the tax code and other regulations by (often corrupt) officials. In order not to lose too much time in complying with complicated and frequently unclear legal procedures, managers often choose the easier path of paying bribes. Bureaucracy and complexity do not go together with compliance.

Consequences of the informal economy

For the state

The elevated nature of the informal economy in Moldova is the basis of a vicious circle of tax and the evasion of social contributions which, in turn, refuels the informal economy. Part of what is earned informally will be spent informally. This leads to a parallel underground economy. An increase in the informal economy means a reduction of state revenues and the underfunding of budgets which negatively affects the quality and quantity of publicly provided goods (e.g. roads) and services (e.g. public healthcare) and also undermines the general satisfaction of the population with the government.

Turning to Moldova, the ILO report (2016) records that 29.6 per cent of wages and income being undeclared resulted for the state in a loss of 17.1 per cent of its total revenues, including a loss of 25 per cent for the social security budget, 13.5 per cent for income tax and 29 per cent for the health insurance fund. In terms of GDP, the total fiscal gap caused by the informal economy (excluding the illegal sector) is estimated by SM at 7.45 per cent. GET Moldova (2014: 4) comes to somewhat different figures, estimating the total loss as up to 5.7 per cent of GDP, with the loss of social and medical insurance contributions amounting to 35.3 per cent of total social contributions and a shortage in income tax revenue representing 9.2 per cent of the

total. Ravas (2015: 156) puts the total cost of the evasion of tax and social contributions at 6.5 per cent of GDP.

The fiscal contribution base represents only a portion of actual income so the nominal contribution rates turn out to be already relatively high – higher indeed than they should normally be. The massive under-declaration of income may force the government to increase income tax and social contribution rates. However, this would act as an even stronger disincentive to formalise and is also not a positive signal to foreign investors. Therefore, governments will try not to increase income tax and social contribution rates, preferring to rely more on indirect taxes. That is exactly what has happened in Moldova. The effect of the high amount of informality in the economy is very strongly felt in the structure of the general government budget. Moldova relies very heavily on indirect taxes: VAT and excise duties provide 47.5 per cent of total tax revenues, by far the highest in the region (in comparison: Russia 19.9 per cent; Ukraine 32.9 per cent; Slovakia 35.5 per cent; and Romania 36.7 per cent). Unsurprisingly personal income taxes deliver only a very small share of the total tax revenue of the country: 7.5 per cent (in comparison: Slovakia 10 per cent; Romania 13.7 per cent; Ukraine and Russia 13.8 per cent); while social contributions provide 28.9 per cent of total tax revenue (in comparison: Russia 17.3 per cent; Ukraine 31.2 per cent; Romania 34.9 per cent; and Slovakia 40.7 per cent) (all comparative figures from Qehaja 2012).

Another direct consequence of a high level of informality in the economy is that the economic support ratio for pensions (and other social benefits) will be very low: in Moldova, the support ratio is currently around 1.1 contributors for each pensioner; in the EU, the average ratio is around 1.5 per cent.

Furthermore, high levels of informality disturb the smooth functioning of the market economy, undermine the development of a legitimate business environment and result in unfair competition and an unfair distribution of company taxation (CNPM 2015: 8). This is not a positive signal for the international reputation of Moldova as a ‘place to invest’.

For workers

The consequences of a high level of undeclared employment and the under-declaration of earnings are very serious for workers both in the short- and in the long-run.

One immediate consequence is that personal taxation – including higher indirect taxes – is higher than it would be if everyone declared correctly, as a result of governments trying to compensate their losses. This is especially regretful in respect of workers who work on a fully formalised basis: they are the main victims of informality. However, informal workers are not protected by labour law (as regards maximum working time, annual holidays, health and safety regulations, representation, etc.), do not benefit from social security benefits in case of illness or unemployment and do not build up pension rights. These workers have the illusion that they are escaping having to pay social contributions but, in reality, they contribute to the financing of the social system in an indirect way through higher indirect taxes and this without building up any social entitlement.

Workers who under-declare their salary feel the consequences when they receive earnings-related social benefits, especially with regard to building up future pension rights subsequent to the 2016 reform which guarantees full equivalence.

The way forward: addressing the informal economy

According to Schneider (2015: 27), good governance, low corruption and a functioning market economy are the best ways of reducing the informal economy.

Building trust in government is a key factor in convincing citizens. Here, the improvement in tax morale can only be achieved through a combination of three factors: corruption control; quality of institutions; and citizens' participation (Packard 2012, quoted in Goliaš 2013).

Tackling the informal economy further than was achieved in earlier action plans requires, first and foremost, a publicly stated political will by the government, ideally supported by the social partners. A comprehensive and consistent set of general and specific measures has to be worked out in the framework of a long-term strategy and a single public authority (a specific minister or deputy) has to be put in charge of implementing and evaluating these policies.

Several studies suggest possible measures to reduce the informal economy, but what is important is those measures which have proven effectiveness. In this respect the Eurofound (2013) study presents a range of policy measures developed in 31 European countries (in the EEA plus Switzerland) as well as the level of their effectiveness. We propose here a selection of such measures which could be helpful in Moldova.

Overall, CNPM (2015: 10) is correct to state that deterrence measures work best after reforms that increase the integrity and the efficiency of central institutions. Furthermore, international experience shows that effective institutions with integrity are more relevant in reducing the informal economy than restrictive measures such as increasing the penalties. In the specific context of Moldova, repressive measures which are not accompanied by measures which raise integrity can be counterproductive and may well increase corruption (via more and higher bribes). Goliaš (2013: 20) points in the same direction: he reports that, in Slovakia, positive indirect enforcement measures have proved to be the most powerful means of tackling the informal economy.

Invest in good governance and in confidence building measures

Here, there is a wide checklist of measures and ideas, any of which could be adopted and which will assist in the direction set out immediately above.

- develop actions for clean politics in parties and in government
- establish full transparency on budgetary spending
- establish full transparency on the main objectives of the government for the coming years
- establish full transparency on administrative decisions concerning building permits, import/export licences, subsidies, etc. with proper reasoning in the case of refusal

- create an ombud service for public administrations and service providers (e.g. railways, telecoms, banks) and publish an annual report about received complaints and their results
- recruit civil servants and employees through an autonomous public agency on the basis of a comparative exam and publication of the results
- institute full accountability of officials *vis-à-vis* their 'clients' (citizens, companies, etc.) in order to avoid arbitrary decisions
- introduce administrative appeal procedures for citizens and companies against negative administrative decisions (e.g. concerning taxation, permits, licences, etc.)
- deliver equal access to administrative and judicial procedures
- select judges and notaries by an independent High Council of Justice on the basis of a comparative exam and publication of the results
- publish court rulings
- introduce better selection criteria and control of public procurement: the main contractor should ensure the respect of all fiscal and social rules by subcontractors; bids should be assessed as regards impact on informal employment and more regular controls introduced to construction/building sites; tenders should be selected on the basis of 'best value for money' (implying equal importance of price and quality)
- make wider use of mandatory electronic tenders when public authorities purchase or sell goods and services. For important tenders, the call should also be published in English (in Slovakia, this led to more bids and to important savings of between 6 and 15 per cent; see Goliaš 2013: 21)
- create an ethics commission responsible for making public servants, tax inspectors, police officers, judges and prosecutors immune to bribing
- increase transparency about the shareholders of financial sector assets
- sign tariff agreements between the medical professions, the social partners and the government
- provide workers with an annual dashboard of their pension account so that they can see if the social contributions deducted from their wages have been transferred to their pension account; and provide them also with an anticipated pension calculation.

Make public service more efficient and better performing

More efficient and better performing public services does not necessarily mean more civil servants but, in the first place, better qualified, trained, equipped, paid, evaluated and managed ones. In certain departments, however, it may well be necessary to invest in more staff, e.g. the labour inspectorate, which is understaffed, while it may also be opportune to strengthen the service provided by the tax inspectorate.

High efficiency gains can be obtained through the development of interlinked databases and the use of ICT tools in several services. Continuous investment in capacity building among civil servants is absolutely necessary. The development of 'one stop shops' (a single desk policy) is very important both for citizens and for companies (start-ups and internal companies as well as foreign ones).

Public services which are 'open to the public' should be organised in a 'client-friendly' manner and be easily accessible and open space, but privacy-proof where necessary, functional and staffed with 'service-minded' civil servants and employees.

Offer better public goods and services

Again, there is a checklist of measures here which are aimed at improving the public service offer.

- invest more in modernising the road infrastructure all over the country, with special attention to rural areas
- enhance supply in rural areas of other elements of basic infrastructure: water, gas and electricity, telecoms and sewage systems
- invest in more and affordable childcare facilities, also in rural areas
- invest in quality healthcare facilities
- invest in quality social housing
- invest in quality public transport
- invest in better vocational training
- invest in environmental protection and waste management and recycling
- guarantee a close link between social contributions and social benefits: this is now done for statutory pensions but may also work in the area of unemployment benefits and sickness benefits
- make social insurance (pensions and sickness contributions) mandatory, also for self-employed workers, farmers and family members who help out
- start, as quickly as possible and in cooperation with the social partners, the launch of a mandatory private pension system financed by employees, the employers and the state.

Shift the tax burden and monitor the effects

The government should publicly declare that, when formally-declared income increases by 5 per cent in real terms, the social security contribution rate of 24 per cent for employers will be reduced by one percentage point.

Several other measures can be considered in the tax field in order to reduce the under-declaration of earnings, especially by lower wage earners.

Moldova operates a flat income tax rate (of 12 per cent of salary), reduced in a reform implemented in 2018. There are, as we know, many problems with flat tax rates not the least of which is their regressive nature. This has a particular connotation with the informal economy since, as highlighted above, there is a link with income in that lower levels of income are more likely to lead to employees working on an undeclared basis. Consequently, there is substantial merit in switching to a progressive system of taxation based on income with a smooth transition between bands to reduce the deterrent effect of earning income in a higher band (GET Moldova 2014: 14). Starting from a lower rate for low wage earners leading to a higher marginal rate, with three rates in between, would give a new structure of personal income tax looking as follows:

- 5 per cent on incomes from 25 200 lei up to 60 000 lei (c. €3000 at current exchange rates)
- 10 per cent on incomes from 60 001 lei to 95 000 lei
- 15 per cent on incomes from 95 001 lei to 150 000 lei
- 20 per cent on incomes from 150 001 lei to 200 000 lei
- 25 per cent on incomes of 200 001 lei and above.

With average monthly gross earnings in the real sector, on the basis of official SM figures, standing at 8135.7 lei in 2020, such a distribution looks reasonable, if rather modest. In parallel with the redesign of personal income tax, the personal allowance for workers (which currently stands at 25 200 lei; disapplied in respect of those with incomes above 360 000 lei) should be increased by two percentage points above inflation over a ten-year period. Furthermore, a progressive increase in the national minimum wage (which stands at just 1900 lei/month in the private sector, having not been uprated since 2015) by two percentage points above inflation for ten years would also result in a higher level of declared wages.

Start-ups would benefit during their first five years from reduced corporate tax rates: gearing up from 0 per cent in the first year to the full rate of 12 per cent from the sixth year onwards.

Part of the tax burden should be shifted towards higher capital (income) and environmental taxes. We propose:

- higher tax on dividends and on royalties: from 6 to 15 per cent (the rate that applied between 2008 and 2011) and an end to the system in which dividends (and royalties) received by resident companies from Moldovan companies are tax exempt
- an increase in the corporate tax rate from 12 to 15 per cent, but the abolition of all small local taxes on companies
- regular re-evaluation of property values (houses, apartments, land, etc.) and the introduction of a progressive property tax and value added tax on immovable property
- closer monitoring of officially-declared values/prices in sale contracts drafted by notaries
- higher environmental taxes on energy, pollution and waste (in Croatia, these taxes generate 10.9 per cent of all income from tax and social contributions while in Bulgaria the figure is 10 per cent and in Romania 8.7 per cent)

In order to be able to monitor the effects of the measures taken, the government should calculate structural incentive indicators (tax wedge, FTR, METR, etc.).

Facilitate compliance with fiscal, labour and administrative laws and procedures

Fewer rules are perhaps needed, but it is certain that better ones are required. In this respect, a checklist of potential measures is as follows:

- formulate laws and regulations in clear and simple, easy to understand, language
- simplify administrative compliance: reduce the required number of documents for authorisations, licences, clearances, approvals and subsidies (e.g. construction permits, import/export documents)

- speed up procedures by setting shorter deadlines and using ICT tools
- introduce mandatory certified cash registers with fiscal memory in as many sectors as possible (hotels, restaurants and catering, and retail and wholesale, but also for the 'free professions' – lawyers, fiscal advisors, private clinics, etc.). Eurofound (2013) asserts that such a measure was effective in 73 per cent of countries who introduced it, with examples of successful introductions including Belgium, Sweden, Poland, Denmark, Greece, Italy and Hungary. In Belgium, the amount of declared salaries in the hotels, restaurants and catering sector increased during the first nine months of 2016 by €109 million after the mandatory introduction of electronic cash registers with fiscal memory. Sweden introduced mandatory cash registers in 2010 for all businesses selling goods and services for cash. The Swedish tax agency showed that reported VAT for restaurants rose that year by 7 per cent and in hairdressing by 11 per cent. The Polish ministry of finance also made electronic cash registers mandatory in 2010 in a range of professions: doctors, lawyers, tax advisors, physicians running private practices, funeral homes and translators
- make the issuing of an invoice or receipt obligatory for all commercial transactions as well as for medical acts
- introduce new categories of legitimate work in order to facilitate work that is often conducted on an undeclared basis being formalised in the future (a measure which is effective in 59 per cent of countries). Examples here are the mini-jobs regulation in Germany (where mini-jobs in household services showed strong growth to 234 000 in 2012); the Simplified Employment Act (2010) for seasonal employment and casual or temporary work in Hungary (the employer tax is HUF 1000 (c. €3)/day for temporary work) (Eurofound 2013); and the service voucher scheme in Belgium for household work (30 per cent tax deductible) as well as the local employment agencies (PWAs), set up by local authorities to offer simple employment opportunities to the long-term unemployed, and the flexi-job regulation for workers with a full-time or four-fifths job with such workers allowed to take up a secondary job in restaurants/cafés without having to pay income tax or social contributions on their second income while the employer pays only a reduced social contribution rate of 25 per cent
- work out a special regulation for student jobs (for those aged 16 years and above): a limited number of working hours/year; a written labour contract; limited social contributions (30 per cent of normal); and a guaranteed minimum salary of between 65 and 90 per cent of the national minimum wage according to age
- there remains no fiscal support facility to support business start-ups in their first few years. The Moldovan government could grant a start-up premium or, for a certain period, a reduction in tax and/or social security contributions. In Germany, more than 100 000 unemployed people enrol annually in a start-up scheme and can receive, for a maximum of 15 months, a grant of €300/month on top of their unemployment benefit (Eurofound 2013). Other possibilities for support are: a start-up loan; micro-credit; crowdfunding; guarantee regulation; and lower social contributions in respect of the first three people recruited

- award tax deductibility (25 per cent) for maintenance, repair or isolation works in homes at least ten years old when carried out by a registered company. Sweden gives a reduction in labour costs and in VAT for household services (RUT scheme) and for home renovation, conversion and extension (ROT scheme): 50 per cent (ROT) and 30 per cent (RUT) of the labour costs are tax deductible up to a combined personal ceiling of SEK 75 000/year (c. €7400) (of which the ROT element cannot exceed SEK 50 000). The Swedish tax agency has estimated that undeclared work decreased by 10 per cent in these sectors (Eurofound, 2013)
- introduce supply chain responsibility in respect of public procurement. This measure is effective in 78 per cent of the countries who have done it, according to the Eurofound report (2013)
- make access to bank credit easier for companies who work formally
- facilitate the transition from unemployment to formal employment via a phased withdrawal of unemployment benefit and, eventually, other benefits
- design smart safety nets so that any additional formal waged work results in higher net income, including social benefits
- advise people via social and mass media of how to formalise
- create an online user-friendly database of all registered companies per sector and make it publicly accessible
- oblige clear price indications of products and services in shops and other businesses (e.g. hairdressers)
- encourage the formalisation of agricultural enterprises by simplifying tax declarations and by reserving a guaranteed part of investment subsidies for small and medium-sized agricultural enterprises
- limit successive fixed-term contracts to a maximum of two years
- grant individual amnesties for voluntary disclosure (with reasonable fines). This measure is effective in 75 per cent of countries which have implemented it
- engage the social partners in compliance exercises because their role is crucial.

Invest in detection and deterrence in respect of undeclared work and income

The most effective measures in this area reported by the Eurofound (2013) study are:

- data matching and data sharing among government departments and specialist agencies (the tax, labour and social protection inspectorates). This measure was reported effective by 72 per cent of the countries which introduced it
- workplace (on site) inspection (effective in 75 per cent of countries)
- mandatory registration of workers prior to starting work or on the first day (effective in 74 per cent of countries)
- mandatory ID badges in the workplace or on construction sites (effective in 70 per cent of countries).

Meanwhile, having a coordinated strategy on the issue of the informal economy across government departments is efficient in 64 per cent of countries implementing one.

The Eurofound (2013) study also shows that, although penal sanctions both for companies/purchasers as well as for employees/suppliers are less frequently used than administrative sanctions, they are actually somewhat more effective (59 per cent against 53 per cent).

The labour and tax inspectorates in Moldova should have sufficient inspectors to make an annual check on 5 per cent of companies, focused essentially on those sectors, professions and companies which are most exposed to the informal economy. Only around 2000 inspections were carried out by the Labour Inspectorate in the first ten months of 2021, which looks rather under-strength. Procedural rules should also be relaxed: inspections should be possible without prior notice and, if necessary, several should be allowed per year. Furthermore, the different inspectorates should operate jointly, as far as possible, based on a commonly shared database.

Data sharing and data matching between the labour inspectorate, *Casa Națională de Asigurări Sociale* (the National Insurance House; CNAS), the tax and customs authorities, the statistical office, the banks and notaries is highly relevant in detecting discrepancies between officially declared income and expenditure. Where discrepancies are discovered, the burden of proof should be reversed and it should be possible to lift the banking veil. Where there are reported irregularities concerning CNAS (informal employment or the under-declaration of wages), a compulsory investigation procedure should be started by CNAS. In all cases of proven infringements, sanctions should be effective, high and serious enough to demotivate possible offenders (employers, tax advisers, consultants and business executives but also employees, including those who are self-employed). Sanctions should rank from a simple warning, range over different levels of fines to imprisonment and encompass business or site closures for highly serious offences.

Other measures in this area would include:

- in the case of the purchase of properties, a check on the origins of the money
- check that self-employed workers are not abusing statutory controls
- the conclusion of automatic exchange of information agreements with neighbouring countries
- protecting the freedom of the press.

Put a limit on cash payments and favour electronic payments

Cash payments are required to feed the informal economy. Limiting the use of cash will automatically result in a reduction in the level of the informal economy and, as an important side effect, in better consumer protection.

The checklist of available measures in this area would extend to the following:

- ensuring that all the salaries of civil servants and public employees, as well as all invoices addressed to the public service, are paid by bank transfer
- obliging the electronic payment of salaries by private and public companies
- penalising companies who encourage, through marketing campaigns or by offering discounts, payments in cash

- making banks, exchange offices, notaries and property companies responsible for informing compliance officers (for banks) or the anti money-laundering office (tax department) of illegal cash payments.

Launch information campaigns

There are several activities that could be of assistance here to the Moldovan authorities and these include:

- informing workers, companies and the wider public about the dangers of informal work and the under-declaration of salaries and point to the short- and long-run consequences
- informing workers of the advantages of formalisation and of declaring their real wage
- using the media, including social media. The authorities should consider organising public debates on TV about the issue and put it on the agenda with the social partners and also with academics as a means of generating a public debate about the demerits of the informal economy.

Conclusion

It is clear that the Moldovan government is making some efforts to address the informal economy. It told as much to the July 2019 joint meeting with the EU Sub-Committee on Trade and Sustainable Development, outlining particular actions in the area of information and awareness raising campaigns highlighted immediately above, as well as in voluntary compliance, sanctions and in the strengthening of institutional co-operation. The effects of the Covid-19 pandemic and the lockdowns in Moldova are also likely to have encouraged some other, separate, measures in this direction, too, not least in the context of electronic payments although the vested interests here are also sizable.

Such individual initiatives are all well and good but what is missing is a comprehensive plan, or strategy, which takes a firm grasp of the nettle of the informal economy whenever and however it arises. The policy prescriptions mentioned in this article are designed to form part of such a comprehensive strategy the general concept of which must be taken on board by the Moldovan government; the alternative, it would seem, is that ways around individual piecemeal initiatives will quickly be found such that the informal economy, once squashed in one area, will equally rapidly pop back up in another. The price of that will be a continuation of the gentle slide in the size of the informal economy but remaining nevertheless at a substantial proportion of GDP – which is in the interests of neither the Moldovan government even in the short-term, given its EU ambitions, nor crucially, from our perspective, that of workers in the long-term. Furthermore, social justice and addressing inequality – one of the major issues of our age – demands a more strategic approach to policy which, once the post-pandemic era arrives, truly embodies what it means to be in government.

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