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Measures to reduce informal employment in Moldova

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Measures to reduce informal employment in Moldova

Executive Summary

Informal employment in Moldova is widespread. An estimated 30.9% of the working population participates in informal employment – either by not registering employment or only declaring a part of the wages (envelope payments). Through both ways estimated wages worth MDL 15.41 bn (USD 1.11 bn) remain undeclared – this represents about 31.1% of the national wage sum. In the consequence, the state loses a combined amount of MDL 5.65 bn (USD 0.41 bn) in taxes and social insurance contributions – the equivalent of 16.4% of tax and social insurance revenues. At the same time informal employment is creating an uneven playing field. Companies that play by the rules, have a significant cost disadvantage compared to those participating in informal employment.

What are the reasons for the endemic use of informal employment in Moldova? Engaging in informal employment is a low risk activity, as the likelihood of getting caught is slim with only a low number of labour inspectors, who need to announce their visits in advance and who target the wrong companies. Even if caught, fines currently only exist for employers and they are too low to be a serious deterrent.

Additionally, informal employment pays well. With on average 48% of labour costs the combined tax and social insurance cost in Moldova are at a similar level as in countries like Slovenia and the Czech Republic and much higher than in Denmark and Ireland. Thus, employers can reduce their labour cost by up to 54% through informal employment, increasing their profits even after topping-up wages for employees.

What should be done? The government should pursue a **“carrots and sticks” strategy**: On the one hand, it should improve the incentives (**“carrots”**) so more people fully declare their wages. To do so, the government should gradually reduce the tax and contribution rates to make official work less costly. International experience suggests that lowering taxes or social insurance rates will reduce revenues only in the short-term as more people declare the wages public revenues quickly recover the loss.

At the same time there is an urgent need to increase the risk and cost for those engaging in informal employment (**“stick”**). For this to happen, labour inspections need to become functional. To start with, the current practice of announcing labour inspections in advance – while well-intentioned – needs to be changed as is being discussed already. Another key measure here could be a whistle-blower system, which allows employees to give evidence about informal work practices in exchange for exemption of prosecution. Additionally, the current level of fines is too low to deter anyone. They need to be increased and should depend on the severity of the offence. Fines should also be introduced for employees; although their level should be lower keeping in mind that employees not always have much of a choice. However, this would be an important signal that informal employment is no longer accepted.

For the “carrot and stick strategy” to work, the sequencing is important. We argue that first the pressure through improved inspections and higher fines need to take effect. Once the share of officially declared wages goes up, there is fiscal room to gradually reduce tax and/or social insurance rates.

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1 Types and extend of informal employment in Moldova

Informal employment in Moldova is a challenging issue and needs to be addressed. In order to find suitable measures, it is important to understand how informal employment works and who is likely to engage in it. Additionally, the overall size of informal employment, the impact on fiscal revenues and social insurance contribution, as well as the current costs to the Moldovan economy and potential benefits from de-shadowing employment need to be estimated. The first section of this study will provide an overview on the different types of informal work and an estimation of its magnitude.

1.1 Need for addressing informal employment

Addressing informal employment and reduce the practice of undeclared work is relevant for all economic actors.

First of all it affects **employees** who do not (or not fully) declare their wages and, in the consequence, may be lacking access to the social security and face poorly funded public services.

For **businesses** a large informal economy imposes a serious threat to a fair competition among the participating companies in a market. It causes a competitive disadvantage for those companies that operate according to the law and fully declare their wage payments, as their labour costs are higher. Indeed, a survey among 360 firms in Moldova shows that 13.4% of the firms consider competitors in the informal sector as major constraint (World Bank Enterprise Surveys 2013). Especially retailers and medium-size enterprises are affected. Companies operating informally also face some disadvantages, like a reduced access loans and a lack of legal protection.

Finally – and probably the most severe consequence – informal employment and undeclared wages erode the **public revenues**. As a consequence, the financial means are not sufficient for the provision of public infrastructure and high quality public services which, in turn, reduce the competitiveness of Moldova's economy.

1.2 Quantitative assessment of informal employment

In order to understand to what extent informal employment exists in Moldova and what effect it has on the economy, the data on that subject will be explored in the following section. Clearly, due to the nature of informal employment its scale can only be an approximation.

We first review the official statistics and estimates. Based on the official numbers, we calculate which share of the workforce participates in informal employment, the level of undeclared wages and the size of losses in revenues of the tax system and the national insurance system (CNAS).

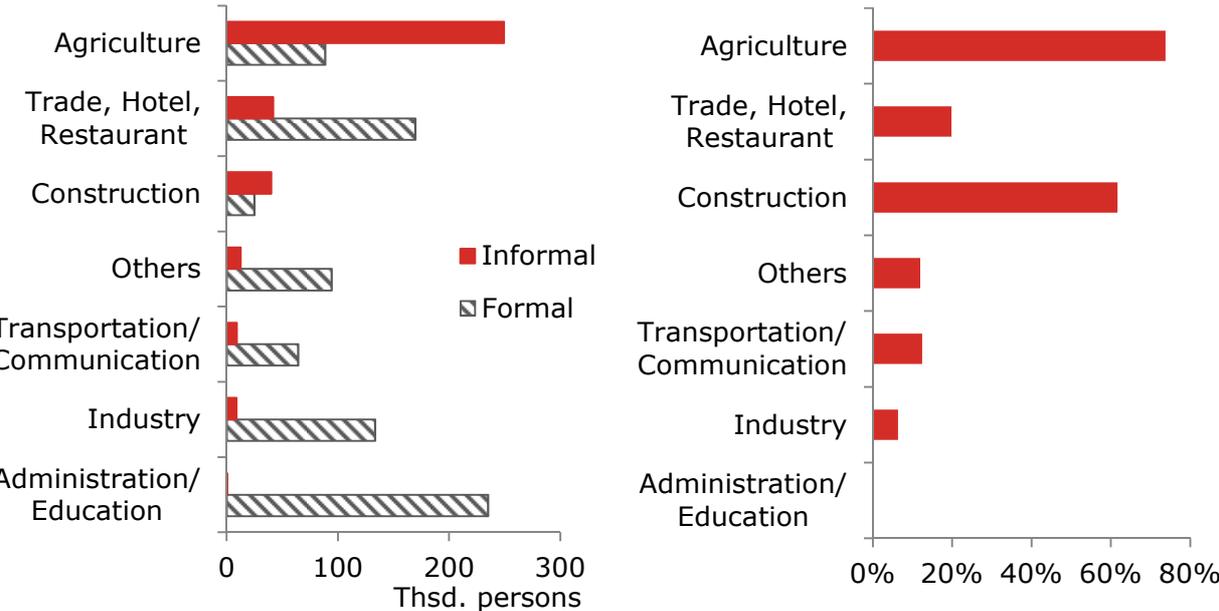
Labour Force Survey

The most relevant statistic is the Labour Force Survey conducted by the National Bureau of Statistics. One section of the survey asks participants about informal employment. As the data is collected by asking people, and since informal employment is a criminal offence, it can be expected, that the figures significantly underestimate the real situation.

According to the Labour Force Survey 2013, **30.9% of all employment in 2013 was fully or partly informal**. However, according to the survey, only 7.8% of the employees of officially registered companies claim to be informally employed. This number seems to be rather small compared to anecdotal evidence.

The sectors with the highest shares of informal employment are the agricultural sector and the construction sector (Figure 1). The share of informal employment is the highest in the construction sector – with almost two thirds of the people working (partly) unofficially. In absolute numbers, most people working informally can be found in the agricultural sector.

Figure 1: Informal Employment in different Sectors – absolute number of persons and relative share



Source: Labour Force Survey of the National Bureau of Statistics

Young workers (15-24 years) and those above the official retirement age are most likely to work informally. Looking at informal employment from a gender perspective, it can be seen, that men are more prone to agree to informality.¹

¹ For more data refer to annex 1.

1.3 Economic impact of informal employment

Based on the official numbers, we now estimate the magnitude of informal wages and the tax, social insurance and medical insurance losses resulting from them. This quantitative assessment is based on the following four classifications used in the Labour Force Survey:²

- a) Employees working in formal sector enterprises
- b) Employees working in informal sector enterprises
- c) Own-account workers
- d) Contributing family members

Following this categorisation and according to the official estimates derived from the Labour Force Survey, in total **362,800 persons participate in informal employment** is. As can be seen in Table 1, the largest group are the own-account workers, which includes for example individual entrepreneurs, like private taxi drivers, retailers, lawyers, artists and farmers.

Table 1: Number of persons involved in informal employment

Group	Number of People
a) Employees in formal sector enterprises	18,288
b) Employees in informal sector enterprises	57,912
c) Own account workers informal employment	261,400
d) Contributing family members in informal employment	25,200
Total	362,800

Source: National Bureau of Statistics Labour Force Survey

Estimation of sum of undeclared wages

What is the amount of wages paid within informal employment arrangements? For employees working in the formal sector, we assume that 40% of the salary payment is made in an envelope.³ For the remaining three groups the wage payment is assumed to be completely informal.

In order to keep the approach simple, we assume that the unofficial wage payment for the employees in informal sector enterprises, own-account workers and contributing family members is at average wage level of MDL 3,600 per month (or MDL 43,200 per year)⁴. For the first group, we assume that the official wage paid is at average wage level, which makes up 60% of total wage. The envelope contains the remaining 40%, which is MDL 2,400 per month.

² For more information on the classification refer to annex 2.

³ This assumption is according to the estimation of the National Bureau of Statistics, who evaluate that the part of payment paid informally amounts to 30-50% of total salary payment.

⁴ Figures from National Bureau of Statistics for 2012 for the real sector.

With these assumptions, the **total amount of undeclared wages adds up to MDL 15.409 bn** (Table 2) or 31.1% of the national wage sum.

Table 2: Sum of undeclared wages

Group	Share of undeclared wage	Assumed annual wage (MDL)	Undeclared wage (m MDL)
a)	40%	28,800	526.7
b)	100%	43,200	2,501.8
c)	100%	43,200	11,292.5
d)	100%	43,200	1,088.6
Total			15,409.6

Source: National Bureau of Statistics, Earnings Statistic, own calculation

Informal employment directly affects the income tax revenues of the state budget, as well as the revenues of the budget of the national social and medical insurance.

Calculating the losses of social insurance and medical insurance contributions leads to a yearly shortcoming of MDL 3.9 bn. Expressed as share of total social insurance contributions, this adds up to 35.3%. The lack of revenues of the tax authorities amounts to MDL 1.7 bn per year or 9.2% of tax revenues.

The total estimated loss sums up to MDL 5.6 bn yearly (Table 3), or to 5.7% of GDP.

Table 3: Overview on the yearly losses due to informal employment

	Sum of Losses (m MDL)
Social insurance contributions	2,525.6
Medical insurance contributions	1,404.7
Income tax	1,718.2
TOTAL	5,648.6

Source: Own calculation based on the Labour Force Survey of the National Bureau of Statistics, the Earnings Statistics, as well as the legal framework.

Conclusion: This rough estimation illustrates that the effect of informal employment is significant and that immediate action is needed. Despite the fact that from an individual viewpoint avoiding tax and contribution payments seems to be rationale. For the system as a whole, a large share of informal employment impedes the functioning of the system. It affects the market competitiveness by discriminating against companies acting according to the law and against their employees.

1.4 Which factors influence the use of informal employment

Informal employment is not uniform throughout the Moldovan economy. Some sectors or types of businesses are more likely to make use of informal employments than others.

Table 4 below present some general facts and anecdotal evidence about factor which have an influence on the likelihood for informal employment. A good understanding of these factors is important when looking for measures to reduce informal employment.

The most important factor seems to be cash payments. The likelihood of informal employment in a given company is increased in sectors where goods and services are paid for in cash (or sometimes goods). Additionally, sectors with seasonal work are also more prone to undeclared wages or work.

In areas of the economy where goods and services are paid predominantly via electronic transfers, the chance of informal employment is reduced significantly.

Additionally, the company size seems to matter with smaller companies more likely to engage in informal employment. Indeed, smaller enterprises tend to fall under the radar of inspections.

On the other hand, in large companies and those owned by foreign investors, undeclared wages are quite uncommon for two reasons: First, the perception and attitude of illegal employment is different for foreign companies. Secondly, in contrast to small companies, the need for cutting labour costs in order to exist in the market is not as prevalent, as the share of labour costs in total costs is smaller. Also, foreign investors may not know the legal system and risks of detection as well as the domestic ones.

Table 4: Factor which influence use informal employment

Factors which <u>increase</u> likelihood of informal employment in any given business	Factors which <u>reduce</u> the likelihood for informal employment
<ul style="list-style-type: none"> - Goods / services are paid cash <ul style="list-style-type: none"> o Construction o Services (hotels, restaurants, retail, hairdressers, etc.) o Transport (Taxis, Maxitaxis, etc.) o Wholesale and Retail - Agriculture, seasonal work - Small and medium sized companies 	<ul style="list-style-type: none"> - Payments are made predominantly bank transfers - Public sector or state-owned - Large companies - Foreign investors (with exceptions) - Business services

Source: Own research

Finally, the chances for informal employment and undeclared wages in the public sector are rather low.

Conclusion: Cash payments are one of the main indicators for informal employment and undeclared wages. Informal employment is most common in those sectors and companies which use cash payments.

2 Reasons for informal employment

Understanding the reasons of people for engaging in informal employment is crucial to developing measures for changing people's behaviour.

As with any other criminal offence, working informally requires means, a motive and an opportunity. Looking at the means, motive and opportunity of informal employment provides the reasons for its widespread use in Moldova.

- **Means:** The ability to engage informal employment
- **Motive:** The motivation / need to engage in informal employment
- **Opportunity:** The possibility to engage in informal employment

2.1 Cash payments as a pre-requisite for informal employment

A prerequisite for informal employment is a sufficient amount of cash money since the wage payments cannot be made via bank transfer as this hugely increases the risk of being detected. Without enough cash money, paying wages in an envelope is not possible.

This explains why informal employment is especially present in the personal services sectors and retail, where cash payments are common and cash money can be channelled off for the purposes of making envelope payments.

While, in such sectors cash payments are common and keeping them off the records is relatively straight forward, several other channels exist for bringing cash into the system, including:

- **Overstating invoices:** Example: A construction company purchases building materials. The materials have a value of MDL 10,000. However, on the invoice, an amount of MDL 12,000 is stated. The purchaser pays the MDL 12,000 and receives MDL 10,000 in form of goods and MDL 2,000 in cash. That way an additional MDL 2,000 is available for off-the record wage payments or other purposes.
- **Running a small business on the side** where payments are made in cash, e.g. a car wash.
- **Other ways** are by smuggling goods for sale or illegally importing "black cash" from abroad.

Conclusion: The main pre-requisite for informal employment is cash money in order to make wage payments which cannot be detected.

2.2 Employers' rationale for informal employment

Having discussed the prerequisite or means for informal employment, there is the question of what is the motive for engaging in informal employment.

Informal employment needs two sides: an employer and an employee who agrees to it. Although those cases may exist, it seems very unlikely that an employee is unaware that he/she is taking part in informal employment. So it is relevant to ask: What is the rationale for both, the employers and the employees, to make an agreement for informal employment?

The major reason for an employer to pay full wages or at least part of it in cash is to reduce the overall labour costs. By not declaring wages an employer does not have to pay tax and contributions to social and medical insurance. The maximum labour cost advantage that can be achieved in comparison to official employment would be 54%⁵. That is, if all wage remains undeclared and the average tax rate is close to 18% (see also box below for an example). Therewith the employer has a strong motive to pay salaries informally. However, this is rather a theoretical result, as wages in the informal sector are not likely to be subject to the highest possible average tax rate, and as the employee partly profits from the labour cost saving by receiving a higher wage.

Box 1: Numerical example of labour cost savings through informal employment

Informal Employment vs. Official Employment

Paying wages (partly) in envelopes helps to reduce labour costs. To what extent this can be effective is shown with the help of the following example.

We assume two workers who both have a net income of MDL 5,000. In the case of informal employment we assume 40% of the MDL 5,000 are undeclared (paid in an envelope). For the second case the entire wage is declared.

As Figure 2 illustrates, by paying some of the wage in an envelope labour cost savings MDL 1,490 compared to paying the same net wage 100% officially can be achieved. In other words, the labour costs for a person receiving 40% of MDL 5,000 net wage in an envelope are 18% lower than those for official employment with the same net wage. The sum of taxes and contributions for social and medical insurance is almost twice as high in the official scenario.

Clearly, not all of the MDL 1,517 labour costs saved go into the pocket of the employer. In order to motivate the employee some of it needs to be used to increase his net wage.

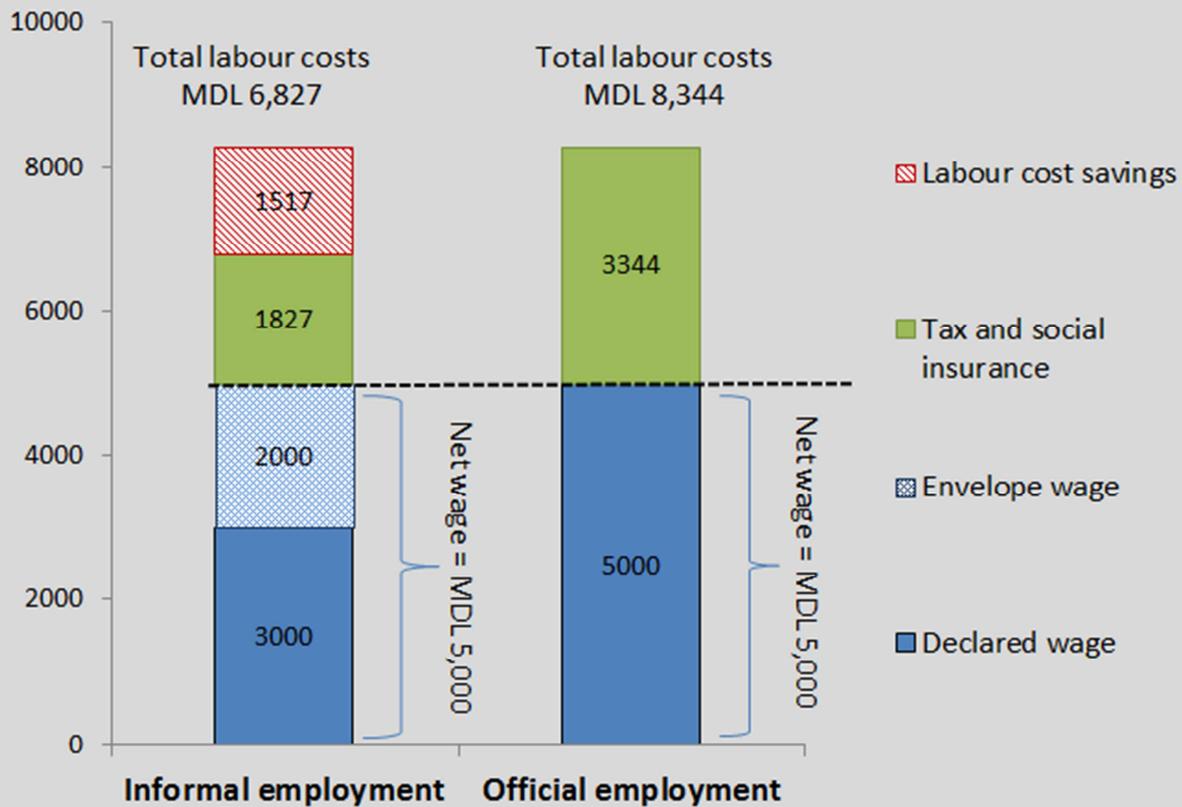
The labour cost savings depend on the share of the wage paid in an envelope. For example, if all MDL 5,000 net wage remains undeclared, total labour costs for the

⁵ Clearly, the employers have to share at least some of the labour cost savings with his employee in order to motivate him to agree to informal employment.

employer would be 45% lower than that of an competitor paying wages officially.

In order to impose at a reasonable level of fines, that have to be paid upon detection, the calculation of cost advantages will act as a helpful reference.

Figure 2: Labour Costs for informal and official employment for MDL 5,000 net wage



Source: Own calculation, applying the current rates for tax and social/medical insurance contributions.

For more information on the rates cf. Annex 3.

However, there is always the risk of being detected and having to pay a fine. Thus, the employers' potential labour costs savings will have to be weighed against expected fines. That is, the average employer will estimate how likely it is that he will be caught and, once this happens, how high the fine is. If the annual labour costs savings are higher than the expected fines, there is a good chance that he will attempt to leave parts of the wage undeclared.

Employers' rationale:

Labour cost savings > Expected cost of being fined

While there is little official data considering the widespread use of illegal payment practices, the chances of being fined appears to be rather low. Indeed, our discussions with stakeholders confirm that labour inspections are not very efficient for several

reasons: There are too few labour inspections, labour inspections are poorly targeted and they have to be announced five days in advance. In addition, proving that actual undeclared payments have happened is extremely difficult if there are no insider tip offs.

Conclusion: Due to inefficient labour inspections and the fact that they actually need to be announced beforehand, the chances of actually being caught in the act of informal employment are rather low.

In the unlikely case, that undeclared wage are detected, the case will be transferred to the prosecution office. It is then up to the prosecutor, whether charges are pressed.⁶

Finally, if actual charges are pursued and the employer is fined, the financial burden is rather low. The fines hardly cover one month of labour costs and amount in the worst case to MDL 10,000 per person working (partly) informal.

Conclusion: As shown, employers have a strong motive for informal employment. On the one hand, the potential for labour costs savings is considerable due to Moldova's high overall tax and social insurance burden. On the other hand, the probability to be detected and the expected amount of fines are low.

2.3 Employees' rationale for informal employment

For employees the main purpose to decide for informal employment is the prospect of higher net wages. Declaring only a small wage may also increase their entitlement for social assistance.

However, the income motive for informal employment is not as strong as for employers for two reasons. Firstly, only some of the labour costs saved by the employer will be passed on to top up the declared wage. Clearly, employers want to keep as much of the labour costs savings for themselves. Secondly, unlike employers, employees have some actual costs as they lose parts of their social insurance entitlements – for example pension entitlements, unemployment benefits, paid sick leave, maternity pay, etc.

However, the large share of undeclared wages means that employees may discount their entitlements. This is due to a number of reasons. As for pensions this is understandable as the pay-back period is often long ahead. Additionally, the link between pension contributions and entitlements is weak (see our PP/02/2014). There may also be a lack of understanding of the fact that social insurance contributions and future benefits are linked⁷. For other social benefits, for example paid sick leave or unemployment benefits the consequences of undeclared wages can be felt immediately. Thus, the employee faces an increased income risk if he accepts salary payments in an envelope.

⁶ Like other areas of the justice system there are severe deficiencies in the rule of law here, too. However, even if some "agreement" can be found, this also represents costs and may thus deter businesses from informal employment practices.

⁷ There is a somewhat widespread notion that the state is responsible for providing pension payments regardless if a person has paid in or not.

An additional motive to engage in informal work is the lack of trust in the state and its institutions. The Gallup WorldView Survey from fall 2012 shows, that only 24% of all Moldovans have confidence in the government. The share of people having trust in the police and the judicial system was at 36% and 27%, respectively.

As there are no fines for employees if detected to be engaged in informal work, the employees' rationale is as follows:

Employees' rationale:

Higher net income \geq Perceived reduced benefit entitlements and pension entitlements

Conclusion: Employees' rationale for not declaring wages is the higher net income as employers may share some of the labour cost savings. However, since they also lose benefit entitlements their motive for informal work is weaker than that of employers.

In the current system, employers and employees have a strong motive and due to the weak inspections also a good opportunity to work (partly) informal. Such illegal behaviour does not have a strong negative notion. This can be explained by the lack of „Guilty Conscience“ due to widespread corruption, as well as the low quality of state institutions and system of benefits.

3 Measures to reduce informal employment

The existence of a high share of wages paid informally suggests that currently the benefits from informal employment outweigh the expected costs.

A previous attempt to address the widespread informal economy was made with the 2011 action plan to minimize envelope payments and informal labour of the Ministry of Labour. The main objectives were inter alia to strengthen enforcement mechanisms for violation on wages, to improve detection of informal employment, to increase the reported wage rate and to promote legal education for employees.

While it is problematic to analyse the result of this plan after such a short time period, the overall share of informal employment (which apart from employees includes own-account workers and contributing family members) has remained unchanged. However, statistics show a drop of informal employment for employees from 11.4% in 2011 to 9.0% in 2013. Furthermore, the share of employees without a written work contract declined from 9.5% in 2010 to 7.8% in 2012.

The total share of all types of informal employment is with 30.9% of total employment considerable. Therefore, immediate action is still needed.

3.1 Overall strategy: "Carrots and sticks"

The problem of informal employment is widespread and will not be solved overnight. What is needed is a long term approach which consists of a host of measures. Those measures need to be consistent and should follow an overarching **double strategy of "carrots and sticks"**.

That is, the relevant ministries should work together to improve the incentives for those working legally (**carrots**) while at the same time increasing the pressure on those who take part in informal employment (**sticks**).

In addition to following such a double strategy, the government seek **to reduce undeclared cash payment**, as undeclared cash is the pre-requisite for informal employment.

Below outline specific measures which follow such a double strategy.

3.2 Increase the likelihood and cost of getting caught for both sides

As mentioned, in order to increase the pressure on those taking part in informal employment the state need to increase both the risk of getting caught and the fines for those who were detected.

A key to a higher likelihood of detection are labour inspection. Efficiently working labour inspections would significantly increase the risk and the costs of being detected and consequently reduce the motive for employers and employees to engage in informal employment. In order to achieve a higher detection rate, it is necessary to expand the number of inspectors, to increase the effectiveness by focusing on the most inclined sectors (like agriculture, construction, retail trade, consumer services) and to introduce higher fines or other means of punishment, like closing businesses or imprisonment.

Inspect businesses according to their risk profiles

One of the problems with the current system is not a lack of controls as such, but labour inspections that harass businesses which are unlikely to engage in informal employment. This adds administrative cost and risk without effectively reducing informal employment. It also increases the risk of companies dropping out of the formal sector. Hence, it is recommended that inspections put a stronger focus on certain sectors prone to informal employment. Such approach has been used in Latvia, Portugal and Romania where companies are inspected according to their risk profile. In general, this would mean that rather small and medium sized enterprises with high likelihood would be selected.

Introduce a "whistle blower" scheme

Detecting and proving informal employment from the outside is frustratingly difficult. To address this problem, employees should have the opportunity to report informal employment to the labour inspection office. This would significantly improve the chances

of detecting and proving criminal actions even if the number of inspectors is kept unchanged. Clearly, such a “whistle blower” scheme would only work if there are sufficient incentives for those reporting the crime. Thus, employees reporting and giving testimony about informal employment practices should be exempted from any penalties.

The government should promote the whistle-blower scheme within a wider public awareness campaign. Those participating in informal employment should be signalled that the chances of being discovered are now much higher. Both the actual introduction and promotion of such a whistle blower system would in itself greatly increase the perceived risk of engaging in informal employment at very low cost to the government.

Strengthen the cooperation between state institutions

Another step towards improved detection of informal employment practices would be better cooperation and data exchange between the state institutions such as fiscal authorities, labour inspections, banks and the statistical office. This could include sharing data on income and real estate tax payments as well as other relevant information which can help to detect discrepancies in officially declared income and expenditures by data-matching. The creation of inter-departmental teams, as has been proposed by the 2011 Action Plan of the Ministry of Labour, is a promising first step in this regard. Additionally, quick and easy access to a commonly shared database can contribute to higher transparency and increase detection.

Specifically, there is a need to improve cooperation between the National Insurance House (CNAS) and the Labour Inspectorate. Often cases of informal employment or underpayment of social insurance contributions are reported by employees to CNAS. However, currently there is no clear mechanism of following up on those reported cases in place. Therefore, we suggest that a clearly defined compulsory procedure should be introduced for cases flagged by CNAS. That way, whenever CNAS reports infringements, the Labour Inspectorate is requested to follow up those cases and report back the outcome. If such a system is not possible, CNAS should get the powers to investigate infringements and impose fines independently from the Labour Inspectorate.

Deter from informal employment by higher penalties for both employers and employees

Even if the risk of being discovered is increased, the current level of fines of maximum MDL 10,000 for employers⁸ is unlikely to deter a large share of those practicing informal employment. Thus, tougher punishment for informal employment through increased fines and expanding the range of measures should be considered. The penalty should depend on the severity of the offence. For example, in Germany employers have to pay social insurance contributions of up to three years. Austria, Romania and Slovakia, the regulations also include imprisonment as one possible measure. In Italy, whole construction sites can be shut down, if irregularities are detected.

⁸ There are currently no fines for employees.

We recommend increasing the minimum fines for employers to MDL 10,000 plus the repayment of the unpaid tax and social insurance contributions of up to three years.

There should also be meaningful fines for employees.

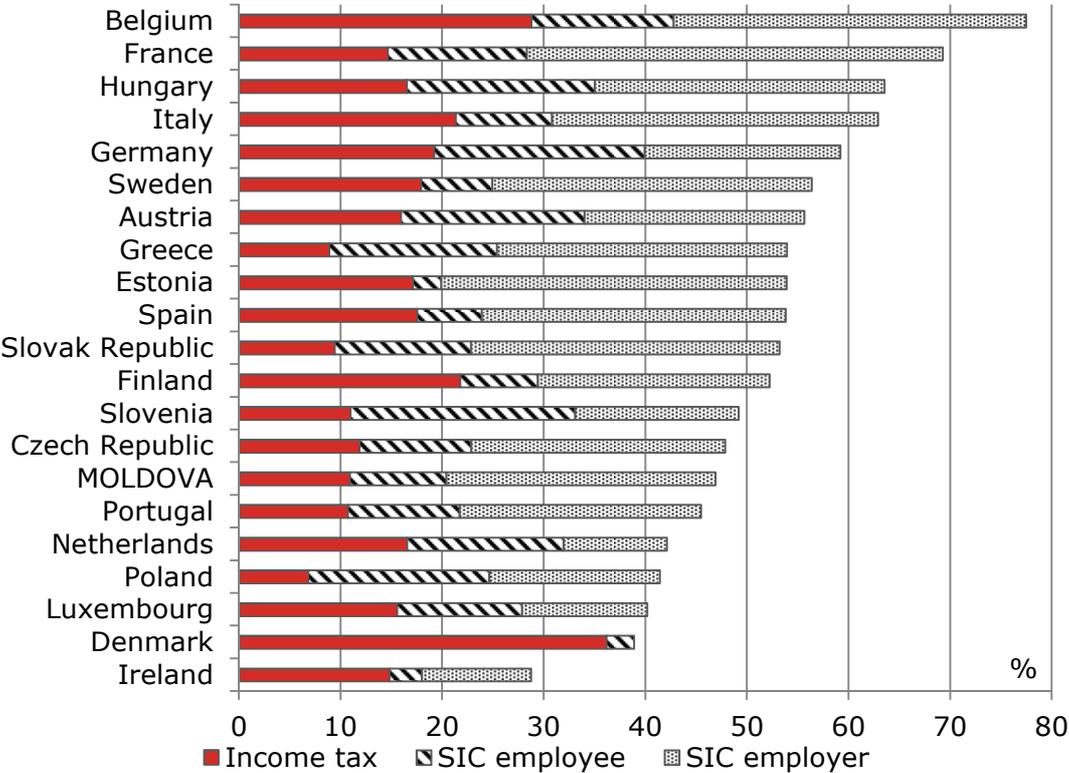
One possible measure to define the penalty is to estimate the amount of taxes and contributions that were not paid due to not fully declaring wages. This amount has to be re-paid to the CNAS and tax authorities. However, the level of fines for employees should be significantly lower than those for employers reflecting the fact that employees often have often little choice but to accept undeclared wages.

Nevertheless, fines are an important signal that informal employment is not accepted and an illegal activity. At the moment accepting undeclared wages is risk free for employees, so introducing fines would significantly reduce their rationale to engage in it. Finally, the suggested whistle blower scheme would only work with fines for both sides.

3.3 Increased incentives

As shown above, the main motive for employers and employees to agree on informal salaries is to save labour costs by avoiding tax and social insurance contributions. Indeed, the combined cost from paying income tax and social insurance accounts on average for almost 48% of total labour costs.

Figure 3: Combined additional labour cost from tax and social insurance for average income



Source: OECD, Effective tax rates and own calculation. Note: SIC – Social insurance contributions

As such, Moldova's tax and social insurance burden is in the range of countries like Slovenia and the Czech Republic and much larger than for example in Ireland and Denmark (Figure 3). At the same time the level of social protection and public services provided is far below those countries. Thus, there is a great incentive for not declaring wages in order to save labour costs.

Reduce the tax and social insurance burden

As the cost saving argument appears to be the strongest for not fully declaring wages, a logical step is to gradually reduce the tax and social insurance burden. Lower rates encourage employers or employees to work within the rules. As a result, more people declare higher wages officially.

To estimate the effect of a reduction in the marginal tax rate in Moldova, the experience of comparable countries can be useful. In 2004, the Slovak Republic and Ukraine reformed personal income tax. By introducing a flat tax rate regime (one common tax rate for all incomes), the marginal tax rate was lowered.

Initially, tax revenues dropped in the year of implementation. However, the data show a recovery of tax revenues to the pre-reform level from the second year onward. This reflects an expansion of the tax base or stronger compliance (World Bank 2007).

Taken these examples into account, reducing the tax burden is a possible and promising measure to take. This would help to unshadow the informal part of the economy and therewith get more people into the official system. Of course, a loss of revenues due to lower rates (at least) in the first year puts pressure on public finances that have to be cushioned, for example by additional measures like a more efficient labour inspection (see chapter 3.2)

An alternative approach to reduce the tax burden is to smooth the marginal income tax rate. In the current tax system, at MDL 27,852 of yearly income the marginal income tax rate increases from 7% to 18%. It can be assumed that this jump deters employees from declaring income above that threshold. An approach for smoothing of the marginal tax rate for income of employees is to lift the threshold and therewith encourage employees to declare higher wages – at least up to the new threshold.

Unshadowing by increasing minimum wage?

In order to reach a higher level of declared wages, instead of setting tax incentives, a higher minimum wage could have a similar effect. The minimum wage level can be seen as the lower threshold for the minimum amount of declared wage. Hence, an increase of that threshold would entail higher declared wages by law. Additionally, especially among low skilled and low paid workers, a higher minimum wage enhances the incentive to declare income as the level of net income would still be acceptable (ILO 2011). Several Eastern European countries like the Czech Republic, Latvia and Estonia have adopted such measure: In the past, minimum

wages have been lifted or fixed in a specified ratio to average wages.

However, increasing the minimum wage may a number of unwanted side effects. Firstly, a reduction of employment or employment moving from the formal to the informal sector has to be avoided in all circumstances. Special concern has to be paid to small companies with a high share of labour costs which might not be able to cushion such shock. Moreover, employers may react by reducing the contractually agreed hours while simultaneously increasing unpaid overtime. As a result, the official wage can be kept below minimum wage.

Additionally, an above average increase in the minimum wage may also lead to increases of other – higher paid – positions since those employees do not want to lose their advantage. High wage growth and inflation and loss of international competitiveness may be the result.

Finally, minimum wage increases should be strictly formula-based as it is currently practiced in Moldova. Indeed, as soon as the government is allowed to arbitrarily adjust the minimum wage, there is the risk that this will be used as a tool to please voters in the run-up to elections.

Due to the risks related to changes in minimum wage, we do not recommend using it as an indirect tool to increase the share of declared wages.

3.4 Reduce use of undeclared cash payments

In addition to the proposed double strategy of increased pressure and improved incentives, the government should also target undeclared cash payments. Indeed, in order to cut the means of informal employment, reducing the undeclared cash would be a major step. Not only would this make the use of informal employment much more difficult, it would also increase the wider tax base.

Several measures can be taken into consideration.

Introduce mandatory cash registers

Retail trade is a major source of unreported earnings which then are used for envelope wages. Thus compulsory cash registers should and sales receipts must be mandatory for retailers. The use of mandatory cash registers can be easily supervised and enforced by random checks of the receipts of costumers. A similar measure has been introduced in Italy and Slovakia with success.

Radically shorten the list of patent activities

In this context, a wholesale review of the list of business activities for which patents can be obtained should be undertaken. Activities, for which book keeping and the use of a cash register can conveniently be introduced, should be taken off the list. This would, for example, include retail businesses in department stores, but not necessarily market stalls.

Promote non-cash payment

To additionally decrease cash payments, incentives should be introduced which promote the use of electronic payments and bank transfers. For example, payments from state institutions (e.g. benefits, salaries, etc.) should be paid out exclusively through bank accounts. That way, less money would be held in cash and the transaction costs of paying non-cash fall. The state could also fast-track VAT refunds for electronic payments.

4 Conclusions

As mentioned above the government should follow a strategy which increases the pressure on those participating in informal employment as well as improving incentives for those working officially. For this double strategy to work, sequencing is important. If the government were to reduce the combined income tax and social insurance contribution burden right away, this would lead to a big fiscal gap while probably not having a big effect on the share of undeclared wages.

To avoid such a situation, the government should first increase the pressure on those taking part in informal employment. Taking part in informal employment needs become much more risky with a high chance of getting caught and, if so, fines that act as a deterrent. Although, the pressure should increase for both parties – employers and employees, the main financial burden should lie on employers.

Increasing the risk would also be an important signal, that informal employment is no longer tacitly tolerated, but a criminal act that will be punished. Such a change of mind is an important component when fighting informal employment.

However, pressure alone will not solve the problem. Currently, the incentives for declaring wages are poor as the high tax and social insurance burden reduces the net income for employees and increases the labour costs for employers. At the same time the level of public services and benefits received in return is poor and the trust in the government low. Thus, there is an urgent need to gradually reduce the currently high cost of those working legally.

Such a **combined strategy which makes working legally cheaper and increases the cost and risk of working informally**, is likely to shift the balance to declaring more wages officially.

After having clarified the overall strategy we will no outline specific measures which would fit into this strategy in more detail.

5 Annex

Annex 1 - Data

Data of the Labour Force Survey 2013:

Sector Data

Year	Agriculture, forestry; Fishery			Industry			Construction			Trade; Hotels; Restaurants		
	Formal	Informal		Formal	Informal		Formal	Informal		Formal	Informal	
2006	139,1	283,2	67,1%	140,6	20,7	12,8%	29,9	37,4	55,6%	125,1	70,9	36,2%
2007	142,9	265,7	65,0%	140,3	17,8	11,3%	32,6	43,1	56,9%	135,5	62,3	31,5%
2008	142,3	246,4	63,4%	145,2	18,1	11,1%	39,3	43,5	52,5%	154,3	54,6	26,1%
2009	113,7	220	65,9%	140,2	15,3	9,8%	30,5	42,4	58,2%	164,7	52,6	24,2%
2010	91,8	222,9	70,8%	130,7	15,1	10,4%	24,7	42,8	63,4%	166,7	46,7	21,9%
2011	90,3	232,8	72,1%	138	15,2	9,9%	22,5	44,3	66,3%	175,4	47,6	21,3%
2012	77,2	226,2	74,6%	139,2	11,7	7,8%	27,1	43,1	61,4%	168,5	40,8	19,5%
2013	88,5	249,4	73,8%	133,4	9	6,3%	24,9	40,1	61,7%	169,5	41,9	19,8%

Year	Transportation, Communications			Public administration; Education; Health and social work			Other		
	Formal	Informal		Formal	Informal		Formal	Informal	
2006	55,7	9,6	14,7%	254,8	1,9	0,7%	70,5	17,8	20,2%
2007	58,3	10,4	15,1%	249,5	0,9	0,4%	68,6	19,2	21,9%
2008	57,7	13,1	18,5%	247,5	0,7	0,3%	75,2	13,2	14,9%
2009	57,1	10,9	16,0%	247,6	1	0,4%	75,1	13,2	14,9%
2010	53,8	9,9	15,5%	249,1	1,6	0,6%	73,1	14,5	16,6%
2011	58,8	8,2	12,2%	248,9	1,3	0,5%	79	11,3	12,5%
2012	61,6	8,8	12,5%	246,6	0,5	0,2%	85,6	9,8	10,3%
2013	64,1	9,1	12,4%	235,1	0,5	0,2%	94,4	12,8	11,9%

Age groups

	2013		
Total	810	362,7	30,9%
15-24 years	65,8	38,5	36,9%
25-34 years	212,9	85,8	28,7%
35-44 years	194,7	83	29,9%
45-54 years	209,2	89,7	30,0%
55-64 years	117,5	51,2	30,3%
65 years and over	9,8	14,6	59,8%

Annex 2 - Definitions

The definition of the four groups is described in the documentation to the Labour Force Survey of the National Bureau of Statistics as follows:

- **Employee** – is the person carrying out an activity under a working contract within an economic or social unit – irrespective of its ownership type – or for private persons, receiving remuneration in form of salary, in cash or in kind, commission, etc. People under military service were also registered with the same status.
- **Employer** – is the person carrying out the activity (craft) within his/her own unit (enterprise, agency, workshop, shop, office, farm, etc.) having one or several permanent employees.
- **Own-account worker** – is the person carrying out an activity within his/her own enterprise or business, without hiring any permanent employee, being helped or not by unpaid family workers. This status covers as well the individual entrepreneurs (haberdashers, private tutors, private taxi drivers, etc.), professional men (strolling players, artists, lawyers), occasional daily workers, and individual farmers. Own account worker can have temporary employees.
- **Contributing family member** – is the person carrying out the activity within a family economic unit, headed by a family member or by a relative, for which he/she does not receive remuneration in form of salary or payment in kind. The agricultural household is considered as such unit. If several persons from a household are working within their own agricultural household, one of them – generally the household head – is considered as self-employed and the others are considered as unpaid family workers.

Annex 3 - Calculation

The number of persons involved in informal employment is derived from the Labour Force Survey:

Group	Number of People
a) Employees in formal sector enterprises	18,288
b) Employees in informal sector enterprises	57,912
c) Own account workers informal employment	261,400
d) Contributing family members in informal employment	25,200
Total	362,800

Source: National Bureau of Statistics Labour Force Survey

The assumptions and the amount of undeclared wage can be seen here:

Group	Share of undeclared wage	Assumed annual wage (MDL)	Undeclared wage (MDL)
a)	40%	28,800	526,694,400
b)	100%	43,200	2,501,798,400
c)	100%	43,200	11,292,480,000
d)	100%	43,200	1,088,640,000
Total			15,409,612,800

Source: National Bureau of Statistics, Earnings statistic, own calculation

To estimate the income tax losses, we apply the average tax rate resulting from the sum of yearly income. For the estimation of the losses for social and medical insurance, we use two different measures: For the groups a) and b) we use the official contribution rates. For the remaining two groups we assume that they would obtain an individual contract with the CNAS, which obliges them to pay an annual fixed sum of MDL 5,748 for social insurance and MDL 4,056 for medical insurance.⁹

⁹ Figures are derived from CNAS and ACI Partners (2014) Legal Flash No. 1, 19.02.2014. The method follows the approach of Ministerul Muncii, Protecției Sociale și Familiei (2012) Propunerea de politici publice: Diminuarea fenomenului de ocupare informală a forței de muncă.

The losses are calculated as follows:

	Group	Contribution Rate / Tax Rate	Sum of Losses (MDL)
SIC	a)	29%	152,741,376
	b)	29%	725,521,536
	c)	MDL 5,748 ann.	1,502,527,200
	d)	MDL 5,748 ann.	144,849,600
	<i>Total</i>		<i>2,525,639,712</i>
MIC	a)	8%	42,135,552
	b)	8%	200,143,872
	c)	MDL 4,056 ann.	1,060,238,400
	d)	MDL 4,056 ann.	102,211,200
	<i>Total</i>		<i>1,404,729,024</i>
TAX	a)	18%	94,804,992
	b)	10.9%	272,897,559
	c)	10.9%	1,231,789,992
	d)	10.9%	118,749,456
	<i>Total</i>		<i>1,718,241,999</i>
TOTAL			5,648,610,735

Source: Own calculation based on the Labour Force Survey of the National Bureau of Statistics, the Earnings Statistics, as well as the legal framework

Note: SIC – Social insurance contributions, MIC – Medical insurance contribution, TAX – Income tax

Annex 4 – Taxation in Moldova

Income tax – two progressive income tax rates

- Yearly income below MDL 27,852: 7%
- Yearly income exceeding MDL 27,852: 18%

Social insurance contribution rate (SIC):

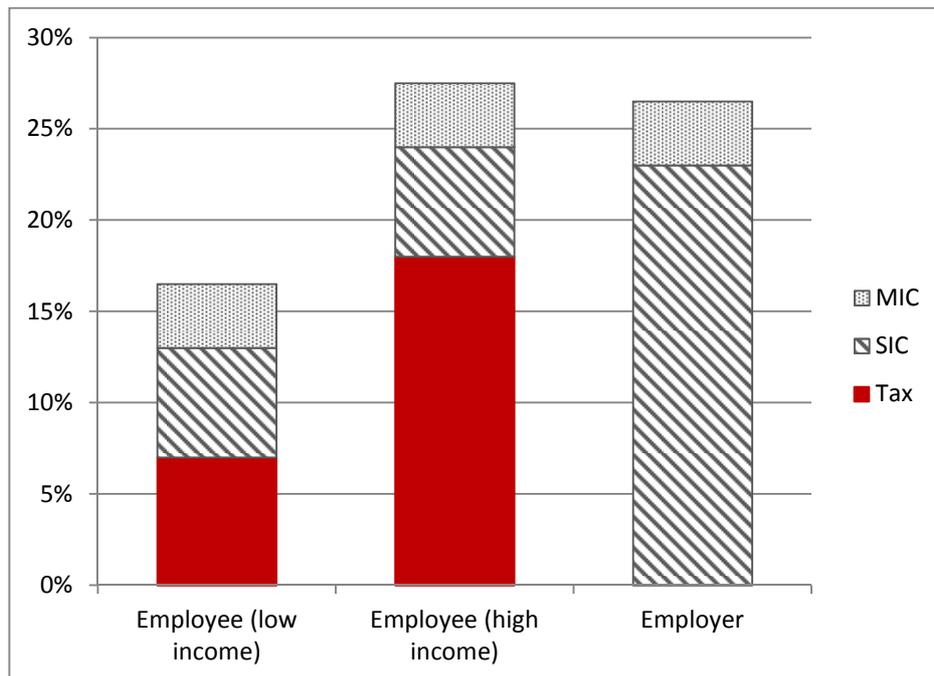
- Employer: 6%
- Employee: 23%

Medical insurance contribution (MIC):

- Employer: 4%
- Employee: 4%

Total:

- Employee
 - low income: 16.5%
 - high income: 27.5%
- Employer: 26.5%
-



Note: SIC – Social insurance contributions, MIC – Medical insurance contribution, TAX – Income tax

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