



INFORMAL ECONOMY IN MOLDOVA

Assessment and ways to tackle

Abstract

This paper has not the ambition to be original but to present a structured compilation of major findings drawn from surveys, articles and reports by several reputed authors who researched on the informal economy in Moldova and elsewhere. The merits for these results are theirs. We only added some own ideas and proposals.

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I. State of informal economy in Moldova

1. Definition of informal economy

A broad definition of informal economy is given by P. Smith (1994, p.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".

F. Schneider¹ uses a narrower definition of the shadow economy. For him, the shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for 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 labor standards, such as minimum wages, maximum working hours, safety standards, etc. and,
- ✓ to avoid complying with certain administrative obligations, such as completing statistical questionnaires or other administrative forms.

This definition includes undeclared work and undeclared salaries but excludes illegal activities of a criminal nature such as drugs dealing.

Undeclared work is defined by the European Commission (2007 p.2) 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."

A typical characteristic of informal economic activities is that they involve only 2 partners (e.g. worker and employer), whereas the formal economic activities involve always 3 partners (2 + the state).

2. Methods to estimate the size of the informal economy

Measuring the extent of the informal economy is the same as trying to know the unknown.

Grosso modo one can distinguish two types of methods: the direct methods and the indirect ones.

¹ Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments (2015, p.4)

Between the direct methods which are often used one can distinguish the sample surveys based on voluntary replies by individuals and the tax auditing reports (micro-economic methods).

Indirect methods use macro-economic data such as the discrepancy between the official labor force and the actual one, or the discrepancy between national expenditure and national income in the national accounts (Schneider, 2002 p. 33-44).

The Moldovan National Bureau of Statistics (NBS) is of the opinion that the macro-economic model used by Schneider (the MIMIC method - multiple indicators, multiple causes) yields exaggerated results, therefore the NBS uses both the system of National Accounts (recommendation of the UN in 1993) and the recommendations included in the Manual of the Dpt. of Statistics and of Sociology of the Republic of Moldova of 2003 (ILO, 2016).

3. Size of the informal economy

If one looks at the available international data, one may say that the informal economy is a world-wide phenomenon. If it is true that informality is universal, it is also true that the level of informal activities is very different from country to country.

The most famous author on informal economy is certainly professor Friedrich Schneider from the university of Linz in Austria. Already in 2002 he published comparative data on the subject.

In 1999-2000 the average size of the informal economy (in % of GDP) in the 23 transition countries was 38%. At the same time, the average size in the OECD countries was 18%.

Amongst the transition countries the highest size of informality was registered in Georgia (67,3%) followed by Azerbaijan (60,6%) and Ukraine (52,2%).

Other transition countries showed also relatively high degrees of informality: the Russian Federation (46,1%), MOLDOVA (45,1%), Bulgaria (36,9%), Romania (34,4%) and Croatia (33,4%).

At the lower end, we found Hungary (25,1%) and the Slovak Republic (18,9%).

By the year 2007 the average size of the informal economy in the transition countries decreased by more than 4% points to 33,7% of GDP (Schneider, 2012 p.17).

In Moldova, the shadow economy stood at 44,3% in 2006 (Schneider, 2010).

By the year 2012, Schneider observed a further decrease in most (new) EU countries: Bulgaria was still at the top of the EU ranking with 31,9%, followed by Romania (29,1%), the Baltic countries Lithuania (28,5%) and Latvia (26,1%), Hungary (22,5%) and Slovakia (15,5%) (Schneider, 2012)

For 2011 the European Commission and Schneider estimated the level of the shadow economy in Moldova at 41,8% of GDP (European Commission ,2013).

According to the National Bureau of Statistics of Moldova, the non-observed economy in Moldova decreased significantly until 2007, followed by a slight increase up to 23,1% of GDP in 2013 (ILO 2016). By 2013, 32,5% of the total employed population in Moldova had an informal job, as compared to 38% in 2003 (figure of the NBS).

Whilst undeclared employment decreased in Moldova, certainly in formal sector enterprises, companies started to look for new ways to save on labor costs. The number of companies that now employ workers partially formal (often on the basis of the minimum salary) and partially informal has increased (ILO 2016).

According to a study of the Moldovan Ministry of Labor of 2011, 57% of the employed population did not declare their full salary in 2010 (ILO, 2016).

The NSB and the GET Moldova (GET Moldova, 2014 p.3) estimate that for employees working in the formal sector, between 30 and 50% of the salary (on average 40%) is paid in an envelope. For the employees in informal enterprises, own-account workers and family members in informal employment the wage payment is assumed to be completely informal.

According to the NBS and the GET Moldova's own calculations (2014 p.4) the total amount of undeclared wages adds up to 31,1% of the national wage sum (for 2010 the ILO (2016) estimated that share at 29,6%, which means 13% of GDP).

That means that in Moldova the phenomenon of under-declaration of salary/income is more widespread than informal employment.

The payment of envelope wages is quite common in East-Central Europe: an Eurobarometer survey on undeclared work in the EU revealed that in 2007 68% of all interviewed employees in these countries received envelope wages; in Continental Europe the figure was 14% and in the Nordic countries only 6% (Eurofound, 2008 p.13).

The Eurobarometer Survey showed further that in countries like Bulgaria, Latvia, Lithuania, Poland and Romania the envelope wage amounted (in 2007) to an average of about half of the formal employees' wages; in the

Czech Republic, Estonia, Hungary, Slovakia and Slovenia it amounted to an average of around one quarter of formal employees' wages.

4. Where do we find informality in Moldova?

The informal economy is highly concentrated in a few sectors. In 2013, 68,7% of the informal jobs were situated in the agricultural sector (Labor Force Survey, 2013 quoted in GET Moldova, 2014). The relative number of informal jobs (in % of total jobs in the sector) decreased in nearly all sectors, except in agriculture and construction.

In 2013, 73,8% of the jobs in agriculture and 61,7% of the jobs in construction were informal. In all other sectors, their share was below 20% with only 0,2% in public administration, education, health and social work.

In 2013 the share of non-observed economy in terms of GVA (Gross Added Value) by sector was the highest in agriculture (close to 60%), followed by hotels and restaurants (over 40%), construction (around 36%), wholesale and retail trade (30%) industry (around 18%) and transport and communication (around 13%) (ILO, 2016 on the basis of data of the NBS).

Agricultural employment counted for 51% of total employment in 2001; by 2013 this figure fell to only 29% (Kraan et al, 2010; GET Moldova, 2014, p.17). Over the period 2006-2013 employment in agriculture decreased by 20%, due partly to the diminishing share of the sector overall (contribution to GDP decreased from 22% in 2003 to 18% in 2007 - see Kraan et al, 2010) and to its modernization (ILO, 2016). Another reason is probably also the decrease of the status and of the attractiveness of the farmers' job, combined with the poor income perspective of the average Moldovan farm (with too small agricultural plots). This can lead to an exodus out of the farmers' profession and an orientation towards other more lucrative (informal) jobs like e.g. in the construction sector. The fact that the number of formal jobs in agriculture decreased by 36,4% over the period 2006-2013 and the number of informal jobs fell only by 12% may indicate that farm work is more and more considered as a secondary informal occupation, mainly performed for own family consumption.

For the construction sector, the Labor Force Survey 2013 reveals a remarkable phenomenon: in the midst of the economic crisis (in the year 2008) formal and informal employment in the sector boomed: formal employment had increased by 31,4% in 2 years' time and informal employment had only grown by 16,3% since 2006. However, from 2009 onwards formal employment fell drastically with 36,6% by 2013 whilst informal employment lost only 7,8% over that same time span. This may indicate a certain consolidation of informal employment in the construction sector combined with a more or less structural loss of formal employment and perhaps also a switch of formal to informal employment.

A case study by the ILO (2016) in the construction sector of Moldova reveals a high turnover of workers and 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 higher wages offered by foreign companies and the migration to better paid and more flexible informal construction jobs in the own country. These last jobs are often offered by households for repair works in older buildings or finishing jobs in newly built apartments which are sold unfinished by formal construction companies. These repairs and finishing jobs are mostly executed by own-account workers. The Labor Force Survey of 2013 reveals further that 30% of these own-account workers would like to change their current informal job for a more regular and secure formal job with a labor contract if they could earn more income by working longer hours.

5. Who are the informal workers?

Most part of the informal employment (72%) is represented by own-account workers in informal sector enterprises.

- By gender

In 2013 the share of informal employment as part of total employment was 34,7% for men compared to 27,1% for women.

About 78% of employed women contributed to the social security fund, compared to only 71% for men (ILO, 2016 and NBS).

- By age

NBS data show that informal employment occurs in all age groups, but that it is very pronounced amongst young people (cohort 15-24y) where around 37% of the employed worked informal and amongst the people of 65 and older: 60% of them who are still active do it informal (ILO, 2016).

- By area of residence

Informal employment is very widespread in rural areas where 46,4% of the active work informal; in urban areas only 13,5% of the employed had an informal job (ILO, 2016).

- By company size and type

Informal employment is most common in medium-sized companies (20-99 workers) and in small companies (5-19 workers). Smaller companies work often under the radar of the tax inspectors. In big companies and in foreign owned enterprises, undeclared work and wages is quite uncommon. GET Moldova (2014, p.5) sees two reasons for that: first, the perception and

attitude of illegal employment is different for foreign companies and second, the share of labor costs in total costs being smaller for them, the need to cut labor costs in order to exist in the market is not so pressing.

Informal employment is also very much present in sectors and companies with seasonal work (GET Moldova, 2014, p. 5).

Another aspect of the problem is that in sectors/companies where goods and services are mainly paid in cash, the chance that informal employment occurs is bigger than in sectors/companies where payments are predominantly made via electronic transfers (bank cards, bank transfers) (GET Moldova, 2014, p.5).

GET Moldova concludes here that the most important factor which increases the likelihood of informal employment is CASH PAYMENTS. This occurs mainly in agriculture, construction, services (hotels, restaurants, retail, hairdressers, wholesale) and transport (taxis) (GET Moldova, 2014, p.5).

- By qualification and level of education

66% of all informal jobs are found in elementary occupations. Craft and related trades workers and service and sales workers represent respectively 10,8 and 11,1% of the informal workforce. But also, the top-qualified people are not absent in the informal work statistics: 0,9% of all informal workers are managers or professionals. Amongst the skilled agricultural workers, the relative number of informal workers is more than 3 times higher than the number of formal workers (ILO, 2016 and NBS).

It is not astonishing that also in Moldova informal employment goes hand in hand with low levels of education 59% of all informal jobs are held by people with only primary or secondary general education. Remarkably, 26% of the informal workers are vocational school graduates. The ILO explains this phenomenon by pointing to the deteriorating quality of the vocational educational system during the last two decades and the broken link between the labor demand and the labor supply by the educational system.

- By employment status

A report of Eurofound (2008, p.13) shows that in East-Central Europe 84% of all employees who received envelope wages received that money for regular work and 43% received that for overtime or extra work.

A more recent report of Eurofound (2013, p.7) demonstrated that in East-Central Europe 62% of all undeclared work is conducted by formally employed people (in Western Europe this is 57%): the officially unemployed were responsible for 17% of the undeclared work (compared to 8% in W.Europe). The formally employed workers earned 67% of the undeclared income (63% in W. Europe) and the unemployed got only 17%

(5% in W. Europe). In East-Central Europe the average hourly undeclared wage of the formally employed was 59% higher than the wage of the unemployed (in W. Europe the difference was 50%).

Eurofound concludes that in countries who pursue active labor market policies and who provide unemployment benefits on a larger scale and at a higher level in relation to the average salary, the unemployed are less forced into undeclared work to make a living.

Remains the question why formal workers and companies are so keen on informality.

6. Cash payments as a pre-requisite for informality²

An 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 money is needed.

Formal employment without cash is possible but informal employment without cash is impossible

GOLIAS (2013, p.7) refers to a study of the World Bank of 2012 who found a strong negative correlation between the frequency of electronic payments and the shadow economy: this means that the size of the shadow economy is bigger in countries where people use less electronic payments.

According to the European Cash Report (2016) of the European Central Bank the % of cash payments in shops is very high in Bulgaria (95%), Greece (95%), and Romania (93%). In the Scandinavian countries and the Netherlands, the percentage is between 36 and 38%.

The GET Moldova (2016, p.1) reports that the number of non-cash transactions per capita in Moldova is 1.8, compared to 11.5 in Romania. In Moldova card payments increased by 379% between 2010 and 2015.

The cash money in circulation in Moldova is 15,62% of GDP, compared to 5,6% in Romania.

The GET Moldova (2014, p.6) gives three examples of how cash is brought in the system:

1. Overstating of invoices whereby the purchaser gets the goods or services and receives on top of that part of the invoice back in cash
2. Running of small business on the side where payments are made in cash - e.g. a car wash
3. Smuggling goods for sale or illegally importing "black cash"

² Policy Paper GET Moldova, 2014, p. 6

Also, Ravas (2015, p. 154 and 156) enumerates a whole series of practices identified by the fiscal controls in Moldova which allow certain companies, businessmen and shops to underreport their profits and to fill their black cash, allowing them to pay envelope salaries.

Among these practices we quote:

- carrying out fictitious operations - often with ghost firms - and paying for false statement documents
- compiling false accounting records
- failure to produce primary accounting documents
- carrying out entrepreneurial activities without authorization/registration
- not declare a taxable matter
- double accounting records: real and fictional
- falsifying the balance sheet (e.g. by overstating the deductions)
- sales without invoice
- making money income in cash without issuing a cash receipt
- retail sale of products without a license
- false custom declarations on the value and the volume of imported goods

Ravas illustrates in her paper how the State Tax Service discovered in 2014 such irregularities in the tourism business. Sometimes operators and travel agencies did not reflect the actual amount of the transactions in the accounts and several travel agencies did not reflect objectively the wages paid.

7. Main "drivers" of the informal economy

Before effective measures against the informal economy can be developed, it is important to understand the rationale of this deviant behavior.

From the outset, it is clear that the general socio-economic situation and the fragmentation of the labor 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 in the country.

If regular and decent jobs are scarce and the unemployment benefits are low or inexistent (e.g. for school leavers) , people tend to accept each job which is offered at whatever price and under whatever condition , be it informal.

The same can be said about poor people without any relevant qualification: poverty can drive them into informal employment just to survive.

On the other hand, people with the right qualifications who are strongly solicited by the market, can put their conditions forward to the employers or the customers and bargain not only on a high salary or price but also on a heavy "envelope" especially when the risk of being caught by the tax inspectorate is low and the rule of law weak.

The reasons for under-declaration or for not declaring their real wage or employment may be different for poor people on low income, especially in the rural areas where well-paid jobs are scarce, and for people on high wages. For people on poorly paid jobs, the satisfaction of their immediate needs (food, rent, electricity, etc.) prevails over their future safety (pensions, etc.) and therefore they work informal and don't declare (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 behavior will be similar.

If we look at the research reports and the position papers of the social partners of Moldova, we find, besides the reference to the general economic situation, several more specific determinants which are frequently quoted, such as:

- the low quality of public goods and services
- the low level of transparency of budgetary spendings
- the low tax morale
- the too heavy burden of taxation
- the weak link between social contributions and social benefits
- the poor quality of public institutions and of the regulatory framework and the low risk of detection

It is important to point out that these motives are interrelated and reinforce each other. That means that in order to reverse the situation, action is needed in different fields and on all levels.

a) the low quality of public goods and services

The ILO report (2016) states, on the basis of the results of the national representative survey conducted in 2014 for the Expert-Grup study "Fiscal gap - an invisible reality" and of other empirical studies, that corruption and efficiency of governance, which measures the quality of public services, are considered to have the most significant impact on the size of undeclared work. One of the triggers for accepting envelope wages is the general dissatisfaction amongst the population with the quality of public services in Moldova, given the level of taxes paid. Dissatisfaction is especially expressed concerning the quality of roads (77%), the social protection system (72%), the functioning of the public institutions (55,9%), the health care (55,7%) and the education system (38,8%). Direct correlation was found between the dissatisfaction on social protection, public institutions and roads and the justification of under-declaring wages and income.

In 2015 (this is one year before the pension reform) Ravas wrote: "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, p. 156-157).

b) the low level of transparency of budgetary spending

The ILO report (2016) refers to the many reports of the Moldovan Court of Accounts since 2001 which reveal that budgetary resources are often used inefficiently and in a non-transparent way. The Expert-Grup survey of 2014 shows that only 11,4% of the population considers themselves as highly informed about how the public money is being spent, whilst 79,4% consider themselves as poorly informed. More people from this last category consider under-declaration of salaries justifiable compared with well informed people.

c) the low tax morale

As third main "driver" of informal economy the ILO report (2016) refers to the widespread tolerance of tax evasion.

The National Confederation of Employers of Moldova (2015, p.7) argues that multiple surveys show that Moldova has a low tax morale. the majority of Moldovan workers have a very low satisfaction with the public services and a very low trust in public institutions. According to the Expert-Grup's survey of 2014, the level of tax morality in Moldova is lower than in other countries of Central and Eastern Europe. This is explained by the weak institutions, the widespread perception of corruption and the low confidence in the pension and budgetary system.

Prof. Erich Kirchler, psychologist at the University of Vienna, argued that tax compliance depends more from the trust that people have in governments and in tax administrations than from police behavior of the tax administration.

A study of the University of Leuven of 2012 has demonstrated a significant correlation between the market share of public television stations and the level of informality in the country. Where the trust in governments (and in public TV stations) is high, the level of informality is low.

E.g. the BBC (UK) had in 2012 a market share of 48,8%; in that same year the level of informal economy (I.E.) was 10,1% (Schneider). Bulgaria on the other hand had an I.E. of 31,9% in 2012 and the market share of the public TV was only 8,5%. The same we found in Romania: I.E. of 29,1% and public TV 's market share of only 6,2%.

Mistrust in governments has several reasons. Some we mentioned already before. Other reasons are: weak rule of law, lack of fairness in the tax system (flat rate taxes), lack of accountability of the tax inspectorate, increasing inequality, etc.

d) the too heavy burden of taxation

For the World Bank (2012) it is simple: high taxes on labor (the "tax wedge" = the difference between the total labor cost and the net take-home pay) and especially on low earnings are a key cause of shadow economy in Central and Eastern Europe. Leibfritz (2011) confirms: relatively low formal salaries, together with relatively high taxes on labor lead to under-declaration of wages by paying part in cash and/or to false declaration of workers as self-employed (= lower taxes).

However, if we look at the situation on the ground in Europe, we must say that what might be true for low wage earners in Central and Eastern Europe and in Moldova in particular cannot be generalized for all wage levels and for all countries.

If indeed high labor taxes (tax wedge) would lead to high levels of I.E., then we should find a high level of I.E. in countries such as Belgium, Austria, Germany and France, who, according to the OECD (2016, p.61) have the highest marginal tax wedges on labor income for single workers on average pay with respectively 66,3%, 60,5%, 60,2% and 59,3% (figures for 2015).

But what we see is that exactly these countries have low levels of I.E.: Austria has the lowest level with only 7,6%, followed by France (10,8%), Germany (13,3%) and Belgium (16,8%).

Hungary is the exception with a relative high marginal tax wedge of 49% and a relative high level of I.E. (22,5%).

In Bulgaria, we find the opposite situation as in high tax countries: a very low average tax wedge (33,6% in 2015 according to the Bulgarian National Statistical Institute) and the highest level of I.E. (31,9% in 2012).

Our conclusion is: generally speaking, higher tax wedges do not necessarily lead to higher levels of I.E. and lower tax wedges are no guarantee for low I.E. Other factors and parameters seem to play a more important role.

The study by Johnson, Kaufmann and Zoido-Lobaton (1998) on corruption, public finances and the unofficial economy, came to the conclusion that it is not higher taxes per se that increases the size of the informal economy, but the ineffective and discretionary application of the tax system and the regulations by governments. Schneider (2002, p.25) mentioned, with reference to a tax reform in Austria, that major tax rate reductions did not

lead to a substantial reduction of the I.E. Also in the W.Balkans we could witness the same phenomenon when the flat-rate taxes were introduced.

The ILO report (2016) suggests even that, the fact that entrepreneurs perceive the fiscal burden in Moldova as high and as a constraint, may be explained by the low labor productivity in the private sector. The GDP per person employed in Moldova in 2016 was indeed only 15,2% of the EU average.

Also in Bulgaria, the GDP/person employed is low: 50,4% of the EU average. All countries with a high tax wedge have also a high labor productivity (GDP/person employed): Belgium 124% of the EU average; France 114,9%; Austria 112,4% and Germany 109,5% (World Bank and ILOSTAT database).

According to GOLIAS (2013, p. 14-17) the formalization tax rate (FTR) and the marginal effective tax rate (METR) offer better information about the motivation of people than the simple tax wedge.

The FTR is defined as a share of informal income that an informal worker has to give up to formalize. The formula of FTR is as follows:

FTR = informal income (informal wage + income tested social benefits like social assistance, housing benefits, higher child allowances, etc.) - formal net income (formal net wage + normal social benefits)/informal income.

The World Bank study (2012) shows that post-communist countries have the highest FTR for lower wage earners. Golias explains that this means that low-earning people in these countries face the biggest financial barrier to enter the formal labor market. In Bulgaria, e.g. single people without children who earn less than the minimum wage in the informal sector have to give up between 50 and 70 % of their income to formalize. For a single who earns 10% of the average wage the opportunity cost in Romania is almost 70% and in Serbia it is even 80%.

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

The study of the World Bank (2012) shows that the new EU member states have very high METR's (mostly 100%) at low wage levels. E.g. in the Czech Republic and in Slovenia, people who earn less than 20% of the average wage lose 100% of every additional euro earned in formal income by (higher) taxes and by the withdrawal of social assistance.

The World Bank concludes that the levels of both FTR and of METR have a strong significant positive correlation with the probability that a worker will

work informal. High FTR's and METR's means high disincentives for workers to go formal.

e) the weak link between social contributions and social benefits

Before the recent pension system reform (December 2016) there was a great dissatisfaction in Moldova about the weak link between the social contributions and the level of the pensions (GET Moldova, 2014, p.9). This dissatisfaction worked as a disincentive to go formal and to pay contributions on the real salary. The fact that through the reform a direct link has been established between contributions and benefits (total equivalence) is 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 the health insurance, the World Bank (2012) argued that this segment of the social protection has the highest influence on the motivation of the workers to go formal or to stay informal. Where for the employer the reduction of the overall labor costs constitutes the major reason to pay salaries in envelopes (GET Moldova 2014, p.7) the employee's rationale is different: he will of course seek a higher net salary, but be more cautious because he will realize that in case of illness he might fall without any income.

If the government guarantees full access to health care for the whole population, even to those people who could pay the health contributions but do not do so or if (nearly) free health care is provided for the people who declare only the minimum salary whilst they earn a normal salary, then the government leaves aside an important lever to convince the free-riders to declare their full wage. The World Bank suggests limiting the entitlement to free health care to the really poor and based on a means test (not on an income test).

f) the poor quality of public institutions and of regulations

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

According to the ILO report, the fact that the level of tax morality is lower in Moldova than in other countries of Central and Eastern Europe, is the result of weak institutions and a widespread perception of corruption.

The Gallup Worldview Survey (2012), quoted by Golias (2013, p.8) points out that the confidence of the people of Moldova in the government is only 24%, in the judicial system 27% and in the police 36%. On the other hand, corruption in government is perceived at 81%. In the World Competitiveness Report 2012-13 (mentioned by Golias, 2013 p. 8)

corruption is mentioned as the most problematic factor for doing business in Moldova.

Golias (2013, p. 6 and 7) reports on the basis of data from the World Bank (2012) a strong negative correlation between government's effectiveness and the shadow economy. The shadow economy is bigger in countries with weak governance, weak institutional credibility and weak control of corruption.

In Moldova, the chance to be caught in case of informal employment is small given the fact that there are too few labor inspectors, that labor inspections are poorly targeted and that the procedure is totally inefficient since inspections have to be announced to the employer five days in advance (what is against the ILO rule) and may take place only once a year in a company (ILO, 2016).

Even if an employer is fined by the prosecutor, the fines are too low to make much impression. Also, the fact that the workers concerned escape from each sanctioning is not an incentive for them to switch to formal employment.

Schneider (2015, p. 11) argues on the basis of empirical survey evidence that fines and punishment do not exert a negative influence on the shadow economy, whilst the subjectively perceived risk of detection does.

Another major problem in Moldova is that the fiscal regulatory framework is ambiguous and the fiscal administration complicated, what undermines the efficiency of the relevant institutions. The ILO report (2016) reveals on the basis of the Expert- Grup study of 2014 that the responsibilities of the key institutions who deal with tax collection, especially the tax inspectorate and the customs service, overlap in many cases and that the coordination between the agencies is poor.

67,8% of the firms created after 2005 consider that the fiscal administration, regulations and procedures are a constraint for 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 e.g. the number is only 7; in Bulgaria 13 and in Romania 14.

Heavy bureaucracy coupled with poor regulatory quality and governmental inefficiency can also be found in the construction and in the trade and transportation sector (two sectors highly exposed to I.E.). In order to obtain a construction permit in Moldova, 27 procedures and 247 days are required. For export, 9 documents have to be collected and an import procedure requires 11 documents (ILO, 2016).

The National Human Development Report (2014) indicates that the reform launched by the Government of Moldova in 2004, aiming at enhancing the business environment, has only produced half of the expected results (see ILO report 2014).

The ILO report (2016) points also to other weaknesses in Moldova, such as the weak anti-trust policies, the weak rule of law, the unequal access to fair justice and the lack of independence of the judicial system.

According to Schneider (2015 p.10) it is in general not so much the number of regulations that is a problem, but the complexity and the discretionary application of the tax code and of other governmental regulations by (often corrupt) government officials that drives companies towards the unofficial economy. In order not to lose too much time for complying with complicated and many times unclear legal procedures, managers often choose the easier way by paying bribes and going successfully informal. Bureaucracy and complexity don't match with compliance.

8. Consequences of the informal economy (I.E.)

a) For the State

The high level of I.E. in Moldova is the basis of a vicious circle of tax and social contributions' evasion which, on its turn, fuels again the I.E. As we saw before, part of what is earned informally will be spent informally. This leads to a parallel underground economy.

An increase of the I.E. means a reduction of the State revenues and an underfunding of budgets, which affects negatively the quality and quantity of publicly provided goods (e.g. roads) and services (e.g. public health care) and the general satisfaction of the population with the government.

The ILO report (2016) states that in 2010 29,6% undeclared wages and income resulted for the State in a loss of 17,1% of its total revenues. This total loss includes a loss of 25% for the social security budget, 13,5% for the income tax and 29% for the health insurance fund.

In terms of GDP the total fiscal gap caused by the informal economy (leaving the illegal sector excluded) is estimated by the NBS at 7,45% for 2013.

The GET Moldova (2014, p. 4) came to somewhat different figures. They estimated the total loss in 2014 up to 5,7% of GDP. The loss of social and medical insurance contributions amounts to 35,3% of the total social contributions. The lack of income tax revenue is 9,2% of the total.

Ravas (2015 p. 156) estimated the total cost of tax and social contributions' evasion in 2015 at 6,5% of GDP.

As the fiscal contribution base represents only a portion of the actual income, the nominal contribution rates turn out to be already relatively high, higher than they should normally be. Massive under-declaration of income may force the government to increase the income tax and the social contribution rates. However, this would act as an even stronger disincentive to go formal and is also not a positive signal towards FDI's.

Therefore, governments will try not to increase the income tax and social contribution rates and prefer to rely more on indirect taxes. That is exactly what happened in Moldova. The effect of the high level of informality in the economy is very strongly felt in the structure of the general government's budget. Moldova relies very heavily on indirect taxes: VAT and excise duties provided in 2009 47,5% of the total tax revenue, which is by far the highest in the region (for comparison: Russia 19,9%, Ukraine 32,9%, Slovakia 35,5% and Romania 36,7%) (IMF, Working Paper WP 12/82).

Not surprisingly personal income taxes (PIT's) deliver only a very small share of the total tax revenue of the country: 7,5% (for comparison: Slovakia 10%, Romania 13,7%, Ukraine and Russia 13,8%) (IMF).

Social contributions provide 28,9% of the total tax revenue (for comparison: Russia 17,3%, Ukraine 31,2%, Romania 34,9% and Slovakia 40,7%) (IMF).

Another direct consequence of a high level of I.E. is also that the economic support ratio for pensions (and for other social benefits) will be very low: in Moldova the support ratio is currently around 1.1 contributors for 1 pensioner. For comparison: in the EU the average ration turns around 1.5%.

b) For the workers

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

An immediate consequence is that the personal income tax level (PIT) will be higher than it would be if everyone would declare correctly. This is especially regretful for those workers who work fully formal: they are the main victims of the informality. Another consequence is that the government will try to compensate the losses due to undeclared income and employment partly by higher indirect taxes, punishing in this way everyone, formal and informal workers.

Informal workers are not protected by the labor law (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 escape from paying 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 will feel the consequences of it when they will get their earnings-related social benefits. Since December 2016 the pension system guarantees a full equivalence between the level of the social contribution (and thus of the declared wage) and the level of the pension. That means in concrete that the workers who declare their full wage will in future benefit from a proportional decent pension.

c) For the companies and the national economy

High levels of I.E. disturb the smooth functioning of the market economy, undermine the development of a legitimate business environment and result in unfair competition and unfair distribution of company taxes (National Confederation of Employers of Moldova, 2015, p.8). Also for the international reputation of the country as a "place to invest", this is not a positive signal.

II. The way forward: how to tackle the informal economy?

Good governance, low corruption and a functioning market economy are (according to Schneider, 2015, P. 27) the best way to reduce the shadow economy.

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

Since 2011 the government has put the fight against informality on the political agenda. Since then 2 action plans were launched but the overall share of informal employment, including employees, own-account workers and family members (in total 30,9% according to GET Moldova 2014, p.10) has remained unchanged. Statistics show however a reduction in the share of employees without a written contract (from 9,5% to 7,8% between 2010-2012) and of informal employment by employees (from 11,4% in 2011 to 9,0% in 2013 (GET Moldova 2014 p. 10)).

Tackling the I.E. further 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 one public authority (a specific minister or vice-minister) has to be put in charge of implementing and evaluating these policies.

Several studies suggest possible measures to reduce the I.E., but what is important to know is which measures have proven their effectiveness. The Eurofound study of 2013 presents a list of policy measures which were developed in 31 European countries (EEA + Switzerland) as well as the level of their effectiveness.

In the following pages we will propose a selection of measures (based on the Eurofound list, on other studies and on our own research) from which we believe that they could be helpful in the specific context of Moldova.

The National Confederation of employers of Moldova (2015, p.10) is right to state that deterrence measures work best after reforms that increase the integrity and the efficiency of central institutions.

According to the employers' organization, international experience shows that effective and integer institutions are more relevant in reducing I.E. than restrictive measures such as raising penalties. In the concrete context of Moldova, more repressive measures which would not be

accompanied by more integrity measures can be counterproductive and increase corruption (more and higher bribes).

Golias (2013, p. 20) points in the same direction: he reports that in Slovakia the positive indirect enforcement measures proved to be the most powerful against the I.E.

1. Invest in good governance and in confidence building

- ✓ develop actions for clean politics in parties and in government
- ✓ full transparency on budgetary spending
- ✓ full transparency on the main objectives of the government for the coming years
- ✓ full transparency on administrative decisions concerning building permits, import/export licenses, subsidies, etc. with proper motivation in case of refusal
- ✓ create ombudservice for the public administrations and service providers (e.g. railroad, telecom, banks) and publish an annual report about the received complaints and their results
- ✓ recruitment of civil servants and employees through an autonomous public agency on the basis of a comparative exam and publication of the results
- ✓ full accountability of officials vis-à-vis their "clients" (citizens, companies, etc.) in order to avoid arbitrary decisions
- ✓ administrative appeal procedures for citizens and companies against negative administrative decisions (e.g. concerning taxation, permits, licenses, etc.)
- ✓ guarantee equal access to administrative and judicial procedures
- ✓ selection of judges and notaries by an independent High Council of Justice on the basis of a comparative exam and publication of the results
- ✓ publication of court rulings
- ✓ better selection criteria and control on public procurement: make main contractor responsible for the respect of all fiscal and social rules by his subcontractors; introduce informal employment assessments of bids and more regular control on

construction/building sites; select on the basis of "best value for money" (that means price and quality are equally important)

- ✓ wider use of mandatory electronic auctions when public authorities purchase or sell goods/services. For important auctions, publish the call also in English (this led in Slovakia to more bids and to important savings - minus 6 to minus 15%. See Golias, 2013 p.21)
- ✓ create an Ethical Commission responsible for making public servants, tax inspectors, police officers, judges and prosecutors immune for bribing
- ✓ increase the 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 extract of their pension account so that they can see if the withheld social contributions have been transferred to their pension account and provide them also with an anticipated pension calculation.

2. Make the public service more efficient and more performant

More efficient and performant public services does not mean necessarily more civil servants, but in the first place better qualified, trained, equipped, paid, evaluated and controlled civil servants.

In certain departments of the public service, it may be necessary to invest in more staff: we think e.g. of the labor inspectorate which is understaffed. Also in the tax inspectorate, it may be necessary and opportune to strengthen the service.

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 of civil servants is absolutely necessary. The development of "one stop shops" (single desk policy) is very important both for citizens and for companies (start-ups, internal and foreign companies).

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

3. Offer better public goods and services

- ✓ Invest more in modernizing the road infrastructure all over the country, with special attention for the rural areas
- ✓ enhance in the rural areas also the other parts of the basic infrastructure: water- gas- and electricity supply, telecom and sewage systems
- ✓ invest in more and affordable childcare facilities, also in the 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; quid for unemployment benefits and sickness benefit?
- ✓ make the social insurance (pensions and sickness) mandatory, also for own-account workers, farmers and family members who help
- ✓ reserve the free health care for the really poor on the basis of a means test (not an income test)
- ✓ start as quickly as possible, in cooperation with the social partners, with the launch of a mandatory 2nd pillar private pension system, financed by the employees, the employers and the state

4. Shift the tax burden and monitor the effects

The government should publicly declare that when the formally declared income increases by 5% in real terms, the social contribution rate of 23% for employers will be reduced by 1% point.

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

Today the jump from 7 to 18% personal income tax rate for income brackets above 29.640 lei deters employees from declaring their income above that threshold (GET Moldova, 2014 p. 14) . This can be corrected by making the transition to the successive tax rates more smoothly, starting from a lower rate for low wage earners up to a higher marginal rate with in between 3 rates. The new structure of the PIT would look as follows:

- 5% rate for incomes up to 25.000 lei
- 10% for incomes from 25.001 lei to 40.000 lei
- 15% for incomes from 40.001 lei to 60.000 lei
- 20% for incomes from 60.001 lei to 90.000 lei
- 25% for incomes from 90.001 lei onwards

In parallel with the redesign of the PIT, the personal allowance for workers (10.128 lei) should be increased by 2% above inflation for 10 years.

The progressive increase of the national minimum wage (2.100 lei / month in the private sector) by 2% above inflation for 10 years would also result in a higher level of declared wage.

Start-ups would benefit during the first 5 years of reduced corporate tax rates: from 0% the first year progressively to 12% from the 6th year onwards.

For "small jobs" (day-contracts, occasional work by employees, seasonal work, service vouchers, local employment agencies) reduced (50%) social security contributions should apply.

The list of products and services on which a reduced VAT rate applies should be revised regularly. The VAT rate for horticultural products (2%) should be increased to 8%.

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

- ✓ higher tax on dividends: from 6 to 15%
- ✓ higher tax on royalties: from 12 to 15%
- ✓ higher corporate tax: from 12 to 15%, but abolition of all the small local taxes on companies
- ✓ regular re-evaluation of properties (houses, apartments, land, etc.)
- ✓ introduction of a progressive real estate tax and a value added tax on immovable property in case of sale within a period of 8 years after construction or purchase
- ✓ closer monitoring of the officially declared values/prices in the contracts of sale drafted by notaries

- ✓ higher environmental taxes on energy, pollution and waste (in Croatia, these taxes generate 10,9% of all tax and social contributions income; in Bulgaria 10,0% and in Romania 8,7%)

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

5. Favor and facilitate compliance with fiscal, labor and administrative laws and procedures

Are less rules needed? Perhaps

But are better rules needed? For sure!

Formulate the laws and regulations in a clear and simple language, easy to understand.

Simplify the administrative compliance: reduced the required number of documents for authorizations, licenses, clearances, approvals, subsidies (e.g. construction permits, import/export documents).

Speed up the procedures by setting shorter deadlines and by using ICT tools.

Introduce the mandatory certified cash register with fiscal memory in as many sectors as possible (horeca, retail, wholesale, but also for the "free professions" like lawyers, fiscal advisors, private clinics, etc.). According to Eurofound (2013), this measure was effective in 73% of the countries who introduced it. Eurofound (2013) reports that mandatory certified cash registers have been introduced successfully in Belgium, Sweden, Poland, Denmark, Greece, Italy and Hungary.

In Belgium, the amount of declared salaries in the horeca sector increased during the first 9 months of 2016 with 109 million Euro after the mandatory introduction of the "white" electronic cash register with fiscal memory.

In Sweden, the mandatory cash register was introduced in 2010. All businesses selling goods and services in return for cash must have such a register. The Swedish tax agency showed that the reported VAT for restaurants rose by 7% and by 11% in the hairdressing sector in 2010.

The Polish ministry of finance made in 2010 the electronic cash register mandatory in a range of professions: doctors, lawyers, tax advisors, physicians running private practices, funeral homes and translators. Results are not yet published.

Make the issuing of an invoice or a receipt obligatory for all commercial transactions as well as for medical acts.

Introduce new categories of legitimate work in order to allow that, work that is often conducted undeclared, can be executed in future in a formal way (Eurofound, 2013) (Measure effective in 59% of the countries).

Examples are the mini-jobs regulation in Germany (from 103.000 mini-jobs in households in 2004 to 234.000 mini-jobs in 2012), the simplified employment act (2010) for seasonal employment and casual or temporary work in Hungary (tax for seasonal work is 1,75 Eur/day and for casual work 3,5 Eur/day), the service voucher scheme in Belgium for household work (30% tax deductible) the local employment agencies (PWA's) in Belgium set up by local authorities to offer simple employment opportunities to long term unemployed, the flexi-job regulation in Belgium for workers with a full-time or 4/5th job : they are allowed to take up a secondary job in restaurants/cafés without having to pay income tax or social contributions on their second income; the employer pays only a reduced social contribution rate of 25%.

Work out a special regulation for student jobs (from 16 years onwards): limited number of working hours/year, written labor contract, limited social contributions (30% of normal), guaranteed minimum salary between 65 and 90% of the national minimum wage according to age.

Support the business start-ups by granting a start-up premium or by granting during a certain period a tax and/or social security contribution reduction. In Germany, more than 100.000 unemployed enrol annually in a start-up scheme and can receive during maximum 15 months a grant of 300 Eur on top of their unemployment benefit (Eurofound 2013). Other possibilities for support are: a start-up loan, a micro-credit, a crowdfunding, a guarantee-regulation, lower social contributions for the first 3 recruitments.

Award tax deductibility (25%) for maintenance-, repair- or isolation works in older homes (> 10 y) when carried out by a registered company.

Sweden gives labor cost - and VAT reduction for household services (RUT scheme) and home renovation, conversion and extension (ROT scheme): 50% of the labor cost and of the VAT for these jobs is paid by the Swedish tax agency up to a maximum of 6.000 Eur per year. In 2010, 1,1 million people used the ROT and RUT schemes. The Swedish tax agency estimates that undeclared work decreased by 10% between 2005 and 2011 in these sectors (Eurofound, 2013).

Introduce supply chain responsibility in case of public procurement. This measure is effective in 78% of the countries who did it (Eurofound, 2013).

Make access to bank credits easier for companies who work formally.

Make transition from unemployment to formal employment easier by the gradual withdrawal of the unemployment benefit and eventually other benefits.

Design smart safety nets so that any additional formal work (wage) results in a higher net income, including social benefits.

Advise via social and mass media how to formalize.

Create an online user-friendly database of all registered companies per sector and make it accessible for the public.

Oblige clear price indications of products and services in shops and other businesses (e.g. hairdressers).

Encourage the formalization of agricultural enterprises by simplifying the tax declaration and by reserving a guaranteed part of the investment subsidies for small and medium sized agricultural enterprises.

Limit successive fixed-term contracts to maximum 2 years.

Grant individual amnesty for voluntary disclosure (with reasonable fines). This measure was effective in 75% of the countries who implemented it.

Engage the social partners in the compliance exercise because their role is crucial.

6. Invest in detection and deterrence of undeclared work and income

The most effective measures reported by the Eurofound study (2013) covering 31 European countries are:

- the data matching and data sharing amongst government departments and specialized agencies (tax inspectorate, labor inspection, social protection inspection). This measure was reported effective by 82% of the countries who introduced it.
- the work place (on site) inspection (effective in 75% of the countries)
- the mandatory registration of workers prior to starting work or on the 1st day of work (effective in 74% of the countries)
- the mandatory ID badge in the workplace or on the construction site (effective in 70% of the countries).

Coordinated operations across government departments (joint tax-, labor-, social inspections) are efficient in 64% of the countries.

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

In Moldova, the labor and tax inspectorate should have sufficient inspectors to control annually 5% of the companies. The controls should be focused essentially on the sectors/professions/companies who are most exposed to I.E. Procedural rules should be relaxed: inspections should be possible without ex-ante notice and, if necessary, several controls per year should be allowed. The different inspection services should operate as much as possible jointly based on a commonly shared database.

Data sharing and data matching between the labor inspectorate, the National Insurance House (CNAS), the tax and customs authorities, the statistical office, the banks and the notaries is very relevant to detect discrepancies between the officially declared income and the expenditures. In case of discovered discrepancies, the burden of proof should be reversed and it should be possible to lift the bank secrecy.

In case of reported irregularities of the CNAS (informal employment or under declaration of wages), a compulsory investigation procedure should be started up by the CNAS and, in case of proven infringement, fines could be imposed by that same institution.

The possible sanctions should be effective, high and serious enough to demotivate possible offenders (own account workers, employers, tax advisors, consultants, businessmen but also employees). The sanctions should rank from a simple warning, over different levels of fines to imprisonment and business or site closure for very serious offences.

- ✓ In case of purchase of properties, check the origin of the money.
- ✓ Check if self-employed and own account workers do not abuse from the statute.
- ✓ Conclude automatic exchange of information agreements with neighboring countries.
- ✓ Protect the freedom of press.

Examples of detection measures presented by Eurofound (2013):

- Joint inspections (tax-, labor- and social inspections) were reported in the following "sensitive" sectors:
 - Romania: in construction, garment and textile industry
 - Latvia and Portugal: in hotel and catering sector
 - Sweden: in taxi industry, hairdressing and construction
 - Slovenia: in driving schools
 - Norway: in cleaning industry
- Joint inspections by teams of labor inspectors, social security inspectors, accident insurance inspectors and the carabinieri took place in 2010 in 10.000 agricultural firms and 10.000 building sites in southern Italy. Irregularities were detected in 60% of the construction sites and in 44% agriculture firms (mainly undeclared workers)
- In 2012 tax officials inspected 278 construction companies in Estonia. 125 companies improved their tax behavior after inspection: before inspection, the average declared salary was 388 Eur/month; after the inspection, it was raised to 532 Eur.

Also, the number of declared employees increased in 52 companies by a total of 166 employees.

- In 2012 the tripartite social dialogue in Luxembourg led to the introduction of an ID card for each worker in the construction sector. The same happened in Belgium with the introduction of the ConstruBadge. This ID card contains all the relevant info about the employee (+ his photo), the employer, the type of contract and the start-date of the job.
- In 2011 Finland set up the Grey Economy Information Unit with a budget of 1,6 mio Eur. In that same year, 732 tax audits were conducted, resulting in the detection of 42 mio Eur undeclared wages and 65 mio Eur undeclared sales.

7. Put a limit on cash payments and favor electronic payments

Cash payments are required to feed the I.E. Limiting the use of cash will automatically result in reducing the level of the I.E. and, as an important side effect, in a better protection of the consumers.

- ✓ make sure that all salaries of civil servants and public employees, as well as all invoices addressed to the public service, are paid by bank transfer

- ✓ oblige the electronic payment of salaries by private and public companies
- ✓ penalize companies who encourage, through marketing campaigns or by offering discounts, payments in cash
- ✓ make banks, exchange offices, notaries and real estate companies responsible for informing the compliance officers (for banks) or directly the anti-money-laundering office (tax dept) of illegal cash payments

In Belgium, the economic inspection detected in 2013 illegal cash transactions in the amount of 714.368.991 Eur, from which 703.538.350 Eur for transactions of gold. Other illegal cash transactions concerned tobacco, second hand cars, vegetables and fruit, antique, horses, travel and weapons.

In that same year, the Belgian notaries informed the anti-money-laundering office about more than 1000 clients who tried to buy houses/apartments with cash money. Today the notary is no longer allowed to accept cash money. In each sales contract, the notary is obliged to write down where the money comes from. He must also mention the bank account number, as well as the way in which the advance has been paid.

8. Launch information campaigns

- ✓ Inform the workers, the companies and the larger public about the dangers of informal work and under-declaration of salaries and point to the consequences in the short and in the long run.
- ✓ Inform the workers of the advantages of working formal and of declaring the real wage.
- ✓ Use all mass media, including the new social media. Organize public debates on TV about the issue, debate the issue with the social partners and with academics and organize debates with the public.

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