

Title:

The Blessings of the Black Economy

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Summary:

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Keywords:

Article Body:

Some call it the "unofficial" or "informal" economy, others call it the "grey economy" but the old name fits it best: the "black economy". In the USA "black" means "profitable, healthy" and this is what the black economy is. Macedonia should count its blessings for having had a black economy so strong and thriving to see it through the transition. If Macedonia had to rely only on its official economy it would have gone bankrupt long ago.

The black economy is made up of two constituent activities:

1.. Legal activities that are not reported to the tax authorities and the income from which goes untaxed and unreported. For instance: it is not illegal to clean someone's house, to feed people or to drive them. It is, however, illegal to hide the income generated by these activities and not to pay tax on it. In most countries of the world, this is a criminal offence, punishable by years in prison.

2.. Illegal activities which, needless to say, are also not reported to the state (and, therefore, not taxed).

These two types of activities together are thought to comprise between 15% (USA, Germany) to 60% (Russia) of the economic activity (as measured by the GDP), depending on the country. It would probably be an underestimate to say that 40% of the GDP in Macedonia is "black". This equals 1.2 billion USD per annum. The money generated by these activities is largely held in foreign exchange outside the banking system or smuggled abroad (even through the local banking system). Experience in other countries shows that circa 15% of the money "floats" in the recipient country and is used to finance consumption. This should translate to 1 billion free floating dollars in the hands of the 2 million citizens of

Macedonia. Billions are transferred to the outside world (mostly to finance additional transactions, some of it to be saved in foreign banks away from the long hand of the state). A trickle of money comes back and is "laundered" through the opening of small legal businesses.

These are excellent news for Macedonia. It means that when the macro-economic, geopolitical and (especially) the micro-economic climates will change - billions of USD will flow back to Macedonia. People will bring their money back to open businesses, to support family members and just to consume it. It all depends on the mood and on the atmosphere and on how much these people feel that they can rely on the political stability and rational management. Such enormous flows of capital happened before: in Argentina after the Generals and their corrupt regime were ousted by civilians, in Israel when the peace process started and in Mexico following the signature of NAFTA, to mention but three cases. These reserves can be lured back and transform the economy.

But the black economy has many more important functions.

The black economy is a cash economy. It is liquid and fast. It increases the velocity of money. It injects much needed foreign exchange to the economy and inadvertently increases the effective money supply and the resulting money aggregates. In this sense, it defies the dictates of "we know better" institutions such as the IMF. It fosters economic activity and employs people. It encourages labour mobility and international trade. Black economy, in short, is very positive. With the exception of illegal activities, it does everything that the official economy does - and, usually, more efficiently.

So, what is morally wrong with the black economy? The answer, in brief: it is exploitative. Other parts of the economy, which are not hidden (though would have liked to be), are penalized for their visibility. They pay taxes. Workers in a factory owned by the state or in the government service cannot avoid paying taxes. The money that the state collects from them is invested, for instance, in infrastructure (roads, phones, electricity) or used to pay for public services (education, defence, policing). The operators of the black economy enjoy these services without paying for them, without bearing the costs and worse: while others bear the costs. These encourages them, in theory to use these resources less efficiently.

And all this might be true in a highly efficient, almost ideal market economy. The emphasis is on the word "market". Unfortunately, we all live in societies which are regulated by bureaucracies which are controlled (in theory, rarely in practice) by politicians. These elites have a tendency to misuse and to abuse resources and to allocate them in an inefficient manner. Even economic theory

admits that any dollar left in the hands of the private sector is much more efficiently used than the same dollar in the hands of the most honest and well meaning and well planning civil servant. Governments all over the world distort economic decisions and misallocate scarce economic resources.

Thus, if the goals are to encourage employment and economic growth - the black economy should be welcomed. This is precisely what it does and, by definition, it does so more efficiently than the government. The less tax dollars a government has - the less damage it does. This is an opinion shared by most economists in the world today. Lower tax rates are an admission of this fact and a legalization of parts of the black economy.

The black economy is especially important in times of economic hardships. Countries in transition are a private case of emerging economies which are a private case of developing countries which used to be called (in less politically correct times) "Third World Countries". They suffer from all manner of acute economic illnesses. They lost their export markets, they are technologically backward, their unemployment skyrockets, their plant and machinery are dilapidated, their infrastructure decrepit and dysfunctional, they are lethally illiquid, they become immoral societies (obligations not honoured, crime flourishes), their trade deficits and budget deficits balloon and they are conditioned to be dependent on handouts and dictates from various international financial institutions and donor countries.

Read this list again: isn't the black economy a perfect solution until the dust settles?

It enhances exports (and competitiveness through imports), it encourages technology transfers, it employs people, it invests in legitimate businesses (or is practised by them), it adds to the wealth of the nation (black marketeers are big spenders, good consumers and build real estate), it injects liquidity to an otherwise dehydrated market. Mercifully, the black economy is out of the reach of zealous missionaries such as the IMF. It goes its own way, unnoticed, unreported, unbeknownst, untamed. It doesn't pay attention to money supply targets (it is much bigger than the official money supply figure), or to macroeconomic stability goals. It plods on: doing business and helping the country to survive the double scourges of transition and Western piousness and patronizing. As long as it is there, Macedonia has a real safety net. The government is advised to turn a blind eye to it for it is a blessing in disguise.

There is one sure medicine: eliminate the population and both unemployment and inflation will be eliminated. Without the black economy, the population of

Macedonia would not have survived. This lesson must be remembered as the government prepares to crack down on the only sector of the economy which is still alive and kicking.

#### Operational Recommendations

The implementation of these recommendations and reforms should be obliged to be GRADUAL. The informal economy is an important pressure valve for the release of social pressures, it ameliorates the social costs inherent to the period of transition and it constitutes an important part of the private sector.

As we said in the body of our report, these are the reasons for the existence of an informal economy and they should be obliged to all be tackled:

- a.. High taxation level (in Macedonia, high payroll taxes);
- b.. Onerous labour market regulations;
- c.. Red tape and bureaucracy (which often leads to corruption);
- d.. Complexity and unpredictability of the tax system.

#### Reporting Requirements and Transparency

a.. All banks should be obliged to report foreign exchange transactions of more than 10,000 DM (whether in one transaction or cumulatively by the same legal entity). The daily report should be submitted to the Central Bank. In extreme cases, the transactions should be investigated.

a.. All the ZPP account numbers of all the firms in Macedonia should be publicly available through the Internet and in printed form.

a.. Firms should be obliged by law to make a list of all their bank accounts available to the ZPP, to the courts and to plaintiffs in lawsuits.

a.. All citizens should be obliged to file annual, personal tax returns (universal tax returns, like in the USA). This way, discrepancies between personal tax returns and other information can lead to investigations and discoveries of tax evasion and criminal activities.

a.. All citizens should be obliged to file bi-annual declarations of personal wealth and assets (including real estate, vehicles, movables, inventory of business owned or controlled by the individual, financial assets, income from all sources, shares in companies, etc.).

a.. All retail outlets and places of business should be required to install - over a period of 3 years - cash registers with "fiscal brains". These are cash registers with an embedded chip. The chips are built to save a trail (detailed list) of all the transactions in the place of business. Tax inspectors can pick the chip at random, download its contents to the tax computers and use it to issue tax assessments. The information thus gathered can also be crossed with and compared to information from other sources (see: "Databases and Information

Gathering"). This can be done only after the full implementation of the recommendations in the section titled "Databases and Information Gathering". I do not regard it as an effective measure. While it increases business costs - it is not likely to prevent cash or otherwise unreported transactions.

a.. All taxis should be equipped with taximeters, which include a printer. This should be a licencing condition.

a.. Industrial norms (for instance, the amount of sugar needed to manufacture a weight unit of chocolate, or juice) should be revamped. Norms should NOT be determined according to statements provided by the factory - but by a panel of experts. Each norm should be signed by three people, of which at least one is an expert engineer or another expert in the relevant field. Thought should be dedicated to the possibility of employing independent laboratories to determine norms and supervise them.

a.. Payments in wholesale markets should be done through a ZPP counter or branch in the wholesale market itself. Release of the goods and exiting the physical location of the wholesale market should be allowed only against presentation of a ZPP payment slip.

Reduction of Cash Transactions

a.. Cash transactions are the lifeblood of the informal economy. Their reduction and minimization is absolutely essential in the effort to contain it. One way of doing it is by issuing ZPP payment (debit) cards to businesses, firm and professionals. Use of the payment cards should be mandatory in certain business-to-business transactions.

a.. All exchange offices should be obliged to issue receipt for every cash transaction above 100 DM and to report to the Central Bank all transactions above 1000 DM. Suspicious transactions (for instance, transactions which exceed the financial wherewithal of the client involved) should be duly investigated.

a.. The government can reduce payroll taxes if the salary is not paid in cash (for instance, by a transfer to the bank account of the employee). The difference between payroll taxes collected on cash salaries and lower payroll taxes collected on noncash salaries - should be recovered by imposing a levy on all cash withdrawals from banks. The banks can withhold the tax and transfer it to the state monthly.

a.. Currently, checks issued to account-holders by banks are virtually guaranteed by the issuing banks. This transforms checks into a kind of cash and checks are used as cash in the economy. To prevent this situation, it is recommended that all checks will be payable to the beneficiary only. The account-holder will be obliged to furnish the bank with a monthly list of checks he or she issued and their details (to whom, date, etc.). Checks should be valid for 5 working days only.

a.. An obligation can be imposed to oblige businesses to effect payments only through their accounts (from account to account) or using their debit cards.

Cash withdrawals should be subject to a withholding tax deducted by the bank. The same withholding tax should be applied to credits given against cash balances or to savings houses (stedilnicas). Alternatively, stedilnicas should also be obliged to deduct, collect and transfer the cash withdrawal withholding tax.

a.. In the extreme and if all other measures fail after a reasonable period of time, all foreign trade related payments should be conducted through the Central Bank. But this is really a highly irregular, emergency measure, which I do not recommend at this stage.

a.. The interest paid on cash balances and savings accounts in the banks should be increased (starting with bank reserves and deposits in the central bank).

a.. The issuance of checkbook should be made easy and convenient. Every branch should issue checkbooks. All the banks and the post office should respect and accept each other's checks.

a.. A Real Time Gross Settlement System should be established to minimize float and facilitate interbank transfers.

Government Tenders

a.. Firms competing for government tenders should be obliged to acquire a certificate from the tax authorities that they owe no back-taxes. Otherwise, they should be barred from bidding in government tenders and RFPs (Requests for Proposals).

Databases and Information Gathering

a.. Estimating the informal economy should be a priority objective of the Bureau of Statistics, which should devote considerable resources to this effort. In doing so, the Bureau of Statistics should coordinate closely with a wide variety of relevant ministries and committees that oversee various sectors of the economy.

a.. All registrars should be computerized: land, real estate, motor vehicles, share ownership, companies registration, tax filings, import and export related documentation (customs), VAT, permits and licences, records of flights abroad, ownership of mobile phones and so on. The tax authorities and the Public Revenue Office (PRO) should have unrestricted access to ALL the registers of all the registrars. Thus, they should be able to find tax evasion easily (ask for sources of wealth- how did you build this house and buy a new car if you are earning 500 DM monthly according to your tax return?).

a.. The PRO should have complete access to the computers of the ZPP and to all its computerized and non-computerized records.

a.. The computer system should constantly compare VAT records and records and statements related to other taxes in order to find discrepancies between them.

a.. Gradually, submissions of financial statements, tax returns and wealth

declarations should be computerized and done even on a monthly basis (for instance, VAT statements).

a.. A system of informants and informant rewards should be established, including anonymous phone calls. Up to 10% of the intake or seizure value related to the information provided by the informant should go to the informant.  
Law Enforcement

a.. Tax inspectors and customs officials should receive police powers and much higher salaries (including a percentage of tax revenues). The salaries of all tax inspectors - regardless of their original place of employment - should be equalized (of course, taking into consideration tenure, education, rank, etc.).

a.. Judges should be trained and educated in matters pertaining to the informal economy. Special courts for taxes, for instance, are a good idea (see recommendation below). Judges have to be trained in tax laws and the state tax authorities should provide BINDING opinions to entrepreneurs, businessmen and investors regarding the tax implications of their decisions and actions.

a.. It is recommended to assign tax inspectors to the public prosecutors' office to work as teams on complex or big cases.

a.. To establish an independent Financial and Tax Police with representatives from all relevant ministries but under the exclusive jurisdiction of the PRO. The remit of this Police should include all matters financial (including foreign exchange transactions, property and real estate transactions, payroll issues, etc.).

a.. Hiring and firing procedures in all the branches of the tax administration should be simplified. The number of administrative posts should be reduced and the number of tax inspectors and field agents increased.

a.. Tax arrears and especially the interest accruing thereof should be the first priority of the ZPP, before all other payments.

a.. All manufacturers and sellers of food products (including soft drinks, sweetmeats and candy, meat products, snacks) should purchase a licence from the state and be subjected to periodic and rigorous inspections.

a.. All contracts between firms should be registered in the courts and stamped to become valid. Contracts thus evidenced should be accompanied by the registration documents (registrar extract) of the contracting parties. Many "firms" doing business in Macedonia are not even legally registered.

Reforms and Amnesty

a.. A special inter-ministerial committee with MINISTER-MEMBERS and headed by the PM should be established. Its roles: to reduce bureaucracy, to suggest appropriate new legislation and to investigate corruption.

a.. Bureaucracy should be pared down drastically. The more permits, licences, tolls, fees and documents needed - the more corruption. Less power to state officials means less corruption. The One Stop Shop concept should be implemented

everywhere.

a.. A general amnesty should be declared. Citizens declaring their illegal wealth should be pardoned BY LAW and either not taxed or taxed at a low rate once and forever on the hitherto undeclared wealth.

The Tax Code

a.. To impose a VAT system. VAT is one the best instruments against the informal economy because it tracks the production process throughout a chain of value added suppliers and manufacturers.

a.. The Tax code needs to be simplified. Emphasis should be placed on VAT, consumption taxes, customs and excise taxes, fees and duties. To restore progressivity, the government should directly compensate the poor for the excess relative burden.

a.. After revising the tax code in a major way, the government should declare a moratorium on any further changes for at least four years.

a.. The self-employed and people whose main employment is directorship in companies should be given the choice between paying a fixed % of the market value of their assets (including financial assets) or income tax.

a.. All property rental contracts should be registered with the courts. Lack of registration in the courts and payment of a stamp tax should render the contract invalid. The courts should be allowed to evidence and stamp a contract only after it carries the stamp of the Public Revenue Office (PRO). The PRO should register the contract and issue an immediate tax assessment. Contracts, which are for less than 75% of the market prices, should be subject to tax assessment at market prices. Market prices should be determined as the moving average of the last 100 rental contracts from the same region registered by the PRO.

a.. Filing of tax returns - including for the self-employed - should be only with the PRO and not with any other body (such as the ZPP).

Legal Issues

a.. The burden of proof in tax court cases should shift from the tax authorities to the person or firm assessed.

a.. Special tax courts should be established within the existing courts. They should be staffed by specifically trained judges. Their decisions should be appealed to the Supreme Court. They should render their decisions within 180 days. All other juridical and appeal instances should be cancelled - except for an appeal instance within the PRO. Thus, the process of tax collection should be greatly simplified. A tax assessment should be issued by the tax authorities, appealed internally (within the PRO), taken to a tax court session (by a plaintiff) and, finally, appealed to the Supreme Court (in very rare cases).

a.. The law should allow for greater fines, prison terms and for the speedier and longer closure of delinquent businesses.

a.. Seizure and sale procedures should be specified in all the tax laws and not merely by way of reference to the Income Tax Law. Enforcement provisions should be incorporated in all the tax laws.

a.. To amend the Law on Tax Administration, the Law on Personal Income Tax and the Law on Profits Tax as per the recommendations of the IRS experts (1997-9).  
Customs and Duties

a.. Ideally, the customs service should be put under foreign contract managers. If this is politically too sensitive, the customs personnel should be entitled to receive a percentage of customs and duties revenues, on a departmental incentive basis. In any case, the customs should be subjected to outside inspection by expert inspectors who should be rewarded with a percentage of the corruption and lost revenues that they expose.

a.. In the case of imports or payments abroad, invoices, which include a price of more than 5% above the list price of a product, should be rejected and assessment for the purposes of paying customs duties and other taxes should be issued at the list price.

a.. In the case of exports or payments from abroad, invoices which include a discount of more than 25% on the list price of a product should be rejected and assessment for the purposes of paying customs duties and other taxes should be issued at the list price.

a.. The numbers of tax inspectors should be substantially increased and their pay considerably enhanced. A departmental incentive system should be instituted involving a percentage of the intake (monetary fines levied, goods confiscated, etc.).

a.. The computerized database system (see "Databases and Information Gathering") should be used to compare imports of raw materials for the purposes of re-export and actual exports (using invoices and customs declarations). Where there are disparities and discrepancies, severe and immediate penal actions should be taken. Anti-dumping levies and measures, fines and criminal charges should be adopted against exporters colluding with importers in hiding imported goods or reducing their value.

a.. Often final products are imported and declared to the customs as raw materials (to minimize customs duties paid). Later these raw materials are either sold outright in the domestic or international markets or bartered for finished products (for example: paints and lacquers against furniture or sugar against chocolate). This should be a major focus of the fight against the informal economy. I follow with an analysis of two products, which are often abused in this manner.

a.. I study two examples (white sugar and cooking oil) though virtually all raw materials and foods are subject to the aforementioned abuse.

a.. White Sugar is often imported as brown sugar. One way to prevent this is to place sugar on the list of LB (import licence required) list, to limit the

effective period of each licence issued, to connect each transaction of imported brown sugar to a transaction of export, to apply the world price of sugar to customs duties, to demand payment of customs duties in the first customs terminal, to demand a forwarder's as well as an importer's guarantee and to require a certificate of origin. The same goes for Cooking Oil (which - when it is imported packaged - is often declared as some other goods).

a.. All payments to the customs should be made only through the ZPP. Customs and tax inspectors should inspect these receipts periodically.

a.. All goods should be kept in the customs terminal until full payment of the customs duties, as evidenced by a ZPP receipt, is effected.

Public Campaign

a.. The government should embark on a massive Public Relations and Information campaign. The citizens should be made to understand what is a budget, how the taxes are collected, how they are used. They should begin to view tax evaders as criminals. "He who does not pay his taxes - is stealing from you and from your children", "Why should YOU pay for HIM?" "If we all did not pay taxes- there would be no roads, bridges, schools, or hospitals" (using video to show disappearing roads, bridges, suffering patients and students without classes), "Our country is a partnership - and the tax-evader is stealing from the till (kasa)" and so on.

a.. The phrase "Gray Economy" should be replaced by the more accurate phrases "Black Economy" or "Criminal Economy".