

# Chapter 10

## Executive Summary

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### 10.1 Main Findings of the Study

#### *10.1.1 Survey of the Informal Activities of Serbian Businesses and Entrepreneurs*

Incentives to formalise the shadow economy should be based on knowledge of the causes and structure of informal activity. A specific problem in designing these incentives is the fact that information on the shadow economy is inherently unreliable and incomplete. A survey of the informal activities of Serbian businesses and entrepreneurs (Survey on Conditions for Doing Business in Serbia) was therefore carried out for the purpose of this study on a representative sample of 1,251 business entities (businesses and entrepreneurs). This made it possible for the first time to view the Serbian shadow economy from the point of view of businesses, to assess the various forms that the shadow economy takes, and to analyse them according to the relevant characteristics of business entities. The survey also allowed us to see the causes of and motives for informal activity, which is of particular importance in drafting recommendations for formalising the shadow economy.

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### ***10.1.2 Causes of the Shadow Economy***

We analysed the causes of the shadow economy using elementary theoretical analysis, comparative data, social partners' views on how institutions operate, and the results of the Survey on Conditions for Doing Business in Serbia. Among the fiscal causes of the shadow economy are the relatively high fiscal burden on labour; complicated and costly tax procedures; complicated and opaque tax system; poorly organised, under-staffed, and under-equipped Tax administration; poor quality of public services; and high tolerance for the shadow economy. The features of the labour market that are particularly significant in fostering and sustaining the shadow economy are high fiscal burden on labour for lower wage earners; a social security system that prevents entitlement to social welfare benefits and other transfers for people in formal employment; high minimum wage; and certain regulations governing employment protection legislation, working hours, unemployment benefits, and the pension system. There are many other institutional and economic factors that contribute to the large extent of the shadow economy. Owing to low productivity, many businesses can only operate at a profit if they evade paying taxes. The economic crisis and pervasive liquidity issues have forced even the more productive businesses to shift a portion of their operations into the informal sector, and inefficient enforcement and market exit mechanisms incentivise businesses operating in the informal sector to remain there. Among the other causes with a significant bearing on the extent of the shadow economy are high administrative burdens on doing business; low quality of the regulatory environment; and legal insecurity. In addition to these regulatory causes the decision to operate informally is affected by widespread corruption and low tax morality. The most important financial factors are the large share of cash transactions in the total volume of payments, informal financing, and the unregistered remittances of migrant workers.

### ***10.1.3 Extent of the Shadow Economy in Serbia***

The shadow economy in Serbia was estimated using three methods: (a) the MIMIC method, a modelling-based approach covering Serbia and ten other Central and Eastern European countries between 2001 and 2010; (b) the Household Tax Compliance (HTC) method based on 2010 data for Serbia, an indirect method based on macroeconomic data; and (c) the Survey on Conditions for Doing Business in Serbia. The methods used differ in their coverage of the shadow economy in terms of institutional sector, form of shadow economy, and methodology used. The MIMIC method has the broadest coverage since it covers all institutional sectors and all forms of the shadow economy. The HTC method estimates only those forms of the shadow economy that can be identified and estimated on the basis of household income and consumption data. The survey was used to estimate the most important forms of the shadow economy among business entities.

**Table 10.1** Extent of the shadow economy according to the various methods of estimation

	Year	% of GDP
Shadow economy according to the MIMIC method	2010	30.1
Shadow economy—HTC method	2010	23.6
Shadow economy—Survey	2012	21.0

*Source:* Own calculations

The results of the assessment using the first method showed that all countries recorded a decline in the extent of the shadow economy over the observed period, with the exception of 2009 when there was a slight increase. In Serbia the shadow economy contracted from 33.2 % of official GDP in 2001 to 30.1 % in 2010 (Table 10.1). The results show that the shadow economy in Serbia (as % of GDP) declined over the period of economic growth and remained nearly unchanged after the beginning of the economic downturn. Serbia's levels were greater than the averages for the other selected 11 countries throughout the entire reporting period. Only Bulgaria had a larger shadow economy, as a percentage of GDP, than Serbia.

The HTC method estimated the extent of the shadow economy in Serbia at 24 % of GDP. The figure obtained using the HTC method is lower than that derived from using the MIMIC model, since data on household income and consumption cannot cover some forms of the shadow economy in the business sector (corporate income and property tax, charges, fees, etc.).

Data from the Survey on Conditions for Doing Business in Serbia made it possible to estimate the extent of the two key forms of informal activity in the sectors of businesses and entrepreneurs, trade in goods, and partly or wholly unreported employment. Using the findings of the survey we estimated that these two forms of informal activity amount to some 21 % of GDP. The extent of the shadow economy estimated using the results of the survey is the lowest, since businesses also take part in the shadow economy by evading the payment of other dues such as corporate income tax, property tax, fees, and charges, and there is also a portion of the shadow economy that takes place outside the business sector (home repairs, private tuition, trade in goods at flea markets, etc.). A comparison of these results with those obtained using the MIMIC method showed that businesses and entrepreneurs accounted for over two-thirds of all activity in the shadow economy, and that these were in the form of illicit transactions and the payment of wages without paying appropriate taxes and contributions.

#### ***10.1.4 Estimates of the Tax Evasion Gap***

The tax gap is the difference between hypothetical (theoretical) tax revenue and taxes actually collected. Hypothetical tax revenues are the sums that would be collected over a particular period of time if all taxpayers paid their taxes in full compliance with tax legislation. The shadow economy is a broader concept than the

**Table 10.2** Estimated tax gap and fiscal effects of formalisation

	Method/ coverage	Year	Amount
VAT gap (as % of GDP)	Macroeconomic data	2011	2.5
	Survey	2012	2.5
VAT gap (as % of hypothetical VAT)	Macroeconomic data	2011	21.3
	Survey	2012	21.6
Personal income tax and social contributions gap (as % of GDP)	Survey	2010	5.0
Personal income tax and social contributions gap (as % of hypothetical income tax and contributions)	Survey	2010	27.7
Fiscal effects of formalisation (short-term), as % of GDP	VAT	2013–2015	0.2–0.5
	Income tax and contributions	2013–2015	0.6
	Total	2013–2015	0.8–1.1
Fiscal effects of formalisation (long-term), as % of GDP	VAT	2013–2020	1.0
	Income tax and contributions	2013–2020	0.9
	Total	2013–2020	1.9

Source: Own calculations

tax gap, as it encompasses all taxable economic activities that take place informally. The tax gap, on the other hand, is the amount of tax that should be paid on those activities. The tax gap is mainly caused by tax evasion, which is why these two terms are often seen as identical. However, the tax gap can, to a lesser extent, reflect reported but unpaid taxes, as well as tax revenue lost due to taxpayer bankruptcy, write-offs of back taxes, etc. Having carried out a detailed analysis of tax rates, volumes of consumption, etc., we estimated the VAT gap at 2.5 % of GDP (Table 10.2). By combining the data from macroeconomic accounts with the findings of the survey, we estimated the tax gap for personal income tax and social security contributions at about 5 % of GDP. We then extrapolated these tax gap estimates to all taxes, and by using data from the Household Consumption Survey we arrived at the figure of 10 % as an approximation of the overall tax gap.

### ***10.1.5 The Shadow Economy in the Business and Entrepreneur Sector***

The Survey on Conditions for Doing Business in Serbia asked respondents to state their views on whether their own business was engaged in the shadow economy, and found that 28 % of all business entities in Serbia did so. These businesses and entrepreneurs employed workers informally and/or made payments in cash even

though they were VAT payers. The term ‘informal workers’ is used to describe workers employed without a contract or those who do have contracts but only declare part of their wage officially, with the remainder paid in cash. The results of the survey show that entrepreneurs, new start-ups, construction businesses and businesses based in Central Serbia are more likely to engage in the shadow economy. Based on respondents’ views on the participation of their own businesses in the shadow economy and their estimates of the extent to which other entities in the same industry take part in informal activities, we estimated the upper and lower limit of the extent of the shadow economy in this sector. The share of employees working without formal contracts ranged from 1.9 % (lower limit) to 23.9 % (upper limit) of the total number of employees. The share of employees with a portion of undeclared wages ranged between 3.8 and 24.7 %, while the share of cash transactions ranged between 11.3 and 21.6 % of the total volume of payments.

Econometric analysis based on the survey data identified specific factors that are statistically significant to a business’s decision whether or not to engage in informal operations. The results obtained were in line with the findings of other studies, where entrepreneurs were seen to be more likely to take part in the shadow economy than other business entities. Business entities in the construction sector were almost twice as likely to operate informally than those in services, while entities in the trade sector were nearly twice less likely to do so. Finally, the attitude of the business entity towards the shadow economy was a major and statistically significant factor determining that entity’s participation in the shadow economy.

The findings of the survey showed that competition from entities operating at least partly in the informal sector was extremely widespread. As many as 85.3 % of the business entities surveyed stated that unfair competition was present in their sector of economic activity. Construction and transportation again led the field, whilst the presence of competition was also determined to a large degree by the likelihood of detection. This shows that most problems appear in sectors where there are greater regulatory obstacles to formalisation and greater difficulty in detecting informally employed workers. Since such an environment is conducive to greater operating savings, the pressure of competition coming from the informal sector is thus also greater.

### ***10.1.6 Effects of Formalising the Shadow Economy***

Although the estimated extent of the shadow economy in Serbia is significant, comparative data show that the average is only about 5 percentage points greater in Serbia than in other Central and Eastern European countries. This leads to the conclusion that the tax gap in Serbia is greater by approximately the same amount as in these other countries. Therefore the optimal aim in reducing the extent of the shadow economy and the tax gap in Serbia would be to reduce them to the Central and Eastern European averages over the medium term, while the long-term goal would be to bring them down to the levels seen in developed Western European

countries. The potential increase in public revenue that could be generated by reducing the Serbian shadow economy was estimated at between 0.8 and 1.1 % of GDP in the medium term (up to 3 years), or some 2 % of GDP in the long term (7–10 years).

These estimates are the upper limit of the potential additional public revenue that could be generated through the reduction of the shadow economy, since the institutional conditions for tackling the shadow economy and tax morality are far higher in Western European countries than in Serbia as a consequence of their long tradition of combating the shadow economy. These fiscal effects can only be achieved in Serbia if all the measures necessary to tackle the shadow economy are applied in a comprehensive, non-selective, and consistent manner. From the fiscal policy standpoint, a reduction in the shadow economy will not allow for any tax cuts or greater public expenditure. Taxing the shadow economy should contribute to a drop in the fiscal deficit and compensate for the decline in tax revenues due to the expected restructuring of the economy towards less-taxable activities such as exports and investment.

The findings of the MIMIC method applied to Serbia and the other 10 Central and Eastern European countries show that the effect of the shadow economy on registered GDP is statistically highly significant and has the expected negative sign: if GDP per capita falls by 1 percentage point, the shadow economy will increase by between 0.6 and 0.7 percentage points, depending on the model used. This means that any future decline in GDP will increase pressure on the shadow economy, since business entities will endeavour to compensate for fewer opportunities in the formal sector by shifting into the shadow economy. This finding underlines the importance of preserving macroeconomic stability and creating conditions for future growth in the future, which will be a major component in the successful strategy for formalising the shadow economy.

## **10.2 Recommendations for Formalising the Shadow Economy**

### ***10.2.1 Fiscal Policy Measures***

Fiscal policy measures are aimed at reducing incentives for operating in the shadow economy and the benefits of doing so on the one hand, and increasing the associated costs and risks on the other. The most important fiscal policy measures for tackling the shadow economy are: reducing distortions introduced by the tax system; reducing tax compliance costs; reducing the return to tax evasion; and reducing tolerance for the shadow economy.

Distortions introduced by taxes in Serbia could be reduced by decreasing the fiscal burden on labour (since other general taxes are moderate), by reducing the number of tax rates applicable to income from different sources or trade in different

types of goods, and by significantly reducing the number of tax exemptions (particularly when it comes to corporate income tax). Tax compliance costs could be lowered by reducing the number of tax procedures and simplifying them, and by introducing mandatory e-filing of tax returns and requiring electronic communication with tax authorities. Thus, the reduction in cost effectiveness of tax evasion could be achieved primarily by increasing the likelihood of the Tax Administration detecting tax evasion: to ensure this, the number of Tax Administration staff tasked with performing audits should be increased, and their training and case selection methodology improved. In addition, there should be more consistent implementation of statutory penalties for tax evasion, particularly by courts.

Moreover, there should be co-operation with other government bodies (such as the Municipal Police) to institute and enforce a ban on the sale of new products at farmers' and flea markets. Improving co-ordination between the Tax Administration and other government bodies, both in terms of exchange of information and of joint action in the field, is another important precondition for tackling the shadow economy and combatting tax evasion. The reach of property taxes should be widened in co-operation with the Property Cadastre and other government bodies, since a significant percentage of properties in Serbia are unregistered and as such not subject to property tax. Co-operation between the Tax Administration and other government bodies is of particular importance in successfully cross checking property and income, which would project a public message of the state's determination to tackle the shadow economy and the tax evasion associated with it. In order to combat the non-payment of taxes, the practice of periodically writing off nominal interest on back taxes should be finally abandoned. A portion of the principal debt is also written off along with nominal interest, which rewards undisciplined taxpayers and fosters moral hazard behaviour, as taxpayers will intentionally defer payment in expectation of a new round of interest write-offs.

Finally, in order to reduce the extent of the shadow economy, the education and public information system must be used to increase public awareness of the adverse effects of the shadow economy and so improve tax morality. An improvement in the quality of public goods and services provided by the state would also contribute to achieving this goal.

### ***10.2.2 Measures Relating to Features of the Labour Market***

In terms of the fiscal burden on labour, the tax wedge of labour (expressed as the ratio of total wage taxes and contributions to total labour costs) is high for low wages and relatively low for high wages, a consequence of the proportional wage taxation system with a relatively low tax-exempt allowance. At about the level of the minimum wage, the tax burden in Serbia is the fourth highest of all European countries. This is a natural incentive for the preservation and growth of informal employment, since informal businesses generally enter the formal economy at approximately that point. Thus, the most important recommendation in the field

of labour taxation is the need to substantially reduce labour costs for lower-paying jobs. Any kind of reform of labour taxation (or, in a broader sense, of the taxation of income derived from work) should ideally entail an increase in the personal tax-exempt allowance to the level of the minimum wage. Most European countries employ this practice. In addition, introducing a tax exempt allowance for dependents would reduce the tax wedge for employees with unemployed spouses and children, and thereby reduce their incentives for joining the shadow economy.

The existence of the minimum social security contribution base makes open-ended, full-time labour contracts unpopular. Another means of reducing the tax wedge for lower wages would be to remove the minimum social security base, which now stands at 35 % of the average wage. While its impact on people working full-time jobs is negligible, since the minimum wage is far above this level, it increases labour costs for part-time workers with standard open-ended employment contracts. An important incentive for formalising informal employees working part-time jobs could be the introduction of less restrictive tax treatment of 'mini jobs' and 'midi jobs', based on the positive experiences of Germany where, for mini jobs, healthcare and social security contributions are much lower than standard, while the rate of income tax can even equal zero. Midi jobs attract contributions that are greater than those for mini jobs but still lower than standard, so that workers in mini jobs can avoid the trap of in-work poverty, and their transition into standard employment is eased.

Welfare benefits in Serbian practice are available almost exclusively to unemployed and inactive persons, which encourage those who are able to work to combine welfare and informal employment. To incentivise employment in the formal sector, an in-work benefits programme should be introduced along the lines of the US Earned Income Tax Credit, which would make it possible for workers to combine formal employment and welfare benefits, with the latter gradually reduced as earnings increase.

To avoid driving down demand for formal work, the minimum wage should be reduced from the current level of 50 % to some 35–40 % of the average wage, as used to be the case in Serbia until several years ago and as recommended by the World Bank for middle-developed countries. Moreover, the introduction of a slightly lower minimum wage for under-25 s should be considered in order to stimulate their open-ended employment. Similarly, the minimum wage could vary slightly by region so as to partly reflect regional variation in the cost of living.

The most urgent requirement in the area of employment protection legislation is the removal of the statutory provision obliging employers to pay employees severance in proportion to each employee's total years of service rather than only years of service spent with their current employer. This would foster formal employment, primarily of elderly workers with work experience. In addition, an extension of the maximum length of employment under individual fixed-term contracts from 1–2 or 3 years should be considered.

Retirement rules are characterised by relatively low standard and minimum retirement age thresholds. Moreover, there are no actuarial penalties for early retirement, which incentivises pensioners to continue working after retirement,



particularly in the informal sector. The current retirement age threshold should thus be increased; in addition, actuarial adjustment of pensions should be introduced to reflect the life expectancy of people who retire earlier, while actuarial rewards should apply to those who continue to work and pay pension contributions after meeting conditions for full retirement, regardless of whether they receive pensions or not.

In order to support entrepreneurship, specific programmes targeted at reducing informal employment should be pursued more vigorously and with reference to experiences of other European countries. Self-employment is supported by the National Employment Service (NES); this assistance takes the form of a one-off non-repayable grant and some in-kind support, provided that the beneficiary regularly pays contributions and taxes for at least the following 2 years. On average, some 3,000–5,000 people per year become self-employed through this programme: NES staff estimate that most of them merely formalise their informal businesses. It is interesting to note that evaluations of such ‘legalised’ entrepreneurs show survival rates greater than for those who started their businesses without previous experience in the informal sector. Microlending is also a measure that facilitates the establishment of legal businesses, especially for categories of people who cannot rely on their own funds or commercial credit, but is as yet virtually non-existent in Serbia due to an inadequate statutory framework.

**Inspection Oversight** The Labour and Market Inspectorates are responsible for tackling informal employment and undeclared and illicit transactions, whilst the Tax Administration is responsible for preventing tax evasion. In addition to the lack of equipment and appropriately qualified staff, one of the key problems in the operation of these institutions is the absence of sufficient co-ordination and integration with other inspection and oversight services. Closer integration is therefore required between the various inspectorates, either through an Inspectorate-General, or, in less demanding form, by means of a co-ordinating body such as a Commission to Co-Ordinate Inspection Oversight. A framework Inspections Law should be adopted, harmonised with European Union regulations, to at least ensure better mutual co-ordination of inspection oversight and to better delimit the powers of the various inspection services, at the same time closing the loopholes in the powers of inspection bodies that have made it possible for the shadow economy to flourish and have hindered the implementation of activities designed to combat it. The advantages of an integrated inspections approach are particularly obvious in the area of the authority of the Market and Labour Inspectorates. A unified database of offenders and offences, accessible to all inspection services, the Tax Administration, the Customs Administration, and the police, would improve the efficiency of the fight against the shadow economy. The integration of powers would mean that inspections that uncover an unregistered or unreported entity or person engaging in an activity under the remit of another inspection would be both authorised and required to order any deficiencies to be remedied and to notify the Tax Administration of the infringement and the measures taken.

### ***10.2.3 Measures Relating to the Financial Sector***

**Curb Transactions in Cash and Incentivise Cashless Payments** Switching to cashless (and particularly electronic) payments would reduce the participation of parties to transactions in the shadow economy. In ensuring this, emphasis should be placed on incentives that will foster cashless transactions. The use of electronic money for payment operations can be fostered by allowing electronic payments in sectors dominated by cash (such as hospitality, taxi cabs, etc.). Other incentives could include subsidising point-of-sale terminals for small and micro-businesses, limited tax breaks for electronic payments, and prepaid cards for people without bank accounts to enable their inclusion in the formal sector. On the macroeconomic level, government subsidies and assistance could be paid out electronically, as could various types of contributions. Further, all government payments could be limited to electronic channels only. To ensure that all remaining cash transactions take place primarily within formal channels, field audits should be strengthened to ensure fiscal cash registers are used and receipts are issued for all transactions. A clear consensus among economic policymakers regarding the application of a de-euroisation strategy would contribute to a substantial reduction in cash payments—particularly informal payments—throughout the system.

**Reduce the Share of Informal Sources of Finance in the Economy** To further stimulate greater transfers of money through formal channels (and the inflow of significant funds from abroad in the form of remittances), transfer costs must be reduced, as was also pointed out by survey respondents. This would increase the transparency of these flows and make it easier to direct them into investment contributing to local growth and national development. Greater competition between formal transfer intermediaries and lower transfer service costs would increase migrant interest in sending remittances through formal channels, since these offer numerous benefits to recipients such as easier access to financial institutions, cheaper finance for the broader public, lower cost of investment due to more options for diversification, and better education of beneficiaries about alternate modes of employing funds. Regulatory authorities in sending and receiving countries should enter into bilateral agreements to formalise and facilitate transferring, channelling, and registering funds. This process could take the form of a public-private partnership, with the participation of financial institutions. Closer co-operation between banking sectors in sending and receiving countries should lower transaction costs of transfers and accelerate the sending of remittances through formal channels.

A greater role played by banks in the transfer of remittances should lower transaction costs and increase the speed and reliability of these services. This could also be achieved by developing a unified clearing system for all countries involved in this process. Investment using remitted funds could be stimulated by creating a better climate for investing, as well as by deploying a range of incentives for putting funds to productive use (e.g., tax breaks). A well-developed infrastructure to support

channelling money transfers from abroad would also facilitate access to other financial intermediation services (such as current accounts, savings accounts, and credit instruments) for a broader section of the population, which would, in turn, foster the development of the country's financial sector. Further development of formal channels for transferring remittances could be harnessed to create innovative products that would make it possible for migrants to directly invest in their home countries by purchasing, for instance, land or real estate. Gradual regulation of sending and receiving remittances would be desirable, so that these flows could be better studied and this segment of the market developed without excessive and hasty government intervention, which could retard or disincentivise additional inflow of these funds.

### ***10.2.4 Measures Related to the Business Environment***

Measures related to the business environment are aimed either at business entities already operating formally or at those wholly in the shadow economy. The existing regulatory requirements for businesses operating formally need to be simplified and unnecessary new administrative burdens should be prevented administrative burdens. At between 3.8 and 4.2 % of GDP, Serbia's administrative costs are among the highest of all countries that have made similar measurements. Consistent application of methods such as the SME Test and the Standard Cost Model, as well as regular stakeholder consultation, could significantly reduce existing administrative costs, which would foster the shift of some activity from the informal to the formal sector. There are other areas of the regulatory process that could see major improvement; in particular, bylaws should be adopted in a timely fashion to reduce legal uncertainty.

Solving the issues of 'phoenix companies' and unfair competition are very important in tackling the shadow economy. The former would contribute to greater liquidity, primarily among SMEs, who are often unable to collect receivables from 'phoenix companies' and are thus forced to move part of their businesses into the shadow economy in order to survive. One possible solution would be to set up a special registry of all bans on operating imposed on managers and owners of businesses that face criminal or other proceedings. However, what is most needed to eliminate both 'phoenix companies' and unfair competition is greater consistency in applying the existing legal framework.

There are several steps that would facilitate the operation of business entities wholly in the informal sector and thus promote their integration into the formal economy. In addition to directly lowering costs by removing barriers to entry in particular sectors, an electronic registry of legislation accessible to the public free of charge should be established. Further, existing records should be improved, and a new e-portal for licences, permits, approvals, and consents should be established.

Integration into the formal sector is also affected by the issue of 'legalising' buildings and obtaining construction permits. Unclear and complicated

‘legalisation’, the subsequent issuance of construction permits for unpermitted properties—makes entry into the formal sector more difficult, which means that certain resources are made unavailable for legal transactions and cannot be used by the economy. In addition to legalisation, entry into the market is hindered by the very complex construction permit system, which involves filing for permits with a large number of entities. The resolution of these issues requires a number of measures to accelerate construction permit procedures, including establishing ‘one-stop shops’ at local authorities, changing the role of public entities in the permitting procedure, drafting plans in a timely manner, etc.

### 10.3 Policy Conclusions

The key prerequisites for a successful strategy for formalising the shadow economy are: (1) to complete the process of transition into a market economy, and (2) to stabilise the legal and institutional structures of society; these should be followed by (3) achieving and maintaining macroeconomic stability and (4) creating preconditions for economic growth. The impact of these factors on the shadow economy is just one among their many desirable effects. The econometric findings presented in Chap. 6 indicate that an increase in official GDP leads to a drop in the extent of the shadow economy. In other words, a decline in GDP will increase the shadow economy as business entities endeavour to compensate for fewer business opportunities in the formal sector by working in the shadow economy. In these circumstances the measures proposed above will not be fully effective.

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