

Policy Study No. 43

# UNREGISTERED MICRO-PERFORMERS OF BUSINESS ACTIVITY IN NORTH MACEDONIA

## Analysis with recommendations for a policy action



**UNREGISTERED MICRO-PERFORMERS OF  
BUSINESS ACTIVITY IN NORTH MACEDONIA:  
ANALYSIS WITH RECOMMENDATIONS FOR A  
POLICY ACTION**

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### **Disclaimer**

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# 1. INTRODUCTION

The prevalence of informality in the emerging and developing countries attracted the attention of researchers to explore the reasons why firms and workers stay in the informal sector. Informal sector accounts for about one-third of GDP and informal employment forms 70% of total employment in these countries (Elgin et al. 2021). While an abundance of research attempts to define and measure informality (e.g., Elgin et al. 2021; Schneider & Enste, 2000; Ulyssea, 2020), the concept of informality necessitates a clear definition, so the causes and consequences of it to be thoroughly examined. Ulyssea (2018) adopts the legalistic definition of informality, where the firms and workers who operate at the margins of the relevant laws and regulations are considered as informal, and distinguishes between two margins of informality: (1) extensive margin with regard to whether firms register and pay entry fees to become formal; and (2) intensive margin with regard to whether formal firms hire workers without a formal contract. The focus of this research is related to the extensive margin, specifically, the reasons firms prefer to stay unregistered and informal. Since such economic operators are usually small and reduce even to a single person, the term used throughout the study is ‘micro-performers of business activity’.

The reduction of the informal economy has been assigned a strategic priority of the Government of North Macedonia. This was primarily demonstrated through the adoption of the Strategy on Formalization of Informal Economy 2018-2022, with an accompanying Action Plan. However, the progress in tackling the operationalization of the Strategy and of the informal economy has been rather slow. There is hardly systematized information about the progress in realizing the tasks and activities of the Strategy, which does not necessarily mean that some of the activities have not been realized or not put in the pipeline. However, apparently the lack of strong coordinating mechanism / institutions for the Strategy – which is strongly pan-institutional – may be the key hurdle in making any results visible.

Furthermore, supportive to our argument, however, is the recent estimate of Finance Think (2022) which demonstrated that the share of the informal economy in total economy stagnated, at best, in the last decade. The policy brief

uses the cash demand method of Ardizzi et al. (2014) whose main assumption is that informal transactions are performed in cash to conceal any trace for institutions. Hence, the increase in the informal economy causes an increase in the demand for cash in circulation. To isolate the abnormal demand for cash, the brief defines a structural model which estimates the normal preferences for liquidity and adds factors which may affect the informal economy. Then, the 'excess' of cash that could not have been explained by the normal structural factors is assigned to the growth of the informal economy. With such an approach, the brief estimated that the informal economy in North Macedonia reduced from 31.6% in 2007 to 23.2% in 2020, but the main reductions happened in 2008 (potentially explained with the introduction of the flat tax) and 2012 (potentially explained with the introduction of the minimum wage). In 2013, the informal economy was assessed at 23.4% and stagnated to 23.2% in 2020.

Other older studies use the same or other methods to calculate the share of informal economy in total economy and they arrive at similar, yet extending to larger estimates, namely, in the 21.3% - 39.1% span (Schneider et al. 2010; Garvanlieva et al. 2012; Elgin & Oztunali, 2012; Kelmanson et al. 2019; Trenovski et al. 2021; Elgin et al. 2021).

The purpose of this paper is to understand the reasons for the unregistered micro-performers of business activity in North Macedonia staying informal. The specific objectives of the action include:

- To depict the micro-performers of business activity in the informal sector (types of business activity performed, size, region etc.);
- To understand the reasons for the informality of micro-performers of business activity (high costs, high administrative burden, low probability of being discovered, poor awareness of the benefits of formalization, etc.);
- To design a map / list of all duties, including parafiscal charges, related to the establishment of a micro-business and its management in the initial years;
- To propose policy measures (fiscal, labor, information) that will encourage greater formalization of micro-performers of business activity.

To attain these objectives, this study relies on own-collected data through the Survey on Unregistered Micro-Enterprises (SUME), which included questions about the costs of being formal, the benefits from formalization and the costs for staying informal, and was executed on 151 unregistered micro-performers of business activity in North Macedonia. As SUME was pursued on the selected target only, its objective is not to provide information about the size of the problem, but rather to dig into the problem and provide answers about the reasons of certain behavior of the target population. SUME was executed over



May 2022 through a computer-assisted telephone interview (CATI). Survey data were complemented with interview data from registered micro-performers of business activity which were subsequently collected over June 2022. The data collected are analyzed through descriptive and factor analysis.

The key novelty that this paper brings into the discussion about the informal economy in North Macedonia consists of its detailed examination of the reasons for being informal and motives that could potentially encourage formalization of micro-performers of business activity. The rest of the paper is organized as follows: Section 2 offers a brief nesting of the discussion into the relevant literature. Section 3 makes a more detailed overview of SUME. Section 4 presents the results from the descriptive analysis. Section 5 presents the results from the factor analysis. Section 6 concludes and offers venues for policy interventions. The Annex provides a summative list of all duties, including parafiscal charges, related to the establishment and running of a business in the country.



## 2. WHAT MAKES FIRMS TO BECOME OR STAY INFORMAL? AN OVERVIEW OF THE LITERATURE

The governments' efforts to formalize small firms provide various benefits: firstly, the formalization broadens the tax base; secondly, firms can bid on government contracts, have access to formal financial services and can become exporters; thirdly, the formalization creates the sense of rule of law; and finally, the registration of firms enables governments to understand the structure of their economies (Campos et al., 2018). However, despite the formalization attempts and reforms, majority of firms remain informal in the developing countries (Bruhn & McKenzie, 2014). There are two main schools of thought about why firms remain informal. The first relates to the costly regulations and bureaucracy as the main reasons firms stay hidden from the government's eye (e.g., de Soto, 1989). The **costs of formalizations** are high enough to erase the productivity gains of formalization, thus the firms decide to remain informal. Thus, the reduction of legal and regulatory barriers should motivate informal firms to become formal. The second relates to the dual perspective, namely parallel co-existence of fundamentally different groups, formal and informal firms, where the formal firms are led by educated entrepreneurs who pay taxes, raise capital and access public goods to expand their businesses, while the informal firms are small, unproductive and stagnant (e.g., La Porta & Shleifer, 2014). Hence, the productivity improvements and development of formal firms reduces the importance of informal sector in the economy.

Theoretically, firms weigh the costs and benefits of becoming (for ex., paying registration fees) and staying formal (for ex., paying taxes and recurrent administrative costs), and vice versa, the costs and benefits of becoming and staying informal (for ex., being detected and punished by government inspectors) (Ulyssea, 2020). In some cases, the weighing of costs and benefits of formalization mirrors the weighing of costs and benefits of remaining informal and it is difficult to classify the importance of the cost or of the benefit side in examining the channels of influence towards formalization. For instance, the



benefit of becoming formal and having access to the capital markets represents an opportunity cost of remaining informal. Regardless of the elusive concept, our attempt is to review the existing literature with respect to the three channels of influence: reducing the costs of formalization, increasing the benefits of formalization and increasing the costs of informality.

With respect to the costs of formalization, the firms decide to remain formal due to the existence of excessive taxes and regulations, the bad (and corruptive) regulatory enforcement, or the combination of both, high taxes and restrictive regulatory policies mediated by incomplete implementation. The restrictiveness and complexity of regulations and tax systems stimulate informal activity in the economies (Schneider & Enste, 2000). Fortin et al. (1997) show that the rise of payroll taxes, profit taxes and registration/licensing fees stimulates firms to transit towards informality. Moreover, Auriol & Warlters (2005) argue that fixed costs of formalization (registration fees) are significantly higher in poorer countries and keep small and poor entrepreneurs away from the formal sector. Similarly, Ulyssea (2010) finds that the reduction of the costs of entry into the formal sector raises the formal employment, while Rocha et al. (2018) discover that tax reductions increase the number of formal firms. On the other side, Piza (2018) finds that tax simplification programs do not affect formalization rates. Besides the legal and regulatory setup, the poor law and regulatory enforcement increases the costs of businesses in the formal sector motivating the firms to remain informal. Johnson et al. (1998) and Friedman et al. (2000) argue that even though firms are willing to comply with the existing laws and regulations, they prefer to avoid the arbitrary and bureaucratic demands and corruptive behavior by staying informal. Finally, Loayza (1996) and Djankov et al. (2002) reason that the restrictive tax and regulatory systems are accompanied with a lack of capability for enforcement or higher levels of corruption stimulating informal economy. Moreover, Williams & Bezeredi (2018) find that the higher is the perceived public corruption, the lower is the tax morale and higher acceptability of informality of small entrepreneurs, while Dabla-Norris et al. (2008) argue that regulatory burden may stimulate informality, however the stronger is the rule of law, the weaker is the effect on stimulating informality.

On the other side, the informality of firms may arise due to **unrecognized or negligible benefits of formalization** which particularly relate to the access to public goods and services. In general, the limited access to official means of contract enforcement and to capital markets, as well as the lack of information on the benefits of formalization keep the firms in the informal domain. For instance, Quintin (2008) emphasizes the role of contract enforcement in relaxing the borrowing constraints of formal firms enabling them to grow and be profitable. Similarly, related research finds that improving access

to credit for the formal sector reduces the size of the informal sector (e.g., Lopez-Martin, 2019).<sup>1</sup> Finally, informal firms may lack information about the registration procedures and costs, as well as about the benefits of becoming formal. De Giorgi & Rahman (2013) find that information campaigns improved the knowledge of informal firms about the registration procedures, however did not stimulate business registration. Differently, Benhassine et al. (2018) find that offering information for the potential benefits of formalization, business training and support for opening business and tax mediation services stimulates informal firms to become formal, however the formal firms have no significant gains in terms of increased loans, sales, profits or standards of living.

Finally, firms would be forced to formalize if the **costs of being informal** increase, especially with stricter enforcement and higher probability of detection of informality. The reasons why tighter controls and inspections may reduce the size of informal sector relate to the labor market frictions, low-productivity firms and high tolerance of informality. Meghir et al. (2015) argue that search frictions enable firms to be profitable by posting jobs in both, formal and informal sector, accounting for the compliance costs (fines if being caught). Thus, search frictions help low productivity firms to remain informal and be profitable and increasing enforcement would cause better allocation of workers towards higher productivity jobs. In parallel, informal firms are so-called 'parasite firms' which earn profits due to cost advantages of not complying with the regulations. Stricter enforcement would drive the low productivity firms out of the market and improve the allocation of resources in the economy (e.g., Ordóñez, 2014; Ulyssea, 2018). Lastly, high tolerance of informality arises from lower tax morale of entrepreneurs and population, which in turn, is driven by weak institutional systems (Littlewood et al., 2020; Williams & Bezeredi, 2018). While increasing the probability of detection may increase the sense of population for moral and social obligation (de Andrade et al., 2016), forcing compliance with the excessive and inefficient regulation may lead to higher unemployment, resulting in higher tolerance of informality (Ulyssea, 2010).

<sup>1</sup>More about the role of financial constraints in driving informal activity, see Straub (2005), Catão et al. (2009), De Paula & Scheinkman (2011) and de Mel et al., (2013).

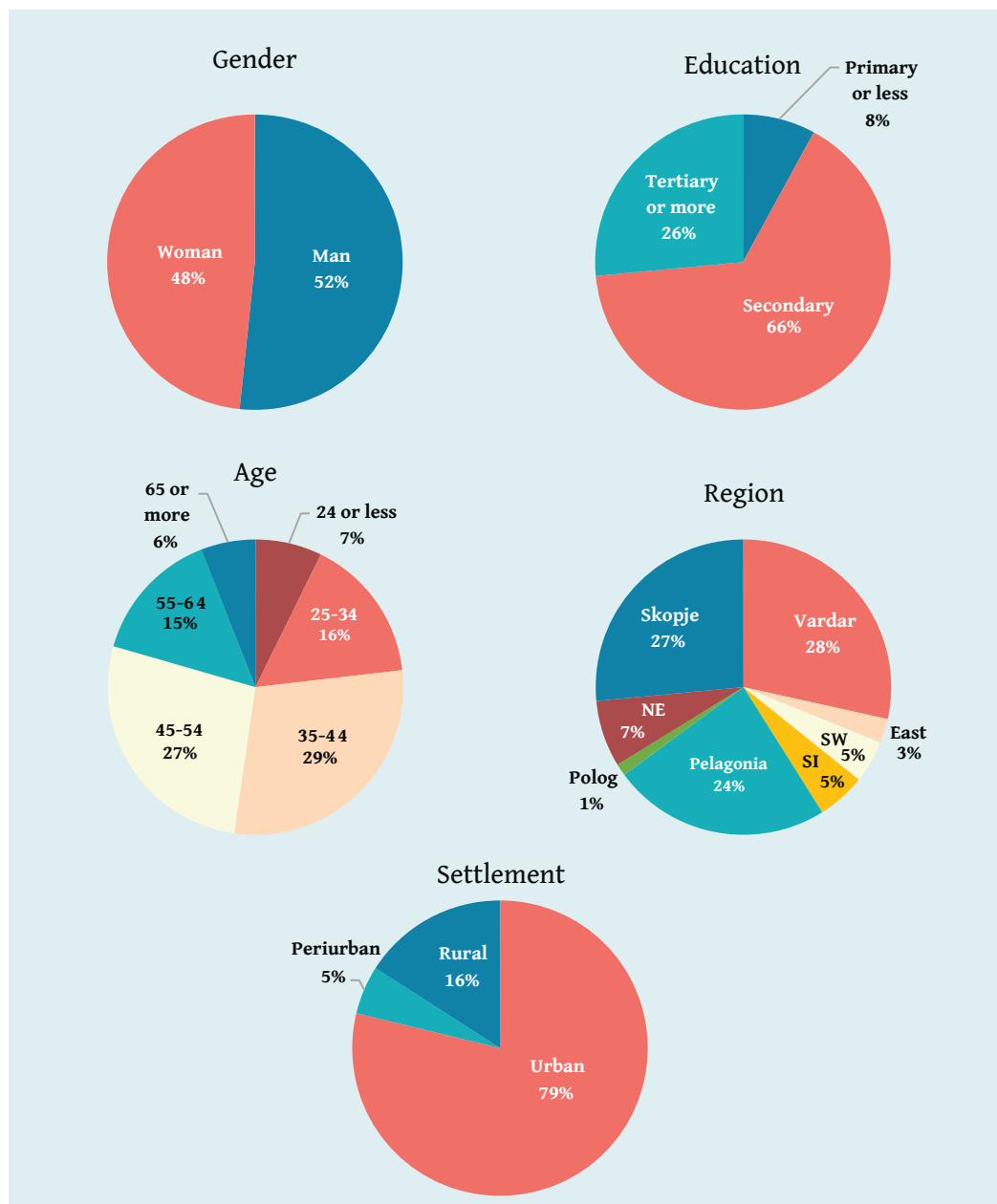
### **3. SURVEY ON UNREGISTERED MICRO-ENTERPRISES (SUME) IN NORTH MACEDONIA**

To attain the objective of this policy research, including to be able to formulate viable policy options that will produce registration gains, we conducted a Survey on Unregistered Micro-Enterprises (SUME). SUME consists of about 70 questions on the actual and perceived costs and benefits of formalization, as well as the cost of staying informal in the country. SUME is aimed only at unregistered micro-performers of business activity / micro-enterprises in the country, i.e. individuals and groups of individuals that perform certain economic activity which is not registered with the institutions nor any income from it is declared to relevant authorities. The grasp of such enterprises is presented in the next section. SUME is consisted of 151 respondents, all falling into the definition of the Survey, all attained through the technique of snow-ball sampling, i.e. one respondent leading to others that, similarly to him/her, perform unregistered business activity.

Such setup of the Survey implies at least two things. First, SUME cannot be used to understand the importance / share of the informal economy due to unregistered businesses in the total economy, but only to investigate the costs and benefits of going formal by the targeted group of unregistered micro-performers of business activity. Second, SUME is not a representative survey as the number of respondents of 151 is insufficient to claim so, but it aimed at achieving sufficient heterogeneity, to be able to rely on the obtained results in the policy design process.

Figure 1 presents the distribution of the sample according to five most prominent characteristics of the respondent and business' settlement: gender, education attained, age, region and urban/rural settlement. It could be observed that distributions offer sufficient level of diversity, while some of them mimicking the population characteristics, hence securing level of robustness of the analysis.

**Figure 1: Sample characteristics**



Source: Authors' calculations based on SUME.

The results of SUME will be presented in the following sections through a descriptive and factor analysis. These results are complemented by the conclusions from 10 interviews with registered micro-performers of business activity, which were collected through a telephone in the second half of June 2022, in order to verify, reject, support or further elaborate the survey findings.

## 4. DESCRIPTIVE ANALYSIS

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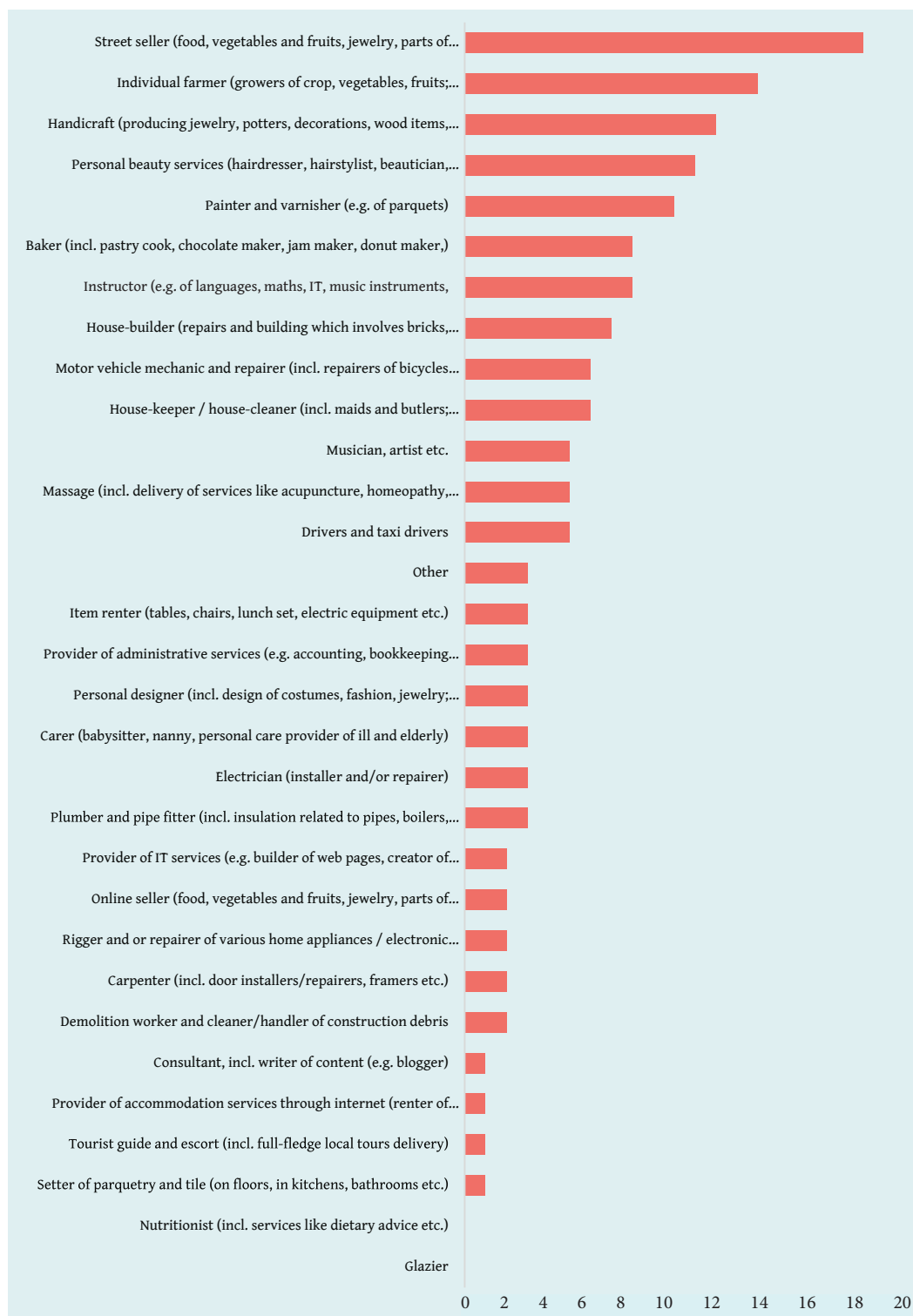
### 4.1. THE FACE OF INFORMALITY

We commence the analysis by looking at the facets of informality among unregistered micro-performers of business activity. SUME identified 28 business activities with the probability to be performed informally, through a thorough search of the International Standard Classification of Occupations. During the survey, two additional business activities emerged, so that respondents are classified in a total of 30 unregistered business activities. While the survey does not give a precise overview of the weight of each of them due to their abundance, yet **Figure 2** reveals that unregistered micro business activity is concentrated in a 10 areas, namely:

- street sellers of food, jewelry, garment etc.
- individual farmers
- handicraftsmen
- personal beauty services
- painters and varnishers
- bakers (of various products like donuts, jams, pastry), including cooks
- instructors of languages, science, music lessons etc.
- house builders of limited extent and plasterers
- motor vehicle mechanics and repairers
- house-keepers and house-cleaners.



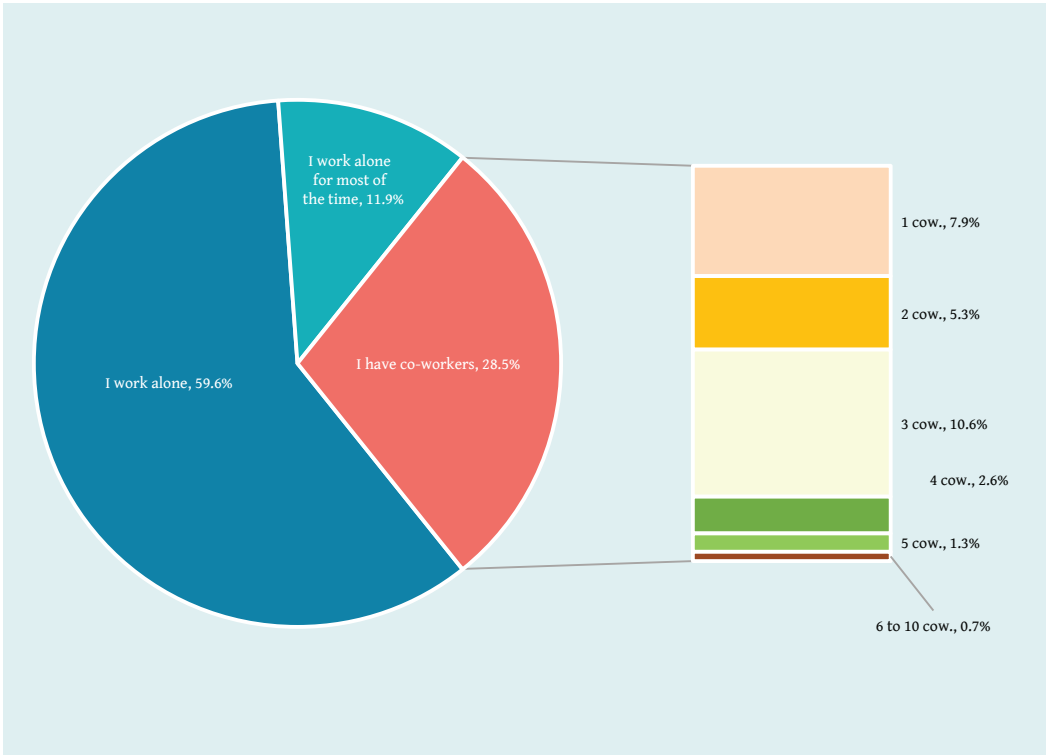
**Figure 2: Types of unregistered micro-enterprises**



Source: Authors' calculations based on SUME.

73% of all micro-performers of business activity reported they did not have at all a bank account. 90% reported did not obtain any license or such license was not needed to run the business activity. From the rest, most of them (7% of the total) reported they obtained license from relevant issuer (e.g. a tourist guide license). Figure 3 reveals that in most of the cases (59.6%), the work is performed by the respondent only; while for 11.9% it is mostly performed by the respondent. In less than a third of cases, it is a group of co-workers who perform the work, with most of the cases being a total of four persons (respondent plus three co-workers), 10.6%. It is apparent that such groups rarely exceed six persons; the option for 11 to 19 and over 20 co-workers remained with no answers. For the cases when there have been co-workers, 84% responded that all of them were paid workers. 62.8% of the co-workers were not members of the family at all, while in 30% of the cases all were family members.

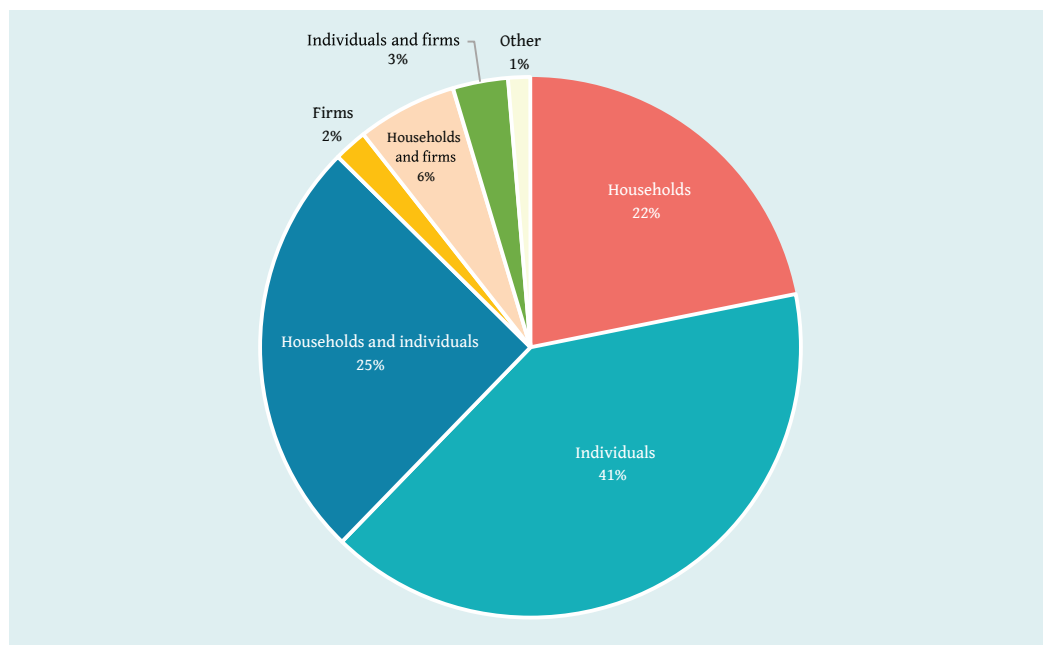
**Figure 3: Number of workers per unregistered micro-enterprise**



Source: Authors’ calculations based on SUME.

Figure 4 reveals that it is mostly households and individuals who are the clients of unregistered micro-enterprises, a total of 87.4% of the cases. Firms alone account for only 2%. This corroborates the expectation that unregistered micro-enterprises are usually small and could hardly offer their service to a registered firm due to the informality of their own business.

**Figure 4: Types of clients of unregistered micro-enterprise**



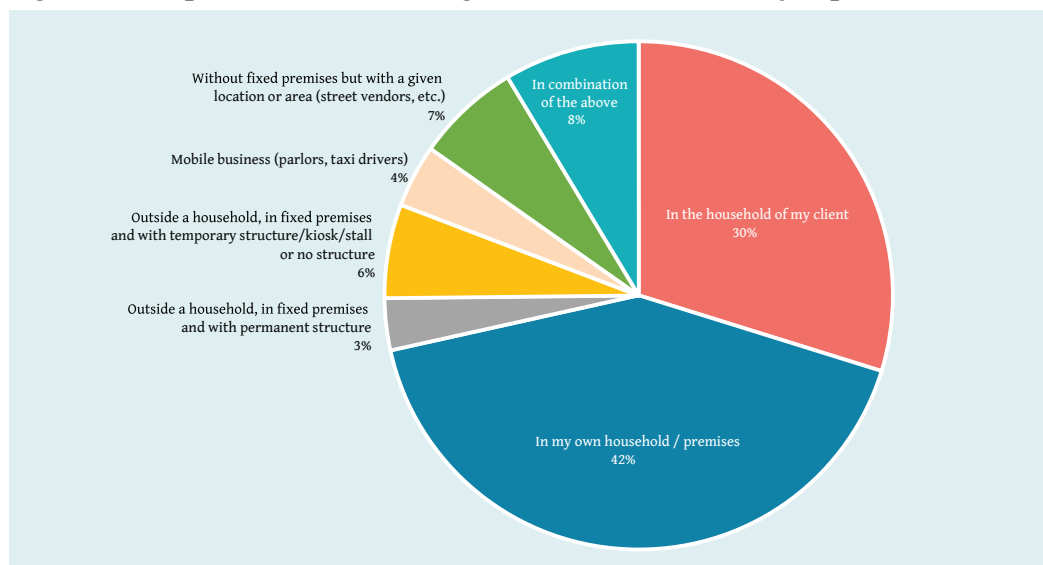
*Source: Authors' calculations based on SUME.*

95% of all unregistered micro-enterprises receive their payment in cash, the rest of 5% involving cases when the payment was received on own personal account. The survey offered an option to respond 'through an official invoice issued from my enterprise', but none answer was received, corroborating the informality of the business activity. Interestingly, for these 5% of the cases, the personal income tax was either not paid, as the transfer from physical to physical person is usually under the radar of the authorities or the tax was paid through a provisional periodical amount (usually applicable for individual farmers).

That the unregistered micro-enterprises are small is corroborated with the annual income they earn. 86.8% of those who reported their annual income (75.5%), earned less than 250.000 MKD (cca. 4.000 EUR) over 2021. For the share of them who reported the actual income earned (not all of them revealed the exact amount), the average annual earnings were slightly less than 70.000 MKD (cca. 1.150 EUR). This amount is about 2.5 average net monthly wage in the country, hence being very small.

In 41.7% of cases, the unregistered business activity is performed in own household or premises, while for 29.8% in the household of the client (Figure 5). The other options also resonate the types of unregistered businesses identified, e.g. street sellers who usually perform their activity outside the household in permanent or temporary, fixed or mobile structures.

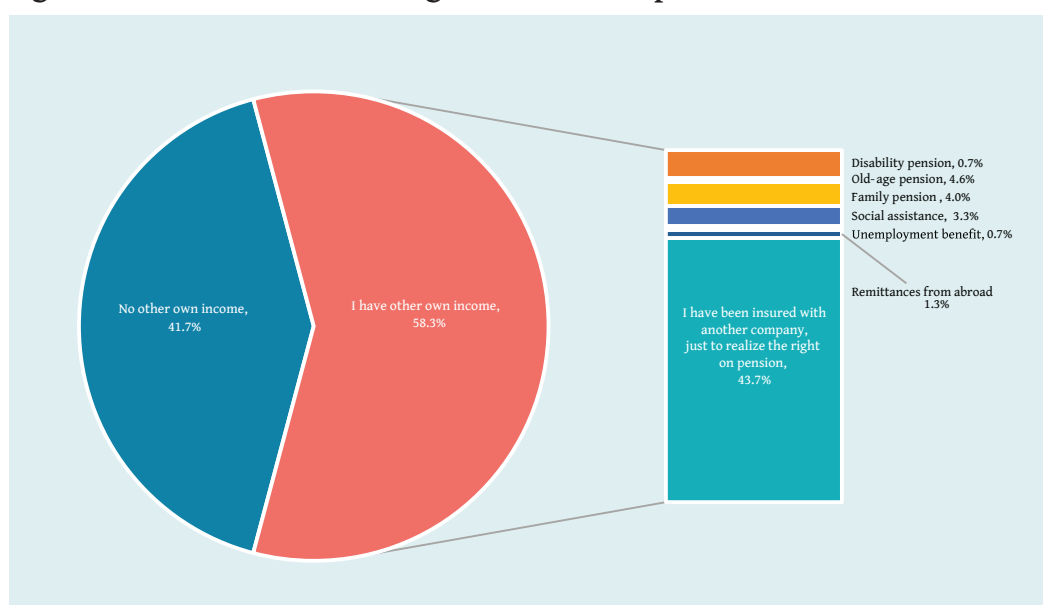
**Figure 5: The place where the unregistered business activity is performed**



Source: Authors' calculations based on SUME.

58.3% of the micro-performers of economic activity have other income except the informal one attained from the execution of the unregistered business (Figure 6). Dominant share of them, 43.7% work elsewhere or are only formally insured in another firm, to be able to realize the right to pension in old days. Few cases reported social type of other income received, while 41.7% of all respondents did not report other income.

**Figure 6: Other income the unregistered businesspersons**

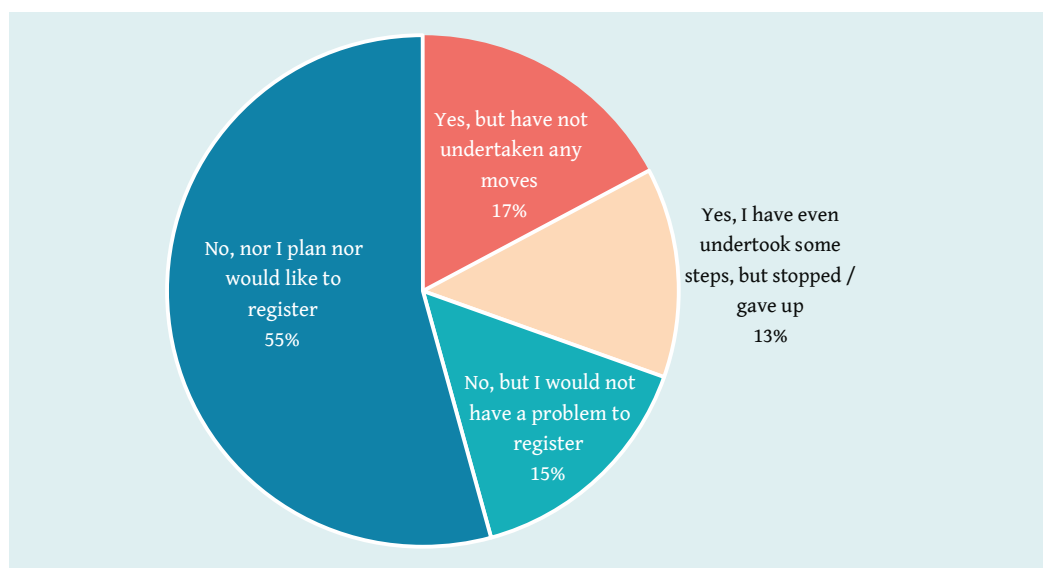


Source: Authors' calculations based on SUME.

## 4.2. COSTS OF FORMALITY

Majority of respondents (55%) have not ever considered registering nor would like to register (Figure 7). However, the shares of the other responses are non-negligible: 17% responded that they considered registering the business without having undertaken any moves, 15% did not consider registration but would not have a problem to register, while 13% have considered registering and even undertook some specific steps. Hence, the answers testify that not registering is not the hardest choice of respondents but their considerations related to costs and benefits of formalization and the motives to stay informal should be thoroughly understood.

**Figure 7: Other income the unregistered businesspersons**



Source: Authors' calculations based on SUME.

We first disentangle the costs of formalization, divided in two parts: barriers to formalization in broader sense and financial cost. Figure 8 portrays the barriers to formally registering a business divided in 10 categories. There a couple of important conclusions from the figure. Bars A-C suggest that getting information related to registering, the knowledge and time needed to pursue a registration is generally no or small obstacle for unregistered micro-performers of economic activity. These findings were confirmed by the interviewed registered companies. Although getting information for registration is not a burden, getting information about compliance with regulatory obligations once the company is registered is perceived as a moderate burden. This perception differs depending on entrepreneur's knowledge and literacy.

A positive practice to address this issue was revealed through the delegation of these activities to an accounting service company. Fees (bar D) already



constitute an obstacle, despite the considerations are rather spread. However, taxes, contributions, parafiscal charges and the cost for accounting (bars E-G) represent quite a significant burden for informal entrepreneurs.

Similarly, with slightly lower burdening magnitude works the effort to deal with government institutions and inspections (bars H-I), while the considerations on bribery are ambivalent (bar J). However, 98% of respondents have never been in a situation to have to pay any informal payment to remain unregistered.

**Figure 8: Barriers to registering a business**



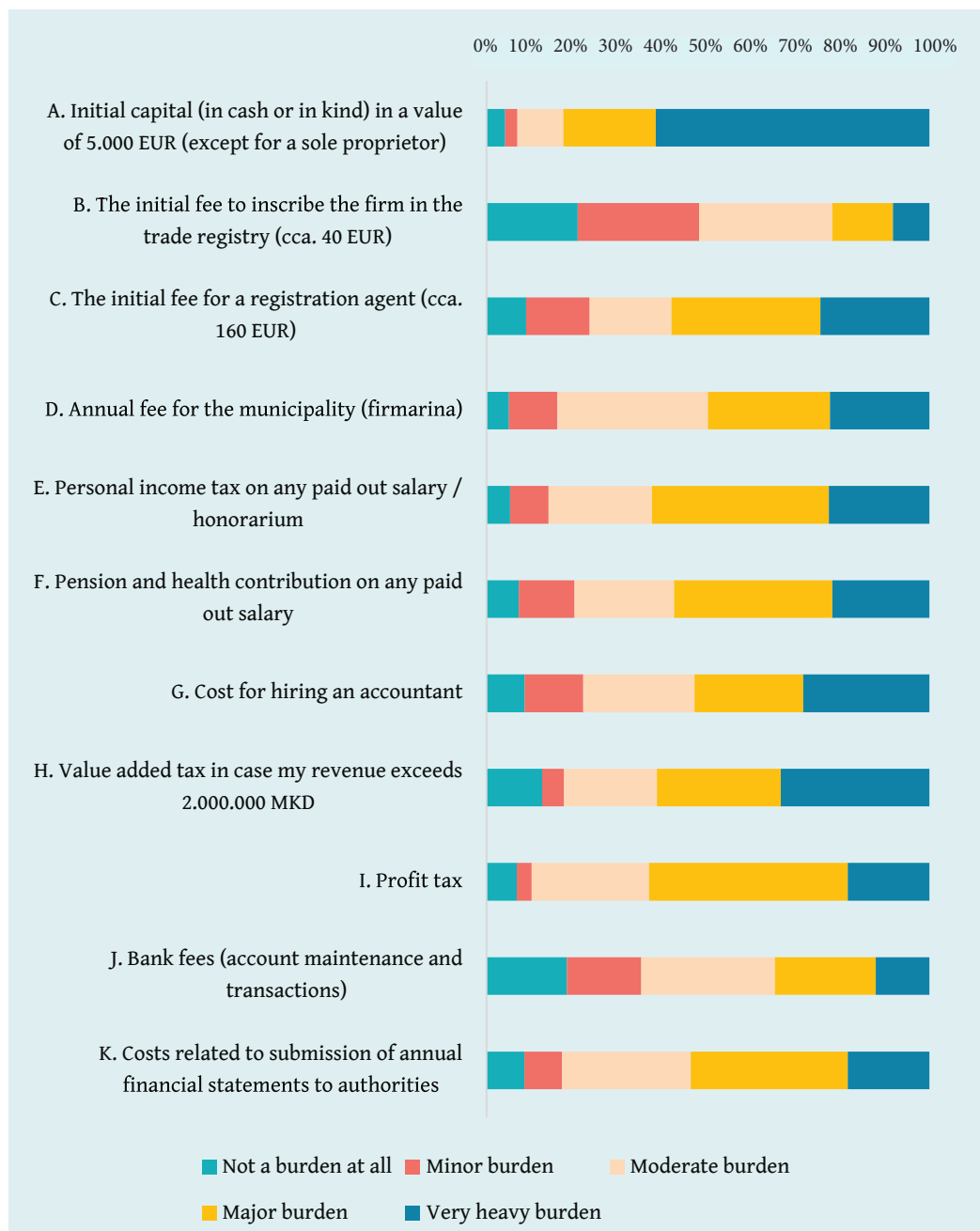
Source: Authors' calculations based on SUME.

Indeed, 43% of responses marked the taxes and contributions to be paid on personal and company income as **the key obstacle to formalization**. 32.5% ranked parafiscal charges as **second most important obstacle for formalization**, while 22.5% expressed their opinion on the expensiveness of going formal as a third-ranked reason.

A more thorough examination of the costs for registering and running of a formal business (Figure 9) reveals notable patterns. The initial capital in the amount of 5.000 EUR is a key burden to register (bar A), despite the cost for registering as a sole proprietor is actually zero and may be a matter of insufficient amount of information available to respondents. The initial fee to inscribe a firm in the Central Registry is generally considered bearable (bar B), but as the cost for using a registration agent quadruples (bar C), it is already observable that it becomes heavier. Findings from the interviews show that for those who operate in occupations with a higher profit margin, the fees for registration, even the initial capital, are not an obstacle. However, this is not the case for those who operate in businesses with lower profit margin and without access to capital (particularly relevant for female entrepreneurs and those without family support), for whom these costs are an obstacle and a heavy burden. The grants for establishing a company (self-employment grant through the active labor market measures) were mentioned as positive practices that stimulate formalization and relieve this burden. Parafiscal and fiscal charges (bars D-I) are predominantly a major burden, while the rest of the costs (bars J-L) are a moderate burden. According to the perceptions of the registered businesses, the burden of the parafiscal charges is mainly perceived as large, due to their linearity. Namely, the key parafiscal charges - “firmarina” and the communal fees (for the sectors for which are relevant) refer to all companies regardless of their size, earning potential and maturity. Therefore, although in general the size of these charges is not large, the relative burden for start-up and low-income companies is perceived as heavy. Pension and health contributions are found as more significant and a higher burden than the parafiscal charges, in the first year of registration. In general, Figure 9 validates the early signs from Figure 8 that costs to run a business – particularly taxes, contributions and parafiscal duties, are considered a major source of burden for micro-performers of business activity.

In favor of

**Figure 9: Costs for running a formal business**



Source: Authors' calculations based on SUME.

### 4.3. BENEFITS OF FORMALITY

Figure 10 presents the opinions on the perceived benefits from formalization of unregistered micro-performers of business activity. Access to finance (bars A-B) is not a large motive for formalization, while the government support in crises times (part of which was channeled through the Development Bank) is more incentivizing albeit answers are tilted to the left on bar C. According to the interviews with registered companies, the access to finance for newly established companies is scarce and it could be a moderate motivation. One of the entrepreneurs emphasizes: *“At the beginning, we were not eligible for obtaining finance from anywhere. The bank required creditworthiness, we did not have it. Neither we could satisfy the eligibility criteria from the Development Bank. The second year is easier, but in the first year, no one gives money”*, although then she added that more money was actually needed in the second year, when the business was growing. This problem is even greater for companies in rural areas where mortgages are hardly accepted by banks.

**Market factors may be more motivating** as the approach to more serious customers (bar D), to a more reliable sellers of inputs (bar E) and to new markets (bar F) has been assessed as major motive, despite the answers remain distributed along the incentive spectrum. This finding was confirmed by the registered companies. They spelled out access to more serious customers, building a brand, access to different benefits (trainings, grants, subsidies), eligibility to apply on government tenders and achieving economy of scale as key incentives to being formal.

*“You can act as a serious subject. Calls for training, for grants, for every opportunity, the criterion is to be a registered legal entity. To build a brand.”*

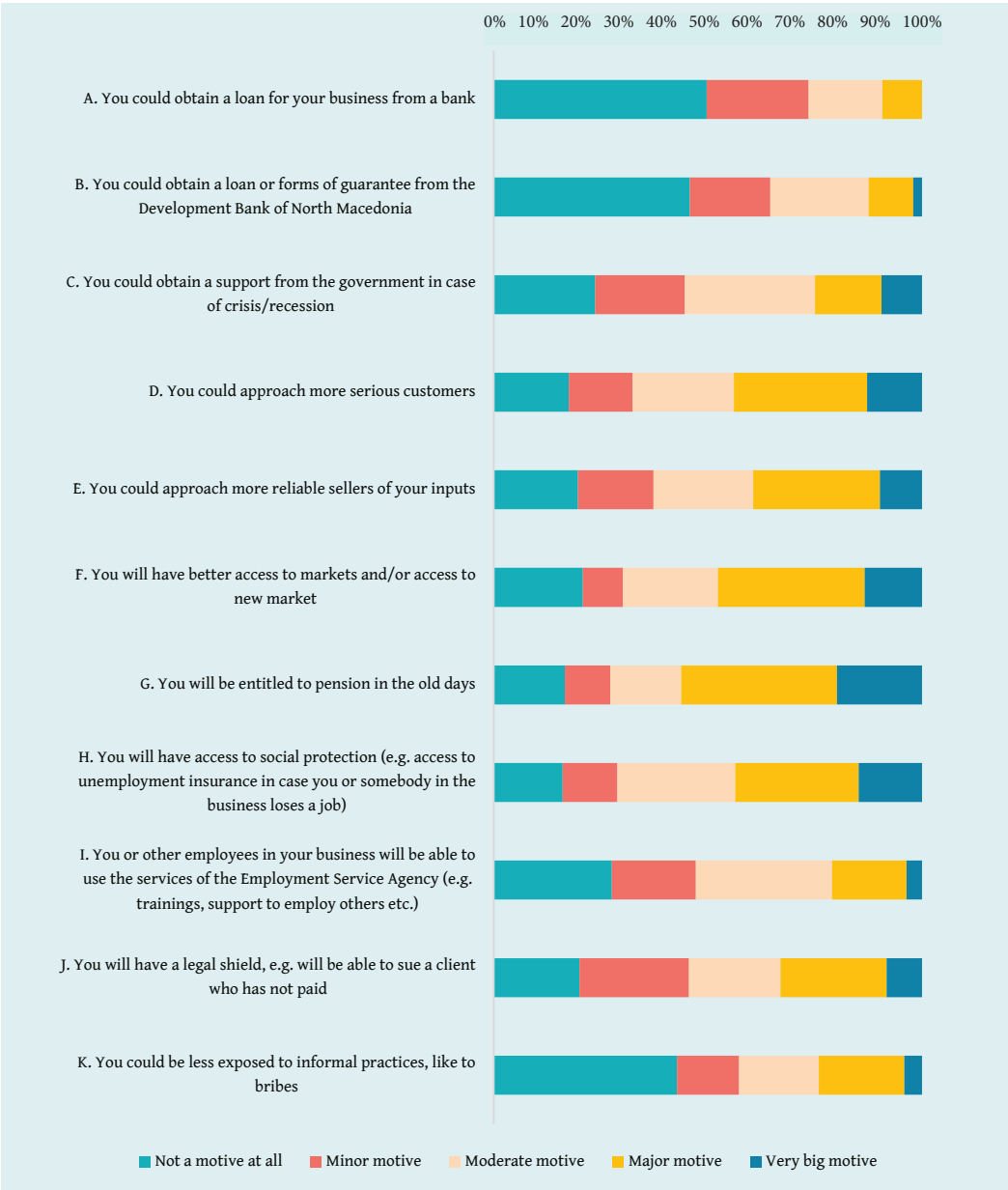
*“You will reach more credible customers. When you are an individual, everyone will say ‘who is he’? And, as a company, it is instantly different. Customers see you differently. You immediately have access to more serious customers, bigger customers, companies”.*

The possibility to be insured through social protection and old-age pension (bars G-H) provide **fairly strong incentivization for formalization**, which corroborates the earlier finding that a large share of unregistered micro-performers of business activity effectively or fictively work for another firm just to realize the right to pension and social protection. On the other hand, the access to the palette of active labor market programs of the Employment Service Agency (ESA; bar I) was assessed as not incentivizing. Opposite to the findings of the survey, the interviewed owners of registered companies emphasized that the ESA measures for establishing a company and supporting employment/salaries in the first year are an overwhelming opportunity and motivation for registration. Some of them had registered their company through these measures. Hence, on the part of the unregistered micro-

entrepreneurs, it may be just a matter of insufficient information available to them on what is offered through ESA as active labor market measures.

The incentive derived from having a legal shield through being registered (bar J) is varying and spread through the motive spectrum. Being shielded from informal practices if registered (bar K) is not a motivational factor for formalization, which either suggests that bribery is not an important issue, or that it is equally important whether informal or formal business.

**Figure 10: Benefits from running a formal business**

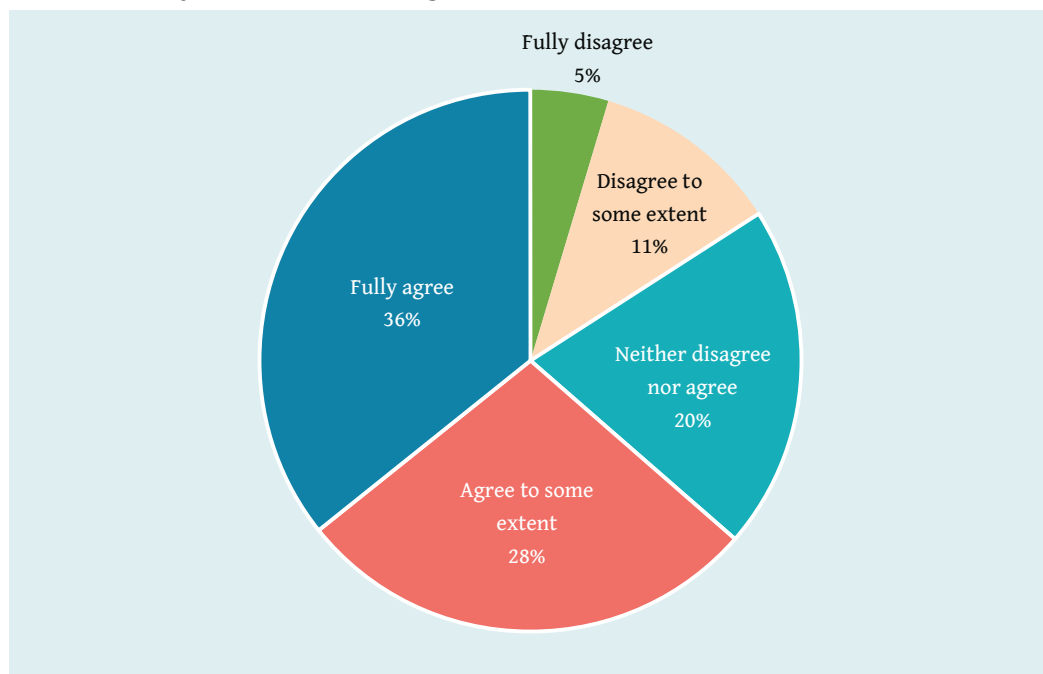


Source: Authors’ calculations based on SUME.



Figure 11 presents the perception on the net cost, i.e. the extent to which costs from formalization outweigh benefits from formalization. Sheer majority of unregistered micro-performers of business activity still consider costs to outweigh benefits, i.e. do not recognize large enough benefits from formalization. 36% fully agreed with the negative net benefit, while 28% agreed to some extent.

**Figure 11: Considering all costs and benefits from registering a business, you would still say that costs outweigh benefits**

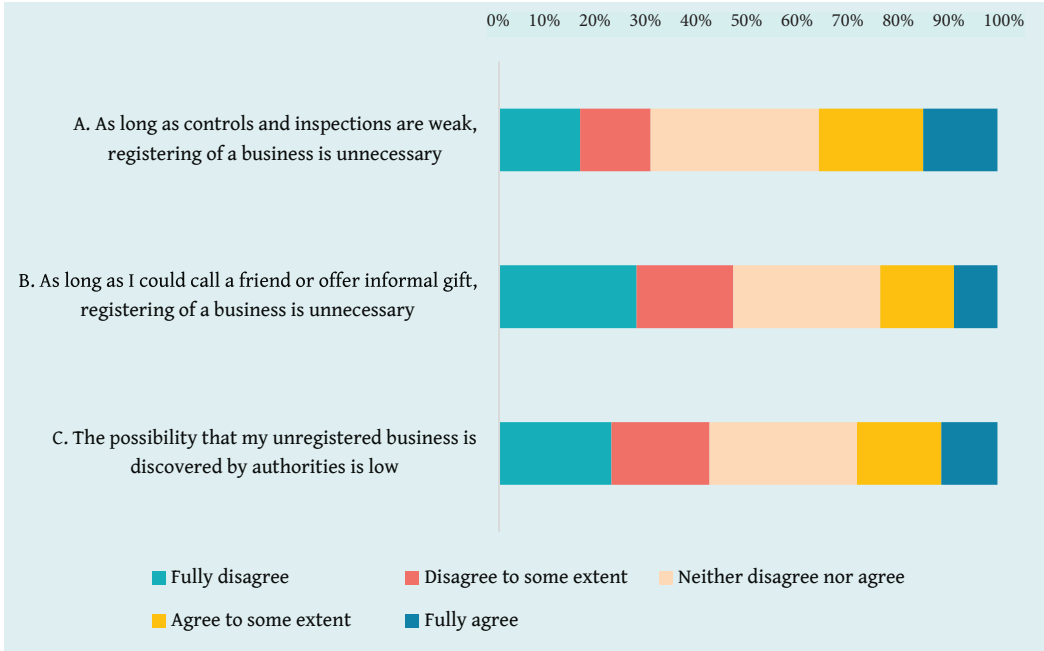


Source: Authors' calculations based on SUME.

4.4. COSTS OF STAYING INFORMAL

Finally, we shed some light on the perception of the probability of being detected and an aspect of the tax morale as factors that may help staying informal (Figure 11). Respondents were on average neutral on the non-necessity to register when controls and inspections are weak (bar A). Yet, there is still some leaning of the answers towards the agreement side, suggesting that controls and inspections may work to make staying informal expensive. On the other hand, calling a friend or offering an informal gift to stay informal (bar B) is generally to the disagreement side, suggesting that working to eliminate such practices – e.g. through an awareness-raising campaign – may produce only limited results. The probability of being detected (bar C) is generally not considered low, so that increasing the pressure to detect informal business may likewise not result in widespread formalization. Registered companies confirmed that their fear of inspections is lower after having registered. *“The greatest benefit is the personal peace. Anyone who has a dilemma whether to be unregistered to save on taxes and contributions or to register and pay all costs: do register! By being registered, we are sure that we are in accordance with the law while the business opportunities are increasing.”*

Figure 12: Costs of staying informal



Source: Authors’ calculations based on SUME.

# 5. FACTOR ANALYSIS

The groups of factors were analyzed individually so far, but their relative weights could be only understood if they are considered jointly. We would like to reduce the large number of variables from SUME into fewer numbers of factors through extracting maximum common variance from all variables and putting them into a common score. Hence, we pursue a factor analysis.

We start the analysis by providing estimates of the Kaiser-Meyer-Olkin (KMO) test and the Bartlett’s test of sphericity. Both tests are important to determine if data are good to be grouped in several underlying factors; in particular, the KMO test indicates if data factor well. Table 1 provides a KMO value of 0.791, which is above the threshold of 0.5 suggesting that we could proceed with factor analysis in this case. Similarly, the Bartlett’s test rejects the null hypothesis that variables are not correlated, providing grounds for conducting a factor analysis.

Table 1: Tests for data factoring

Test	Value
Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy	0.791
Bartlett’s test of sphericity H0: variables are not inter-correlated (p-value)	0.000

Source: Authors’ calculations.

We proceed with the factor analysis. As usual in the literature, we consider only the factors whose estimated eigenvalue is higher than 1, and retain only factor loadings whose absolute value exceeds 0.35. Based on this, we obtain the following output. Table 2 presents the identified factors (24, equal to the number of used variables); only the first four factors have an eigenvalue greater than 1, so that we continue with these factors. In addition, they explain ~89% of the variance in our data, supporting the notion that four concepts (factors) are sufficient to explain the phenomenon of unregistered micro-performers of business activity in North Macedonia.

**Table 2: Identification of factors**

Factor	Eigenvalue	Difference	Proportion	Cumulative
Factor1	5.42185	1.48807	0.3741	0.3741
Factor2	3.93378	1.64911	0.2714	0.6455
Factor3	2.28467	1.00218	0.1576	0.8031
Factor4	1.28249	0.42321	0.0885	0.8916
Factor5	0.85927	0.13384	0.0593	0.9508
Factor6	0.72543	0.31655	0.05	1.0009
Factor7	0.40888	0.14214	0.0282	1.0291
Factor8	0.26674	0.03807	0.0184	1.0475
Factor9	0.22867	0.04857	0.0158	1.0633
Factor10	0.1801	0.03003	0.0124	1.0757
Factor11	0.15007	0.06634	0.0104	1.0861
Factor12	0.08373	0.02881	0.0058	1.0918
Factor13	0.05492	0.0729	0.0038	1.0956
Factor14	-0.01798	0.01676	-0.0012	1.0944
Factor15	-0.03474	0.02419	-0.0024	1.092
Factor16	-0.05893	0.03589	-0.0041	1.0879
Factor17	-0.09482	0.00703	-0.0065	1.0814
Factor18	-0.10185	0.00599	-0.007	1.0744
Factor19	-0.10784	0.01875	-0.0074	1.0669
Factor20	-0.12659	0.03063	-0.0087	1.0582
Factor21	-0.15722	0.03509	-0.0108	1.0473
Factor22	-0.19232	0.04405	-0.0133	1.0341
Factor23	-0.23637	0.02097	-0.0163	1.0178
Factor24	-0.25734	.	-0.0178	1

Source: Authors' calculations.

Table 3 presents the factor loadings on the various variables we use throughout the analysis. The first factor has major importance and explains 37.4% of the total variance. This factor entirely relates to benefits from formalization. Despite respondents explained that costs exceeded benefits, the major loading of this factor suggests that a look at benefits may be actually more important than prioritizing costs. However, the second factor which explains 27.1% of total variance is a clear identification of costs (despite some loads on the effort needed to deal with institutions and inspections). Hence, while of subordinated importance to benefits, costs for formalization still explain a significant share of the informal status of the micro-performers of business activity. Consequently, it is necessary to observe benefits and costs together, i.e. a work on one of the two key fronts is unlikely to produce formalization gains.

The third factor is clearly identifying the issues relevant for registration, primarily non-financial ones, explaining 15.5% of total variance. The significance of this factor is quite lower, as expected, yet the efforts to reduce such administrative burden may not be worthless, but only subordinated to policy effort to increase benefits and reduce costs of formalization. The last factor weighs 8.8% and captures the cost for staying informal, corroborating the general conclusion from Section 4.4. that such cost is perceived fairly unimportant for the decision to formalize, i.e. that even if the probability of being discovered increases this may not lead to a significant share of unregistered micro-performers of business activity going formal.





**Table 3: Factor loadings**

Variable	Variable	Factor1	Factor2	Factor3	Factor4
Administrative burden	Getting information			0.8458	
	Knowledge to prepare documentation			0.8988	
	Time for registration			0.8163	
	Dealing with government institutions		0.7826		0.3513
	Dealing with inspections		0.4582		
Costs for formalization	Fees for registration		0.6143	0.3962	
	Taxes		0.8259		
	Parafiscal charges		0.8626		
	Accounting services		0.8795		
Benefits from formalization	Getting a loan from bank				
	Getting a loan from DBNM	0.5524			
	Government support in crises	0.6893			
	More serious customers	0.801			
	More reliable sellers of inputs	0.6954			
	Pension in old days	0.7753			
	Access to social protection	0.7864			
	ESA services	0.6906			
	Access to new markets	0.7617			
	Legal shield	0.6106			
	Less exposed to informal practices	0.3695			
Costs of staying informal	Bribes to be paid				0.5825
	Weak controls and inspections				0.3508
	Call a friend or bribe				0.4579
	Possibility of being discovered				0.4138

## 6. CONCLUSIONS AND RECOMMENDATIONS

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Most common forms of unregistered micro-performers of economic activity include: street sellers, individual farmers, handicraftsmen, performers of personal beauty services, painters, plasterers, bakers, providers of lessons, vehicle mechanics and house-keepers and cleaners. They are very small as accounted through their income which usually does not exceed 250.000 MKD annually or through the fact that they usually perform the business activity alone (one worker), while when performed with co-workers, their number does not exceed five and they are most frequently paid and are not members of the family. The unregistered business is mainly performed in the household of the customer or in the own household, hence the clients are dominantly households and individuals and rarely firms. Strikingly, 58.3% of unregistered micro-performers of economic activity dispose with another source of income, which is predominantly from standard employment, either real or fictional, to be able to provide for a social security.

Costs for becoming a registered micro-firm have been identified as important impediment to doing so, particularly the taxes, contributions, parafiscal charges and the cost for accounting. To a limited extent, the time and fees to deal with the administration work to deter unregistered micro-performers of business activity from registering, while access to information and exposure to bribery have been found not to play a role.

On the benefits side, access to bigger customers, to a more reliable sellers of inputs and to new markets have been assessed as large benefits from formalization. The second incentive is the access to social protection and pension in old days. On the other hand, access to finance, to services from ESA and reducing the exposure to bribery have not been considered so important benefits, but this may be due to the fact that unregistered micro-performers of business activity have not been in a situation to sense these benefits.

Costs for staying informal have limited power in motivating registration. Only strengthening controls and inspections may work to some extent to increase the cost of staying informal, while less so actions to increase tax morale or reduce informal practices.

We pursued factor analysis to understand the joint variation of the factors for informality and to disentangle their relative weights. It suggests that there are four common themes underlying informality of micro-performers of business activity (in order of significance): benefits from formalization, costs for registering and running a business, administrative burden to register a firm, and the cost of being detected and penalized. However, of the four factors, the first two have significant loadings to justify a policy intervention as powerful in producing formalization gains. While the net benefit of formalization has been assessed as negative, a government intervention needs to focus first on elevating benefits and then on reducing costs for formalization of micro-performers of business activity. We hence devise some policy proposals.

Before authorities opt for cutting/management of the costs for being formal, it is indispensable to offer a palette of services that may increase the (perception of) benefits by the unregistered micro-performers of business activity, along the following lines:

- A favorable loan of cca. 3.000 EUR, with a large 80% grant component, either through the Development Bank of North Macedonia or the Employment Service Agency, specifically devised for unregistered micro-performers that intend registration. It will be aimed to cover the costs for registration, compliance and remaining costs in the first year of operation, particularly the cost of accounting services. This would imply that some kind of proof of an ongoing business activity must be presented, e.g. in a form explaining the type of business, its earning capacity, plan for growth etc. It is worth noting that the Self-Employment Grants offered within the active labor market policies (ALMPs) operationalized through ESA may be close to this definition and they might have provided support to formalization in the past. However, the proposal for loan+grant type of incentivization will need to be specifically and succinctly designed for users with history of doing informal business, hence possessing extra conditions and caveats to take into account such circumstances. The operationalization of such proposal should be pursued through DBNM or ESA.

It is important to note that such a measure should be commensurate to a measure which supports the already registered enterprises of the same size and type, in order not to impair the level playing field among companies who are to register due to the measure versus those who already registered when the measure did not exist. Such comparative measure may be sought in the Self-Employment Grant under the ALMPs, hence already existing, hence the design of the formalization measure must take its characteristics into account and make it equally beneficial.

- Workshops/trainings for managing and enlarging customers, acquiring new markets, and approaching to more reliable suppliers of inputs, as well as B2B meetings and a mentorship program to be devised and operationalized either as part of the ALMPs of ESA, or through a private provider under the umbrella of the Organization of Employers or Chambers of Commerce. For the end users, such events will need to be free of charge, suggesting that the government will either need to fund their conduct (as is done with major part of the ALMPs), or if provided privately, will need to finance the end-users for their participation. Pursuance of the events may be a condition for obtaining the loan-grant funding. Further operational issues will need to be disentangled together with the Ministry of Finance and ESA.

- Run information session for the micro-performers of business activity to be able to have update information on all possibilities for being subsidized, granted or loaned funds, primarily the active labor market programs of ESA, as well as the programs run through the Plan for Economic Growth, the loan and guarantee-extending lines of the Development Bank of North Macedonia, the various competitiveness-enhancing programs of the Ministry of Economy, the innovation-boosting programs of the Fund for Innovation and Technological Development, as well the array of existing other non-government programs for business development and funding.

- Workshops for financial literacy, preferably at the local level, may elevate the skills of the micro-performers for financial management, working with a bank, access to finance, access to insurance and other related services.

- Consider establishing association or cluster of micro-performers of business activity who pursued formalization of their business, to provide grounds for future participation in the social dialogue.

On the costs for being formal side, the following is a set of recommendations:

- Define the micro-performers of business activity as all of them whose annual income is lower or equal to 2.000.000 MKD and for such performers introduce a 'monotax' system merging various taxes, social security contributions and parafiscal charges into one lump sum. For those with annual income up to 1.000.000 MKD, the monotax rate may be equal to 10% of earned income, but not less than 7.000 MKD annually (being about 10% of the current median income of the unregistered micro-performers of business activity). For those with annual income between 1.000.000 MKD and 2.000.000 MKD, such rate increases to 14% of earned

income. Such a system would imply that net wages are paid out of the earned income, according to relevant laws, after the monotax percentage is paid-out to authorities, hence technically relieved from payment of pension and health insurance. For the government, such setup would not make a significant difference, because the country runs a universal health insurance scheme, while the provision of pension insurance will be guaranteed and semi-subsidized by the government, which anyway runs multiple schemes for subsidizing wages or contributions.

- Ensure that all parafiscal charges, particularly ‘firmarina’ and communal charges, in the first year of operation fall under the monotax system, i.e. they technically do not exist. After the threshold of 2.000.000 MKD is exceeded, the size of the parafiscal charges needs to be made commensurate to the earned income. A numerical proposal will be made as part of the operationalization of these recommendations.

- The loan+grant scheme will aim to also cover the accounting service cost, but for this to be acceptable, it is important that the annual financial reporting towards the PRO and the CRNM is simplified – for the earners below the above specified thresholds - at the level that secures low cost of hiring accountants. Such simplification will be attempted as part of the operationalization of these recommendations.

As more than half of the interviewed have had a second income in the formal economy (with related benefits), they might not be too inclined to go fully formal in their own cost-benefit calculation. Therefore, it is important to work on the benefit side for the households’ end-users of the service:

- Enable households to be able to deduct some of the expenses incurred from their own income tax when presenting an invoice for a purchase of a service from provider who is a subject of the ‘monotax’ system, and up to the amount of 8% of the total paid price. This might put some pressure on the informal service providers to go formal and be able to provide an official bill to their client to be used for tax deduction. Technically, the ‘Moj DDV’ mobile application may be upgraded to handle this.

Finally, to secure a layer of sustainability of such formalization efforts, it is key to run an information and awareness-raising campaign that will secure that micro-performers do not go back to informal market as they grow or as they approach the threshold above which they will be treated as any other firm. Ultimately, it is indispensable to enforce applicable rules through effective and deterrent sanctions.

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## ANNEX: SUMMARY OF COSTS FOR ESTABLISHING AND RUNNING OF A BUSINESS IN NORTH MACEDONIA

### Establishing a company in North Macedonia

Establishing a company in North Macedonia is regulated by the Law on Trade Companies (Official Gazette of RNM 61/2016) and is done by inscribing into the trade register within the Central Registry of North Macedonia, exclusively via authorized applicants known as registration agents (Law on the One-Stop Shop System and on Keeping the Trade Register and the Register of Other Legal Entities; Official Gazette of RNM 97/2015). Before starting the registration process, the founder should choose the form of the company, its name, headquarters and the managerial structure and should provide a founding investment (for a specific form of company, if required). The registration can be done via electronic system (free of charge) or in paper form by paying appropriate cost depending on the company's form. The most common forms of companies are 1) A sole proprietor, 2) Limited liability company / Limited liability company established by one person and 3) Joint venture.

A sole proprietor is a natural person who performs any of the trade activities defined by the Law on Trade Companies. He/she is personally and unlimitedly responsible for the obligations. To enter the trade registry as a sole trader, the founder should provide his/her personal information, name and headquarters of the company and its subject of operation. No founding investment is required. A limited liability company can be founded by one or more natural and legal persons who participate with one investment in the pre-agreed share capital of the company. In proportion to their shares in the company, the partners are entitled to an appropriate share of the profits. This form of company can be established by one person as a single-person partner, whereby the company's form is a limited liability company established by one person. Before entering the trade registry, the founders of a limited liability company should sign an establishment agreement or, if the founder is one person, he/she should provide an establishment statement. Then, an application is submitted to the Central Registry with the following information: personal information of the founder(s), name and headquarter of the company, its subject of operation and name and surname of the manager. Hence, the manager is chosen by the owners of the company and does not have to be the owner at the same time. The minimum founding investment is EUR 5,000 in cash or in kind. If the company is founded by several individuals, each has one investment that can be of different size. A joint venture is a company established by at least

three persons, whose founding investment is divided into shares. Such a company can be simultaneously or successively established. A simultaneous establishment means that the founders take over all shares, without a public call, and adopt the statute. In successive founding, the founders will adopt the statute, will register a certain number of shares and will announce a public call for subscription of shares. The minimum founding investment is EUR 25.000 and EUR 50.000 for simultaneous and successive founding, respectively.

### **Costs for running a company**

After establishing a company, the founder(s) are obliged to create a **bank account** for performing all transactions related to the operation of the company, which will cause monthly / annual costs for the account maintenance and commissions for the realized transactions. Also, they should choose an accountant that will record all inflows and outflows of funds in and from the company and will take care of regular servicing of tax and salary liabilities. Thereby, all companies are taxpayers obliged to have unique tax number within the Public Revenue Office, in order to fulfil their liabilities on the basis of the 1) Value added tax (VAT), 2) Profit tax, and 3) Personal income tax. VAT taxes the turnover of goods and services by natural and legal persons whose total turnover in the past year exceeded the amount of MKD 2,000,000. Also, a newly established company may register as a taxpayer of VAT if it expects a turnover higher than MKD 2,000,000. VAT liabilities are paid monthly, if the company's annual turnover is higher than MKD 25,000,000 or quarterly for all companies below this threshold. VAT is calculated by applying general tax rate of 18% and preferential tax rate of 5%. For some activities, such as restaurant activities, VAT is different from these rates, and their turnover is taxed at 10%. **The profit tax** taxes 10% of the profit that the legal entities realize from their operation. The basis for calculating the profit tax is the difference between total income and total operating expenses realized in the calendar year (1 January – 31 December). Micro and small companies whose annual turnover is below MKD 3,000,000 are exempt from the obligation for paying profit tax, while those with annual turnover between MKD 3,000,001 and MKD 6,000,000 may pay 1% total income tax instead of profit tax. **The personal income tax** of 10% taxes the income of all natural persons like salaries, income from independent activities, sale of agricultural products, property, capital gains, etc. When paying salaries, the employer is obliged to pay personal income tax for all employees, and the tax base is calculated as difference between the gross salary, personal reduction and **contributions**. Contributions refer to the compulsory social security as pension and health insurance, which is another cost that the employer is obliged to pay for all employees. The tax base for the

contributions is the gross salary of the employee, and the current minimum cost for contributions is MKD 7,398.

Additionally, companies have some compulsory liabilities toward the local authorities, whose amount is determined by them and may vary depending on the company's headquarters. Most common fixed local expenses are the cost for company ("firmarina") and the communal fee which is calculated on the size of the company's physical space.

**Table 4: Costs for establishing and running a company**

Type of cost	Cost value in MKD
Entry in a trade register	Via electronic system – free of charge In paper form – MKD 1,952 for a sole trader, MKD 2,399 for limited liability company, MKD 3,852 for joint venture
Registration agent	MKD 10,000
Minimum founding investment	No founding investment for a sole trader MKD 308,450 (EUR 5,000) for limited liability company MKD 1,542,250 (EUR 25,000) for simultaneous founding of JV MKD 3,084,500 (EUR 50,000) for successive founding of JV
Bank account	No cost for opening up MKD up to 500 for monthly maintenance Variable cost for provisions
Accountant	MKD 4,000 for monthly accounting services MKD 5,000 for preparing annual final bill
Value added tax	18% - general rate 5% - preferential rate 10% - preferential rate for restaurant-related services
Profit tax Total income tax	10% of the gross profit 1% for micro and small companies whose turnover is MKD 3,000,001-6,000,000 on the gross income 0% for micro and small companies whose turnover is below MKD 3,000,000
Personal income tax	10% of gross salary minus personal reduction minus contributions (MKD 1,024 minimum cost)
Social security contributions	18.8% pension and disability insurance (MKD 4,967 minimum cost) 7.5% health insurance (MKD 1,982 minimum cost) 1.2% unemployment insurance (MKD 317 minimum cost) 0.5% health insurance in case of injury at work or occupational disease (MKD 132 minimum cost)
Cost for company ("firmarina")	MKD 2,000 – 8,000

<b>Communal fees</b> - For use of the space in front of business premises for performing activities, m2 per day - To display advertisements and announcements in public places - For setting up space for displaying goods outside from the business premises	MKD 5 -15 for m2
	MKD 400-1.600
	MKD 700-2.700

