

## **Income Tax on Wages and Factors Affecting their Tax Evasion - the Case of Kosovo**

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**Abstract:** This paper addresses the factors causing tax evasion on income from wages in Kosovo, who have contributed to revenue shortfall at a satisfactory level for government also affects the welfare of the employees when they will reach retirement age because Kosovo has organized pension system in a way that accounts for the Employed Individual pensions are means each pays and collects about themselves for retirement income. For this reason, the Employed who are not involved in the informal economy and do not shirk from income tax will have a strong base of income to increase their personal welfare but also the welfare of the country in general. To achieve this, this study was focused to answer the question: What are the factors that push businesses in Kosovo that their work activities to engage employed undeclared for tax purposes? Why Employers avoid taxes on wages even when the Employed are notifying the tax authorities? This paper will address exactly that, their deficiencies and Employed businesses and the problems they encounter. The basic method used is survey data and then are further processed and analyzed by descriptive statistical methods different charts. Also work builds on a theoretical analysis by developing a comparative analysis and descriptive.

**Keywords:** personal welfare; pension contributions; informal economy; informal employment

**JEL Classification:** H26

### **1. Introduction**

Throughout the study the optimal tax system should also be considered tax evasion which has two key moments to analyze: first tax evasion arising from failure to register in the database of entities and persons, and second tax evasion stemming from tax avoidance which is a result of the relationship between taxpayers and tax inspectors.

Kosovo entered the group of countries with very high degree of informality and consequently and tax evasion. Informality figures go up to 40%, which indicates that efforts to reduce this evasion could provide significant resultant effects even in the short term. I think that the assessment and the government's objective to increase

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revenues by reducing tax evasion is completely feasible and positive effects if it was the willingness of tax administration officials and political will to fight corruption and the rule of law.

As explained by Gjokutaj (2014), in the last ten year old all are witnessing large fiscal developments worldwide. In the largely European countries have made changes in fiscal administrations by reforming their tax systems, coupled with tax reform in the way the value of labor, pension contributions and their use in order to increase the welfare of the citizens increasing levels of income per capita.

## 2. Review of Existing Literature

Today there are a number of definitions and authors who have addressed the issues of the informal economy and tax evasion. Many studies and scientific papers have shown that fighting informal economy is an important factor that affects the growth of the welfare of individuals and therefore economic growth of any country. Informality is a very widespread phenomenon, but its presence is greater in developing countries. As cited by Arturo (2014), Schneider and Enste (2000) have detailed the informality can be explained by many factors. The burden of taxes and pension contributions are typically identified as one of the important factors to explain informality. Based on these findings are sometimes motivated governments to reduce taxes on income from wages, to promote labor formality.

Gutmann (1977) is first calculated the size of the informal economy and the informal economy defined as large amounts of undeclared income and undeclared work and employment. He also showed that participants in the informal economy are anyone who engages in transactions with cash.

Schrage (1984) and Thomas (1992) defined as the informal economy: A number of economic activities in principle but not exercised legally declared as legal economic activities and as such are not subject to payment of taxes and not included in the value of income national the Informal Economy the Concept and Causes.

The informal economy is present as in developing countries as well as underdeveloped, but when it comes to informal employment, the difference lies between informal employment, voluntary and involuntary. As noted by Kucera and Roncolato (2008), this difference depends on the level of development of the state because in developed countries social security is higher and the unemployed can easily choose to be unemployed than to be employed involuntary informal, while the unemployed in underdeveloped countries where social security is very high poverty are forced to engage in informal work without their will. Despite what has been said above, various authors have identified several factors as determinants for inclusion in the informal economy as well employed to employers. So, for example Lehmann and Muravyev (2012) in their empirical research have found that the burden of

taxation and employment regulations have great effect on the level of the informal sector of each country. While, Schneider (2007) notes that besides the tax burden, the determining factor informal economy adds poor quality of public services, corruption of public officials and unfair treatment of taxpayers by tax administration officials.

### **3. History of Tax on Wages in Kosovo**

Since the establishment of the new tax system in Kosovo in 2000, especially in the last ten year old are continuously reform the tax system both in administration and in tax rates including the income tax. However, despite the reforms undertaken in connection with these results in the collection and their growth is not at the level to be desired, although the rate of taxation in Kosovo wage tax is among the lowest in the region and in EU countries that in general. This made to understand that the solution of this problem is not the tax burden but some other factor such as low income per capita, low fiscal culture, non- coordination clear economic laws fiscal, an informal surrounding environment, almost all of these factors caused by the presence of high corruption and nepotism public officials followed by political instability prevails in the country.

As was stated above one of the factors affecting the informality of income taxes on wages are low income per capita in Kosovo, caused by low wages and high unemployment rate.

The minimum wage in Kosovo until April 2011 was € 78, and since that period is 130 € for persons under 35 years old and 170 € for persons over the age of 35 years old. Besides Albania, Kosovo record low minimum wage in the region and EU countries (MLSW, 2013)<sup>1</sup>.

The average net salary annually in state administration in 2003 was € 167 and had a slow growing every year, so in 2013 the average net wage was € 364. Also the unemployment rate remains the highest in the region and the EU. In 2003 the unemployment rate was 49.7% and since that time there has been a slow decrease, so in 2013 the unemployment rate in young (15-34 years old) was about 56%, while the average unemployment rate for the all age groups was 30% (SAK, 2014)<sup>2</sup>.

Also, tax rates and the overall tax rates on wages in particular are the lowest in the region and despite this degree of informality of the labor force and the rate of evasion of taxes and pension contributions is very high.

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<sup>1</sup> Ministry of Labour and Social Welfare in Kosovo.

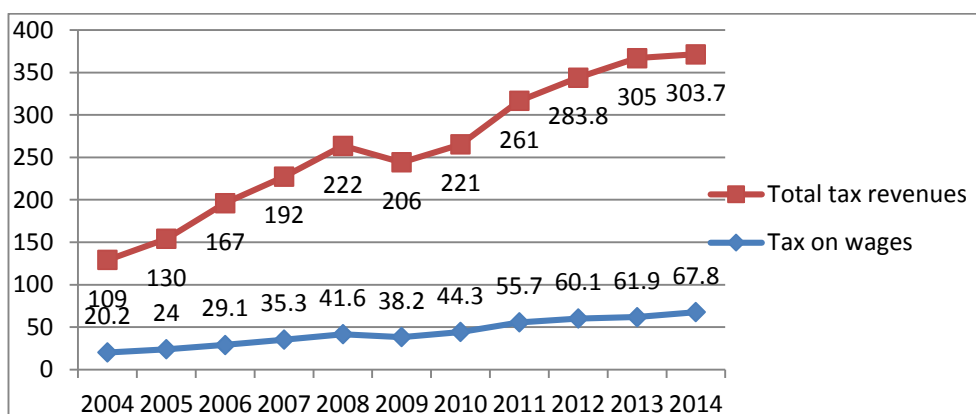
<sup>2</sup> Statistical Agency of Kosovo.

**Table 1. Income from wages and tax rates in% in Kosovo**

Amounts in €	Tax rates in %	
	Until 2009	After 2009
Monthly salary		
Up to 80	0%	0%
80-250	5%	4%
250-450	10%	8%
Over 450	20%	10%

Source: Tax Administration of Kosovo

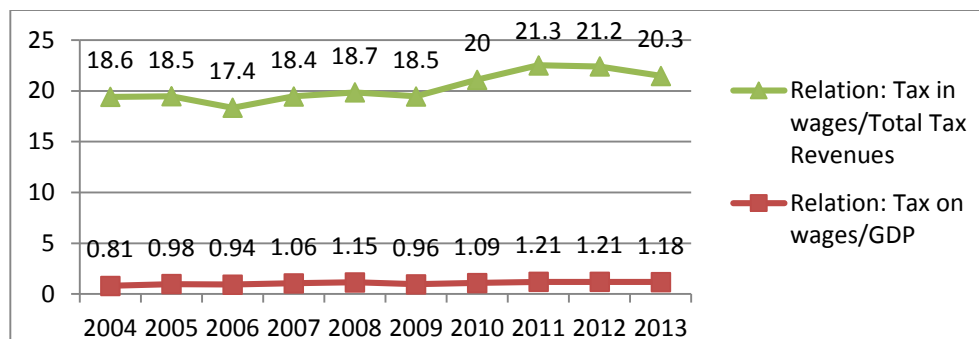
As shown in Table 1, in January 2009, there was a progressive decrease in the rates of personal income tax in Kosovo, which was aimed at stimulating business and employees to declare their income, but despite the lowering of rates tax informality workforce and tax avoidance has become a phenomenon on the rise.



**Figure 1. Performance of Wage Tax to Total Tax Revenues, in millions**

Source: Tax Administration of Kosovo

As shown in Figure 1, revenues from income tax, ranging from 2004 to 2014 have shown increased in numbers, although not large, except when in 2009 there was decrease not only in this category of income but also the total income tax, it happened because of lowering tax rates. Dynamics of this category of income in relation to total income had no significant difference over the years.



**Figure 2. Relation between Tax on Wages/GDP and the relation between Tax on Wages/Total Tax Revenue in% - Case of Kosovo**

Sources: Tax Administration of Kosovo and SAK

As shown in Figure 2, the relation of tax on wages to total tax revenue in 2004 was 18.6%, while in 2013 was 20.3%, i.e. increase in margin of 1.7%. Also, the relation between tax on wages/GDP has not undergone significant difference over the years, this relation was 0.81% in 2004, while 1.18% was in 2013, i.e. an increase of 0.37% of their margin within 10 years. Also, as seen from the chart participation in wage tax to GDP is very low.

**Table 3. Tax rates on wages in the region country**

Country	The Tax Rates	Country	The Tax Rates
Bosnia & Herzegovina	10%	Croatia	12% 25% 40%
Montenegro	9%	Serbia	12%
Macedonia	10%	Albania	10%

Source: Tax authorities of the countries concerned, 2013, edited by author

As shown in Table 3, progressive tax rates applicable wage tax in Kosovo from 0%, 4%, 8% and 10% are the lower rates in the region. Progressively higher rate applicable in Kosovo of 10%, which applies to wages in value over 450 € per month is equal to the applicable fixed rates in Bosnia and Herzegovina, Macedonia and Albania. While, Croatia tax rate higher than threefold with Kosovo.

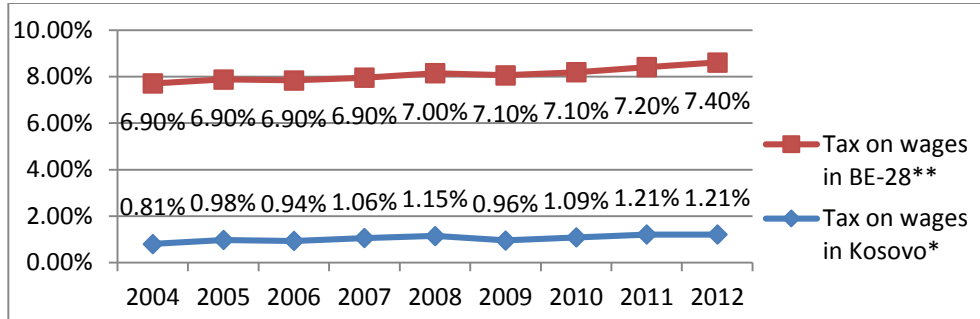
**Table 4. Wage tax rate in EU countries (single average income worker)**

Country	The Tax Rates	Country	The Tax Rates
BE	22.0	LT*	10.3
BG*	7.4	LU	15.1
CZ	8.8	HU	12.5
DK	35.8	MT*	11.3
DE	16.0	NL	14.3
EE	13.0	AT	12.6
IE	13.3	PL	5.9
EL	7.1	PT	13.1
ES	12.8	RO*	9.7
FR	10.4	SI	9.4
HR**	-	SK	7.1
IT	16.3	FI	18.4
CY**	-	SE	13.7
LV*	16.2	UK	13.3

Note: 100% of average wage; \*Data for non-OECD-EU countries (BG, LV, LT, MT and RO) are only available for 2012. For these countries, changes in tax wedge refer to 2011 - 2012. \*\* No data is available for HR and no recent data for CY.

*Source: Commission services, OECD.*

In table 4 show tax rates on wages in EU countries, but apply only to taking the average salary Employed and if we calculate tax on wages average salary in Kosovo that is somewhere 390 € (gross) applicable rates (progressive) Kosovo would still pick the amount of tax payable in Kosovo average wage is less than the amount which would be payable in any EU country. E.g. the amount of tax that must be paid in Kosovo to pay 390 € (after deduction of pension contribution) is 16.44 €, while the same salary the amount of tax payable in Poland (which as shown in the table has the lowest EU tax) is 21.86 €.



**Figure 3. Labor income (not including social contributions) in Kosovo and the EU, as% of GDP**

Source: \* Data for Kosovo were obtained from the Tax Administration of Kosovo and SAK.

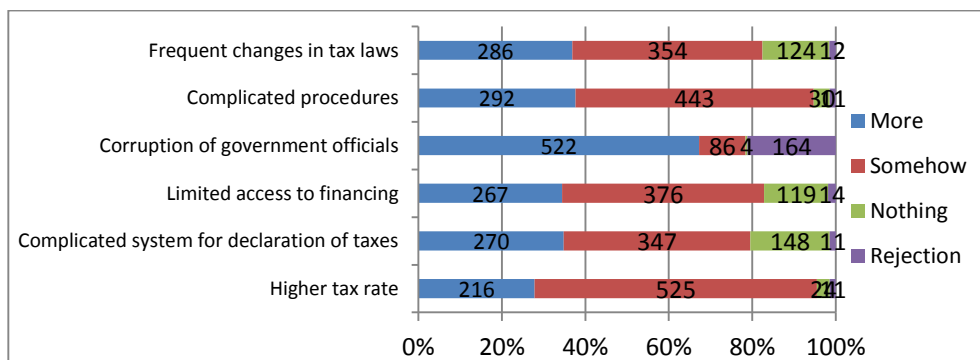
\*\* Data for EU countries were obtained from the European Commission.

As shown in Figure 3 the amount of wage tax as a% of GDP is very low in relation to the participation of this type of tax in EU countries.

#### 4. Results of the Survey

To get acquainted with the best situation in Kosovo informal economy and especially its workforce informality and evasion of tax on salaries have developed (the author) a survey with businesses in Kosovo. The survey was conducted with 776 people mostly business owner and manager. Results are presented with statistical method by means of graphs.

1) When asked which issues listed below represents the major obstacle to doing business and simultaneously pushes businesses to become part of the informal economy, the businesses have shown causes to be presented in graph the following:

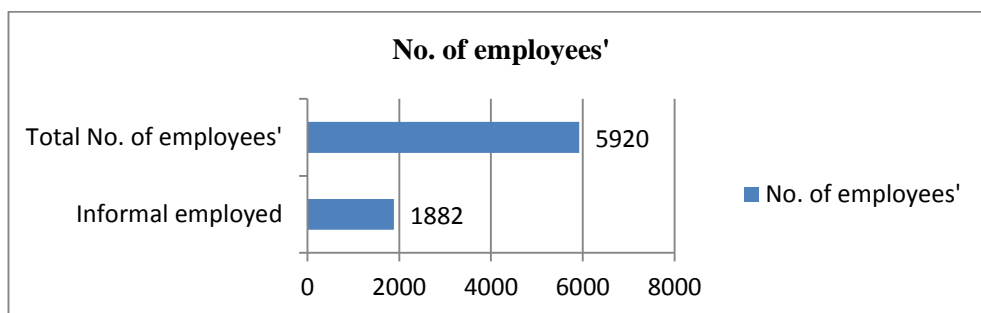


**Figure 4. The causes of the informal economy in Kosovo**

Source: Survey conducted by the author with businesses in Kosovo, in December of 2014.

As shown in the graph biggest obstacles to doing business and that just pushes businesses informal economy is the corruption of public officials, of 776 respondents, 522 or 68.3% of them think that corruption is the main cause of informality, while 21.1% of have refused to talk to this phenomenon, which shows that even by businesses not willing to fight this phenomenon, as other cause great impact on the complicated array informality 37%, frequent changes in tax laws 36.8% , complicated system for paying taxes 34.8%, 34.4% limited finances and higher tax rates 27.8%. The second group of causes of informality but with little impact on small rank higher tax rates 67.6%, the complicated 57%, 48.4% limited finances, frequent changes in tax laws 45.6%, complicated system for declaration of tax 44.7% and 11% corruption. While not constitute an obstacle at all: complicated system for declaration of taxes for 19% of business, frequent changes of tax laws for 16% of business, limited access to financing for 15% of businesses, complicated procedures for 3.9% of businesses, higher tax rates to 3% of businesses. While they refused to respond to the aforementioned factors 1.8% of respondents, with the exception of this phenomenon for which they have refused to answer 21.1% of respondents.

2) In the question of how much is the total number of employees in the businesses and how many of them have declared for the purposes of payment of tax on wages and pension contributions shown in the following figure.



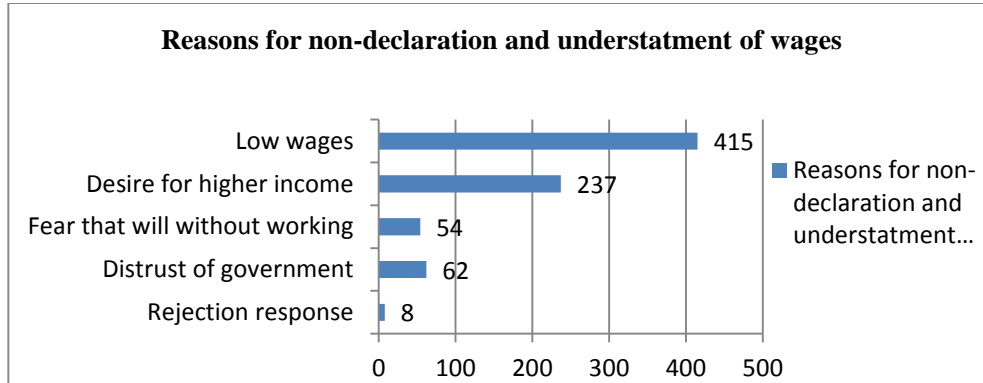
**Figure 5. Number of formal and informal employees**

*Source: Survey conducted by the author with businesses in Kosovo, in December of 2014*

In figure No. 2 shows that of 5920 persons as is the total number of employees' to the businesses in 1882 or 31.8% of them are employed informal, i.e. not registered with tax authorities and pay no tax on wages and pension.

3) In case of Employed is not registered, according to respondents, it happens by the will of the employees in 70.3% of cases, with the will of employer occurs in 6.9% of cases, while 22.8% of respondents have refused to answer this question. However, what is the reason of non-declaration or understatement of the salary of employees, expressed as respondents, will be shown in the chart below:



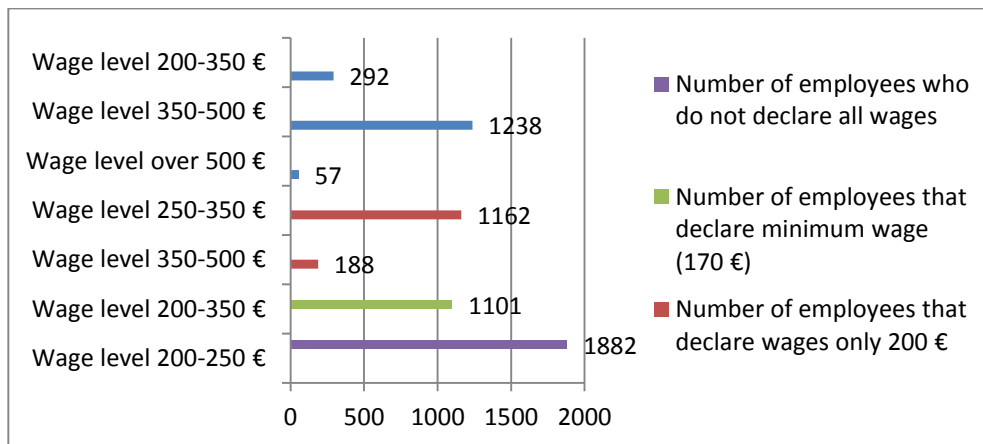


**Figure 6. Reasons for non-declaration and understatement of wages**

Source: Survey conducted by the author with businesses in Kosovo, in December of 2014.

In the figure no. 3 indicated that the biggest reason for the failure to file or pay understatement is the low level of wages in Kosovo, 415 people or 53.5% of respondents say this; 237 or 30.5% of respondents therefore have a desire to higher income; 54 or 6.9% fear they will lose their job; 62 or 8.1% do not trust the government, while 8 or 1% of the respondents refused to answer.

4) To understand how much are the monthly salaries for employees and how they are declared for the purposes of payment of tax on wages and pension contributions of respondents have taken data which will be presented in the following figure.



**Figure 7. The rate of wage tax evasion in Kosovo**

Source: Survey conducted by the author with businesses in Kosovo, in December of 2014.

As shown by the data presented in the chart above, the number of employees who receive wages from 200-250 € and never declare them altogether for tax purposes is 1882 or 31.8% of the total number of employees in the businesses and it appears to be that their wages are lower than the average wages in Kosovo. Another category of 1101 persons or 18.6% of the total number of employees in the businesses who receive wages 200-350 € declare them in many of 170 € for the purposes of tax on wages and pension contributions, so their wages is declared just as much it quotes the minimum wage in Kosovo. Category of employees from 1162 persons or 19.6% of the total number of employees who receive wages from 250-350 € and another category of 188 persons or 3.2% of total employees who receive wages 350-500 € disclose their wages 200 € for tax purposes. While, as research shows only 26.80% of employees declare their wages amounting true, the extent paid. Most of these employees have wages of 350-500 €, pay over € 500 is only 0.97% of the employees who have been the subject of research. This shows that the rate of tax evasion tax on wages is quite large, ie, 31.8% appears to be the extent of non-registration of employees while 41.4% is the rate of tax evasion in salary and pension contributions.

## 5. Conclusions and Recommendations

The conclusions arising from the realization of this paper dealing with the identification of the causes of informality of the labor force and its consequences in the implementation of important income tax on wages and pension contributions. These conclusions result from a survey carried out by businesses in Kosovo. From the survey results it appears that the main cause of the informal economy by businesses is the corruption of government officials which list businesses with great constraint, followed by complicated administrative procedures, frequent changes in tax laws, complicated system declaration of taxes and higher tax rates. Only about 28% of businesses consider higher tax rates, as the major obstacle when it is known that the tax rates in Kosovo are among the lowest in the region and EU countries. While, in 2012, in Kosovo wage tax share in GDP is 1.21%, in EU countries this share is 7.4%. While pension contributions in Kosovo are not at all part of the state budget, but they are managed by an independent institution called Pension Savings Trust. While watching the part of employees, 53.5% of the main reasons for declaring the low wages they pay, then 30.5% say that the reason is the desire for higher income, 6.9% of them are afraid that they will remain without work. As a result of the aforementioned occurrences illegal sector and tax evasion rate is very high; all of these can be explained as a consequence of not rule of law. Since 2004 the participation of tax from wages in GDP, compared to 2013 increased only by 0,37 %. Results of the survey show that 31.8% of employees are informal, ie. are not registered with the tax authorities and pay no tax on wages and pension contributions, to the Kosovo budget of causing millions of euros in losses each year, also employed each of his loss itself causes 10% of his monthly salary to preserve

the retirement pension; 41.4% is the rate of tax evasion in wages and pension contributions, while only 26.8% real declare and pay tax amounts.

Given the findings and identification of negative phenomena that cause tax evasion recommend as follows:

- To act rule of law as public officials as well as businesses involved in illegal activities.
- The government should stimulate employed financially fiscal administration depending on the growth of fiscal revenues and combat tax evasion.

The fight against informal economy and tax evasion should be a priority not only of the tax administration but should be done in coordination and local governments, businesses and citizens.

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