

## TACKLING THE UNDECLARED ECONOMY IN CROATIA

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### **Abstract**

To evaluate how undeclared work is being tackled in Croatia this paper reports an e-survey and in-depth interviews with key stakeholders in Croatia. It is revealed that, compared with the European Economic Area countries, Croatia has a weak institutional infrastructure for tackling undeclared work and pursues a narrower range of policy measures. The outcome is a call to develop a single body to better coordinate actions to tackle the undeclared economy in Croatia and for a shift towards an approach that seeks to provide gateways to formalisation. Furthermore, Croatia needs to modernise its work and welfare regime through higher levels of state expenditure in the labour market and social protection, coupled with redistribution via social transfers so as to construct a more equal society.

**JEL Classification:** E26, O17, H10, H26, K42, K2

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## **Introduction**

In order to provide a systematic overview of how the undeclared economy is being tackled in Croatia in comparison to the European Economic Area (EEA) the following issues are addressed in this paper: the extent of undeclared work in Croatia and how it compares with the EEA; the institutional structures and policy approaches employed in Croatia for tackling undeclared work and how this compares with the EEA; the range of policy measures implemented in Croatia compared to those adopted in the EEA, and exploring what should be done to improve the fight against undeclared work in this country.

Accordingly, the paper is organised so that the review of institutional structures, policy approaches and available measures for tackling the undeclared economy are presented first along with a discussion of those that have been implemented across the EEA. Following this, the second section is focused on the methodology employed to evaluate the institutional structures, policy approaches and measures adopted in Croatia, succeeded by the findings. Finally, a section synthesising the findings is presented including a discussion of the ways forward for Croatia with regard to what could be done to tackle the undeclared economy more effectively in this country.

Firstly, it is important to define what is understood by undeclared work. Although the phenomenon is variously denoted by 45 adjectives, including ‘informal’, ‘cash-in-hand’, ‘underground’, ‘hidden’ and ‘shadow’ and 12 nouns such as work, employment and economy (Williams 2004; Nadin and Williams 2012), a firm consensus exists in terms of the type of activity that is to be included and excluded whilst discussing this form of work. The widely, though not officially, accepted definition within the European Union includes ‘productive activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems between Member States’ (European Commission 2007, p2). Endeavours within the undeclared economy are on the fringes of the law and are therefore differentiated from criminal activities such as drug trafficking, people smuggling and money laundering. Furthermore, non-cash exchanges and subsistence production that is not exchanged is not encompassed by the term.

## **Settling the Scene: Tackling Undeclared Work in Europe**

The focus on measuring the magnitude of undeclared work is widespread within the undeclared work literature. Consequently, the area has constructed copious estimates of the size of the undeclared economy using various indirect and direct measuring methods (Jutting and Laiglesia 2009; OECD 2002; Schneider 2011, 2012; Schneider and Enste 2002; Thomas 1992; Williams 2004, 2006). The issue of tackling undeclared work has remained a marginal topic. Recently, however, it has attracted interest causing a small but growing body of literature to surface. Hence, a review of the available information, of how the fight against undeclared work is organised institutionally in Europe, and the policy approaches and measures used by European countries when tackling undeclared work, is presented in this section.

Academics such as Feld and Larsen (2012) and Williams (2005) have written about the ways in which particular countries approach the undeclared economy and how they may come up with policies to increase the disincentives to people engaging in undeclared work. This work, however, falls short of a comparative analysis taking into account multi-nation cross-examination. Dekker *et al.* (2010), however, did just that, and evaluated at length the efforts of 31 European countries in their combat against undeclared work, and more specifically, the institutional organisation of those nations. Their findings showed that many nations (74%) did not have either a central committee or central agency responsible for the efforts to reduce undeclared work. (Germany and France with an agency and 6 countries including Italy, Slovenia and the Czech Republic with a central committee) The remainder of the studied countries were more-decentralised, either with the tax offices taking the bulk of responsibility, as is the case in many Nordic countries, or the Labour Inspectorate, seen in other Eastern and Southern European countries.

Concerning the introduction and implementation of policy, there seem to be two distinct areas of focus. Countries may choose to either adopt an incentive scheme focused around the tax system, encouraging individuals into legitimate work as they are more highly rewarded for it (the enabling approach), or they may increase the disincentives of being found to be engaging in the undeclared economy. These two approaches are quite highly contrasted, with the latter increasing the search for workers or businesses failing to declare income, and then increasing penalties and punishments on these persons. Hasseldine and Li labelled (1999) this approach economic deterrence, compared with the tax method, which they labelled as 'fiscal psychology'; to put it more simply, 'the Stick vs. the Carrot' (Small Business Council, 2004).

Table 1 provides a summary of the methods and measures used by these two contrasting approaches. The deterrence principle focuses on an individual behaving as a rational being, somebody who weighs up the pros and cons of a decision before choosing which option to go for (Allingham and Sandmo, 1972). Individuals will assign an 'is it worth it' weighting to disincentives such as a criminal record, or a prison sentence, as well as obvious weightings such as a cash fine. Their chances of being caught will also be taken into account, therefore to increase deterrence individuals must realise that there is a much higher chance of being found to be engaging in undeclared work, whereas if there is absolutely no chance of being caught, many more would practice the behaviour. On the alternative side, individual, rational economic actors will think of the legitimate, declared side of the economy as more positive if the fiscal policy is more accommodating. For example increasing the VAT threshold may see business owners declaring more of their earnings. As Allingham and Sandmo (1972) describe it, policy makers should impose a 'negative reinforcement approach', making sure that everyone knows that the illegal behaviour will be caught and punished severely.

On the other hand, academic research into the approaches of policy makers to undeclared work has led to an increase in backing for the enabling method. Kagan and Scholz (1984) believe that viewing the public as ‘social actors’ is a more realistic approach. They believe that people, by their nature, will comply with the law and those that don’t have been forced out of doing so by the tax system. Murphy (2005) offers the hypothesis that the tax authorities should be ‘enablers’, who offer the appropriate incentives to individuals who wish to declare earnings. The European Commission (2007) backs this motivation as does the Small Business Council (2004). In the long term individuals will seek to maximise their utility by following laws and engaging in legal activity as much as they can.

**Table 1.** Policy approaches towards undeclared work

<b>Approach</b>	<b>Method</b>	<b>Measures</b>
Deterrence	Improve detection	Data matching and sharing Joining-up strategy Joining-up operations
	Penalties	Increase penalties for evasion
Enabling compliance	Preventative	Simplification of compliance Direct & indirect tax incentives Smooth transition into self-employment Introducing new categories of work Micro-enterprise development
	Curative	Purchaser incentives - service vouchers - targeted direct taxes - targeted indirect taxes
		Supplier incentives - society-wide amnesties - voluntary disclosure - business advisory & support services
	Fostering commitment	Promoting benefits of declared work Education Peer-to-peer surveillance Tax fairness Procedural justice Redistributive justice

*Source:* derived from Williams and Renooy (2009)

Governments have a choice of three methods when aiming to achieve a reduction in the levels of undeclared work. The first is a fiscal system which encourages people to behave legally from the beginning, Williams and Renooy (2008) suggest that this will stop the need for individuals to stray from the declared economy. Another approach is to incentivise a switch from not declaring earnings to declaring them, amnesties for those wishing to switch, for example. A third option is the soft policy approach, such as redistributive justice, or education on tax immorality.

Williams and Renooy, in a 2009 paper, explained that the deterrence approach was still the most popular policy choice in 2001, and that the first approach, focusing on a fair and engaging tax system, was rarely used across Europe. This bias towards the deterrence approach continued throughout the early part of the decade; however, by 2005, more member states were committing to enabling approaches. Tax systems began to focus more on the preventing of individuals engaging in undeclared work while the softer, educational approaches, encouraging people to look at tax morality, were lacking. Indeed, beyond the 15 original states of the EU, the deterrence method was still a hugely popular and dominant policy. In cases where an enabling approach was adopted, it was confined mostly to preventive methods as softer measures engendering higher commitment to tax morality remained largely absent.

To find out whether a wider range of approaches and methods were being used, Dekker *et al.* (2010) surveyed senior officials involved in the fight against undeclared work from either labour inspectorates, tax offices, social security administrations, trade unions, employer representative organisations and other relevant agencies such as customs, border police and immigration in the 31 countries of the European Economic Area (EEA). Ranking the four approaches from most important to least important in their country, 57 per cent stated that the deterrence approach was the most important in their country and only 43 per cent considered the enabling approach as the most important. On the other hand, when asked to order the approaches from the least important, 84 per cent declared enabling approaches and merely 16 per cent the deterrence approach. This clarifies that whilst there is a continuing shift towards adopting enabling approaches, the majority of member states remain entrenched in a deterrence approach that pursues the eradication of undeclared work.

Although in 2010 all 31 EEA countries were continuing to use deterrence methods it is evident that there has been an increase in the range of methods and measures being adopted since the onset of the recession. This is shown through a greater implementation of preventative, curative and commitment methods than in the period preceding the recession. By 2010, 90 per cent of European Economic Area (EEA) countries used one or more preventative policy measures, 64 per cent of countries adopted one or more curative measures and 69 per cent had implemented commitment measures (Dekker *et al.*, 2010). Therefore, it is clear that although the deterrence approach is still widely used, the enabling approach has started to be more broadly introduced.

Thus far, however, there have been no evaluations of either how the fight against undeclared work is organised institutionally or the policy approaches and measures that are being used in Croatia. The current paper seeks to fill this gap.

## Methods

In order to identify the policy approaches and measures adopted in Croatia, as well as to identify how the fight against undeclared work is being organised more generally, we first carried out a comprehensive literature review including academic, governmental and social partners' statistical sources. This involved a review of surveys of undeclared work in Croatia, a desk-based survey of the institutional structures employed to fight undeclared work in Croatia encompassing both published and 'grey' literature and a desk-based survey of policy measures. This, however, resulted in large gaps in knowledge of both the organisation of the fight against the undeclared economy and the policy approaches and measures being implemented.

In order to fill the gaps in understanding as well as to provide up-to-date information and further detail an e-survey was conducted [see Appendix 1] gathering data from key stakeholders.

Based on Dekker *et al.*'s (2010) survey instrument used to study EEA countries the information sought was: the characteristics of the current national institutional framework in Croatia; the existing policy measures used; their perceptions of the importance of each policy measure in the overall approach adopted; their perceived best practices in this field, and the usefulness of various possible policy options. A total of some 9 responses were obtained from senior stakeholders. The participants were chosen by contacting relevant institutions and asking for knowledgeable representatives to participate. Although there are limitations with such a number of responses the key aim was to get representatives from government departments involved in the fight against undeclared labour, as well as social partners such as employer's associations and expert academics. Additionally we obtained the responses of a World Bank economist.

Subsequent to the web survey three in-depth semi-structured interviews were carried out with a sample of the stakeholders who were asked to comment on the results of the e-survey and to provide any additional information they had with regard to the country's fight against undeclared work. This was done in order to obtain additional information to satisfy any gaps or disparities on existing national institutional frameworks and policy measures adopted in Croatia as well as to seek richer in-depth understanding of the effectiveness and importance of the various approaches being implemented. The respondents were asked to comment on each policy approach that had been outlined as present (from the e-survey) in Croatia's fight against undeclared work.

Finally, in order to validate our findings, a workshop was undertaken in November 2012 in Zagreb with experts and representatives of key stakeholders involved in the fight against undeclared work in Croatia. The results from the study are reported below.

## Findings

To contextualise the findings a brief outline of the extent and nature of the undeclared economy in Croatia is provided, followed by the results of the organisation of the fight against undeclared work in Croatia relative to other EEA countries and an evaluation of the adopted policy approaches and measures, along with broader findings that reveal the size of the undeclared economy to be indivisibly connected to the type of work and welfare that prevails in a country. This provides the necessary material to yield some conclusions of what needs to be done to more effectively tackle the undeclared economy in Croatia.

### Extent and nature of the undeclared economy in Croatia

With a population of 4,430,003, Croatia is defined by the World Bank as a 'high income' country with a GNI per capita of US\$13,760 (World Bank Doing Business Survey, 2012). In September 2012, the monthly minimum wage was 2,814 kuna, the average gross monthly earnings/person in paid employment was 7,958 kuna and monthly net earnings/person in paid employment was 5,499 kuna. The registered unemployment rate in October 2012 was 19.61% (Croatian Bureau of Statistics, 2012).

#### *Extent of undeclared work*

In Croatia, as in other countries, many different estimates of the size of the undeclared economy exist, each using different measurement methods. It is important, therefore, to be aware of the measurement method underpinning any estimate. Table 2 reports the findings of the World Bank Enterprise Survey 2007, which interviewed 633 firm owners, and uses the same questions across many countries. This reveals that 98.1% of the firms surveyed reported that they were formally registered when they started operations and the 1.9% of firms that were not registered operated on average for just 1.1 years without formal registration. Nevertheless, evidence that many formal and informal businesses operate on an undeclared basis is provided by the fact that 31.7% of firms report that they compete against unregistered or informal firms and 25% report that the practices of informal sector competitors are a major constraint on their business.

A further measure of the extent of the undeclared economy is provided by Schneider (2011), who measures its size as a proportion of GDP using his Multiple Indicators Multiple Causes (MIMIC) method<sup>1</sup>. Figure 1 compares the size of the undeclared economy in Croatia with its EU-27 counterparts. It reveals that the undeclared economy in Croatia

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1. As with the MIMIC estimation procedure one obtains only relative values, with the help of the currency demand approach, for a few countries (Austria, Germany, Poland and Switzerland). These values have been calibrated into absolute ones.

is equivalent to 30.4% of GDP and as such, is larger than in all EU-27 member states with the exception of Bulgaria. However, other researchers, such as Klaric (2011), dispute such high figures of undeclared work within Croatia. Klaric (2011), using the MIMIC method, finds that in 2009 the annual undeclared work income relative to the official GDP was 4.18%. However, for the current paper the limitation of Klaric's method lies in this statistic not being compared with that of other countries.

**Table 2.** Magnitude of Undeclared Work in Croatia

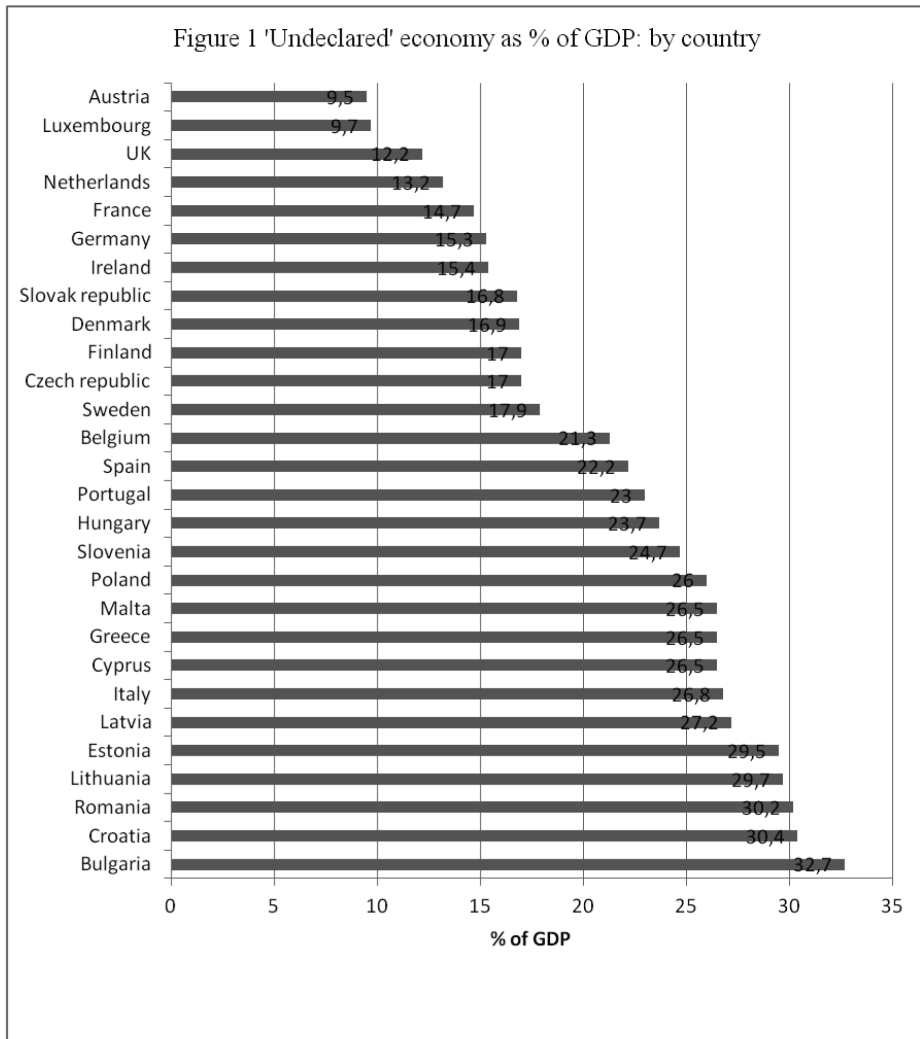
N=633	Croatia	Eastern Europe and Central Asia	World
% of firms formally registered when started operations in country	98.1	96.3	87.7
Number of years operated without formal registration	0	1.1	0.9
% of firms competing against unregistered or informal firms	31.7	45.2	56.3
% of firms identifying practices of competitors in the informal sector as a major constraint	25.0	28.7	31.6

*Source:* World Bank Enterprise Survey 2007

Examining the trends over time in the magnitude of the undeclared economy, Schneider (2011: 42) finds that it has slightly reduced in size from 33.8% of GDP in 1999, through 32.1% in 2003 to 30.4% in 2007.

Care, however, needs to be taken with such estimations of the size of the undeclared economy that result from indirect measurement methods. Using proxy indicators and/or seeking statistical traces of undeclared work in data collected for other purposes, there are often marked variations in the estimates of its size. As the Institute for Market Economics (2002) shows, summarised in Table 3, at any one time different methods can produce different estimates of the size of the undeclared economy as well as different views of its trajectory. For example, while the approach which seeks discrepancies in the national accounts (Madzarevic and Mikulic, 2001) reveals a sharp decline in the size of the undeclared economy between 1995 and 2000, monetary methods show a slight increase over the same period, as does the electricity consumption approach (Sosic and Faulend, 2001).





Source: data from Schneider (2011)

**Table 3.** Estimate of the Size of the 'Undeclared Economy' 1990-2000: % of GDP

Method	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Discrepancy method	14.37	28.15	29.40	36.88	25.45	18.38	16.31	11.38	9.12	8.41	6.81
Monetary-Cash deposits						25.0	24.7	29.2	29.8	34.0	25.3
Monetary-foreign currency in circulation						25.0	22.0	26.1	25.5	24.9	25.8
Electricity consumption method						25.0	24.8	24.0	26.3	29.8	26.5

*Source:* Institute for Market Economics (2002)

#### *Nature of undeclared work*

Various surveys highlight how the undeclared economy is concentrated in some sectors of the economy more than others (Bicanic and Ott, 1997; Institute for Market Economics, 2002; Mikulic and Madzarevic, 2001). Comparing the undeclared economy in agriculture, industry and trade over the period 1990-1999, Bicanic and Ott (1997) note that while the undeclared economy in agriculture was somewhere between 6.8-16.9 per cent of GDP between 1990-1999, in industry it was rather lower, ranging from 2.3 per cent in 1996 to 5.2 per cent in 1998. In trade, meanwhile, the undeclared economy was far more prevalent although the trends over time in its relative size were identical to industry, with a sudden growth in the undeclared economy in retailing during the 1990-1993 period (to almost 60 per cent of trade as a whole), followed by a sudden fall in 1993-1994 (to around 35 per cent) and then a mild decline or stagnation from 1995 until 1999. Overall between 1990 and 1999, undeclared work was reducing in trade and stagnating in agriculture, but rising in industry. Their argument is that the process of transition into a market economy was variable across sectors, with the transition being most rapid in trade and slowest in industry. Although many studies have been carried out more recently to estimate the size and extent of the informal economy in Croatia, there is a lack of research investigating its nature.

Svec (2009) finds that the labour activity rate is inversely proportional to the estimate of people unemployed in the undeclared economy. In Croatia, therefore, as the activity rate falls, the undeclared employment grows. This suggests that the population switches between the formal and informal economy. However, in order to make further conclusions as to why this happens we would need more qualitative data investigating the issue.

To evaluate the distribution of the undeclared economy across sectors in Croatia in a manner that is comparable cross-nationally, the World Bank Enterprise Survey can be analysed. In 2007, and as Table 4 reveals, businesses in the food sector (i.e., agriculture and allied industries) were most likely to witness competition from unregistered or informal firms, followed by manufacturing and retailing. Examining whether the activities of informal or unregistered businesses were a major constraint on formal businesses, meanwhile, the finding is that this was most widely felt in the food sector, followed by other services and then the garment industry. Although retail businesses witnessed competition from undeclared enterprises, therefore, they did not perceive these undeclared competitors as a major constraint on their operations.

**Table 4.** Prevalence of the Undeclared Economy in Croatia: by Sector, Firm Size, Location, Exporting Status and Ownership

N= 633	% of firms competing against unregistered or informal firms	% of firms identifying practices of competitors in informal sector as a major constraint	% of firms formally registered when started operations in country	Number of years operated without formal registration
All	31.7	25.0	98.1	0
<b>By sector:</b>				
Food	54.5	42.2	99.8	0
Garments	25.1	24.3	100.0	0
Fabricated metal products	26.1	12.3	100.0	0
Other manufacturing	38.4	14.3	97.8	0
Retail	35.7	13.8	100.0	0
Other services	25.4	30.1	97.1	0
<b>By firm size:</b>				
Small (5-19)	32.5	31.3	99.4	0
Medium (20-99)	33.0	19.8	96.3	0
Large (100+)	20.0	11.8	98.9	0.1
<b>By Location:</b>				
Zagreb	53.0	33.1	97.9	0.1
North	41.2	6.5	100.0	0
Slavonia	40.8	40.6	100.0	0
Dalmacija	17.0	29.2	100.0	0
Istra I Hrvatsko Primorje	12.3	4.1	90.0	0.1
Like I Banovina	25.6	33.1	100.0	0
<b>By exporting status:</b>				
Direct exports 10%+ of sales	18.8	7.2	97.8	0
Non-exporter	34.3	28.1	98.1	0
<b>By ownership:</b>				
Domestic owned	32.6	25.9	98.1	0
Foreign owned	10.2	5.2	98.3	0

Source: World Bank Enterprise Survey 2007

### *Socio-economic, business and spatial variations*

Table 4 also reveals that large firms appear to be less affected by the existence of unregistered or informal businesses than smaller and medium sized businesses. While one-third of SMEs assert that they compete against informal or unregistered firms, only one-fifth of large firms assert that this is the case. Indeed, small businesses are far more likely than medium or large businesses to assert that informal or unregistered businesses are a major constraint. Related to this, it is non-exporting businesses and domestically-owned businesses who are more likely to witness competition from informal or unregistered businesses, and who are more likely to state that the undeclared economy constrains their business than exporting and foreign-owned businesses.

There are also significant spatial variations in the prevalence of the undeclared economy. While 53 per cent of businesses in Zagreb state that they compete against unregistered or informal businesses, 41.2 per cent in the North and 40.8 per cent in Slavonjia, this figure is just 25.6 per cent in Lika and Banovina, 17 per cent in Dalmacija and 12.3 per cent in Istra and Hrvatsko Primorje.

### *Types of undeclared work*

No known contemporary studies have sought to evaluate the prevalence of different types of undeclared work in Croatia. For example, it is not known what proportions of the undeclared economy is composed of 'envelope wages', waged informal employment, informal self-employment and paid favours. This will require investigation in future studies. One way to achieve this would be to replicate the 2007 Eurobarometer survey that covered the EU-27 in Croatia (European Commission, 2007b).

### *Barriers to formalisation*

The annual World Bank *Doing Business* surveys provide one of the few data sources on the barriers to formalisation in Croatia. These provide data (which is cross-nationally comparable, given that the survey is annually conducted in 183 countries) on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business when complying with relevant regulations. It measures and tracks changes in regulations affecting 10 areas in the life cycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Consequently, the survey allows an understanding of the broader business environment and assesses a particular set of issues that aid the explanation of undeclared activity, thereby giving policy makers an insight into potential areas of reform. Examining quantitative estimates of the ease of doing business in each of these ten areas and comparing the findings with 183 other countries, the finding is that, overall, Croatia was ranked 80<sup>th</sup> out of 183 in 2012 in terms of the ease of doing business (the

EU-27 overall as a composite would be ranked 38<sup>th</sup>) and 79<sup>th</sup> in 2011. The implication is that it is more difficult to open and run a small business in Croatia than in the EU-27 as a composite, although Croatia does perform better on some aspects than others relative to other countries.

Take, for example, starting a business. Evaluating how easy it is to start a business, Croatia is ranked 67<sup>th</sup> out of 183 countries, whilst the EU-27 as a composite would be ranked 66<sup>th</sup>. Starting a business in Croatia requires 6 procedures, takes 7 days, costs 8.6 per cent of income per capita and requires paid-in minimum capital of 13.8 per cent of income per capita. In part, this was because in 2011, Croatia has made it easier to start a business by allowing limited liability companies to file their registration application with the court registries electronically through the public notary (World Bank Doing Business Report Croatia 2012).

Examining the ease of paying taxes, meanwhile, Croatia stands at 32<sup>nd</sup> in the ranking of 183 economies, whilst the EU-27 as a composite is 71<sup>st</sup>, suggesting that paying taxes is easier in Croatia than the EU-27 as a whole. On average, firms make 17 tax payments a year, spend 196 hours a year filing, preparing and paying taxes and pay total taxes amounting to 11.5% of profit. Although the World Bank Doing Business Survey states that no reforms have occurred in the 2010 to 2012 period, this is not the case. In 2009, the standard VAT rate in Croatia was increased from 22% to 23% and a 'crisis tax' was introduced, levied on the net income of households and the abolition of all tax relief in the personal income system. This had a negative impact in citizens' minds on operating formally but by November 2010 the crisis tax was revoked. Furthermore the government changed the law on personal income tax, decreasing the tax brackets from four to three, reducing the lowest tax rate (from 15 per cent to 12 per cent). This was done in order to lower the tax burden for the employed.

Comparing Croatia with the EU-27, moreover, Grdovič Gnip and Tomič (2010) show that Croatia has a higher tax burden and a higher employment protection legislation index. They also point out that the greatest impact of the overall tax burden falls on Croatian workers in the lower income brackets. Therefore, although the government has started to take some action to reduce the tax burden in an attempt to make formalisation easier, this is perhaps an area for further improvement in Croatia, despite its apparently higher ranking than the EU-27 in the World Bank *Doing Business* surveys. The aforementioned surveys are, however, limited in scope with regard to measuring barriers to formalisation and therefore more studies should be carried out in Croatia that seek to investigate the nature of such barriers and obtain a broader perspective on policy challenges.

### **Organisation of the fight against undeclared work**

Analysing how the fight against undeclared work is organised in 31 European countries, Dekker *et al.* (2010) find that in eight countries (26%) there is either a single agency responsible for the fight against undeclared work or a central coordinating committee responsible for ensuring coordinated action by the multifarious departments who have a stake in tackling undeclared work. This is not true of Croatia, which does not have a single agency or coordinating committee responsible for ensuring joined-up action by the array of departments involved in tackling undeclared work. Furthermore, there is no lead department responsible for tackling undeclared work.

In Croatia, different governmental organisations are responsible for different aspects, including the Ministry of Finance, Ministry of Labour and Pension System, State Inspectorate, Tax Administration, Croatian Employment Service, Ministry of Tourism, Ministry of Agriculture and Customs Administration. These government departments largely have their own separate targets for undeclared work. From the interviews conducted it was found that the responsibilities of each department were not clearly defined over the long term but varied with projects.

Despite responsibility for tackling undeclared work being distributed across numerous departments and the targets pursued being largely department-based rather than shared, there are individual examples of where operational cooperation and coordination occurs, such as joint inspection visits. It was also found from our e-survey and interviews that data sharing across departments has been improved since the introduction of individual identification numbers for citizens. Furthermore, occasionally objectives and projects run across departments and shared plans and goals are adopted. This is exemplified with the shared goal of informing the public of the pitfalls of undeclared work and the benefits of formalising.

#### *The role of social partners*

It is important to emphasise the crucial role that social partners can play with regard to fighting undeclared work. They are often instrumental with preventative action such as information campaigns or initiatives to improve education and training. Furthermore, they have an important part to play in implementing social legislation as well as aiding the monitoring carried out by relevant authorities.

In Croatia the involvement of social partners occurs through the Economic and Social Council (ESC), established in 1994 to enable tripartite social dialogue between the government, employers and trade unions. To further improve this, the Office for Social Partnership was introduced in 2001. The ESC has had a different number of working bodies over the years. Currently, since the new Agreement on establishing the ESC was signed in February 2012, the ESC has 5 permanent working bodies – the Committees. The union associations that participate are the Union of Autonomous Trade Unions of Croatia (SSSH), the Independent Croatian Trade Unions (NHS), the Croatian

Trade Union Association (HUS), the Association of Workers' Trade Unions of Croatia (URSH) and the Association of Croatian Trade Unions (Matica). Although there are more than 500 registered trade unions in Croatia, these five major associations cover approximately 90 per cent of trade union membership in the country. The dominant employers' organisation is the Croatian Employers' Association (HUP), established in 1993.

Despite the establishment of this formal institutional arrangement in the form of the ESC and the Office of Social Partnership, there remains a relatively weak culture of social dialogue (Milicevic - Pezelj, A., 2011). As Šokčević (2009: 322) states, there exists "a deep division in values and interests between actors of collective bargaining". This is exemplified by the trade unions withdrawing from the ESC in 2010 for six months in protest at the weak dialogue. The reason was that there was no real dialogue. In their opinion, they were given a short time to study the materials sent out by state bodies and they were not satisfied with the voting procedures. However, new Rules of Procedure have been adopted to ensure restoration of the work of the ESC in the sense that there is no longer voting on each item on the agenda. When situations arise where consensus is not reached, social partners are able to state their disagreement which will then be published on the website of the Independent Service for Social Partnership.

### Policy approach and measures

As has been mentioned and displayed in table 5, despite the call by the European Commission to transform undeclared work into declared employment, most countries remain entrenched in a repressive approach that seeks to stamp out undeclared work. The view that undeclared work needs to be transferred into the declared realm is far from being widely accepted.

**Table 5.** Stakeholder Opinion of the Relative Importance Accorded to Different Types of Policy Measure in their Country

<b>% citing (% for 5 EU Candidates in brackets):</b>	<b>Most important</b>	<b>2nd Important</b>	<b>Least important</b>
Repression measures	57% (80%)	17% (20%)	16% (0%)
Preventative measures	19% (20%)	46% (60%)	23% (0%)
Curative measures	14% (0%)	19% (20%)	32% (60%)
Fostering commitment to declared work	10% (0%)	18% (0%)	29% (40%)

*Source: Dekker et al (2010)*

This is similarly the case in the 5 EU Candidate Countries (CC5). Indeed, in the CC5, the widespread view is that repression measures are accorded the greater importance in their country when tackling undeclared work. This is similarly the case in Croatia. Interviews with government officials and social partners strongly confirm that deterrence remains the dominant policy approach, although there is a recognition that a much wider range of measures are being introduced over time, even if they are not yet accorded the same importance as deterrence in the fight against undeclared work.

Is it the case, therefore, that measures are being pursued in Croatia similar to those of the EEA countries? As Table 6 displays, all 31 EEA countries were continuing to use repressive measures aimed at stamping out undeclared work, with all seeking to improve detection and 93% using penalties and/or sanctions. However, they are also pursuing measures to change the 'benefits' side of the equation by making it easier and more beneficial to operate in the declared economy, as called for by the European Commission; 90% adopt one or more preventative policy measure, although the range of measures used is relatively narrow beyond simplifying compliance, and 64% use one or more curative measures, although again the range used is narrow beyond the use of targeted direct tax incentives (e.g., income tax relief/reduction/subsidy schemes). Moreover, there has been recognition of the need to shift from purely the 'harder' policy approach which changes the cost/benefit ratio confronting suppliers and purchasers and towards a 'softer' approach that seeks to move away from compliance and towards engendering a commitment to tax morality; 69% of the 31 countries adopt some commitment measure.

Comparing the range of measures used in Croatia with the EEA, Table 6 reveals that a full range of deterrence measures are similarly used. Although enabling measures are also starting to be used, until now it has been largely preventative measures that have been adopted. Curative measures that seek to transform undeclared work into declared work are particularly scarce compared with the EEA whilst policies aimed at fostering commitment to declared work, although introduced, are quite recent measures and their impact is not yet known.

Over the past few years, one of the priorities of the Croatian government has been to update the laws and clarify the conditions that businesses and persons must meet to be fully legal. Steps have been taken to improve labour relations within a stronger regulatory framework (World Trade Organisation, 2010). It was found from our interviews and the validation workshop that the majority of updates to the laws, however, have adopted a deterrence focus, signalling the continuing prominence given to the repressive approach. For example, the powers of government inspectors have been expanded and inspections are increasing annually as well as intensified during seasons of increased working (e.g. summer in the region of Dalmacija). A coordination of various inspection bodies in this regard has been introduced to ensure greater efficiency.



**Table 6.** Policy measures used in Croatia and the EEA to tackle undeclared work

Policy measure	Croatia	% of 31 European nations using measure:
<b>REPRESSION</b>		
<i>Penalties:</i>		93
Administrative sanctions for purchasers/companies	✓	87
Administrative sanctions for suppliers/employees	✓	83
Penal sanctions for purchasers/companies	✓	74
Penal sanctions for suppliers/employees	✓	52
<i>Measures to improve detection:</i>		100
Data matching and sharing	✓	83
Workplace inspections	✓	100
Registration of workers prior to starting work or on first day of work	✓	74
Coordinating strategy across government	✓	57
Certification of business, certifying payments of social contribution and taxes	✓	65
Use of peer-to-peer surveillance (e.g. telephone hotlines)	✓	39
Coordination of operations across government		61
Coordination of data sharing across government		65
Mandatory ID in the workplace	✓	65
<b>ENABLING COMPLIANCE:</b>		
<i>Preventative measures:</i>		90
Reduce regulations	✓	48
Simplify compliance procedures	✓	87
Technological innovations (e.g. certified cash registers)	✓	43
New categories of work (e.g., for small or mini-jobs)	✓	35
Direct tax incentives (e.g., exemptions, deductions)	✓	61
Social security incentives	✓	35
Ease transition from unemployment into self-employment	✓	65
Ease transition from employment into self-employment	✓	44
Changing minimum wage upwards	✓	48
Changing minimum wage downwards		9
Training & support to business start-ups	✓	61
Micro-finance to business start-ups	✓	52
Advice on how to formalise	✓	61
Connecting pension schemes to formal labour	✓	61
Introducing supply chain responsibility		17
Restricting free movement of (foreign) workers	✓	43
<i>Curative measures:</i>		64
Stimulate <i>purchasers</i> to buy declared:		
Service vouchers	✓	26

Targeted direct tax incentives	✓	61
Targeted indirect taxes		17
Stimulate <i>suppliers</i> to formalise:		
Society-wide amnesties		9
Individual-level amnesties for voluntary disclosure		17
Formalisation advice to business	✓	30
Formalisation support services to businesses		30
Targeted VAT reductions		17
Free record-keeping software to businesses		13
Fact sheets on record-keeping		22
Free advice/training on record-keeping		22
Gradual formalisation schemes		13
<i>Fostering commitment to declared work:</i>		69
Campaigns to inform undeclared workers of risks and costs of working undeclared	✓	61
Campaigns to inform undeclared workers of benefits of formalising their work	✓	57
Campaigns to inform users of undeclared work of the risks and costs	✓	61
Campaigns to inform users of undeclared work of the benefits of declared work		52
Use of normative appeals to people to declare their activities		52
Measures to change perceived fairness of the system		26
Measures to improve procedural justice of the system (i.e., degree to which people believe government has treated them in a respectful, impartial and responsible manner)	✓	17
Measures to improve tax/social security/labour law knowledge	✓	65
Adoption of commitment rather than compliance approach (e.g., 'responsive regulation')		30
Campaigns to encourage a culture of commitment to declaration	✓	39

Nevertheless, the use of enabling measures has also increased in recent years. Akin to other EU-27 member states, incentives have been introduced to help the unemployed move into self-employment, although certain sectors are excluded - such as the hospitality industry. These provide 12 month grants ranging from €2,500 for crafts people to €3,250 for traders (Hrvatski Zavod za Zaposljavanje, 2012).

Akin to many other EEA countries, a voucher system has also been introduced. In Croatia, this has been in the agricultural sector. No evaluations have yet been conducted but if successful, the intention is to extend it to tourism, household services and other seasonal activities. This provides employees with a daily voucher for each recorded day of work and provides employers with incentives for declaring seasonal work. Under the previous law, social contributions had to be paid for the entire month even if the

weather allows the seasonal employee only five days of working. Workers must receive a minimum daily wage of 70.40 HRK (€9.40) and work no longer than a maximum of 12 hours per day. A seasonal worker can be employed for 90 days per calendar year. The penalties for violating the provisions of the act are up to 50,000HRK for legal persons and 10,000-30,000HRK for individuals (Hrvatski Zavod za Zaposljavanje, 2012). The law is simple and clear, and the process is limited in administration.

There has also been a simplification of business registration procedures akin to the 'one stop shop' principle used in many other EEA countries. The HITRO.HR business registration service enables citizens and entrepreneurs to have quicker and simpler access to information and services in one location. As part of this initiative, a multifunctional smart card (FINA e-card) has been introduced and is intended for electronic business, simplifying and speeding up business processes and eliminating unnecessary paperwork. The e-card therefore saves time and money for businesses willing to operate electronically.

Promoting a culture of commitment to tax morality has also been pursued, using campaigns in daily newspapers, on television, the internet and other media. The intention is to clarify certain procedures, new laws and policies and show that working on an undeclared basis is not profitable.

In sum, although Croatia gives prominence to deterrence measures, it is also paying greater attention to enabling policy measures. Until now, however, this has been mostly in the realm of preventative measures. The use of supply-side curative measures has been very limited, whilst the adoption of 'softer' commitment measures to improve citizens' tax morality has been recent. The lesson for Croatia, therefore, is that there needs to be greater attention paid to curative and commitment policy measures that seek to transform undeclared work into declared work.

### **Undeclared economies and work/welfare regimes**

Changes beyond the realm of direct policy measures are needed in order for undeclared work to be tackled. As is outlined below there is evidence that the broader work and welfare regimes also affect the size of the undeclared economy in a country.

It is evident that thus far two opposing perspectives have prevailed. A neo-liberal perspective would in this case argue that undeclared economies are a direct consequence of high taxes, over-regulation and state intervention in the free market therefore advocating for countries to engage in de-regulation, tax reductions and minimal state interference. Alternatively, if considered from the perspective of social democracy, it is under-regulation that propels the undeclared economy and the solution is therefore state intervention and higher levels of social protection (Vorley and Williams, 2012).

To evaluate these rival perspectives, five indicators can be analysed that compare the impacts on the size of the undeclared economy of the more interventionist 'welfare capitalist' approach and less interventionist 'neo-liberal' approach. These are the level of implicit tax rates on labour income (Eurostat, 2007, 2011), state expenditure on interventions in the labour market as a proportion of GDP (Eurostat, 2011), the level

of state social protection expenditure (excluding old age benefits) as a proportion of GDP (European Commission, 2011), the effectiveness of state redistribution via social transfers (European Commission, 2011) and the level of intra-national equality in the society, as measured by the gini-coefficient (European Commission, 2011). For further explanation and details of data-sets and methodology, see Williams (2012a,b) and Vorley and Williams (2012).

As Table 7 reveals, there is no statistically significant correlation between the implicit tax rates on labour (i.e., the average effective tax burden on labour income) and the size of undeclared economies. Using Spearman's rank correlation coefficient ( $r_s$ ) due to the non-parametric nature of the data, no statistically significant correlation is found between the size of the undeclared economy across the EU-27 and the implicit tax rates on labour ( $r_s = -0.266$ ). Indeed, merely 10.2 percent of the variance in the size of the underground economy is correlated with the variance in implicit tax rates ( $R^2 = 0.1019$ ). However, there is a statistically significant correlation between the size of undeclared economies and the level of state expenditure on labour market interventions, expenditure levels on social protection, the level of state redistribution via social transfers, and the degree to which societies are equal. In summary, the finding is that welfare regimes where there is greater labour market intervention, higher levels of social protection and redistribution via social transfers, and there is greater equality, tend to have smaller undeclared economies. This could have significant implications for Croatia. It tentatively suggests that undeclared economies will be reduced not only by pursuing targeted policy measures but also by modernising its work and welfare regime through higher levels of expenditure on state intervention in the labour market and social protection, coupled with redistribution via social transfers so as to construct more equal societies.

**Table 7.** Bivariate regressions of relationship between size of undeclared economy and work and welfare regimes

Country	Undeclared work as % of GDP	
	$r_s$	$R^2$
Implicit tax rate	-0.266	0.102
Lab Market expenditure	-0.599**	0.235
Social protection expenditure	-0.700**	0.467
State redistribution via social transfers	-0.642**	0.457
Inequalities (gini-coefficient)	0.448**	0.227

*Data:* Eurostat and European Commission publications, based on the analysis of the situation in the EU27

*Note:* \*\* Correlation is significant at the 0.01 level

## Conclusions

In this paper a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in the EU Candidate country of Croatia has been presented. The objectives encompassed within this have been to analyse: the scale and nature of undeclared work in Croatia, how the fight against the undeclared economy is organised and the policy approaches and measures being adopted.

Throughout the paper, a comparison of Croatia with the EU-27 is made but is done so bearing in mind the intricate nature of undeclared work and differences among countries. A call, therefore, is made for more in-depth research to be carried out within the context of Croatia, as taking into consideration that the undeclared economy is affected by the wider contextual environment creates a more holistic and intricate picture and therefore more appropriate policy recommendations.

The finding is that the undeclared economy in Croatia is equivalent to 30.4% of GDP and as such, is larger than in all EU-27 member states with the exception of Bulgaria. Nor is the undeclared economy evenly distributed in Croatia. It is most concentrated in agriculture and allied trades, followed by manufacturing and retailing. Large firms, and exporting and foreign-owned businesses, furthermore, are less affected by informal businesses and less likely to view them as a major constraint, than smaller and medium sized businesses, non-exporting and domestically-owned businesses. At present, nevertheless, it is not possible to compare who does undeclared work in Croatia, what types of work they do and for what reasons with other EU-27 member states. One way forward, therefore, might be the implementation of the 2007 Eurobarometer survey and/or the inclusion of the CC5 in any future second wave Eurobarometer survey, so as to enable a comparison of the nature of undeclared work in Croatia with the EU-27.

Turning to how the fight against undeclared work is organised in Croatia, there is no one single compliance unit/agency/organisation responsible for tackling undeclared work. Nor is there even a government department that takes lead responsibility. Instead, different governmental organisations take responsibility for different facets, including the Ministry of Finance, Ministry of Labour and Pension System, State Inspectorate, Tax Administration, Croatian Employment Service, Ministry of Tourism, Ministry of Agriculture and Customs Administration. On the whole, these departments do not have common or shared targets with regard to tackling undeclared work, and the pursuit of a joined-up approach is in its infancy so far as strategy is concerned, although there are limited examples of joining-up operations and data sharing on a cross-departmental basis. Furthermore, although formal institutional arrangements and a framework exist for the involvement of social partners, including the Economic and Social Council (ESC) and the Autonomous Service for Social Partnership, the culture of social dialogue remains relatively weak.

Finally, and similar to the EEA countries, Croatia has given prominence to the repressive approach towards undeclared work, seeking to stamp it out. Although enabling measures are starting to be used in Croatia, especially preventative measures, there is little use of curative measures, especially incentives to encourage those working undeclared to formalise, and measures to foster commitment to tax morality are fairly recent. The lesson, therefore, is that Croatia needs to pay greater attention to curative and commitment policy measures that seek to transform undeclared work into declared work. Besides such direct policy interventions, this report also provides evidence of a strong correlation between countries in which there is greater labour market intervention, social protection, redistribution and equality, and smaller undeclared economies. It is to be hoped, therefore, that the findings from this paper will help Croatia in its fight against undeclared work. If it does so, it will have fulfilled its objective.

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## Appendix 1 (E-survey)

We would like to start with a few questions about your background:

**1. Please state your country:**

**2. What is the name of your department/organisation?**

**3. What is the function of your department/organisation?**

- Labour inspectorate
- Revenue administration/tax
- Social security department
- Employer's organisation
- Employee's organisation
- Third sector organisation (e.g. NGO's)
- Local government
- Social intelligence/inspection
- Customs
- Immigration office
- Research organisation

Other (please specify)

### Characteristics of Existing National Policies

**4. What are the three most dominant policy 'themes' used in your country to tackle undeclared work?  
Please list 1st, 2nd and 3rd in order**

Deterrence: Penalties

Deterrence:  
Measures to improve  
detection

Enabling:  
Preventative  
measures

Enabling: Curative  
measures

Enabling: Fostering  
commitment to  
declared work

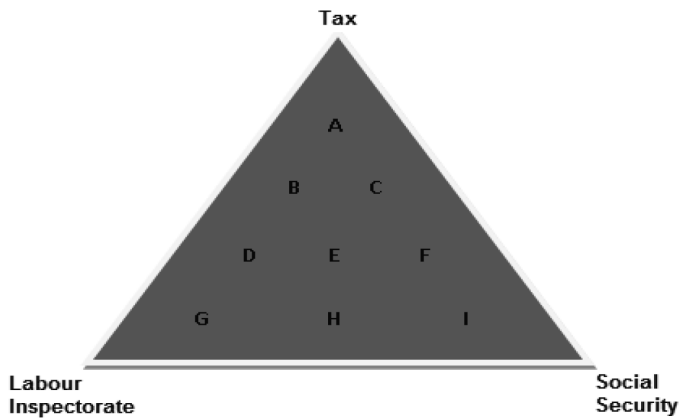


**5. Can you please list some examples of policies (good practice)?**

**Try to identify at least 3 policy measures, stating:**

- Objectives
- Results
- If transferable
- Information (evaluations, contacts)
- Bibliography

1.	
2.	
3.	
4.	
5.	



**6. Please choose which point on the image best signifies where the responsibility lies for tackling undeclared work in your country:**

- A
- B
- C
- D
- E
- F
- G
- H
- I

**7. Please choose which of the following statements best denotes the trajectory of change in terms of where the responsibility lies for tackling UDW:**

- Fairly constant
- Shifting towards tax
- Shifting towards labour inspectorate
- Shifting towards social security
- Shift towards tax and social security
- Shifting towards tax and labour inspectorate
- Shifting towards social security and labour inspectorate

**8. How did policy towards UDW develop in the last 10 years?**

- Any shift of emphasis in policy?
- Involvement of social partners?
- Influence of EU?

### Policy Measures

These questions relate to the national polices with regard to tackling undeclared work in your country. Although no official definition of undeclared work (UDW) exists, there is a broad consensus on what is included and excluded. In this project, this consensus is reflected by using the following definition of undeclared work as a starting point:

'any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account the differences in the regulatory system of Member States' (European Commission, 2007: 2)

**9. Please tick the policy measures that are used in your country**

- Use of penalties and fines for purchasers/companies
- Use of penalties and fines for suppliers/employees
- Measures to improve detection
- Data matching and sharing
- Workplace inspections
- Registration of workers prior to starting work or on first day/week of work
- Coordinating strategy across government
- Coordination of operations across government
- Coordination of data sharing across government
- Use of peer-to-peer surveillance (e.g. telephone hotlines)
- Certification of business, certifying payments of social contribution and taxes
- Mandatory ID on the workplace
- Reduce the regulations

- Simplify procedures for complying to existing regulations (e.g., easier registration procedures; simplify forms; reduce duplication)
- Technological innovations to prevent undeclared transactions (e.g. certified cash registers)
- Introducing new categories of work e.g., simplify procedures for small or mini-jobs
- Use of direct tax incentives (e.g., exemptions, tax deductions)
- Use of social security incentives
- Initiatives to ease transition from unemployment into self-employment
- Initiatives to ease transition from employment into self-employment
- Changing minimum wage upwards
- Changing minimum wage downwards
- Training & support to business start-ups
- Micro-finance to business start-ups
- Advice on how to formalise
- Connecting pension schemes to formal labour
- Introducing supply chain responsibility
- Restriction on free movement of (foreign) workers
- Measures to encourage purchasers to buy formal goods and services:
  - service vouchers
  - targeted direct tax incentives (e.g., income tax relief/reduction/subsidy schemes)
  - targeted indirect taxes (e.g., VAT reductions)
- Measures to stimulate suppliers to formalise:
  - society-wide amnesties
  - individual-level amnesties for voluntarily disclosing undeclared activity
  - 'formalisation' advice to business
  - 'formalisation' support services to businesses
- Targeted VAT reductions
- Provide free record-keeping software to businesses
- provide fact sheets on record-keeping requirements
- provide free advice/training on record-keeping
- Gradual formalisation schemes (e.g. wage alignments in Italy)
- Campaigns to inform undeclared workers of the risks and costs of working undeclared
- Campaigns to inform undeclared workers of the benefits of formalising their work
- Campaigns to inform users of undeclared work of the risks and costs
- Campaigns to inform users of undeclared work of the benefits of declared work
- Use of normative appeals to people to declare their activities
- Measures to change perceived fairness of the system

- Measures to improve procedural justice of the system (i.e., degree to which people believe government has treated them in a respectful, impartial and responsible manner)
- Measures to improve tax/social security/labour inspectorate knowledge
- Adoption of commitment rather than compliance approach (e.g., 'responsive regulation')
- Campaigns to encourage a culture of commitment to declaration

**10. Are any of the above policy measures in your opinion particularly effective in tackling undeclared work?**

### Cross Border Cooperation

The next questions relate to characteristics of existing cross-border co-operations on undeclared work

**16. To your knowledge, does your country participate in any cross-border co-operation in relation to tackling undeclared work?**

- Yes
- No

**17. Please state with which countries:**

**18. Is this cooperation in the realm of:**

- Strategy
- Operations
- Data-matching
- Don't know

Other (please specify)

### Nature and Extent

**19. Do you know of any estimates of the extent of UDW in your country?**

Percentage of GDP?

Percentage of the labour force?

Years of measurement?

Authors?

Development in extent (growing, getting smaller)? (last 10 years)

**20. What is the nature of UDW in your country?**

Percentage of envelope wages

Percentage of waged informal employment

Percentage of informal self-employment

Percentage of paid favours between friends, neighbours and acquaintances

**21. In what sectors do you think undeclared work is concentrated in your country?**

**22. Are there differences in participation between regions? If so, please state the differences and name the regions**

**23. What do you think the distribution of UDW is between rural and urban areas? (please state in percentages)**

Rural

Urban

**24. Do you think there are differences in demographic factors of participants? (e.g. more women than men)**

Sex

Education

Occupation

Other (please state)

**Concluding**

**25. In November we will organize a workshop with experts from the five countries in the study. The main goal of this international workshop will be to validate our findings. Would you be interested to participate in the meeting?**

Yes

No

**26. Could you please provide us with your details so that we can contact you for future reference**

Name

Professional Status

Email

Phone Number

Skype Name

**27. To conclude, could you please provide us with contact details of the persons or departments/agencies you think should also be interviewed. For example, of the organisations that you mentioned earlier within your national institutional framework, or involved in cross-border co-operation.**

Name

Email

Phone Number