



TACKLING UNDECLARED WORK IN SOUTHEAST EUROPE: KNOWLEDGE-INFORMED POLICY RESPONSES

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KEY POINTS

- Undeclared work is **socially accepted and widely practiced** in Bulgaria, Croatia, and the FYR of Macedonia.
- More than 1 in 5 adults in these countries acknowledge that they have bought goods and services on the undeclared economy in the prior year. More than 1 in 12 report that they have undertaken undeclared work, and more than 1 in 10 declared employees report that they receive from their employer in addition to their declared salary an additional undeclared 'envelope' wage.
- But **undeclared work differs across and within the three countries**. For every one working undeclared due to their exclusion from the formal economy, there are three that have chosen to exit the formal economy, and this varies across countries.
- Policy makers need to prioritise policy measures to **improve vertical (in institutions) and horizontal (among people) trust**, complementing measures to improve detection and deterrence.

¹ The current policy brief is a synthesis report of the policy relevant findings of the research and data on undeclared work produced under the GREY Project supported through the European Commission's Framework 7 Industry-Academia Partnerships Programme (IAPP) grant no. 611259 entitled 'Out of the shadows: developing capacities and capabilities for tackling undeclared work in Bulgaria, Croatia and FYR Macedonia'.

Participation in undeclared work (UDW) is a widespread and accepted practice in the economic and social life of Southeast Europe (SEE). The region's prolonged transition from central planning to market economy, entangled by ethnic wars and autocratic tendencies, and further complicated by the great recession, the migration crisis and resurgent geopolitical rivalries in recent years, have all contributed to considerable asymmetries between formal and informal institutions, low trust in society and towards the authorities, and systemic corruption and state capture². This has resulted in **some of the highest and most sustained levels of undeclared work in Europe**, with some estimates putting more than one-third of some SEE countries' GDP in the undeclared economy³ and one in four citizens engaged in some form of undeclared work⁴. As some of the countries from SEE have joined the EU while others have embarked on a path to accession, designing policies to tackle the problems of undeclared work has become priority for most governments in the region. As they do not have the needed expertise and policy processes in place to properly understand the different characteristics and forms of these complex phenomena, most administrations have resorted to increasing

² SELDI (2016), *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*, The Southeast European Leadership for Development and Integrity, Sofia, 2016. Available at: <http://seldi.net/publications/publications/shadow-power-assessment-of-corruption-and-hidden-economy-in-southeast-europe/>

³ Schneider, F. (2015), *Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments*, Johannes Kepler University, January 2015, Available at: <http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf>

⁴ SELDI (2016), *Hidden Economy in Southeastern Europe: Building Regional Momentum to Mitigate Its Negative Effects*, Policy Brief, December 2016, Southeast European Leadership for Development and Integrity and the Centre for Regional Enterprise and Economic Development at the Sheffield University Management School, 2016.

sanctions and surveillance, whose effectiveness has decreased with time. The current policy brief provides an overview of the findings, lessons learnt, and recommendations for tackling undeclared work from four years of data gathering and research in three SEE countries, namely Bulgaria and Croatia (EU Members from 2007 and 2013 respectively) and FYR of Macedonia (EU Candidate).

Macroeconomic Overview

Understanding a country's macroeconomic development and constraints provides an important background to the discussion of the forms and characteristics of undeclared work, and the available policy options for tackling the phenomena.

All three countries have overcome the great recession and **have returned to a growth level, which outpaces the EU average, yet remains fairly subdued given the countries' relative economic backwardness.** In 2016 the three countries' GDP per capita at purchasing power parity as a % of EU-28 average were: 48% for Bulgaria, 59% for Croatia, and 38% for FYR of Macedonia. This is a general indication of the fairly large differences in the capabilities and capacities in the three countries to design and implement relevant, complex policies for tackling the undeclared economy.

This has been further exacerbated by **continuing structural difficulties in the labour markets** of the three economies, with FYR of Macedonia being in the worst position by far. This indicates an environment fertile for undeclared work and its social acceptability. While Croatia and Bulgaria have seen their populations shrink in the past decade, the FYR of Macedonia has lived through a slight increase. Employment rates in all three countries have increased but have remained below the EU average, with this rate in FYR of

Macedonia still below 50% in 2016. Unemployment in Bulgaria has fallen back below the EU average in 2016, including for the youth, while it remained well above this benchmark for Croatia and in particular the FYR of Macedonia⁵. Long-term unemployment in particular, remains stubbornly high and above the EU average for all three countries.

Governments in all three countries have very little room for manoeuvre on public spending and public debt. This indicates the **need for highly innovative and budget efficient measures for tackling the undeclared economy**. But it is also an indication of the intrinsic interest of governments from the region to bring in more business and employment to the formal economy. All three governments have run deficits since the great recession started in 2008, with them being particularly pronounced in Croatia and FYR of Macedonia, which resulted in an increase of public debt. Bulgarian public debt also doubled in the past five years, but at below 30% of GDP in 2016, still remains well below the EU average. Similarly, public debt in FYR of Macedonia was below 40% in 2016 but is quickly rising⁶.

Since their membership of the EU, **Bulgaria and Croatia have enjoyed considerable financial and technical aid from the European Union** and partner countries, which has resulted in considerable improvement in their overall policy environment. Croatia, for example, has only returned to growth and fiscal stability after 2013 when it became EU member. Notably, since 2016 both countries can also benefit from their participation in the European Platform Tackling Undeclared Work⁷. Yet, both countries have been continuously recommended by the Council

⁵ Source: Eurostat.

⁶ Source: Eurostat and the Macedonian National Bank.

⁷ For more information, see:

<http://ec.europa.eu/social/main.jsp?catId=1299&langId=en>

and the European Commission to **remove burdens on business, tackle social exclusion and adopt adequate measures for addressing undeclared work**⁸.

FYR of Macedonia though continues to be stuck in no-mans-land, as its long-standing name dispute with neighbouring Greece has precluded the country from starting negotiations with the EU, although it had a positive opinion for doing so from the European Commission already back in 2005. This has resulted in slow institutional reforms, in particular regarding rule of law and modernization, which has culminated in the protracted political crisis of 2015 – 2017. In its latest report on FYR of Macedonia the European Commission notes that the sizable undeclared economy in the country continues to hamper business development⁹.

Definitions

Undeclared work is defined by the European Commission as ‘any paid 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 among Member States’. This definition implies that any form of criminal employment, such as drug dealing would not be considered undeclared work as it is illegal. By extension, if a good or service such as drugs is illegal, it is part of the criminal, and not part of the informal economy.

An **envelope wage** is a second wage or supplement paid to a formal employee by a formal employer, separately from the officially declared wage without the required tax and social contributions.

⁸ See the 2017 European Semester Country Specific Recommendations/Commission Recommendations for Bulgaria and Croatia, available at:

https://ec.europa.eu/info/publications/2017-european-semester-country-specific-recommendations-commission-recommendations_en

⁹ The former Yugoslav Republic of Macedonia 2016 Report, SWD (2016) 362 final, Brussels, 9.11.2016

Undeclared Work in SEE

More than one in five adults in Bulgaria, Croatia and FYR of Macedonia have knowingly purchased from the undeclared economy¹⁰. Nearly 1 in 13 of the adults have admitted to working in the undeclared economy in the prior year¹¹, while on average 1 in 9 of the formally employed received envelope wages¹². A third of the population has reported using personal relations to circumvent formal rules, while more than two thirds of the adults consider such practices as an important coping mechanism¹³. This points out to a **serious deficiency of trust**, both among citizens and towards the authorities in the region, which provides an excellent breeding ground for the undeclared economy.

¹⁰ Williams, C.C., and Bezeredi, S. 2017 *Explaining Consumers' Motives for Purchasing from the Informal Economy: Some Lessons from a Study of Bulgaria, Croatia and FYR Macedonia*, GREY Paper, Sheffield University Management School, University of Sheffield, 2017.

¹¹ Williams, C. and Bezeredi, S., *Explaining and Tackling the Informal Economy: a Dual Informal Labour Market Approach*, GREY Paper, Sheffield University Management School, University of Sheffield, 2017.

¹² Williams, C. and Yang, C., 2017. *Tackling Falsely-Declared Salaries in Bulgaria: Evidence from a 2015 Survey*, GREY Paper, Sheffield University Management School, University of Sheffield, Submitted to *Economic Alternatives*, April 2017; Franic, J. and Williams, C., (2017). *Illegitimate Economic Practices in Croatia*, GREY Working Paper No. 9, Sheffield University Management School, University of Sheffield, Institute of Public Finance, Zagreb, 2017; Williams, C. and Bezeredi, S., (2017). *Illegitimate Economic Practices in FYR Macedonia*, GREY Working Paper No. 10, Sheffield University Management School, University of Sheffield, 2017.

¹³ Williams, C. and Yang, C., 2017. *Evaluating the Use of Personal Networks to Circumvent Formal Processes: a Case Study of 'Vruzki' in Bulgaria*, GREY Paper, Sheffield University Management School, University of Sheffield, Submitted to *South East European Journal of Economics and Business*, April 2017; Franic, J. and Williams, C., (2017). *Evaluating the Use of Personal Connections to Circumvent Formal Processes: a Study of 'Veze' in Croatia*, Sheffield University Management School, University of Sheffield; Williams, C.C. and Bezeredi, S., (2017). *Evaluating the Use of Personal Connections to Bypass Formal Procedures: A Study of 'Vrski' In Republic Of Macedonia*, Sheffield University Management School, University of Sheffield

Governments in Bulgaria, Croatia, and FYR of Macedonia need to embark on a comprehensive agenda of understanding and tackling the undeclared economy. This policy brief contributes to the better understanding of the complexity of the issues governments in the region face and provides policy recommendations, which emphasise curative, preventative and commitment measures in addition to the widely preferred repressive measures.

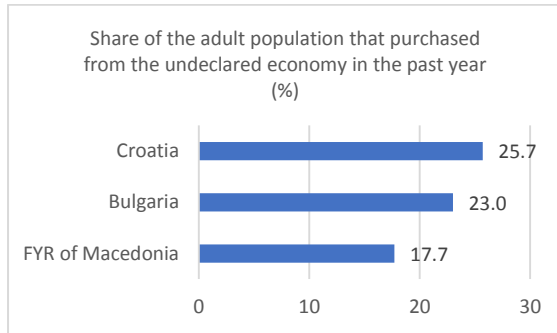
In order to fully grasp the undeclared economy, the division between its demand and supply side should be understood as well as the different motivations and deterring factors for participation. The demand side is the engagement in the purchase of undeclared goods and services. The supply side consists of the people who are working in the undeclared economy. There is a high correspondence between **the main sectors** identified as most prone to the phenomenon on both sides: **car repairs, house repairs (construction), domestic food (agriculture), home services (babysitting)**. This indicates that for the most part undeclared work is related to the normal social environment in a country and is widely accepted, just like in the rest of Europe.

Demand side

Buying in the undeclared economy is widespread in SEE, and in particular in Bulgaria, Croatia, and FYR of Macedonia (Figure 1). The GREY project has filled in a gap in existing research on the undeclared economy in SEE by taking a closer look at the demand side, the characteristics of such consumers and their motives for doing so. The propensity to purchase goods and services in the undeclared economy is revealed to be significantly greater among men, the divorced/separated, and those living in larger urban areas, who perceive the **penalties and**

risks of detection as lower, and who to a greater degree lack **vertical trust** (i.e., their norms, values and beliefs differ to the laws and regulations) and **horizontal trust** (i.e., they perceive a higher proportion of the population to engage in the informal economy).¹⁴

Figure 1. Propensity to buy in the undeclared economy



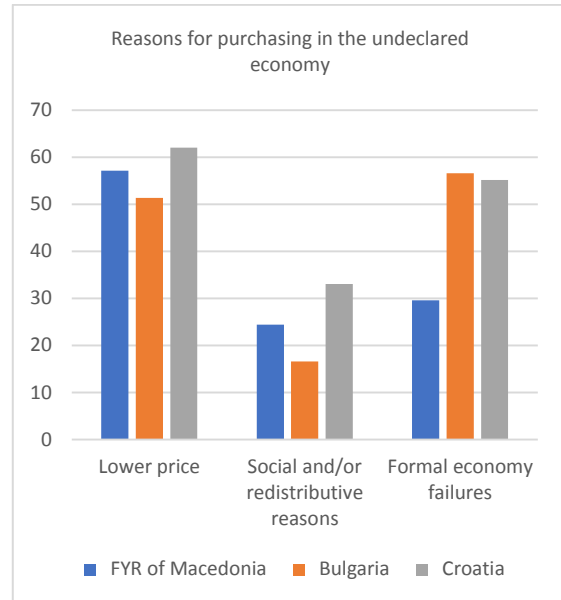
Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

There are three broadly accepted and competing **explanations for consumers purchasing goods and services in the undeclared economy**: *firstly*, as rational economic actors seeking a lower price, *secondly*, social actors engaging in such purchases for social and/redistributive rationales, and *thirdly*, as doing so due to the failings of the formal economy. No one explanation for purchasing goods and services from the undeclared economy in SEE suffices. (Figure 2) Although shares differ across the three countries, altogether the conventional explanation that consumers purchase in the undeclared sector to pay a lower price is a motive in just 57.1% of cases. Social and/or redistributive rationales prevail in 25.1% of cases, and formal economy failings in just

¹⁴ Williams, C. and Bezeredi, S., *Explaining Consumers' Motives for Purchasing from the Informal Economy: Some Lessons from a Study of Bulgaria, Croatia and FYR Macedonia*, GREY Paper, Sheffield University Management School, University of Sheffield.

under a half (48.9%). If consumers' motives are to be fully explained, all these rationales need to be employed.

Figure 2. Rationale for buying undeclared

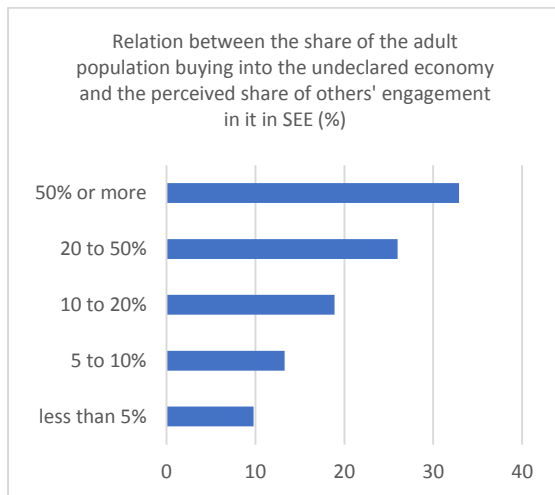


Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Different types of Southeast European citizen are more likely to cite particular motives. Consumers more likely to cite **the motive of a lower price** include the unemployed and those lacking horizontal and vertical trust. These consumers are also more likely to cite social or redistributive rationales. Consumers displaying a propensity to cite **formal economy failings**, meanwhile, include older age groups, the employed and self-employed, those who are more comfortable financially, but who again lack horizontal and vertical trust, and perceive the expected sanctions as lower. This suggests that **relatively more affluent groups are using the undeclared economy to overcome supply blockages** in the formal economy and for **expediency and quality rationales**, whilst **for less affluent social groups, it is more about seeking lower cost goods and services**, and to help out others.

While characteristics differ from country to country and from one social group to another, probably the strongest explanatory variable altogether of why citizens buy into the informal economy is **the lack of horizontal trust**, the belief or the perception that others are doing it too and in great numbers. (Figure 3).

Figure 3. If they are doing it, I can do it too



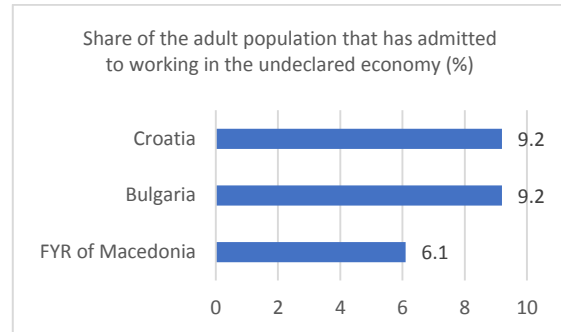
Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Supply side

Self-reported working in the undeclared economy is more prevalent in Bulgaria and Croatia than in FYR of Macedonia. (Figure 4) And it is more common in all three countries than on average in the EU. It should be noted though that these numbers most probably represent a lower bound estimate of such participation as people are naturally inclined not to disclose their law transgressions to the full extent in surveys. They might also reflect different levels of freedom of speech and expression in each country. More than 4/5ths of those working in the undeclared economy do so on a **self-employed** basis. Only 17% in Bulgaria and FYR of Macedonia and 13% in

Croatia have declared they have done so as part of **waged employment for business**¹⁵.

Figure 4. Working in the undeclared economy



Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

There are two competing theoretical views as to **why workers get involved in the undeclared economy**: (i) as a result of **exclusion**, either because companies seek to cut costs in the deregulated global economy or because of poor skill sets, which do not allow workers to reach the higher standards of formal economy employment positions; and (ii) as a result of **exit**, as workers choose to escape the burdens of the formal economy imposed by the state or as they see formal institutions as failing to live up to standards and provide fair treatment.

GREY research has demonstrated that rather than being competing, these two motivations co-exist in different groups of the population in all of the three countries and workers on

¹⁵ Williams, C. and Bezeredi, S., (2017). *Evaluating Policy Approaches towards Undeclared Work: Some Lessons from FYR Macedonia*, GREY Paper, Sheffield University Management School, University of Sheffield; Williams, C. and Yang, C., (2017). *Evaluating Competing Perspectives towards Undeclared Work: Some Lessons from Bulgaria*, GREY Paper, Sheffield University Management School, University of Sheffield; Franic, J. and Williams, C., (2017). *Evaluating Competing Perspectives towards the Informal Economy: the Rational Economic Actor versus Social Actor Approaches*, GREY Paper, Sheffield University Management School, University of Sheffield.

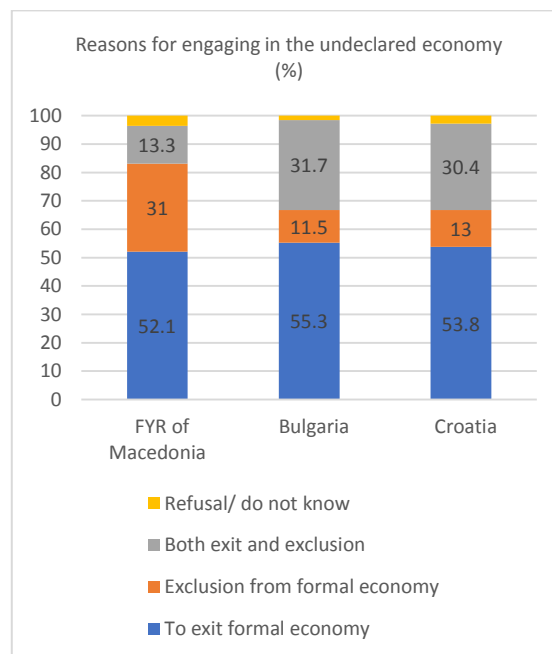
the supply side of informal economy can be generally divided into three types:¹⁶

- **“Lower-tier” exclusion-driven workers:** this group is left out of the formal economy and is generally less affluent. More common members are women, older people, the unemployed, students and inactive, and self-employed, and those living in rural areas or smaller towns.
- **“Upper-tier” exit-driven workers:** this group does work in the undeclared economy voluntarily, mostly driven by the lack of vertical (towards the institutions) and horizontal (among citizens) trust. More common members are men, younger people, the employed and retired, those who are not struggling financially, and living in larger towns.
- **Mixed exclusion and exit driven workers** who form the continuum between the above two groups and cite a mixture of reasons for engaging in the undeclared economy.

Thus, for every exclusion-driven worker in Bulgaria, Croatia, and FYR of Macedonia correspond 4.8, 4.1, and 1.7 exit-driven workers exist respectively (Figure 5). The existence of a still large portion of mixed motivation driven workers in the undeclared economy reveals that a spectrum of rationales should be conceptualised ranging from those driven by purely exit rationales at one end to those driven by purely exclusion rationales at the other end with corresponding policy measures addressing each group.

¹⁶ Williams, C. and Bezeredi, S., (2017) *Explaining and Tackling the Informal Economy: a Dual Informal Labour Market Approach*, GREY Paper, Sheffield University Management School, University of Sheffield.

Figure 5. Exit vs. exclusion driven participation in the undeclared economy



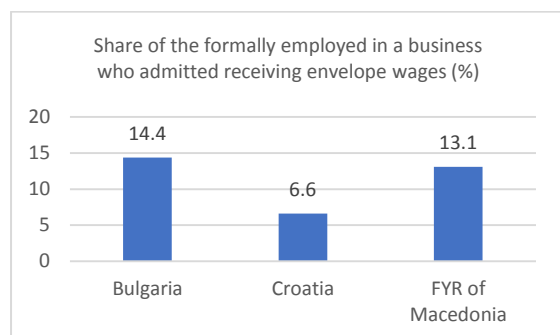
Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Envelope wages

One particular form of supply of undeclared work persistent in Southeast Europe has been the practice of envelope wages, or the under-declaration of work. In practice, formal employers pay their formal employees two wages, namely an official declared wage plus an additional undeclared (envelope) wage, which reduces the tax and social contributions that are paid to the authorities. It has come increasingly under the spotlight of policy-making as it is a direct drag on public finances for what otherwise is formal employment. GREY data revealed that **the practice is twice as prevalent in Bulgaria and in the FYR of Macedonia than in Croatia** (Figure 6). Moreover, in both Bulgaria and Macedonia, the share of additional income which remains undeclared is close or above one-third of net reported income, which adds up to a sizable fiscal policy challenge. In all three countries though such practices have been found most

commonly in agriculture, construction, and the hospitality sector¹⁷.

Figure 6. Envelope wages



Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents.

Contrary to popular belief, it is not always the employer who proposes to or coerces the employees to under-report the wage though this is the predominant modus operandi. In nearly one-third of the cases in all three countries, the employee has had an active role. In fact, the employees have expressed a higher degree of happiness with the arrangement of under-declaration when they have actively participated in the agreement. Interestingly, this has usually led to additional conditions being attached outside the formal working contract: most commonly additional working hours, but also additional tasks, taking less statutory leave, etc. Thus, when tackling envelope wages, **policymakers should consider the incentives of workers as well.**

In terms of population groups involved in under-declaring their wages, it has been more prevalent among men, the youngest and the

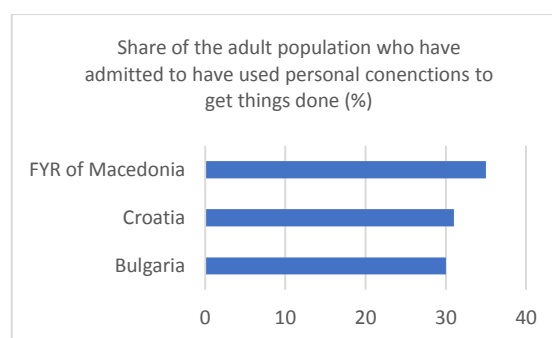
¹⁷ Williams, C. and Yang, J. (2017), *Tackling Falsely-Declared Salaries in Bulgaria: Evidence from a 2015 Survey*, GREY Paper. Sheffield University Management School, University of Sheffield; Williams, C. and Bezeredi, S., *Tackling the Illegal Practice of Under-Reporting Employees' Wages*, GREY Paper, Sheffield University Management School, University of Sheffield; Franic, J. and Williams, C., (2017). *Illegitimate Economic Practices in Croatia*, GREY Working Paper No 9, Sheffield University Management School, University of Sheffield, Institute of Public Finance, Zagreb.

oldest (close to or retired), the single or divorced, and the ones living in larger families. The authorities could take this into consideration when designing their risk targeting strategies.

Pulling Strings

While not considered part of the undeclared economy, one practice that has been related to informality and has been particularly widespread in former communist states and has made its in-roads into their present-day societies is the “pulling of strings” or **the use of informal connections to circumvent formal rules for personal benefit.** While this informal social practice is present everywhere around the globe, and is viewed as normal, it has been widely seen as harmful in Central and Eastern Europe, as it has usually been employed to circumvent the formally established rules of the game, reducing their efficiency. Interestingly, in both Croatia and FYR of Macedonia, **more than half of the population view such practices as harmful, yet more than a third have used them, and more than four-fifths acknowledge they are “important” or “very important” to get things done.**

Figure 7. Pulling strings



Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Unsurprisingly, the groups of the population that are **more likely to “pull strings” are the better off financially, and those that are**

more prone to participating in the undeclared economy. While in Croatia and Bulgaria the practice is more prevalent in urban areas, in FYR of Macedonia it is also present in rural areas. Pulling strings is usually employed to get things done in important and non-frequent events in life, such as getting faster and better **medical treatment**, **finding a job**, securing better **education**, dealing with **law enforcement** (courts, police), etc.

Policy Approaches and Options

Tackling the complex phenomenon of the undeclared economy requires a proper framework based on a detailed understanding of the potential policy choices and policy measures. In terms of **policy choices** governments face four broad options¹⁸:

- Do nothing;
- Deregulate the declared economy so that what has been viewed as informal be brought into the formal/declared realm;
- Eradicate the undeclared economy through repression;
- Move undeclared into the declared economy through changing motivations.

Clearly, governments in SEE would find it difficult not to tackle these phenomena, given their urgency, which leaves out the first policy option. The second has been the predominant choice in transition countries but its effectiveness has worn out with time and this has also resulted in some policy fatigue. The third choice has been the natural default option by governments across the world but it has backfired at times and does not reflect the more social character of most of the forms of undeclared work. This leaves the fourth option, which is the least developed and most likely to produce effective results.

¹⁸ Williams, C. (2014). *Policy Approaches Towards Undeclared Work*, GREY Working Paper No. 4, Sheffield University Management School, University of Sheffield.

Comprehensive government strategies to tackle the undeclared economy would require the combination of all these choices either targeting different characteristics of the phenomena or sequencing them throughout time.

Available specific policy responses, i.e. **policy measures**, to tackle the undeclared economy can be divided in several **types**. The vast majority of policy measures used in SEE in the past are based on the **rational actor approach**, and have been orientated towards **detering/repressing the undeclared economy**. Such policies assume that people will engage in the undeclared economy as long as the benefits from doing so exceed the costs. If the costs of engaging in such illegal practices are increased, they will stop participating in them. Examples of such policies include increasing the sanctions of engaging in undeclared work and improving the surveillance system over the undeclared economy¹⁹.

The other three types of policy measures used to tackle the informal economy and work include:

- **Preventative policies** seeking to reduce non-compliance before it has occurred. Such measures try to limit the potential for illegitimate behavior.
- **Curative policies** striving to support firms and people, who work on an undeclared basis, to formalize their activities.
- **Commitment policies** seeking to increase citizens' tax morale and foster their voluntary compliance.

The traditional rational actor approach has gradually given way to the more modern and European-based **social actor approach**. It suggests that people are more likely to engage in undeclared work because of the 'normalisation' of undeclared work and the

¹⁹ Ibid.

non-alignment between formal and informal institutions. The policy measures, which are based on this approach, aim at increasing citizens' trust in formal institutions and challenging the normalization of undeclared work. In particular, these are mostly commitment policies such as education campaigns about the value of taxation and active anti-corruption campaigns.

The social actor approach has two pillars in building trust in society and the economy:

- **Horizontal trust** is the idea that people are more likely to engage in the undeclared economy when they perceive that a larger share of the population does so.
- **Vertical trust** is the idea that people are more likely to participate in undeclared work, when they have low tax morale, i.e. perceive that there is a big gap between formal and informal institutions.²⁰ The lower is their perception about the transparency and accountability of institutions, the lower is their tax morale and respectively their vulnerability to engaging into undeclared work.

Policy Recommendations

An important consideration for governments from the region embarking on developing holistic²¹ strategies for tackling the undeclared economy is that they need to **engage adequately all stakeholders in the**

²⁰ Tax morale is the intrinsic motivation of citizens to pay taxes. It can also be seen as the extent to which formal rules and institutions correspond to the socially accepted norms. It is measured by the Asymmetry Index. For a detailed description, see Franic, Josip and Colin C Williams, *Illegitimate Practices in Croatia*, Sheffield University Management School and Institute of Public Finance, Zagreb, Working Paper No. 9 GREY Project.

²¹ Williams, C.C. (2017) *Developing a Holistic Approach for Tackling Undeclared Work: a learning resource*, European Commission, Brussels.

preparation, implementation, and evaluation of policy measures. One of the more underrated probable causes of policy failure has been the apparent lack of knowledge and understanding of the needs, attitudes and abilities of policy beneficiaries and targets²².

Deciding on the **proper mix of policy measures** as well as on the **transferability of best practices within Europe**²³, requires further understanding of the guiding motivations and potential responses to policy measures by the ones engaged in the undeclared economy in Bulgaria, Croatia, and the FYR of Macedonia on the demand- and supply-side. GREY data research has provided policy insights in each of the countries and for the region altogether. Findings on both sides have reinforced each other.

Policy Implications: Background Issues

GREY research has uncovered a number of contextualising factors²⁴ in the three countries which are likely to present obstacles to successful implementation of prospective measures. What is common for all three countries is that in order for more targeted measures towards the undeclared economy to be successful, there is a need to **strengthen the broader institutional foundation**, by increasing government efficiency, confronting corruption, strengthening the rule of law and increasing the legitimacy and transparency of public institutions overall. At the same time, **improving the quality of public goods and**

²² Kojouharov, A. and Williams, C., (2015). *Evaluating Policy Measures to Tackle Undeclared Work: the Role of Stakeholder Collaboration in Building Trust and Improving Policy-Making*, GREY Working Paper No. 8, Sheffield University Management School, University of Sheffield.

²³ Williams, C., Dzhokova, R., Baric, M., Franic, J. and Mishkov, L., (2014). *Assessing the Cross-National Transferability of Policy Measures for Tackling Undeclared Work*, GREY Working Paper No 5, Sheffield University Management School, University of Sheffield

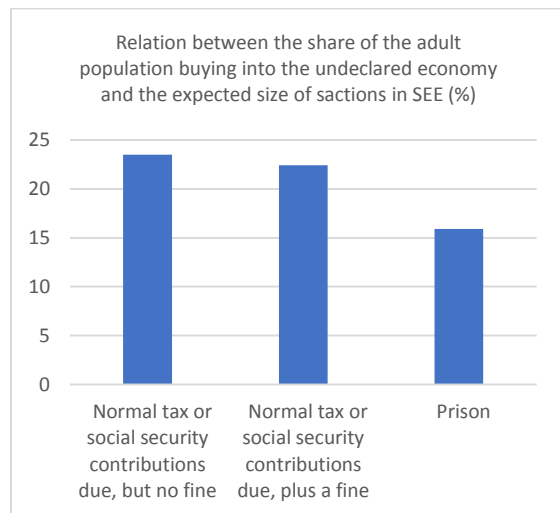
²⁴ Ibid.

services, as well as broader economic developments, should be pursued in order to **restore social solidarity and reduce inequality**. Low trust in public institutions, and hence low tax morale and a weak social contract are identified as key variables at the core of **the gap between citizens and the state** and as driving the persistence of undeclared work. Therefore, in all three countries more attention should be placed on measures which seek to reduce the disparity between formal institutions (laws, regulations and codes) and informal institutions (values, norms and beliefs of citizens).

Policy Implications: Demand-Side

The important findings of the GREY studies²⁵ is that **deterrence measures need to be supplemented by policy measures that deal with the lack of vertical and horizontal trust**, and failings of the formal economy.

Figure 7. Repressive measures can only produce limited effect

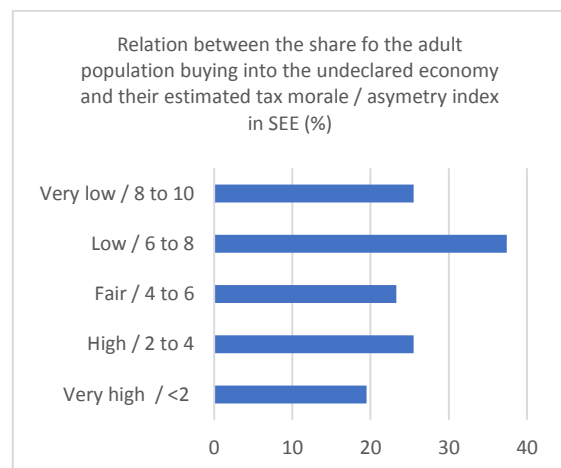


Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

²⁵ Williams, C. and Bezeredi, S., *Explaining Consumers' Motives for Purchasing from the Informal Economy: Some Lessons from a Study of Bulgaria, Croatia and FYR Macedonia*, GREY Paper, Sheffield University Management School, University of Sheffield.

On the one hand, consumers display a greater propensity to purchase from the undeclared economy when they believe many others do so (i.e., there is a lack of horizontal trust) and also when their norms, values and beliefs are not in symmetry with the laws and regulations (i.e., when there is a lack of vertical trust). Indeed, **for those citing lower cost as a rationale, it is particularly vertical trust that needs to be dealt with, and for those citing social and/or redistributive rationales as well as formal economy failures, it is more horizontal trust that needs to be addressed**. This requires the use of policy measures to alter the norms, values and beliefs regarding both the extensiveness of the undeclared economy and acceptability of participation. Such measures thus involve **marketing and education campaigns** to raise awareness about both the limited extent of actual participation as well as the benefits of formality and costs of operating in the undeclared economy.

Figure 8. Vertical trust issues need to be tackled with priority



Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

On the other hand, however, improvements are also required in formal goods and services provision. Circumventing the shortcomings of formal sector provision will require a whole

host of initiatives to improve the effectiveness of formal sector delivery, including local-level telephone hotlines, web-portals and one-stop shops for customers to find formal suppliers and where suppliers can advertise, along with the greater use of quality assurance labelling to tackle the issue of reliability and quality.

It also requires the **development of greater trust of citizens in formal institutions**. On the one hand, this requires a **modernisation of the formal institutions and quality of governance**, or pursuing improvement in the view of citizens that there is procedural and redistributive justice and fairness in how formal institutions operate. This will necessitate not only **education and awareness raising campaigns** but also changes in the formal institutions to resolve the deficiencies which result in a lack of vertical trust. On the other hand, policy initiatives are also needed to **change the macro-level economic and social conditions** which previous studies show are associated with informality, including the level of welfare benefits and expenditure on social protection

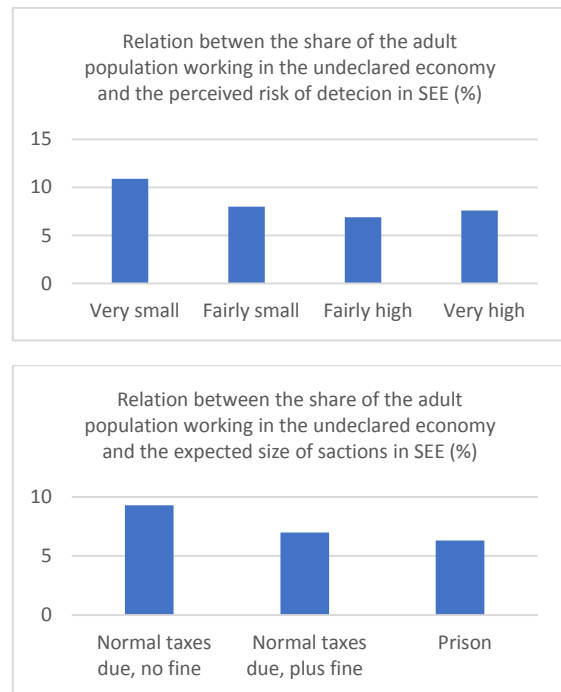
Policy Implications: Supply-Side

GREY findings advocate a shift away from the current either/or debates and towards a both/and approach which recognises the existence of both exclusion- and exit-driven undeclared workers²⁶.

Different policy approaches are required to tackle these different tiers. The conventional **deterrence approach** that seeks to raise the costs of participation in the informal economy by increasing the penalties and risks of detection has been shown to have no effect on those driven by exclusion rationales and

neither does it have any influence on those driven by exit rationales.

Figure 9. Detection and sanctions are unlikely to have high effect on the supply side

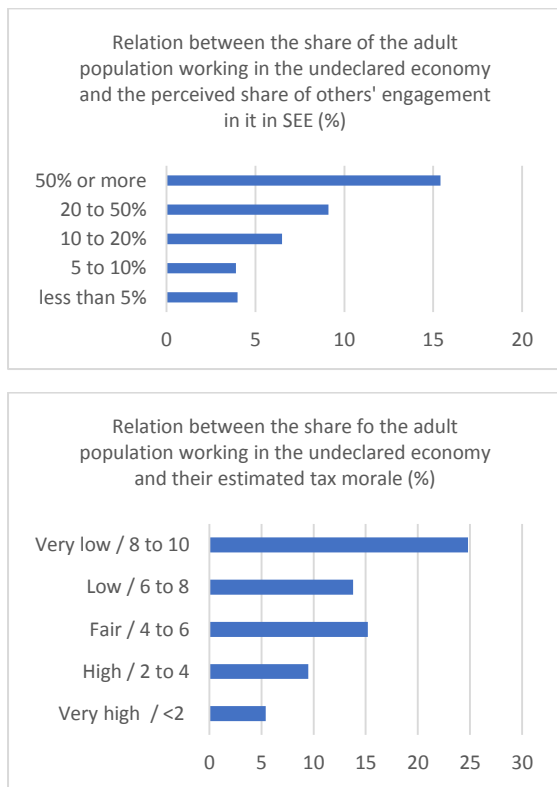


Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Instead, **to tackle those driven by exit rationales, tackling both the lack of horizontal trust that other citizens are operating in a compliant manner and the lack of vertical trust in formal institutions is advocated**, both of which are significantly correlated with exit-driven participation in the undeclared economy. Those who voluntarily engage in the undeclared economy have a higher propensity to participate when they believe that many others do so (i.e., there is a lack of horizontal trust) and also when their norms, values and beliefs are not in symmetry with the laws and regulations (i.e., when there is a lack of vertical trust).

²⁶ Williams, C. and Bezeredi, S., (2017) *Explaining and Tackling the Informal Economy: a Dual Informal Labour Market Approach*, GREY Paper, Sheffield University Management School, University of Sheffield.

Figure 10. Building horizontal and vertical trust should be prioritized on the supply side



Source: GREY Project calculations based on nationally representative surveys of altogether 6019 respondents in Croatia, Bulgaria and FYR of Macedonia.

Governments can develop several batches of policy measures to tackle effectively the supply-side of the undeclared economy. Firstly, policy measures are required to **alter the norms, values and beliefs** regarding both the extensiveness of the undeclared economy and the acceptability of participation. This requires **marketing and education campaigns** to raise awareness about both the limited extent of participation as well as the benefits of formality and costs of operating in the undeclared economy. Secondly, however, **changes are also needed in the formal institutions**, especially in the countries

studied here where **formal institutional deficiencies result in a lack of trust in government**. On the one hand, and to tackle the lack of vertical trust, there is a need to **modernise the formal institutions and quality of governance**, by pursuing improvement in the view of citizens that:

- the state authorities treat them in a **respectful, impartial and responsible manner**;
- they pay their **fair share** compared with others; and
- they receive the goods and services they deserve for the taxes they pay.

On the other hand, and to tackle the problem of undeclared workers driven by exclusion into the undeclared economy, **policy initiatives are needed to change the macro-level economic and social conditions**. As previous empirical studies reveal, this includes policy initiatives to **increase the level of expenditure on active labour market policies** to support vulnerable groups, and the level of expenditure on social protection.

Similar considerations can be applied to the **policy measures to tackle envelope wages**. GREY research has demonstrated that also in this domain there is a need for a shift from the dominant rational actor approach to the more modern social actor approach with the corresponding emphasis moving from policy measures to improve deterrence to such fostering vertical and horizontal trust.

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