

Undeclared Work in Croatia

A baseline assessment

2014

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Executive Summary

The aim of this report is to evaluate the extent and nature of undeclared work in Croatia and the policy approaches and measures currently employed to tackle this sphere.

Extent and nature of undeclared work

In recent years, there have been substantial efforts to reduce undeclared work in Croatia. Faced with significant deficits in the public budget, the government has sought effective policy responses that would result in increased compliance. Nonetheless, it is hard to know whether these strategies are resulting in a decrease in the prevalence of undeclared work. While some studies of the magnitude of undeclared work suggest that it is continuing to decline in size, others suggest that the trend is in the opposite direction.

Examining the nature of the undeclared economy, the 2013 Eurobarometer Survey on undeclared work highlights how much undeclared work in Croatia is for and by close social relations; 57% of the respondents who were carrying out these activities stated that the purchasers were their friends, colleagues or acquaintances. Generally, individuals with a lower level of education are the most susceptible for carrying out undeclared work in Croatia. Men, moreover, are almost three times more likely to work undeclared than women. Nearly one third of people engaged in undeclared work are manual workers, and almost every fourth undeclared worker is unemployed, while about every seventh undeclared worker is retired. Therefore, these three groups, namely manual workers, unemployed people and the retired, represent about 70% of all undeclared workers in Croatia. This will be important when designing policy responses.

Turning to the firm level, the findings are that those in agriculture and related industries are the most likely to recognise competition from unregistered or informal firms as a serious obstacle to their business. In addition, small and medium-sized firms are far more likely to identify the existence of the unregistered units in their sector than are large firms. Finally, domestic owned and non-exporting businesses more often witness the presence of unregistered firms and the constraints caused by them in comparison with exporters and firms in foreign ownership.

The most common reason for individuals engaging in undeclared activities is the lack of formal employment opportunities, indicating that unemployment is the central issue that requires consideration when combating undeclared work in Croatia. In the case of retired individuals, there are two subgroups highly susceptible to engagement in undeclared work. Those with a small pension find their incentive in an insufficient level of income, while privileged ones, who took early retirement, are often motivated by the surplus of time. The most salient features of the labour market that provide disincentives for formal employment are the high tax burden and benefit traps. From the perspective of businesses, the main obstacles to formalisation are the non-transparency and instability of the tax system, followed by complexity of administrative procedures.

An important additional factor fostering informality in Croatia, so far neglected in endeavours to tackle this phenomenon, is the low level of tax morale. Particularly concerning is the fact that young people are the most prone to opportunistic non-compliant behaviour, indicating a possible long-term trend in such a high share of undeclared work. Having in mind that 9% of people surveyed in the European Values Study are highly tolerant of cash-in-hand activities, and 7.1% highly tolerant of tax

evasion (with an additional 23.2% and 14.8% respectively tolerant of these activities to some extent), one can conclude that socio-cultural factors play an important role in making decisions about (non)compliance in Croatia.

Institutions, policy approaches and measures

A low level of trust in public institutions in Croatia suggests that the government should revise its tactics when tackling undeclared work. So far, repression has been the most prevalent approach. Nevertheless, as Walsh (2012) argues, practicing repression in situations when there is a weak psychological contract between citizens and the authorities can additionally deteriorate the willingness of citizens to comply and consequently result in even higher levels of non-compliant behaviour. Therefore, there is a need to put greater emphasis on an enabling compliance approach, especially on commitment and curative measures, which do not appear to be fully recognised as effective strategies in a Croatian context.

An additional problem in this regard is the weak coordination among ministries and various government departments when pursuing the fight against undeclared work. Each of them defines their own separate targets and this often results in an overlapping and/or awkward division of responsibilities. This raises a need for reorganisation of the existing institutional system in order to achieve better efficiency. One viable option is the establishment of a central coordination body, which would harmonise activities in this field. In that regard, one might argue whether a recent reform in the inspection system was indeed a move in a positive direction, or whether it will result in the deteriorated effectiveness of enforcement. A further problem is the weak social dialogue in Croatia in this context characterised by numerous disputes between the government and trade unions. As such, tripartite social dialogue currently has a limited role in tackling undeclared work, therefore representing a further area for the achievement of a significant improvement.

1. Introduction

Economic activities not declared to the authorities for tax, social security or labour law purposes, when they should be declared, have been widely recognised as having deleterious impacts on both the functioning of the market economy as well as social inclusion. In the light of persisting high unemployment and economic recession, tackling this complex and multifaceted phenomenon has become a political priority in Croatia. Indeed, the Ministry of Labour has denoted 2014 as ‘the year of the fight against undeclared work’ (Ministry of Labour and Pension System, 2014). This is not perhaps surprising when it is recognised that, according to some estimates, Croatia has one of the largest undeclared economies in the European Union, estimated to amount to some 30% of the official GDP (Schneider, 2013).

The aim of this report is to provide a baseline assessment of the size and nature of the undeclared economy in Croatia along with the policy approaches and measures used to tackle this sphere. To do this, chapter 2 reviews the diverse measurement approaches applied at the national and international level to estimate the size of the undeclared economy in Croatia. Chapter 3 then provides a detailed overview of the specific characteristics and nature of the undeclared economy in the country, whilst chapter 4 examines the context-embedded barriers to formalization that need considering when designing suitable policies to tackle the issue. Chapter 5 then reviews the current institutional framework for combating undeclared work in Croatia followed in chapter 6 by the policy approach and measures currently adopted.

This will reveal that until now, there is a paucity of knowledge about the nature and causes of undeclared activities in Croatia. Apart from two research projects by the Institute of Public Finance in 1996 and 2002, attempts to explore this phenomenon and estimate its prevalence have been limited. However, this has begun to improve, especially since the accession of Croatia to the EU in July 2013. Probably the most important step in conceptualising this phenomenon in Croatia so far is the Eurobarometer survey on undeclared work in the EU, conducted in all the member states during 2013. Although this highlights undeclared activities only from an individual perspective, and does not consider business-to-business transactions for example, this comprehensive survey provides an important insight into the nature and prevalence of undeclared work, as well as into economic and socio-cultural factors that influence decisions about (non)compliance.

Before commencing, however, we need to clarify the definition of undeclared work in this report. With more than 40 existing adjectives and nouns used to denote this phenomenon in the literature (Williams, 2004), many of which include forms of activity that others do not, it is often difficult to systemise and compare findings from different sources. In order to resolve this problem, all definitions used in different studies discussed in this report will be explained. However, throughout this report, ‘undeclared work’ will be defined as “any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account differences in the regulatory system of Member States” (European Commission, 1998, p. 4).

This definition is in line with the one adopted in Croatia and used in the official reports on this issue published by the authorities. As the Prohibition and Prevention of Unregistered Activities Act (Official Gazette, 2011) states, ‘unregistered activity’ is any type of legal work conducted by individuals or firms without complete and valid documentation and required permissions. In terms of subjects involved in these activities, the act clearly states that, apart from those who carry out undeclared activities, each individual and firm who purchases undeclared products and services, or in any way enables execution of these activities, is denoted as a participant. On the other hand, activities such as work for one’s own

needs, family assistance, or help to friends and neighbours, are not considered as undeclared, providing that the work is carried out without financial or material benefit and is not done on a regular basis.

2. Extent of undeclared work in Croatia

Since undeclared activities were first described by the British anthropologist Keith Hart in his study on urban unemployment in Ghana (Hart, 1973), the issue of measuring their prevalence has presented one of the biggest challenges and the central point of disputes in this field. Bearing in mind the fact that quantifying something that is concealed from the public can be better denoted as an art rather than a science, it is not surprising that various approaches give significantly different results. There are a number of methods developed for estimating the extent of undeclared work, each of them with its own advantages and drawbacks. Here, we can divide these methods in two groups: direct and indirect measurement methods (Feld & Larsen, 2012; Gërxhani, 2004; International Labour Organization, 2013).

Based usually on questionnaire survey¹, direct methods investigate undeclared activities from a microeconomic perspective. Surveys are particularly suitable if microanalysis of factors determining the decision for (non)compliance is the focus of the research because they can provide insight into the key characteristics of surveyed individuals and/or firms. The main drawback of this approach is the fact that respondents have a strong incentive to be dishonest in their answers (or even refuse to participate) due to illicit nature of these activities. In that light, estimates using questionnaire surveys should be perceived only as providing only lower-bound estimates of the real magnitude of undeclared work (European Commission, 2014b).

For this reason, researchers often rely on indirect measurement methods, which analyse undeclared work from the macroeconomic perspective. Based on comparisons of various economic aggregates, indirect methods aim at assessing the absolute or relative value of undeclared activities in the whole economy. The main advantage of this approach is the possibility for analysing longitudinal changes in the prevalence of undeclared activities, which is usually not the case with costly and time-consuming questionnaire surveys. Nevertheless, due to the different definitions of the phenomenon and different assumptions used in analyses, as well as because of constraints in the availability of data and problems with the accuracy of existing data, various indirect methods applied to the same area or country can yield quite dissimilar or even contradictory estimates. Given this, these estimates often raise more questions than they really answer. Some critics argue that “indirect measures are likely to be no better than guestimates which should be taken at best as interesting novelties” (Dixon, 1999, p. 335). This issue will be discussed in more detail in the section 2.2 where the results of several recent estimates of undeclared work in Croatia are presented.

¹ Although the direct approach can also include other methods (for instance analysis of tax audit results), only questionnaire surveys are discussed. This is due to the non-existence of research about undeclared work in Croatia based on other direct methods.

2.1. Estimates using direct methods

The most important direct survey of undeclared work so far conducted in Croatia is the aforementioned Special Eurobarometer Survey on undeclared work conducted in 2013. Given this, we shall start our discussion by presenting the key findings of this EU-wide study. First conducted in 2007 and then repeated in 2013, the Special Eurobarometer Survey on undeclared work explores personal experiences with undeclared activities and attitudes towards some violating behaviours among about 27,000 EU citizens. Croatia was not included in the first wave, and therefore only the second wave is discussed. This second wave encompasses 1,000 individuals from Croatia surveyed during April and May 2013.

The analysis from the labour supply side presented in Table 1 shows that 7.3% of respondents in Croatia were engaged in undeclared activities during the 12 months preceding the survey. However, as explained, this should be treated as a lower-bound estimate not only because some people probably gave a false answer but also because 2.9% of respondents refused to answer.

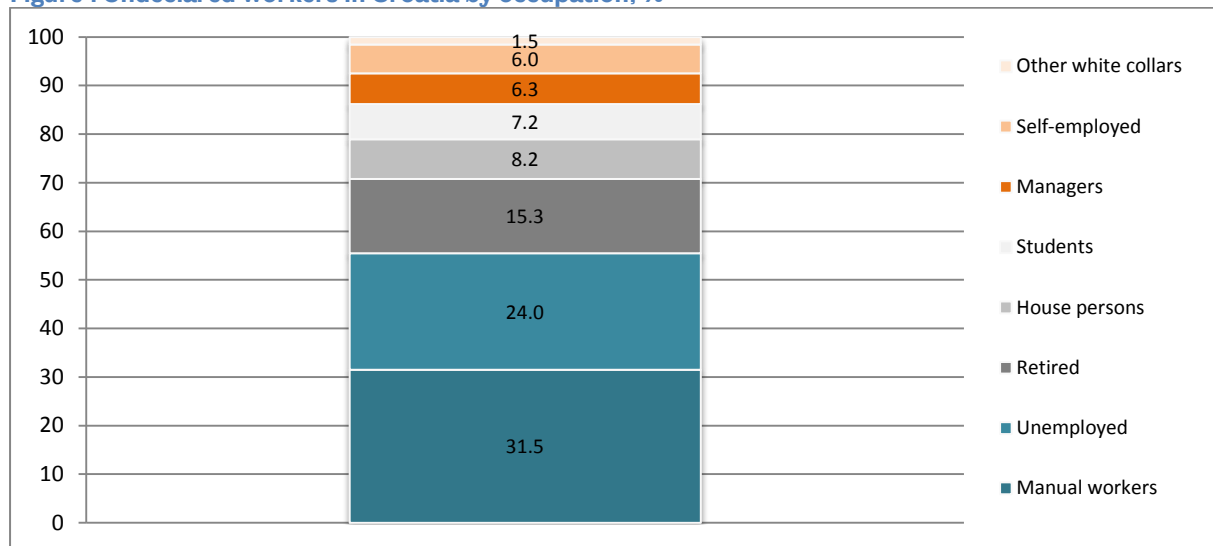
Table 1 People engaged in undeclared work in Croatia, % of respondents

	Yes	No	Refusal (SPONTANEOUS)	Do not know
Total	7.3	88.9	2.9	0.9
Gender				
Male	10.9	84.2	4.0	0.8
Female	4.0	93.1	1.9	1.0
Age				
15 - 24	8.1	85.2	4.0	2.7
25 - 39	11.9	82.4	4.9	0.8
40 – 54	7.6	90.1	1.9	0.4
55+	3.5	94.2	1.7	0.6
Occupation				
Unemployed	10.2	81.9	7.2	0.6
Self-employed	13.3	83.3	3.3	0.0
Retired	3.7	95.3	1.0	0.0
Students	5.1	89.8	1.0	4.1
Managers	6.7	89.3	4.0	0.0
Other white collars	1.2	94.0	4.8	0.0
Manual workers	12.7	84.5	2.8	0.0
House persons	8.3	83.3	2.8	5.6
Age when finished education				
<15	1.8	94.7	1.8	1.8
16-19	9.9	85.3	4.5	0.4
20+	5.8	92.7	1.5	0.0
Still Studying	5.1	89.8	1.0	4.1
No full-time education	0.0	100.0	0.0	0.0

Source: Authors' calculations based on the Special Eurobarometer 402

Further analysis reveals that men are almost three times more likely to engage in undeclared work as women. Moreover, undeclared practices are more prevalent among people between 25 and 39 years of age and among those with a lower level of education. When it comes to occupation, by far the most likely to be involved in these activities are the self-employed (13.3%), manual workers (12.7%) and the unemployed (10.2%).

Figure 1 Undeclared workers in Croatia by occupation, %



Source: Authors' calculations based on the Special Eurobarometer 402

If we examine the occupational structure of the group engaged in undeclared activities (Figure 1), it is noticeable that manual workers, the unemployed and retired together account for about 70% of all undeclared workers in Croatia. Nearly one third of people engaged in undeclared work are manual workers. Similarly, almost every fourth undeclared worker is unemployed, while about every seventh undeclared workers is retired.

Table 2 Purchasers of undeclared products and services in Croatia, % of respondents

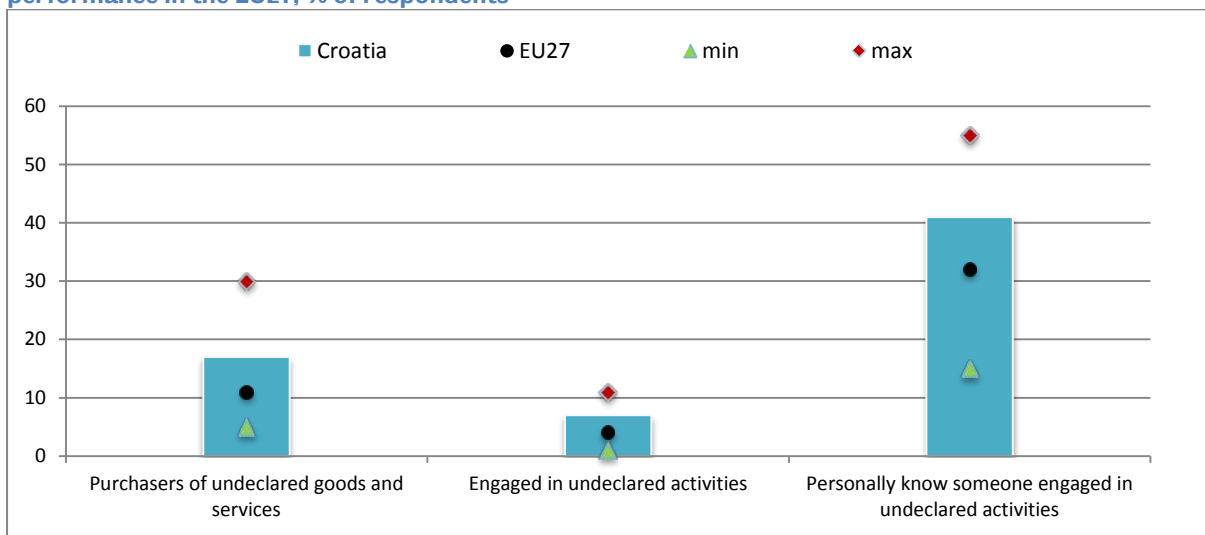
	Yes	No	Refusal (SPONTANEOUS)	Do not know
Total	17.4	75.8	2.8	4.0
Gender				
Male	17.0	74.4	3.8	4.8
Female	17.8	77.0	1.9	3.3
Age				
15 – 24	18.0	75.3	1.3	5.3
25 - 39	22.2	71.2	3.3	3.3
40 – 54	19.5	72.9	3.8	3.8
55+	12.2	81.4	2.3	4.1
Occupation				
Unemployed	14.5	78.2	4.2	3.0

Self-employed	30.0	63.3	3.3	3.3
Retired	13.9	81.6	1.4	3.1
Students	18.4	75.5	0.0	6.1
Managers	25.7	63.5	2.7	8.1
Other white collars	22.9	65.1	3.6	8.4
Manual workers	18.2	75.7	4.4	1.7
House persons	15.5	78.9	2.8	2.8
Age when finished education				
<15	7.0	86.8	2.6	3.5
16-19	16.9	75.8	3.9	3.3
20+	26.7	66.5	1.9	4.9
Still Studying	18.4	75.5	0.0	6.1
No full-time education	4.2	87.5	0.0	8.3

Source: Authors' calculations based on the Special Eurobarometer 402

Although differences among socio-economic groups are less salient when it comes to purchasing undeclared goods and services, it is noticeable that people with a higher level of education (more than 20 years of age when they finished their education) are by far the most likely to purchase undeclared products (Table 2). Furthermore, the self-employed, managers and other white collars are more likely to buy undeclared products and services. Overall, 17.4% of respondents in Croatia stated they suspect that some of products and services they paid for had been produced in the undeclared economy.

Figure 2 Prevalence of undeclared work in Croatia, comparison with the average, best and the worst performance in the EU27, % of respondents



Source: European Commission (2014b)

Figure 2, which compares the findings for Croatia with those in other member states, suggests that the practice of undeclared work in Croatia is more prevalent than in the EU27 as a composite. A closer insight reveals that seven other member states had the same or a higher share of people engaged in undeclared work than Croatia, while eight of them scored the same or worse when it comes to purchasing undeclared products and services (European Commission, 2014b). Similarly, in comparison to Croatia, five of the 27 member states had the same or a higher share of those who know someone engaged in undeclared work.

However, we should bear in mind that the Eurobarometer Survey highlights undeclared work only from the perspective of workers and purchasers, and therefore does not give any information about these activities at the enterprise-level, such as business-to-business transactions. Although there is no comprehensive study on undeclared practices among firms in Croatia, the World Bank Enterprise Survey provides some insights on this issue. This survey, first conducted in 1998 and occasionally repeated in 135 countries all around the world, scrutinises perceptions of firm representatives about a number of topics regarding the business environment, such as infrastructure, taxes, regulations, access to finance, competition, corruption and informality. Table 3 summarises the findings about undeclared practices among enterprises in Croatia from the last wave of the survey, which was conducted in 2007.

Table 3 Extent of undeclared work among enterprises, % of respondents

	Croatia	All countries
firms formally registered when they started operations in the country	98.1	87.5
firms competing against unregistered or informal firms	31.7	57.0
firms identifying practices of competitors in the informal sector as a major constraint	25.0	30.1

Source: World Bank (2008)

This reveals that 98.1% of firms in Croatia claim that they were formally registered when they started operating. Notwithstanding this, almost one third of surveyed firms recognises the existence of informal competitors, while one in four identifies informal practices of others as a major constraint in the running of their business. However, it should be stressed that these results illustrate only the opinion of surveyed managers about practices. It is not an examination of actual practices. Therefore, it is difficult to give any relevant conclusion on this issue without a survey of undeclared practices among enterprises. Until now, such a business survey has not been conducted in Croatia.

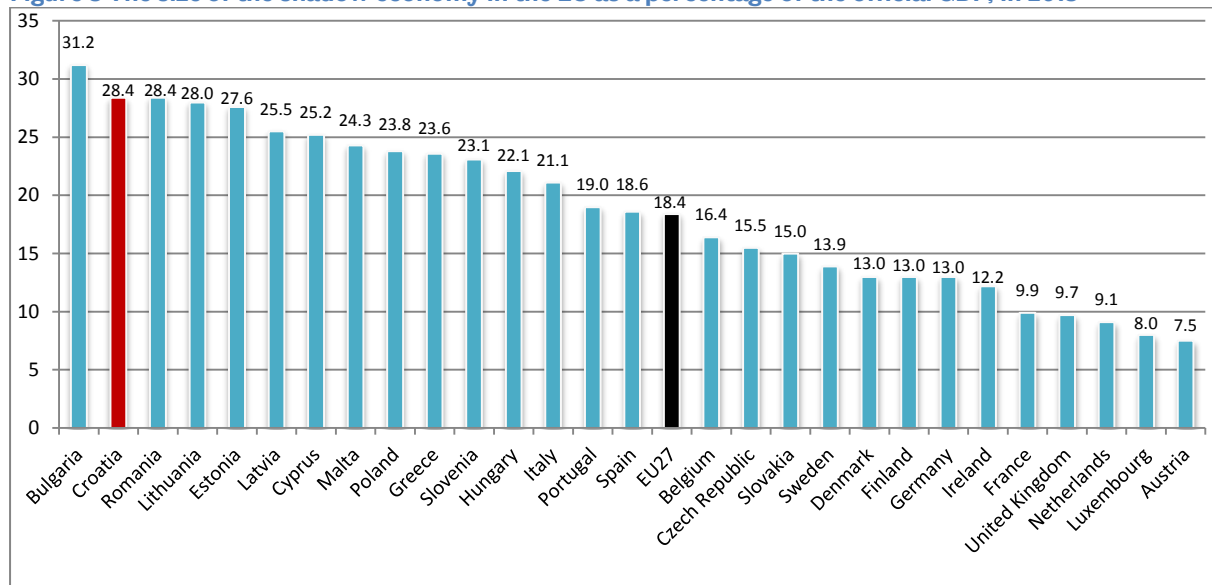
2.2. Estimates using indirect methods

This section summarises the results of several indirect estimates of extent of undeclared activities in Croatia. Before commencing, it should be stressed that here the focus is only on the period after 2000. This is because indirect estimates for 1990s were highly influenced by the constant and significant changes in statistical system during this period, which makes comparisons quite unreliable (Ott, 2002).

Figure 3 presents the results of cross-section estimates by Schneider (2013), which enable us to see how Croatia stands in comparison with other member states. Schneider uses MIMIC method² and the term 'shadow economy' which encompasses "legal business activities that are performed outside the reach of government authorities" (Schneider, 2013, p. 3), which is very much akin to the definition of undeclared work used in this report.

² This method is based on a structural equation model with unobservable dependent variable.

Figure 3 The size of the shadow economy in the EU as a percentage of the official GDP, in 2013



Source: Based on Schneider (2013)

As Figure 3 illustrates, the shadow economy in Croatia accounted for 28.4% of the official GDP in 2013. Apart from Bulgaria and Romania, this share was higher than in all other member states. Having in mind that the average share of the shadow economy in the EU27 was 18.4%, we can therefore see that undeclared practices in Croatia are relatively pervasive compared with the rest of the EU-28. This therefore explains why authorities in this country have recognised that the fight against undeclared activities is one of the most important priorities.

In order to analyse longitudinal changes in the prevalence of undeclared activities in Croatia, the results of four different estimates are summarised in Table 4. As can be noticed, apart from significant variations in the magnitude, these estimates also vary in the trend after the onset of the economic crisis.

Table 4 Recent estimates of the undeclared work in Croatia, % of the official GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
MIMIC [*]	-	-	-	32.3	32.3	31.5	31.2	30.4	29.6	30.1	29.8	29.5	29.0
MIIMIC ^{**}	6.7	6.2	5.3	5.4	5.3	5.0	4.8	4.7	4.6	4.2	-	-	-
Labour force method ^{***}	-	-	-	-	4.0	3.7	3.4	3.1	1.7	3.8	4.2	-	-
Non-exhaustiveness of national accounts ^{***}	8.5	8.3	8.2	7.4	7.3	7.3	6.7	6.1	5.9	6.4	-	-	-

Sources: * Schneider (2012), ** Klarić (2011), *** Galić Nagyszombatý (2012)

According to the estimates produced by Schneider (2012), after a steady decrease in the period 2003-2008, the share of the shadow economy in Croatia rose in 2009³. However, a slight decrease is noticeable during the subsequent period, with the share of concealed activities accounting for 29.5% in 2012. His latest estimate presented earlier suggests that this decreasing trend has continued in 2013 when the shadow economy accounted for 28.4%.

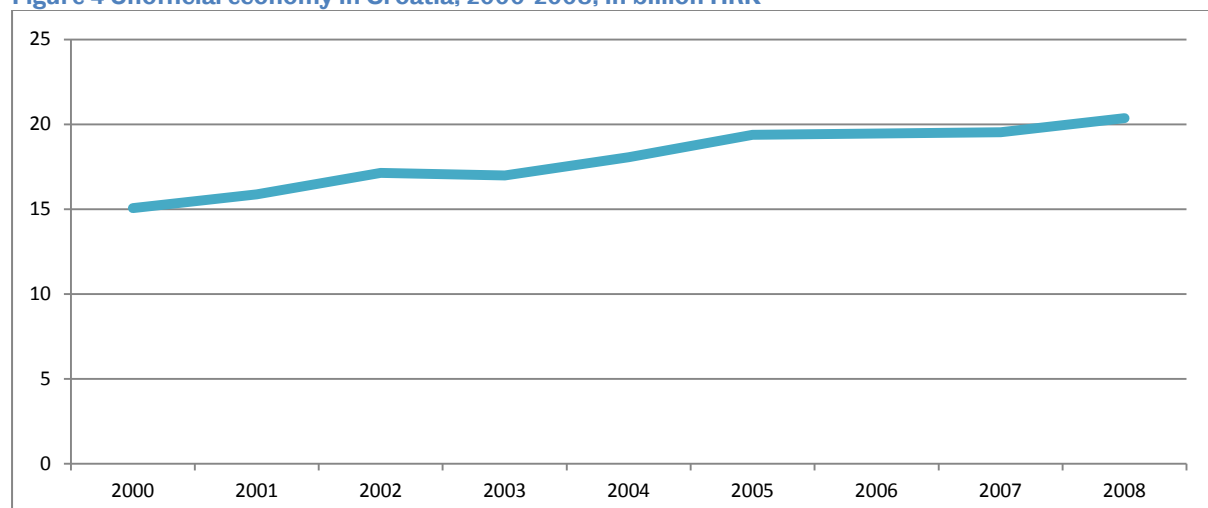
³ In this case, the definition and method used are the same as those in Schneider (2013)

Although applying the same method, Klarić (2011) used a quite different definition in comparison with Schneider. In this case, the author estimated the share of the non-observed economy, which encompasses informal, illegal and underground production, as well as some other types of GDP under-coverage⁴. However, despite analysing a broader range of activities, Klarić found that the share of these activities was significantly lower in comparison with Schneider's estimates. Namely, this share ranged between 6.7% in 2000 and 4.2% in 2009. Additionally, although his results also indicate a decreasing trend until 2008, Klarić found a continuation of this trend even in 2009. The author explained this drop with the possibility that the crisis and the adopted policy measures to neutralise it left the entire economy shaken up which required a certain time for adjustment to the new situation.

Finally, Galić Nagyszombaty (2012) estimates the share of the 'unofficial economy' using two different approaches: the labour force method and non-exhaustiveness of national accounts. Here the unofficial economy connotes both legal and illegal production of goods and services that remain undetected and therefore not included in official GDP estimates. Although Galić Nagyszombaty also found a decreasing trend until 2008, her results for the period after the beginning of the crisis are quite different in comparison with those of Schneider and Klarić. In line with Schneider, she also found an increase in 2009, but estimates using the labour force method suggest an increase even in 2010. Nevertheless, one should bear in mind that the labour force method assesses only the share of unregistered labour, while deliberate misreporting is not included.

Despite these relatively inconclusive results about the changes in the size of the undeclared economy after the onset of the crisis, all studies confirm that there was a decreasing trend in the period preceding the crisis. Nonetheless, this decline does not necessary imply the eradication of undeclared activities. Indeed, in their analysis of the non-exhaustiveness of national accounts, Lovrinčević, Mikulić, and Galić Nagyszombaty (2011) found that there was a constant increase in the absolute value of unofficially produced products and services during the period 2000-2008 (Figure 4). Having in mind high rates of GDP growth in the same period⁵, one can realise that the drop in the relative size of undeclared work was a result of the faster growth of the formal economy, not a result of a diminution in undeclared work.

Figure 4 Unofficial economy in Croatia, 2000-2008, in billion HRK



Source: Based on Lovrinčević et al. (2011)

⁴ For detailed explanation see OECD (2002)

⁵ The real growth rates of the official GDP in the given period ranged between 2.4% and 5.5% (Croatian National Bank, 2010)

3. Nature of undeclared work in Croatia

A useful starting point when discussing the nature of undeclared work in terms of the sector, business and spatial variations, are the results of surveillance activities in Croatia. According to the State Inspectorate (2013b), although violations in employment relations were present in almost all industries, they were the most prevalent in the catering sector, construction and the trade sectors. Unregistered activities are also quite common in professions such as car mechanics, car body painters, hair stylists, massage therapists, tailors, florists, beauticians and various activities associated with the repair of household appliances. Those activities are usually carried out in private apartments and garages which makes it extremely difficult to detect them (State Inspectorate, 2013a).

When it comes to different types of undeclared work, the 2012 Annual report of the State Inspectorate reveals that the most common recorded violations were employment without a contract and employment on a piece work agreement in situations where a standard work contract should be applied. This is followed by non-declaring to pension or health insurance authorities, employing foreign workers illegally or without informing the relevant authorities and hiring seasonal workers for seasonal jobs in agriculture on undeclared basis (State Inspectorate, 2013b).

3.1. Demand and labour supply level - sector and spatial variations

According to the 2013 Eurobarometer survey, there are quite significant regional differences in both demand and supply of undeclared work in Croatia. For instance, people from Istra, Rijeka and Gorski Kotar, as well as those from Zagreb and surrounding area are far more likely to carry out undeclared activities in comparison with their counterparts from other regions (Table 5). A similar trend exists regarding the purchase of undeclared goods and services. However, it should be mentioned that although Dalmatia scored low in the case of undeclared labour supply (5.7%), about one fifth of respondents (more than in any other region) stated they purchased goods and products on the undeclared market.

Table 5 Prevalence of undeclared work in Croatia among individuals, by location and type of community, % of respondents

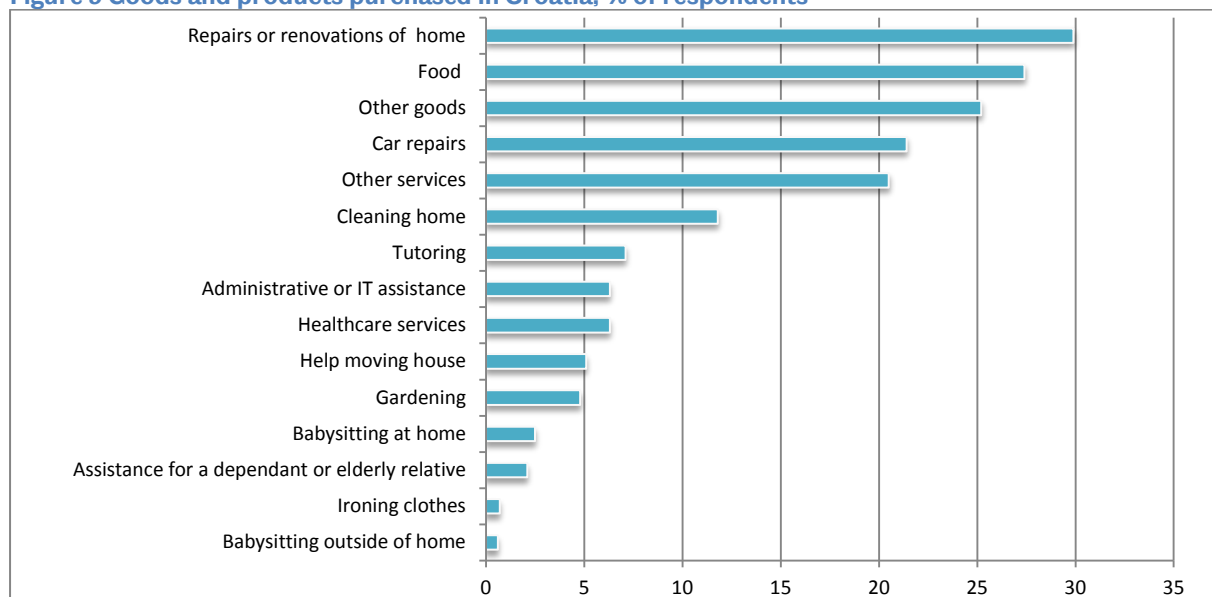
	Engaged in undeclared work	Purchase undeclared goods and services
Total	7.2	17.5
Region		
Zagreb and surrounding	11.3	20.6
North Croatia	1.7	15.6
Slavonia	7.4	16.5
Lika & Banovina	2.3	8.0
Istra, Rijeka and Gorski Kotar	12.7	16.9
Dalmatia	5.7	20.8
Type of community		
Rural area or village	9.0	15.1
Small/middle town	5.4	18.9
Large town	6.7	20.1

Source: Authors' calculations based on the Special Eurobarometer 402

Interesting findings are noticeable in the analysis according to the type of community. As Table 5 suggests, while individuals from rural areas are more likely to be engaged in these activities from the labour supply side, those from urban areas are more often involved from the demand side.

Another interesting question we should examine is what types of undeclared goods and services people usually buy. Figure 5 reveals that almost 30% of respondents who declared that they purchased some products and services without getting a receipt did so for home repairs and renovations⁶. This is followed by purchasing domestic food (for instance agricultural and farm products), with 27% of respondents having this practice. On the other hand, we can realise that, apart from cleaning homes, people do not pay on an undeclared basis for other home-based activities, such as gardening, babysitting and ironing. As Rubić (2013) argues, this is due to the strong family and neighbour networks: people rather prefer to help each other in these small-scale everyday activities on an unpaid basis rather than to spend money if not necessary. This perhaps reflects that in Croatia, there has not been the incursion of monetary exchange into the realm of mutual aid, as has been witnessed in other European regions (Onoshchenko and Williams, 2013; Vorley and Williams, 2012; Williams, 2004, 2009b, 2014).

Figure 5 Goods and products purchased in Croatia, % of respondents

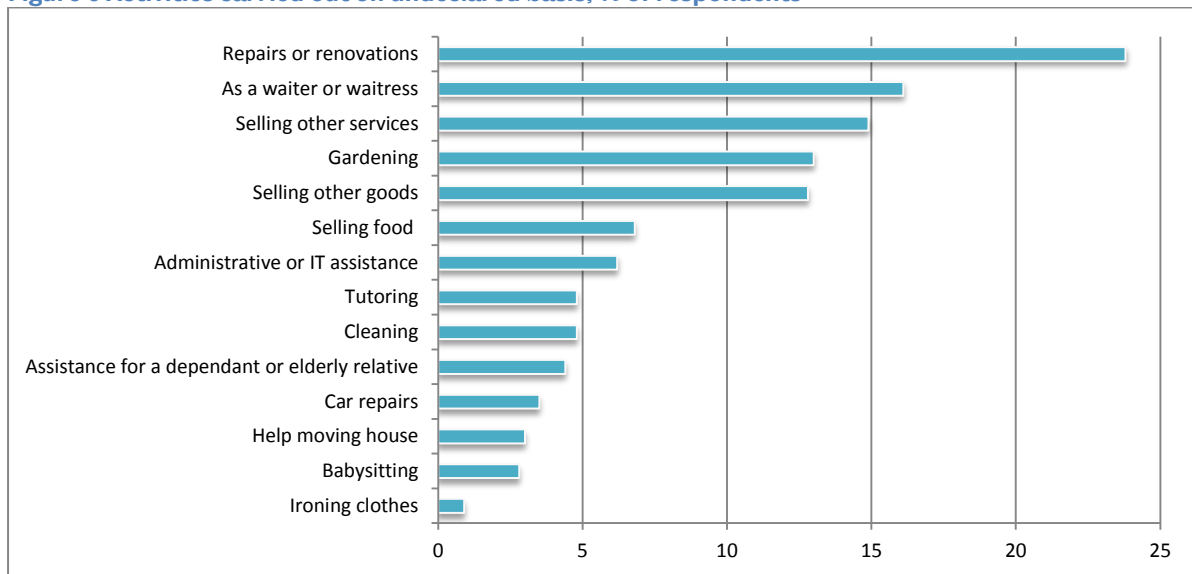


Source: Authors' calculations based on the Special Eurobarometer 402

This finding is confirmed by an examination of the labour supply side. As Figure 6 illustrates, it seems that paid activities in the field of personal and household services comprise only a minor part of undeclared work in Croatia. On the other hand, work in the construction industry is far the most common type of activity carried out on undeclared basis. For instance, almost one quarter of respondents engaged in undeclared activities stated they were working on repairs or renovations.

⁶ In this case, multiple answers were possible and therefore the sum of percentages exceeds 100.

Figure 6 Activities carried out on undeclared basis, % of respondents



Source: Authors' calculations based on the Special Eurobarometer 402

3.2. Firm level - sector, business and spatial variations

In order to get some insight into the sector, business and spatial variations in off-the-books practices among firms in Croatia, we can once again examine findings of the World Bank Enterprise Survey. Analysis by sector reveals that firms in agriculture and related industries are the most likely to recognise competition from unregistered or informal firms as a serious obstacle to their business (Table 6). More than a half of respondents in this sector stated they are competing against unregistered or informal firms, while 42.2% identified informal practices of competitors as a major constraint in running a business. On the other hand, despite being highly aware of the existence of unregistered or informal firms in their sector, enterprises in manufacturing and retail sector do not consider informal units as presenting a threat to their operations.

Table 6 Prevalence of undeclared work in Croatia among enterprises, by sector, location, firm size, exporting status and ownership, % of respondents

	firms competing against unregistered or informal firms	firms identifying practices of competitors in informal sector as a major constraint
All	31.7	25.0
By sector:		
Food	54.5	42.2
Garments	25.1	24.3
Fabricated metal products	26.1	12.3
Other manufacturing	38.4	14.3
Retail	35.7	13.8
Other services	25.4	30.1

By location:		
Zagreb	53.0	33.1
North	41.2	6.5
Slavonija	40.8	40.6
Dalmacija	17.0	29.2
Istra i Hrvatsko Primorje	12.3	4.1
Lika i Banovina	25.6	33.1
By firm size:		
Small (5-19)	32.5	31.3
Medium (20-99)	33.0	19.8
Large (100+)	20.0	11.8
By exporting status:		
Direct exports 10%+ of sales	18.8	7.2
Non-exporter	34.3	28.1
By ownership:		
Domestic owned	32.6	25.9
10% or more foreign ownership	10.2	5.2

Source: World Bank (2008)

When it comes to spatial variations, it is noticeable that firms from Zagreb are most likely to recognise the presence of informal firms in their sector, followed by firms from the North of Croatia and Slavonia. Interestingly, although informal practices are widely recognised in the North (41.2%), only 6.5% of respondents perceived informal firms as a major constraint in running a business. Compared to the rest of the country, firms from Istria and Dalmatia to a much lower extent recognise the presence of unregistered firms in their sector.

In general, large firms are the least likely to recognise the existence of unregistered units in their sector, as well as the negative influence of those units on running a business. On the other hand, although there is no significant difference between small and medium firms in their perception about the prevalence of unregistered activities, small ones more frequently recognise informal practices as a major obstacle to their business. Finally, domestic owned and non-exporting businesses more often witness the existence of unregistered firms and constraints caused by them than exporters and firms in foreign ownership. Nevertheless, it should be repeated that these results represent only the personal perception of respondents, which does not necessarily equate with the real situation.

To give a comprehensive picture of undeclared work in Croatia, we should also examine variations from the macro-level standpoint. In their analysis of the non-exhaustiveness of national accounts in Croatia, Lovrinčević et al. (2011) find significant changes in the sector variations during the period 2000-2008. For instance, while almost a half of the total unofficial economy in 2000 was located in manufacturing and the trade sector (Table 7), both sectors faced a continuous downward trend during the given period. On the other hand, relative importance of the undeclared economy in some sectors such as hotels and restaurants, or real estate, renting and business activities almost doubled during the given period.

Table 7 Structure of total non-exhaustiveness by activities, %

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Agriculture, hunting and forestry	7.73	6.55	6.74	6.19	5.94	5.02	5.17	5.18	5.07
Fishing	0.03	0.46	0.56	0.54	0.58	0.52	0.47	0.44	0.45
Mining and quarrying	0.15	0.17	0.18	0.23	0.19	0.21	0.18	0.19	0.02
Manufacturing	22.53	19.58	21.45	17.02	15.28	16.27	15.04	14.87	15.23
Electricity, gas and water supply	0.34	0.33	0.43	0.30	0.28	0.27	0.02	0.23	0.25
Construction	9.36	11.42	9.87	12.22	14.91	13.02	12.34	11.45	11.67
Wholesale and retail trade	20.74	23.43	18.88	20.87	18.72	19.70	20.14	19.22	18.52
Hotels and restaurants	7.75	8.90	9.45	10.55	11.12	11.89	11.51	12.61	12.83
Transport, storage and communication	6.10	5.94	5.49	4.88	6.14	6.59	6.53	5.99	5.82
Financial intermediation	1.58	0.08	1.72	1.72	0.58	0.93	0.86	0.82	0.82
Real estate, renting and business activities	7.89	8.93	10.24	11.01	12.27	11.40	12.77	13.36	13.11
Public administration	0.23	0.21	0.02	0.02	0.15	0.13	0.14	0.01	0.12
Education	0.77	0.23	0.61	0.32	0.03	0.28	0.30	0.26	0.27
Health and social work	1.95	1.93	1.77	1.05	0.98	0.96	0.85	0.83	0.84
Other community, social and personal service activities	3.46	0.18	3.03	2.66	2.15	2.33	2.18	2.27	2.19
Illegal activities	9.13	9.33	9.39	10.27	10.43	10.47	11.28	12.16	12.59

Note: the sum of individual column may slightly differ from 100 due to rounding

Source: Calculation based on Lovrinčević et al. (2011)

3.3. Envelope wages

Due to constraints in the availability of data, our discussion about the nature of undeclared work in Croatia has so far relied on the separate analysis of individuals and enterprises. This gap can be to some extent bridged by the insight into the practice of legitimate employers paying so-called 'envelope wages'. In the case of envelope wages, although the work conducted is based on a formal work contract for a legitimate employer, a certain share of the remuneration for that work is paid on an undeclared ('envelope wage') basis. This connotes an agreement between an employer and his formally employed worker that, in order to avoid taxes and social contributions, only a part of the wage will be declared to the authorities, while the rest of the wage is paid in cash (Williams, 2008a,b, 2009c,d, 2013a,b; Williams and Padmore, 2013a,b).

As explained by Williams (2009c), the remuneration in envelope wages is quite prevalent practice in transitional countries of Central and East Europe. Croatia is certainly not an exception in this regard. Indeed, in its 2013 Operational programme, the Ministry of Labour and Pension System recognises that "the most common practice in the informal economy is the truncation of the wage into two parts: the minimum mandatory wage is declared as the taxable wage on which contributions are levied while the rest of the wage is given in cash" (Ministry of Labour and Pension System, 2013, p. 15).

Table 8 summarises the main results about envelope wages in Croatia from the 2013 Eurobarometer survey. As presented, this type of remuneration is far more prevalent among men than among women, while young people (15-24 years of age) are the most frequently engaged in this type of informality. Furthermore, analysis by education reveals that people who finish their education quite early (between 16 and 19 years of age) are the most likely to be receiving envelope wages, which is in line with the fact that skilled manual workers are the most susceptible to these practices.

Yet an interesting finding is that highly educated professionals (such as employed doctors, lawyers, accountants, architects etc.) are far more likely to be remunerated in this way in comparison with other occupations, with the only exception being skilled manual workers.

Table 8 Prevalence of envelope wages in Croatia among individuals, by gender, age, occupation, education, location and type of community, % of respondents

	Yes	No	Refusal (SPONTANEOUS)	Do not know
Total	8.3	85.8	4.4	1.5
Gender				
Male	10.8	82.3	5.4	1.6
Female	5.2	90.2	3.3	1.3
Age				
15 - 24	20.8	70.8	0.0	8.3
25 - 39	6.3	87.4	5.6	0.7
40 – 54	7.9	87.0	4.3	0.7
55+	9.1	87.9	3.0	0.0
Occupation				
Employed professional (employed doctor, lawyer, accountant, architect)	11.4	85.7	0.0	2.9
General management, director or top management (managing directors, director general, other director)	0.0	100.0	0.0	0.0
Middle management, other management (department head, junior manager, teacher, technician)	8.6	91.4	0.0	0.0
Employed position, working mainly at a desk	1.6	91.8	6.6	0.0
Employed position, not at a desk but travelling (salesman, driver, etc.)	0.0	91.3	8.7	0.0
Employed position, not at a desk, but in a service job (hospital, restaurant, police, fireman, etc.)	13.3	83.3	3.3	0.0
Supervisor	0.0	100.0	0.0	0.0
Skilled manual worker	12.1	78.5	5.6	3.7
Other (unskilled) manual worker, servant	0.0	100.0	0.0	0.0
Age when finished education				
<15	0.0	91.7	0.0	8.3
16-19	10.5	84.0	5.0	0.5
20+	4.9	91.2	2.9	1.0
Region				
Zagreb and surrounding	12.1	83.5	3.3	1.1
North Croatia	4.5	88.1	3.0	4.5
Slavonia	10.0	85.0	2.5	2.5
Lika & Banovina	3.4	96.6	0.0	0.0
Istra, Rijeka and Gorski Kotar	7.3	87.8	4.9	0.0
Dalmatia	7.2	84.1	8.7	0.0
Type of community				
Rural area or village	4.5	86.6	6.7	2.2
Small/middle town	5.3	89.5	3.8	1.5
Large town	21.6	77.0	1.4	0.0

Source: Authors' calculations based on the Special Eurobarometer 402

Furthermore, this practice is most common in large towns, where 21.6% of employed respondents stated they are receiving envelope wage. When it comes to spatial differences, envelope wages are the most prevalent in Zagreb and surrounding area (12.1%), followed by Slavonia (10%).

4. Barriers to formalisation in Croatia

There is a vast body of literature on the factors fostering noncompliance. Broadly speaking, we can distinguish five different views on this issue. Here, we briefly discuss each in turn before moving to analysis of the situation in Croatia. Derived directly from the field research or developed indirectly from philosophical debates, each of the five approaches scrutinise undeclared work from a different angle. Although with lots of mutual criticism, these schools should not be perceived as contradicting attempts to explain the causes of undeclared work, but rather as complementing pieces in a holistic approach used when conceptualising this phenomenon (Williams & Round, 2008).

From the perspective of the dualist school, undeclared work is a set of survival activities carried out by low-skilled unemployed individuals (Hart, 1973; Sethuraman, 1976; Tokman, 1978). Dualists point at the lack of formal employment opportunities as the main driver of informality, and therefore advocate creation of new jobs as a viable solution for combating this phenomenon (Hart, 1973). Nevertheless, by restricting the undeclared workforce only to those not in the declared economy, this school misses out all other important stakeholders inside the undeclared realm, such as enterprises or formally employed individuals (Moser, 1978).

According to the legalist school, undeclared activities are a direct consequence of administrative and financial burdens imposed by the state (de Soto, 1989). The focus of this approach are small-scale entrepreneurs who are persuaded to work undeclared in order to survive on the market. As explained by legalists, a decision to circumvent rules is a “popular resistance to an unfair and overly intrusive state” (Rakowski, 1994, p. 506). In line with that, proponents of this approach see weakening the state’s role in business regulation as the main solution to reduce undeclared work (Gërkhani, 2004).

Another set of ideas about the cause of undeclared activities is the so-called structuralist approach. Advocates of this school depict the undeclared economy as a by-product of its formal counterpart (Moser, 1978). From this perspective, undeclared practices are a result of competition among large formal firms, which try to reduce their expenditures by subcontracting a part of the work to small-scale undeclared companies and self-employed individuals (Castells & Portes, 1989). As structuralists explain, a decision to work on an undeclared basis is usually imposed by large firms. It is not a voluntarily chosen endeavour by the workers themselves.

From the standpoint of the voluntarist approach, however, individuals and firms make decision about (non)compliance “after weighing the costs-benefits of informality relative to formality” (Chen, 2012, p. 5). Allingham and Sandmo (1972) argue that taxpayers are rational agents who voluntary decide to operate on an undeclared basis if the benefits of these activities are higher than the cost of being detected and punished. In line with that, the authorities should act in order to increase this cost/benefit ratio and therefore make noncompliance less attractive (Maloney, 2004).

The last and a relatively new view on the causes of undeclared work is the complementary approach, which scrutinises this phenomenon from a quite different perspective. Here, the focus is only on small-scale, community-oriented activities that are not necessarily motivated by financial gains.

Williams and Round (2008) argue that people often engage in undeclared work in order to reinforce social ties, establish their position in a community, or simply to help their neighbours and kin. As such, these activities are depicted as “a good part of the informal economy” (Gaughan & Ferman, 1987, p. 25). Although this type of activity is more prevalent in developed countries, it can also be found in post-socialist countries, as we will see later in the case of Croatia.

In addition to these five theories, we should also mention some recent findings on the link between tax compliance and socio-cultural factors. The central point in this field of research is the role of the ‘tax morale’, which is defined as “an individual’s intrinsic willingness to pay taxes” (Alm & Torgler, 2006, p. 224). Torgler and Schaltegger (2005) argue that there are three different groups of factors that shape tax morale: cultural, institutional and policy factors. As they explain, apart from cultural peculiarities such as religiosity or national pride, which are positively related to tax compliance, taxpayers’ decisions on this issue are also shaped by the level of trust in institutions, the perceived tax burden and the way tax authorities treat them.

This is in line with results of studies about the role of ‘taxpayer ethics’ in the decision-making process. Generally, taxpayer ethics can be defined as “the norms of behavior governing citizens as taxpayers in their relationship with the government” (Song & Yarbrough, 1978, p. 443). As Feld and Frey (2002) state, the way authorities treat taxpayers will shape the implicit psychological contract that exists between these two groups of stakeholders. In that light, a tax administration that acts as a resolute enforcement body, practicing deterrence rather than collaboration from a customer-oriented service perspective, is more likely to face greater level of disobedience among its taxpayers.

Furthermore, Wintrobe and Gërxhani (2004) found a positive link between tax compliance and the level of trust in national institutions, as well as between perception of prevailing norms in society and tax compliance. If citizens think government does not spend their taxes efficiently and fairly, they will be less willing to comply. Similarly, individuals who perceive evasion as a widespread practice in society are more likely to evade taxes too. This is in line with Wenzel (2004) who concluded that taxpayers identify themselves with other taxpayers in their surrounding and tend to act in accordance to prevalent behaviour inside the group.

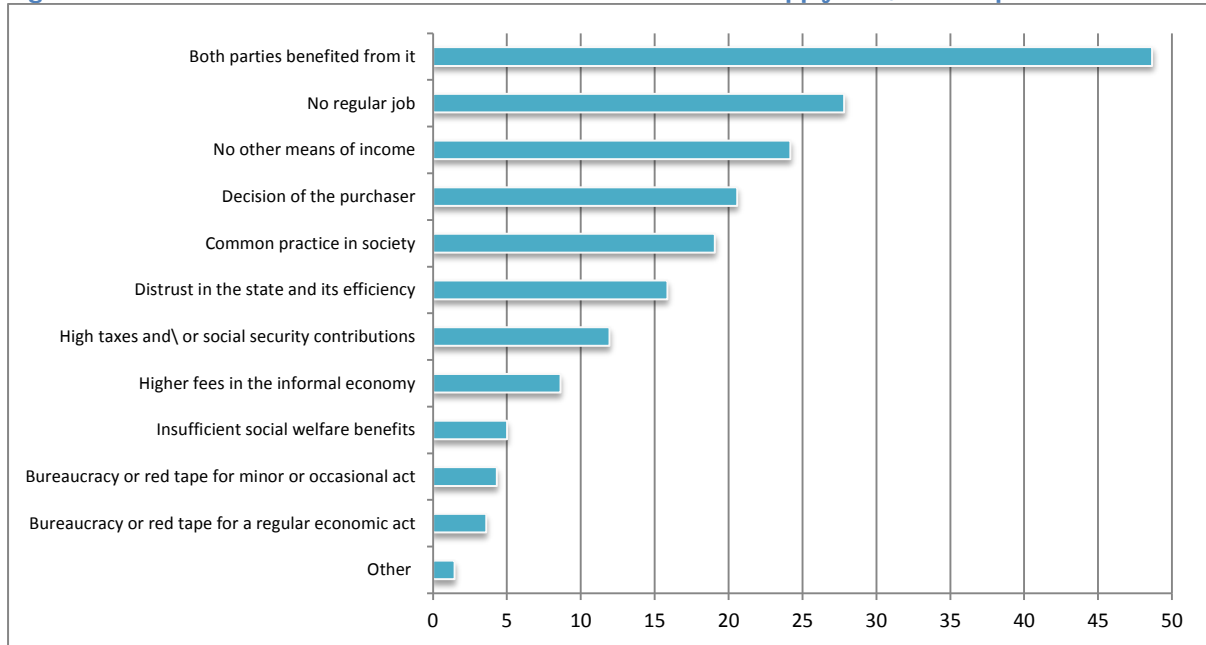
4.1. Causes of undeclared work in Croatia from the perspective of labour supply

Before commencing a discussion about the factors fostering undeclared work in Croatia, we should examine the findings of the 2013 Eurobarometer survey on this issue. The survey respondents who carried out unregistered work were asked for reasons why they decided to hide those activities from the authorities. As illustrated in Figure 7, almost a half of respondents describe their undeclared practices as an outcome of a mutual agreement with purchasers due to the financial gain for both parties. In part, this argument can be seen as a direct result of these participants not understanding and appreciating the value of paying taxes to the wider society. However, the two subsequent rationales probably better clarify the rationales behind undeclared work in Croatia⁷. The fact that about 28% of undeclared workers were motivated by the lack of formal employment opportunities and 24% by the lack of any alternative income suggests that undeclared work provides a survival

⁷ As multiple answers were allowed, financial gain for both parties was often just an additional justification alongside other reasons.

practice for a significant part of population. These findings, which to some extent correspond with the dualist approach, will be discussed later in detail.

Figure 7 Reasons for undeclared work in Croatia from the labour supply side, % of respondents

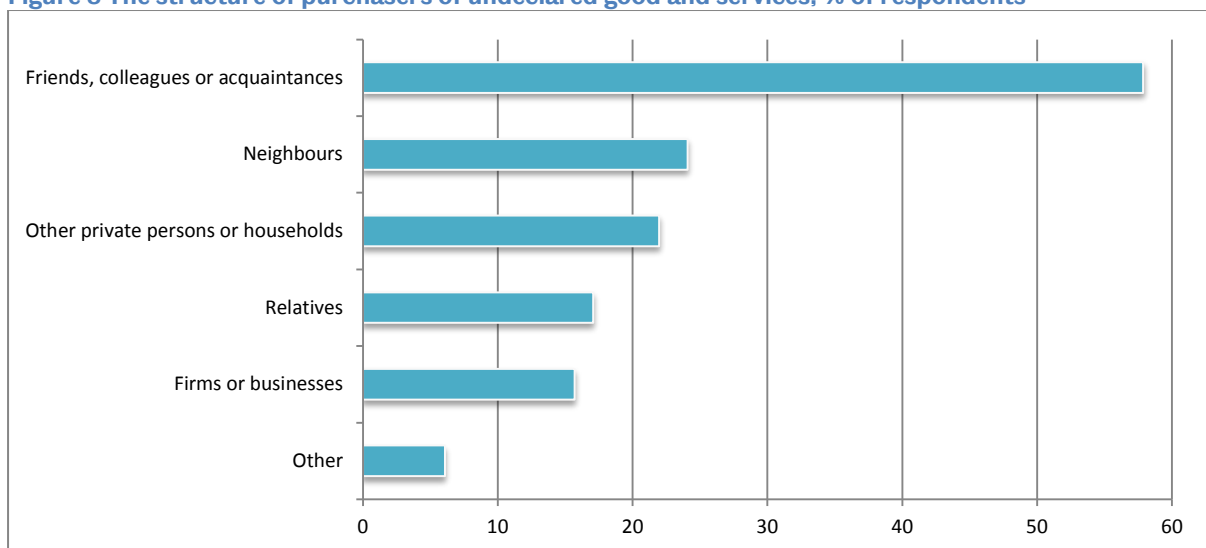


Source: Authors' calculations based on the Special Eurobarometer 402

Another interesting fact is that 19% of respondents recognise undeclared work as a common practice highly widespread in their country, while about 16% of them justify their behaviour by disproportion in imposed liabilities and received support from the state. This therefore suggests that apart from institutional obstacles, socio-cultural factors also play an important role in shaping decision about (non)compliance.

Further insight reveals that far the most frequent purchasers of undeclared goods and services are friends, colleagues and acquaintances, followed by neighbours (Figure 8). These results are in line with ideas of complementary approach, pointing at social networks as a basis for undeclared activities.

Figure 8 The structure of purchasers of undeclared good and services, % of respondents



Source: Authors' calculations based on the Special Eurobarometer 402

4.1.1. Institutional factors

In accordance with the presented reasons for engaging in undeclared work in Croatia, probably the best starting point in our overview of the institutional obstacles from the labour supply side is the issue of unemployment. In this regard, we shall particularly emphasise two important characteristics of unemployment in this South-East European country: the high share of the long-term unemployed and pervasive unemployment among young people.

Accounting for 17.2% in 2013, the unemployment rate in Croatia is one of the largest in the EU, with Spain and Greece as the only member states facing more prevalent unemployment (Eurostat, 2014b). In comparison, the average unemployment rate in the EU28 was 10.8% in 2013. Even more concerning thing is that 63.7% of unemployed people in Croatia are long-term unemployed, i.e. individuals who have not found a formal job for more than 12 months (Eurostat, 2014a). As Crnković-Pozaić (2002) concludes in her analysis of the link between unemployment and undeclared work in Croatia, these long-term unemployed represent one the most vulnerable groups in society and therefore are extremely susceptible to engaging in undeclared activities, particularly in undeclared self-employment. She describes their choice to work on an undeclared basis as a decision taken out of necessity because, apart from losing faith in finding a regular job, many of them are faced with the loss of any alternative income (time-fixed social benefits, savings, financial aid from family etc.).

Another worrying phenomenon is an extremely high unemployment rate among young people between 15 and 24 years of age, which accounted for 43.1% in 2012 (Croatian Bureau of Statistics, 2013). The lack of formal employment opportunities for this group is inherent for all types of individuals, regardless of gender, level of education and residence. Every fourth unemployed person in Croatia is below the age of 24, most of them being individuals without any work experience. Nevertheless, this pervasive unemployment among young people is not solely a consequence of the economic downturn; it is also partially a result of disproportion between labour demand and supply. As the survey of 10.432 employers conducted by the Croatian Employment Service in 2013 reveals, 11.3% employers had problems in finding workers despite such a high unemployment rate (Croatian Employment Service 2013). The most important obstacle for surveyed employers is the impossibility to find a worker with appropriate profession, with about 60% of them recognising that as the major problem.

Particularly worrying in this regard are recent developments concerning higher education in Croatia. In order to improve the quality of university education, the Government launched a reform in the second half of 2000s. Apart from aligning the system with those in other European states, the reform also included a significant increase in the number of study programs and overall quotas. This resulted in the number of individuals who graduated in 2011 being almost two times higher in comparison to 2006 (Croatian Bureau of Statistics, 2011, 2012). Yet, this increase of quotas was pursued completely unsystematically, without taking into consideration the conditions on the labour market. For instance, 30% of all students in the academic year 2009/2010 were studying on numerous programs in the field of economics, followed by 10% of those enrolled in various law schools (Agency for Science and Higher Education Croatia, 2014). On the other hand, there is a general lack of people with a university degree in fields such as medicine and engineering. This disparity between labour market demand and labour supply on the higher education level can certainly help in explaining why more than one third of those who finish their university degree cannot find formal employment in Croatia (Obadić & Majić, 2013). Having no experience and formal employment, undeclared work is often the only income opportunity for these young highly educated people.

Nevertheless, there are also noteworthy rationales for carrying out work on an undeclared basis in Croatia for many of those who have an opportunity to work formally. Among the most important incentives are definitely high taxes and social contributions. Indeed, in their analysis of tax systems in Croatia and the EU27, Grdović Gnip and Tomić (2010) found that Croatian workers face a much higher overall tax burden than their European counterparts. This is particularly pronounced in the case of workers with a lower income (67% of the average gross wage) whose personal average tax rate⁸ in 2009 accounted for 27.5% of the gross wage, while it was 23.4% in the EU27. For Croatian workers with average earnings this rate was 30.5% (27.6% in the EU27), and for those with high income it was 35.2% (33.2% in the EU27). Together with a high tax burden, an additional rationale for non-compliance can be found in a broadly accepted belief among workers in Croatia that high social security contributions “are not proportionate to their future pension and health care insurance costs and benefits” (Bejaković, 2012, p. 2).

Apart from the prevalent distrust in its long-term sustainability, there are some other features of the Croatian pension system that provide incentives for undeclared work. This especially applies to numerous options for early retirement available for some privileged groups, such as war veterans and former political prisoners. Accounting for 15% of all retired persons (European Commission, 2013a), these ‘privileged pensioners’ represent a potential undeclared workforce due to the fact that a significant portion of them is still middle aged and capable of work. However, even more susceptible for undeclared work are the poorest pensioners who should not be neglected in this regard. As Urban (2011) found in his analysis of the living standard of pensioners, 28% of all retired persons in Croatia are receiving an amount that is below the minimum value necessary for basic needs. This lack of income certainly provides enough incentive for engaging in undeclared activities, which can explain why retired people comprise more than 15% of all undeclared workers in Croatia.

Another potential issue that should be discussed here is the link between undeclared work and the system of social protection in Croatia. The biggest problem in this regard are the so-called ‘benefit traps’, which distract those with lower income opportunities from formal employment. Namely, as formal earnings very often exceed low income thresholds imposed on eligibility for social benefits in Croatia, some individuals who accept a formal job can potentially lose more than they earn (European Commission, 2013a). Making formal employment pay is therefore important if the undeclared economy is to be tackled.

This is in line with findings of Bejaković, Urban, Bezeredi, and Matejina (2012) who analysed the marginal effective tax rate for eight different types of family⁹. Indeed, in some cases and for some types of family the results suggest that income would be even lower if the person accepts a regular job and leaves the social assistance programme. Furthermore, although in most scenarios unemployed people would have higher overall income if they start working formally, these paybacks are quite poor which encourages them to stay inside the assistance programme and work on an undeclared basis. In addition, the authors of the study conclude that particularly pronounced disincentives for the formal employment in Croatia are provided by allowances that are not conditional upon efforts of the beneficiary finding a job (e.g. child allowance). However, some of these drawbacks were removed with new the Social Welfare Act, which came into force on 1 January 2014 (discussed later).

In general, major critiques of the social security system are directed to its poor efficiency in redistribution endeavours. As Bejaković (2009) points, the large share of the GDP spent on these

⁸ The sum of income tax and social security contributions paid by the employee as the proportion of the gross wage.

⁹ Families are distinguished in accordance to the number of grown-ups, their job status and the number of children.

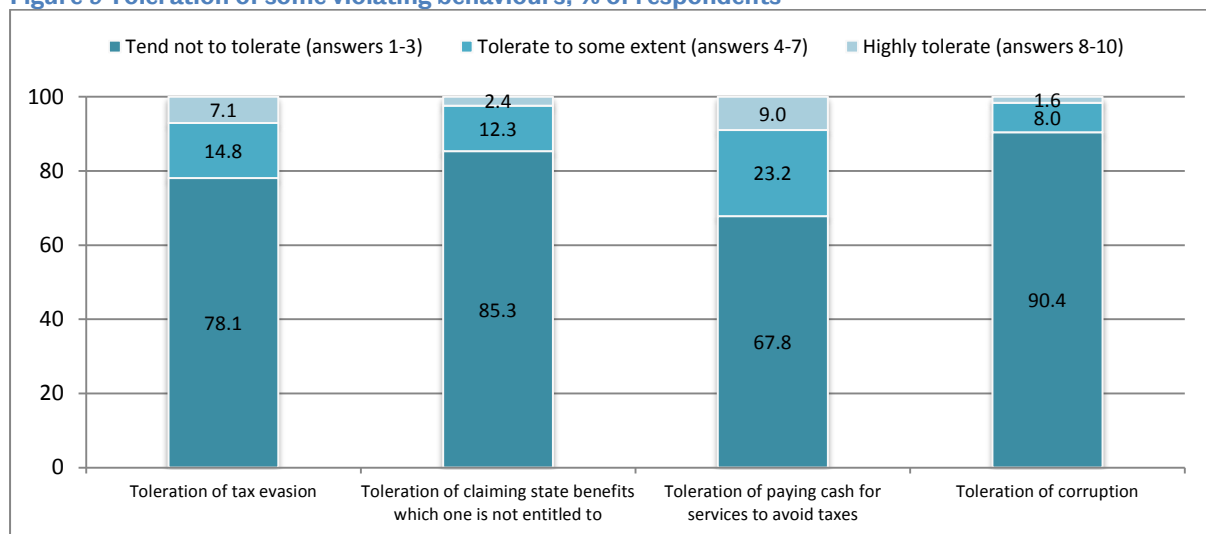
social programs results in even greater inequality. This is because the system fails to provide adequate protection for the elderly and disabled, while at the same time offering tangible benefits for relatively well-off individuals and households. This contributes to dissatisfaction among taxpayers and consequently reduces their willingness to pay social contributions.

4.1.2. Socio-cultural factors

One of the most important sources of information about socio-cultural determinants of undeclared work in Croatia is the European Values Study. This large-scale survey, first launched in 1981 and repeated every nine years, provides insights into personal attitudes and beliefs about family, society, work, politics, religion, and some moral values in 47 European countries/regions. Croatia was included in the last two waves (the 1999 survey of 1,003 respondents and the 2008 survey of 1,525 respondents) which allows us to track longitudinal changes.

The first interesting finding we should discuss is a toleration of four violating behaviours directly or indirectly linked to the practice of undeclared work. Respondents were asked to what extent they are tolerant towards cheating on tax, claiming state benefits which one is not entitled to, paying cash for services to avoid taxes and accepting a bribe. Answers for each variable range from 1 (never justifiable) to 10 (always justifiable). Findings from the 2008 European Values Study are summarised in Figure 9.

Figure 9 Toleration of some violating behaviours, % of respondents

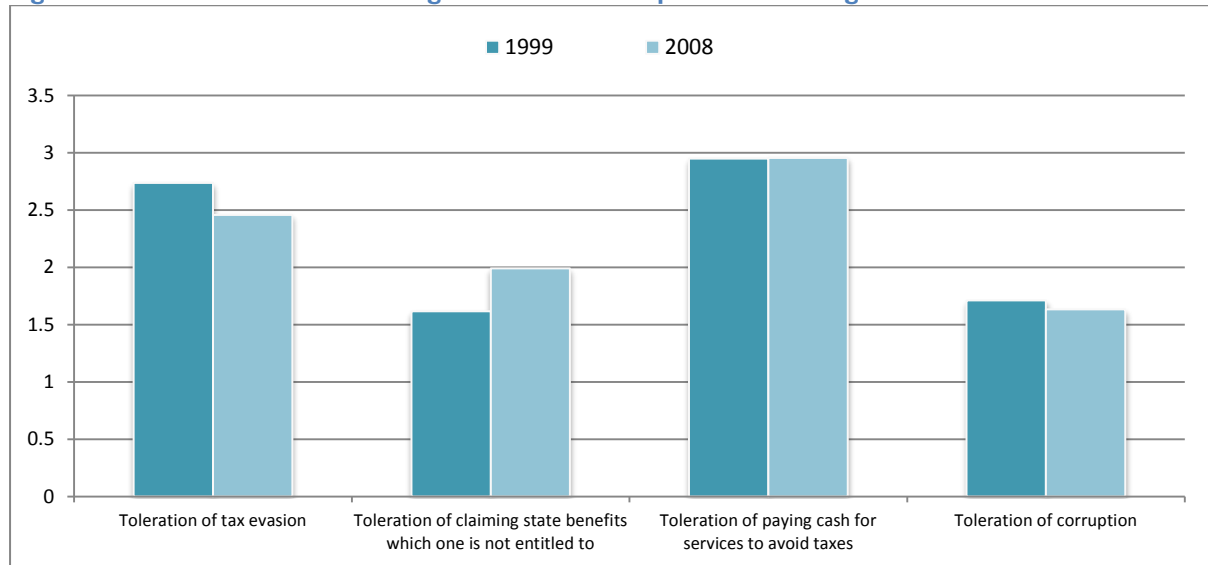


Source: Authors' calculations based on EVS (2011)

As illustrated, although majority of population in Croatia generally do not tolerate these activities, there is a certain proportion of those who do justify such behaviours. This especially applies to the toleration of cash payments and tax evasion. For instance, 9% of respondents highly tolerate cash-in-hand activities (answers 8-10), while 23.2% tolerate these practices to some extent (answers 4-7). Similarly, 7.1% of respondents highly tolerate tax evasion, and 14.8% tolerate it to some extent. On the other hand, around 15% tend to tolerate false claiming state benefits, while about 10% stated the same in the case of corruption. This therefore confirms that tax morale is certainly an important

determinant of undeclared practices in Croatian society, and as such should not be neglected when creating policy responses.

Figure 10 Toleration of some violating behaviours: a comparison of average scores for 1999 and 2008



Source: Authors' calculations based on EVS (2011)

Longitudinal comparison reveals there is a minor decrease in the toleration of tax evasion and corruption during the given period (Figure 10). On the other hand, practice of claiming state benefits which one is not entitled to was tolerated more in 2008 than nine years before, while there was not any change in toleration of paying cash to avoid taxes.

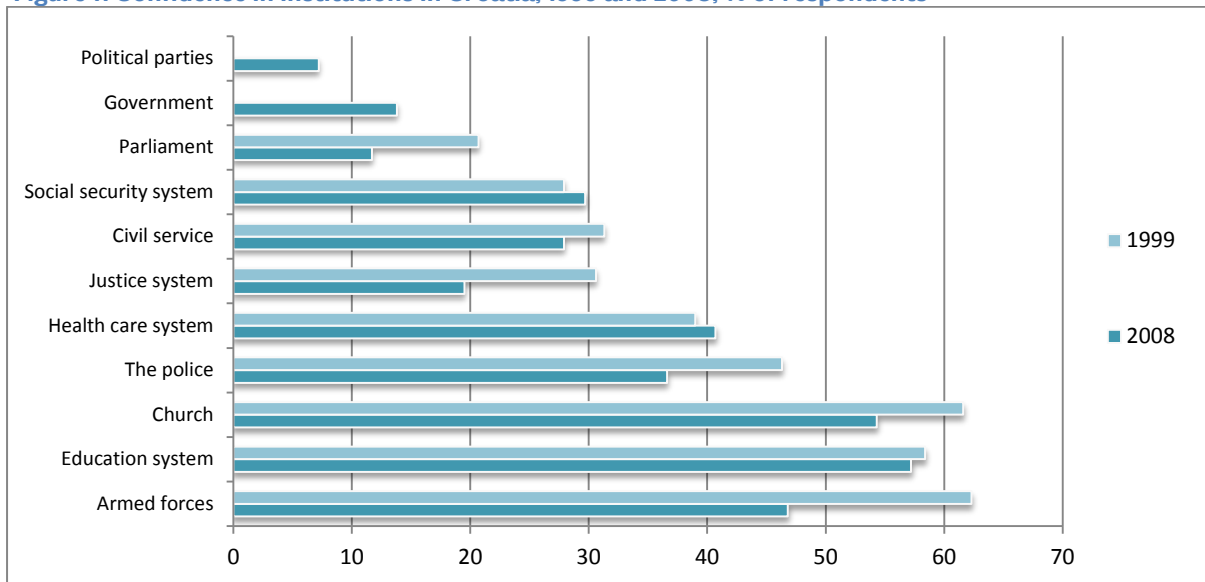
Štulhofer and Rimac (2002) used these data in their quantitative analysis of the link between socio-cultural factors and the underground economy in Croatia¹⁰. They used opportunism as a proxy for inclination to participate in undeclared activities. In this case, the opportunism is calculated as the average of two aforementioned variables: toleration of tax evasion and toleration of corruption. According to the findings, there is a strong negative correlation between opportunism and age, implying that the youngest respondents are the most prone to opportunistic behaviour. The authors also found a positive correlation between the opportunism and education, as well as between the opportunism and income. The most concerning conclusion underlined in the study is a positive attitude towards tax evaders among the younger population, which indicates a possible long-term trend in such a high share of undeclared work in Croatia.

Turning to the trust in national institutions, we can further analyse results of the European Values Study. People were asked to state how much confidence they have in some institutions with the following answers possible: a great deal, quite a lot, not very much and none at all. As Figure 11 display, people in Croatia generally do not trust national institutions, particularly when it comes to the government and national parliament. In 2008, only 11.7% of respondents had confidence in the parliament, which is a significant drop in comparison to 1999 when that share was 20.7%. On the other hand, only 13.8% were confident in government in 2008. Unfortunately, due to lack of data about the

¹⁰ Underground economy here encompasses "all economic activities, direct or indirect (such as tax evasion) that intentionally avoid inclusion in official statistics – remaining unrecorded" (Štulhofer & Rimac, 2002, p. 3)

trust in government for 1999, it is not possible to analyse the trend. Generally, there is a downward trend in the confidence in national institutions.

Figure 11 Confidence in institutions in Croatia, 1999 and 2008, % of respondents



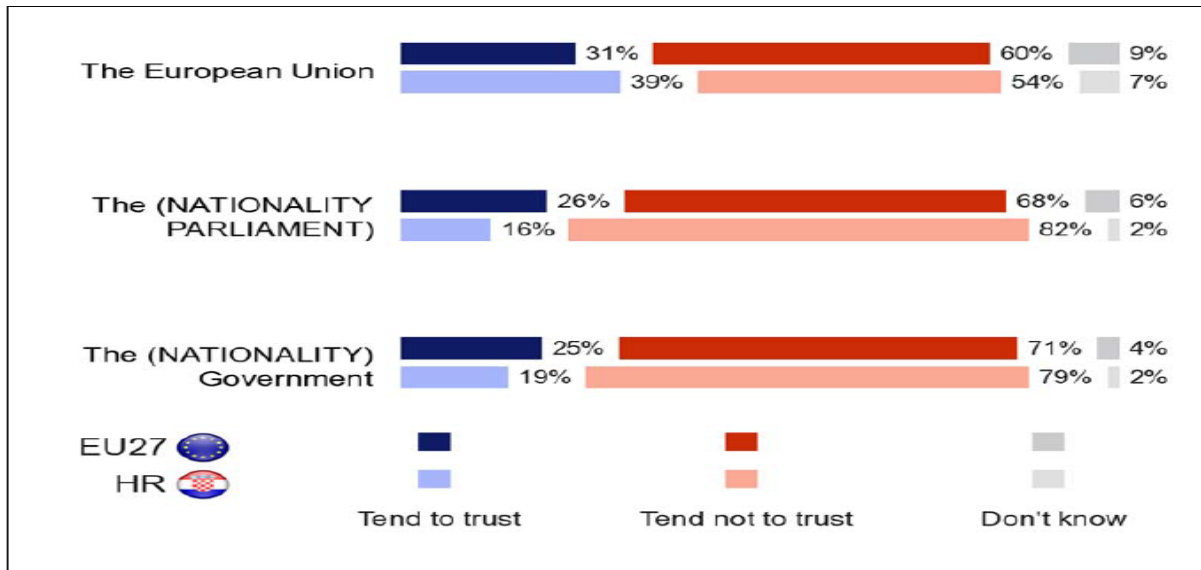
Source: Authors' calculations based on EVS (2011)

With slightly more optimistic results, the survey on 1,002 respondents conducted by the Institute for Social Research in 2010 confirms low level of trust in institutions (Sekulić & Šporer, 2010). For instance, their results show that despite 28.4% of respondents tending to trust government, only 5.1% have complete trust¹¹.

The Eurobarometer Survey on public opinion in the European Union conducted in 2013 suggests that Croatian citizens have less trust in the national government and national parliament in comparison to the EU27 as a composite. While 82% of respondents in Croatia tend not to trust in the parliament and 79% tend not to trust in the government, those shares for the EU27 as a composite are 68% and 71% respectively (Figure 12).

¹¹ There were four possible options to express the level of trust: not at all, very few, quite a lot, complete trust.

Figure 12 Trust in government, parliament and European Union, comparison of results for Croatia and EU27



Source: European Commission (2013b)

Bejaković (2009) argues that foundations for such prevalent distrust in institutions and low tax morale can be traced back to period of Yugoslavia. As he explains, in the Kingdom of Yugoslavia¹², the population was comprised mainly of poor peasants who faced an extremely heavy tax burden on the one hand and a lack of significant support from the government on the other. At the same time, highly privileged politicians rather chose to direct public expenditures to financing the army and enormous bureaucracy, than on social issues. In consequence, such disproportion in liabilities and benefits encouraged citizens to find successful strategies for tax evasion. It should be noted that although this disobedience was often a result of disappointment and dissatisfaction, in many cases it was also a survival strategy due to the widespread poverty among the population.

After the short period of independence during the Second World War, Croatia became one of the six republics in the renewed Yugoslavia, the federation constituted as a socialist republic. The system was characterised by a high degree of bureaucratization and was dependant on the public budget. Apart from a high cost of administration, there were quite excessive expenditures on the army, the police forces and the celebration of national holidays. The society was divided into 'ordinary citizens', who were major contributors to the public purse, and privileged members of the Communist Party, who were completely reluctant to any economic and political change. From the perspective of ordinary citizens there was a high discrepancy between their tax liabilities and the benefits received in return from the authorities, which provided a firm rationale to engage in undeclared activities (Bejaković, 2009).

A good overview of undeclared practices in Croatia during the period of socialism can be found in the ethnographic study conducted by Rubić (2013). This qualitative research encompassed about 50 residents of one settlement near the City of Zagreb, all of them being unemployed people between 50 and 65 years of age and with work experience in the former Yugoslavia. As the author concludes, there were also some other important rationales for participating in the undeclared economy during the socialist period apart from distrust in the institutions. The most salient ones were low levels of income

¹² It was established in 1918 and initially named the Kingdom of Serbs, Croats and Slovenes, but was renamed in 1929 after the constitutional change.

from formal employment and an aspiration for establishing firm social ties inside the community. These rationales were especially pronounced in activities concerning the building of private houses. Not only was the majority of expenses on this issue usually paid with the money earned on an undeclared basis, but also most of the work done in the process of building was based on informal ties (Rubić, 2013).

Another interesting practice during socialism mentioned by informants in the study was carrying out undeclared activities after the regular work by using materials and tools from the company where one was formally employed. It was a common practice to bring company's screwdrivers, pliers or wooden boards home and use them for one's own informal craftsmanship. However, these small-scale informal activities were transformed into main survival opportunities in the 1990s when a part of population lost their regular jobs during the transitional period (Rubić, 2013).

Apart from enlarged unemployment, incentives for undeclared work during the transitional period can be found in the additional deterioration of the tax morale. Certainly one of the most important roles in this regard was played by pervasive corruption in the privatisation process during 1990s (Čučković, 2002). According to the survey conducted by the Institute of Social Sciences Ivo Pilar in 1998, there was a wide public distrust in the two central institutions in charge of privatisation in Croatia: the Ministry of Privatisation and Croatian Privatisation (Šundalić, 1999). Only 5.3% of respondents had high level of trust in the Ministry of Privatisation, and only 4.6% had trust in the Croatian Privatisation Fund.

Tax morale was further weakened by constant and unsystematic changes in the tax system during the given period. After gaining independence, Croatia established a quite simple, consumption-oriented tax system, with synthetic taxation of income and value added tax¹³. Nevertheless, due to political pressures during the late 1990s and early 2000s, gradual changes in the tax legislation resulted in a huge number of exemptions, increased complexity and cost of levying, and consequently in additional dissatisfaction among tax payers (Jelčić & Bejaković, 2012).

In line with the presented arguments, one can conclude that the gap between the authorities and citizens is doubtlessly an important contributing factor for such a high share of undeclared work in Croatia. As noticed by Rubić (2013), her respondents were not reluctant to talk about their unregistered activities because there is generally a permissive attitude towards taxpayers' disobedience. The author therefore concludes that undeclared work in Croatia is a common way of operating which constitutes an integral part of neighbour and kin relationship. As such, undeclared practices are highly widespread and inherent for every part of society.

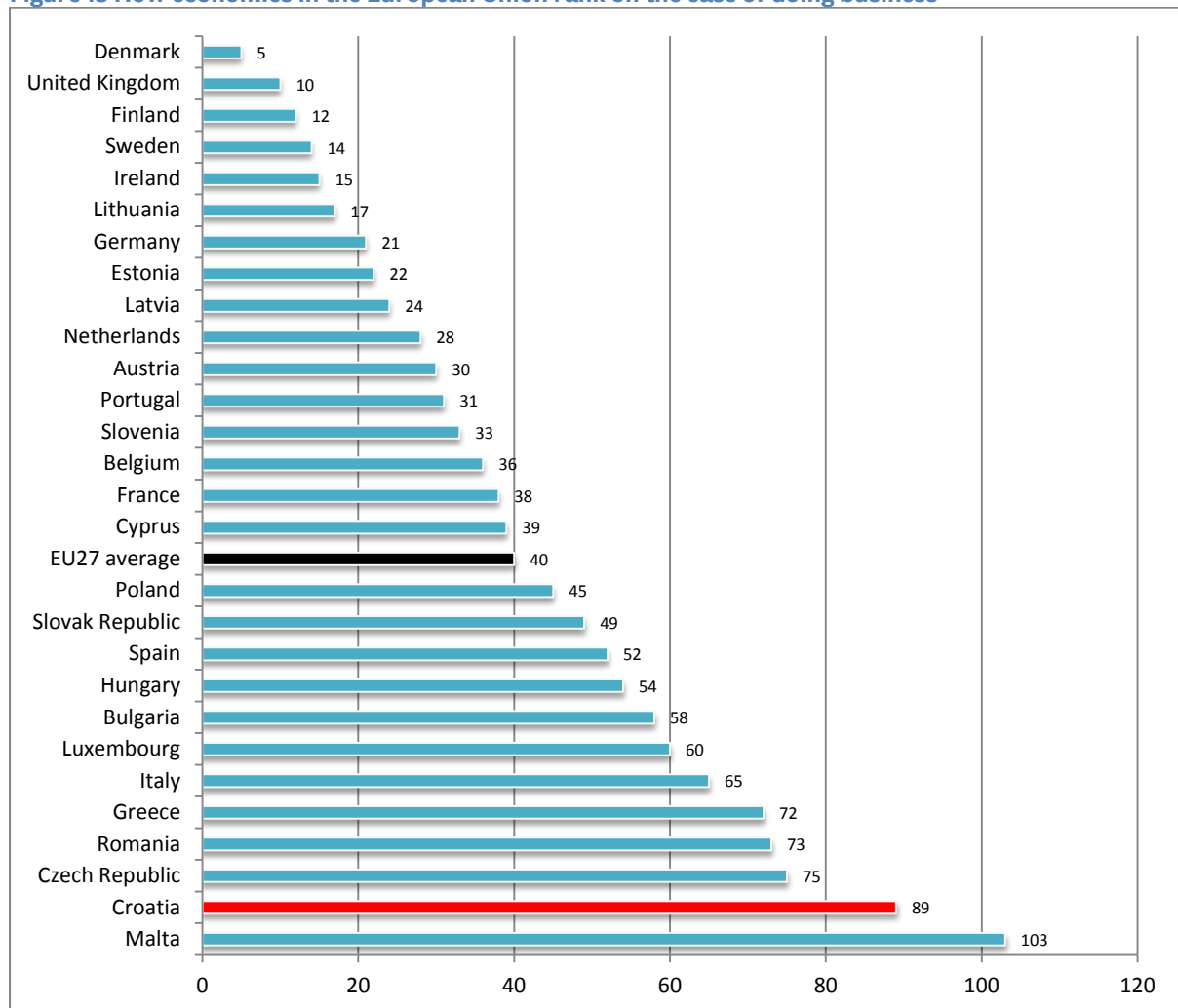
4.2. Institutional obstacles in Croatia from the perspective of businesses

A good insight into the institutional obstacles in the process of starting and running a business in Croatia can be provided by the World Bank Doing Business Survey. Conducted on an annual basis in 189 countries, the survey evaluates the effectiveness of national legislation in 11 different areas concerning the life cycle of a business: starting a business, paying taxes, dealing with construction permits, registering property, getting electricity, getting credit, protecting investors, trading across borders, enforcing contracts, resolving insolvency and employing workers. Apart from rankings in individual areas, an overall country ranking is provided which enables us to analyse how Croatia stands in comparison with other surveyed countries, especially with EU27 members.

¹³ Value added tax is introduced in 1998.

In the Doing Business 2014 survey, Croatia is ranked 89th out of 189 countries (World Bank, 2013a). At the same time, the EU27 as a composite was ranked 40th (World Bank, 2013b) which suggests that it is more difficult to start a business and operate in Croatia in comparison with the EU27 as a composite. Detailed insight shows that Malta is the only EU country where starting and running a business is harder than in Croatia (Figure 13).

Figure 13 How economies in the European Union rank on the ease of doing business



Source: Based on World Bank (2013a) and World Bank (2013b)

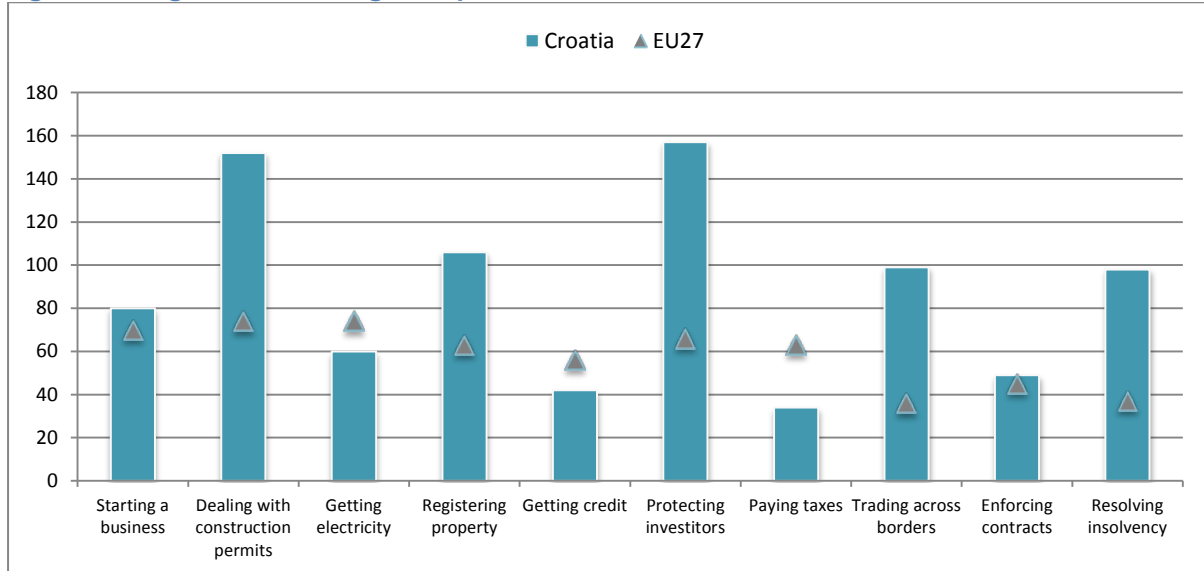
An analysis of the individual factors presented in Figure 14 reveals that it is harder to start a business in Croatia (ranked 80th) than in the EU27 as a composite (ranked 70th). Starting a business in Croatia takes 8 days, requires 6 procedures, costs 9.3% of income per capita and requires paid-in minimum capital of 10% of income per capita (World Bank, 2013a).

On the other hand, paying taxes is the area where Croatia ranks best¹⁴. In fact, in comparison to the EU27 which is ranked 63rd, paying taxes is much easier in Croatia (ranked 34th). Nevertheless, this is

¹⁴ Apart from the number of tax payments and time required to comply during the year, the criteria for evaluation in this area also includes a total tax rate which embraces profit/corporate income tax, social

distorted by poor achievement in other areas, especially when it comes to protecting investors (157th), dealing with construction permits (152nd) and registering property (106th).

Figure 14 Doing Business rankings, comparison of Croatia and EU27



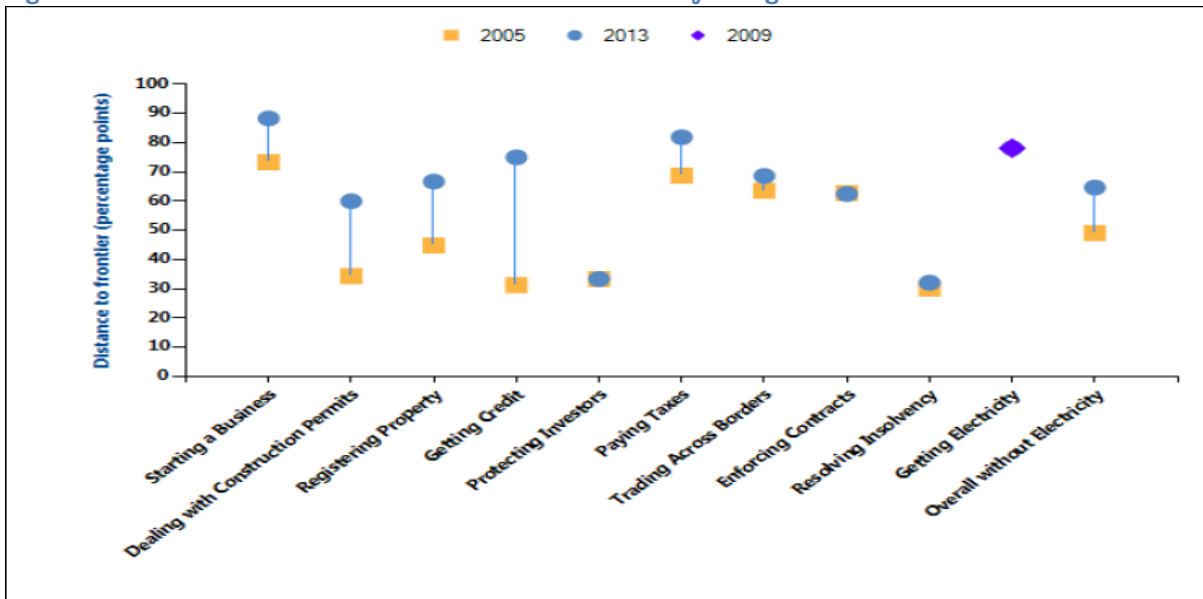
Source: World Bank (2013a)

Yet, one must be cautious when making conclusions because the discussed rankings represent only relative measures. For instance, the fact that Croatia is ranked 34th in paying taxes and 80th in starting a business only suggests there are 33 and 79 countries respectively which performed better in these segments, but does not necessarily mean that there is more room for improvement in the field of starting a business than in paying taxes. Moreover, rankings for individual areas, as well as the overall ranking, do not tell us much about how the business environment in Croatia has changed over time nor how far it is from the best economies.

A much better measure to evaluate the ease of doing business is a distance to frontier measure (Figure 15). It shows the progress Croatia has made since 2005 in comparison to the best performance among all 189 countries analysed in the Doing Business survey. For each factor, values range from 0 to 100, with 100 representing the best achievement in a certain area among surveyed countries. The figure suggests that starting a business is actually the area where Croatia is closest to the best performance, followed by paying taxes, getting credit and getting electricity. However, despite noticeable progress on some indicators, as well as on the overall indicator, there is still a lot of room for improvement. This especially applies to protecting investors and resolving insolvency where no significant progress has been achieved during the past eight years.

contributions, labor taxes paid by the employer, property taxes and property transfer taxes, financial transaction taxes, capital gains taxes and other existing taxes.

Figure 15 How far has Croatia come in the areas measured by Doing Business?

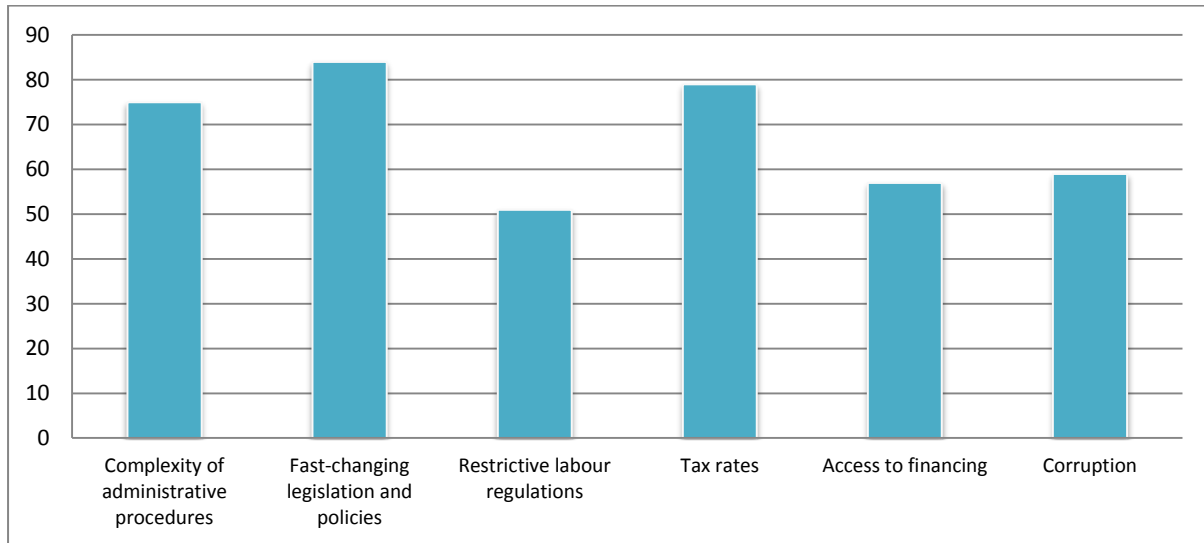


Source: World Bank (2013a)

Nevertheless, one should bear in mind that taxpayers make decisions about (non)compliance in accordance with their personal perception of the state of affairs which often does not match the real situation. This is best exemplified by analysing results of the 2013 Flash Eurobarometer on businesses' attitudes towards corruption in the EU. Although primarily orientated on corruption, this survey of 7,541 firms in all 28 member states also provides some insight into the perception of other obstacles in running a business. The survey in Croatia encompassed representatives of 301 firms in the following sectors: construction and building; energy, mining, oil and gas, chemicals; engineering and electronics, motor vehicles; telecommunications and IT; healthcare and pharmaceutical; and financial services, banking and investment.

Among other things, respondents were offered a list of possible obstacles and asked to state whether they perceive it as a serious problem when running a business. The summary of the results presented in Figure 16 indicates there is a broad negative perception about business environment among Croatian firms. The most salient obstacle is uncertainty caused by fast-changing policies and regulations, with 84% of respondents perceiving it as a serious problem. This is followed by high tax rates (79%) and the complexity of administrative procedures (75%).

Figure 16 Proportion of respondents perceiving the given obstacles as a serious problem in running a business in Croatia



Source: European Commission (2014a)

These results are in line with the survey on the business environment for small and medium enterprise (SME) in Croatia conducted in 2004 as part of the Enterprise Policy Performance Assessments program (OECD, 2005). Namely, the transparency and stability of the tax system among surveyed experts and SME representatives are depicted as being far from satisfactory and rated slightly above poor. However, there is a significant difference in opinion between experts and SME owners and managers. The latter were far more critical, especially in relation to the difficulties in using offered tax incentives. They do not find these incentives attractive due to the complicated procedures required.

Another factor which should be examined as a potential driver of undeclared work in Croatia is the inflexibility of the labour market. In the assessment of the 2013 economic programme for Croatia, the European Commission (2013a) concludes that apart from the obstacles caused by the high cost of hiring employees, probably even more problematic are costly and complex dismissals which can run for several years in court. In the case of firing an employee, the Labour Act prescribes that the employer has to deliver a written justification of the dismissal to the worker at least two weeks in advance¹⁵ (Official Gazette, 2013b). If the worker contest this decision and decides to seek legal protection, the court can enable them to work until the end of the process. The Act also proscribes severance pay if the contract lasted more than two years. These are just some of the rules that can provide incentives for employers to hire their workers on an undeclared basis. By hiring workers on an off-the-books basis, an employer circumvents the rules concerning the protection of the worker and therefore avoids the problems associated with such dismissals, as well as all other liabilities concerning taxes and social contributions.

¹⁵ It applies only if the employment lasted less than one year. This period is progressively extended, up to three months in the case of 20 years of employment (although this can be additionally amplified in the case of half-time work, pregnancy, if the worker is above 50 years of age etc.).

5. Organisation of the fight against undeclared work in Croatia

5.1. Cross-government organisation

There is no single agency responsible for tackling undeclared work or no single committee in charge for coordinating actions in this field in Croatia. Instead, responsibility is shared between different ministries and government departments, including the Ministry of Labour and Pension System, Ministry of Finance, Ministry of Interior, Ministry of Tourism, Ministry of Agriculture, Tax Administration, Employment Service and Customs Administration. Despite some examples of cooperation in data sharing and joint actions, generally there is a lack of coordination among these ministries and departments (Baric & Williams, 2013). They rather define their own separate targets and this often results in overlapping or awkward divisions of responsibility. One such example is surveillance in tourism. The Ministry of Tourism is authorised only for the inspection of activities carried out by registered entities and individuals engaged in providing services in tourism, but not for detection and prosecution of undeclared businesses in this field, which is a responsibility of the Customs Administration. In addition, the Customs Administration is in charge of surveillance of compliance regarding sojourn tax.

A central database on employment status and employment relations in Croatia does not exist and, although there are about 200 different databases or registries on this issue, there is no adequate interconnection among them. However, there has been some minor improvement in this field since the introduction of personal identification numbers for citizens and companies in 2009 (Bejaković, 2012).

Probably the most prominent department when it comes to good cooperation practices was the State Inspectorate, the central surveillance institution in Croatia until January 2014. For instance, in 2011 the State Inspectorate sent out about 4,000 notices concerning possible violations to responsible authorities, in first line to the Tax Administration, Ministry of Interior and Croatian Employment Service (Bejaković, 2012). It also conducted joint actions with the Ministry of Interior in combating the illegal employment of foreigners, and collaborated with Ministry of Finance in surveillance regarding compliance with the minimum wage act and legislation in the field of taxes and social contributions. The next section provides a brief discussion about the organisation and activities of this body, as well as about reasons for its dismissal.

5.2. Surveillance activities

The State Inspectorate was established in 1999 as a central organisation for surveillance in various areas, such as trade, catering business, tourism, safety at work, electric power supply, mining, exploration and exploitation of mineral materials, pressure equipment, accounting and payment of the sojourn tax. In December 2012 there were 672 inspectors in the State Inspectorate working in five regional units and 37 branch offices (State Inspectorate, 2013b). They conducted 103,737 inspections, with 46,781 detected violations. Apart from collaboration with other national authorities regarding the fight against undeclared work, the Inspectorate also successfully cooperated with inspection bodies from other states on this issue, particularly with those in the region.

However, the State Inspectorate was abolished from 1 January 2014 with Amendments to the Organization and Jurisdiction of Ministries and Other Central Government Bodies Act adopted on 29 November 2013 (Official Gazzete, 2013). It is not completely clear what was the rationale for this decision, which was brought without any systematic analysis or public debate on this issue. From the perspective of the government, this reform came out of the necessity to consolidate all responsibilities and surveillance actions in a certain field inside the governmental body responsible for that area (Government of the Republic of Croatia, 2013). In line with that standpoint, the responsibilities of the Inspectorate were taken by special departments constituted inside five ministries: Ministry of Finance, Ministry of Labour and Pension System, Ministry of Economy, Ministry of Tourism and Ministry of Agriculture.

The Labour Inspectorate, one of the most important services in tackling undeclared work, now exists as a part of the Ministry of Labour and Pension System. It is responsible for supervision of compliance with the Labour Act, as well as for surveillance in the field of safety at work (Official Gazette, 2014a). There were 15,665 controls in this field in 2012 (17,970 in 2011), which resulted in 12,242 detected violations (14,806 in 2011). The most common violations are work without contract, employment of illegal foreign workers and work without health insurance (State Inspectorate, 2013b).

The two other important departments in the fight undeclared work that should be mention here are the Supervision department for unregistered activities and the Supervision department in the field of trade of goods and services. The first is dedicated to detection and prosecution of unregistered activities, while the latter supervises approvals for starting a business and monitors usage of product labelling stamps. Inspectors from both departments now operate as a part of the Ministry of Finance. There were 2,163 controls in the field of unregistered activities, almost two times more in comparison to 2011 (State Inspectorate, 2013b). A total of 589 violations were identified (388 in 2011).

Another important department in the fight against undeclared activities is the Inspectorate in the field of catering and tourism, which now works as a part of the Ministry of Tourism. It conducts controls related to the implementation and enforcement of laws and regulations in the field of catering and tourism. Inspectors in this area conducted 33,445 controls in 2012 (37,872 in 2011) and found 12,994 violations (14,346 in 2011). The most prominent type of violations in this case is the work without prescribed conditions, followed by operations without issuing a receipt and renting an apartment without a guest list (State Inspectorate, 2013b).

5.3. Role of social partners

The fight against undeclared work in Croatia does not rely solely on ministries and various governmental departments, but also includes the involvement of trade unions and employers' organisations. This is accomplished through the Economic and Social Council (ESC), a tripartite body established in 1994 to enable knowledge exchange and foster dialogue between representatives of the Government, employers and trade unions. Social partners are also involved in the work of several vital bodies and departments, such as Croatian Employment Service, Croatian Health Insurance Fund, Croatian Institute for Health Insurance, Croatian Pension Insurance Fund, and Croatian Privatisation Fund.

The interest of employers in the ESC is represented by the Croatian Employers' Association, the chief employers' organisation established in 1993. On the other hand, there are four major trade unions included in the work of this body: the Independent Croatian Trade Unions of Croatia, Association of

Croatian Trade Unions, Croatian Workers Trade Union Association and Union of Autonomous Trade Unions of Croatia. These four unions encompass about 90% of all trade union members in the country. The Government has six representatives in the ESC, while Employers' Association and Unions have four representatives each. There is an alternation among these three groups of stakeholders in the position of the president and two vice-presidents, who are each elected on one-year mandates.

The ESC has five committees: a Committee for wage policy, tax system and living standard, Committee for social policy, Committee for employment, education and harmonization of the education system with the labour market, Committee for legislation, collective bargaining and protection of rights and Committee for sustainable development, energy, climate change and stimulation of the economy.

The Committee for wage policy, tax system and living standard monitors the implementation of established wage policies, assesses the influence of price and wage changes on the economic stability and development, as well as the influence of price changes on the living standard. It also monitors, discusses and gives opinion about proposed acts in the field of wage policy, as well as in fields of tax and financial systems.

The Committee for social policy debates and gives its opinion about proposed acts in the fields of social policy and social security, especially when it comes to the pension and health systems. It also assesses the influence of social transfers on the poverty risk reduction.

The Committee for employment, education and harmonization of the education system with the labour market discusses and gives its opinion about proposed acts in the fields of employment policy, education system, labour market conditions, as well as when it comes to alignment of the education system and the labour market demand. It also monitors enforcement of the existing measures and proposes new ones to stimulate active employment and social integration of migrant workers.

The Committee for legislation, collective bargaining and protection of rights considers general issues concerning the improvement of the national legislation, particularly acts on the labour market. It monitors the enforcement of adopted regulations and provides opinion and suggestions for improvement. Moreover, it monitors and gives opinion on the current issues related to the conclusion and implementation of collective bargaining. It also assesses whether proposed rules and acts comply with international labour standards and documents.

The Committee for sustainable development, energy, climate change and stimulation of the economy considers proposals and gives its view on the strategic development documents and acts in the fields of sustainable development, energy and ecology. The Committee recommends to the Council appropriate measures to stimulate the economy, development of the manufacturing sector and business environment in terms of social responsibility. It also discusses issues related to the implementation of international agreements to which Croatia is a signatory and the implementation of the European legislation in the field of energy, greenhouse gas emission and the quota allocation.

Since 2011 there is a possibility to carry out a local tripartite social dialogue by establishing local and regional economic and social councils. There is also an option for bipartite social dialogue between employers and trade unions through sector social councils. The main purpose of these bipartite councils is to facilitate collective bargain, as well as to intervene and mediate in the case of disputes between employers and workers. In line with this, six different sector social councils have been established since 2010. The Social council for the textile, footwear, leather and rubber sector, established on 20 April 2010, was the first among them, followed by the Social council for the sector of forestry and wood industry (established on 6 December 2010). Other sector councils include Social council for the road transport (established on 9 December 2011), Social council for the railway

transport (established on 30 May 2012), Social council for the construction industry and Social council for tourism (both established on 26 September 2012).

In general, the culture of social dialogue in Croatia is quite weak. Šokčević (2009, p. 322) argues that the reason for this can be found in “a deep division in values and interests” among the three parties involved in the dialogue. Another contributing factor is an overall lack of confidence between partners accompanied by inefficient conflict resolution mechanisms (Eurofound, 2012).

One such conflict in 2010 resulted in trade unions withdrawing from the ESC for ten months. This was a response to the unilateral decision of the Government to limit the so-called ‘prolonged application of collective agreements’¹⁶. However, after the trade unions launched a campaign for collecting signatures in order to request a referendum on this issue¹⁷, the Government withdrew its decision. Although the members of the ESC have continued with their regular meetings since March 2011, there was no significant improvement in the social dialogue. Nestić, Rubil, Stubbs, and Tomić (2013, p. 24) argue that “relations between social partners remained strained, and there is an impression that they have recently become more conflictual”.

Indeed, the dialog was additionally weakened in 2012 after the Government unilaterally abolished the Office for Social Partnership¹⁸ and replaced it with the Independent Service for Social Partnership at the Ministry of Labour and Pension System. From the perspective of trade unions, this was a “manifestation of the view of the Government that tripartite social dialogue is ‘ownership’ of MRMS [Ministry of Labour and Pension System]” (Milicevic Pezelj, 2013, p. 6). Currently, there is a disagreement on the proposed amendments of the Labour Act. After failure to find a compromise, trade unions withdrew from the ESC in December 2013 in a protest of the Government’s persistence to increase weekly overtime limit and facilitate the firing procedure. This disruption was complemented by resistance of trade unions to the new Pension Insurance Act (adopted in December 2013), which proscribes a gradual increase of retirement age from current 65 to 67 years in 2038. As a consequence of these disputes, the results of the ESC in terms of formal agreements have been quite poor.

6. Policy responses in tackling undeclared work in Croatia

There are a number of different strategies that can be used to reduce the share of undeclared work. Although each of them has its own specific goals and target population, these strategies can be roughly divided in two groups according to the type of behaviour they are focused on. Namely, while some aim at punishing noncompliance, others are focused on providing incentives for compliance (Braithwaite, 2002; Hasseldine & Li, 1999).

Due to its emphasis on penalising disobedience, the first approach is often denoted as ‘deterrence’ or ‘repression’ (Ahmed & Braithwaite, 2005; Hasseldine & Li, 1999). It relies on the aforementioned ideas of the voluntarist school that taxpayers are rational actors who will opt to cheat authorities if assessed benefits of doing so are higher than cost when being caught and punished. In line with that, deterrence

¹⁶ The extension of an expired collective agreement until a new one is signed.

¹⁷ According to legislation, the Parliament has to organise a referendum if 10% of constituency sign a petition.

¹⁸ The Office for Social Partnership was introduced in 2001 with the aim of providing professional and logistic support to the Council, as well as to act as an intermediary in the case of disputes.

measures seek to increase the cost/benefit ratio, but only by focusing on the cost side. Therefore, the main strategy here is to identify and penalise those who violate labour law and/or evade taxes and social contributions. Common measures used to accomplish this aim are workplace inspections, financial and/or administrative sanctions for individuals and firms involved in undeclared activities, data matching and sharing among departments responsible for the fight against undeclared work etc. (Williams & Renooy, 2008).

On the other hand, 'enabling compliance' approach relies on the idea that undeclared work "can represent a potential asset for economic growth and social inclusion" (Sepulveda & Syrett, 2007, p. 88), as well as a significant source of income for the public budget if these activities are shifted to the formal realm. In line with that, measures from this group are focused on providing various incentives for operating formally. Contrary to the deterrence approach, here the taxpayers are depicted as social actors, and therefore the authorities aim at establishing "cooperation rather than coercion" (Williams & Round, 2008, p. 15).

As Williams and Renooy (2008) explain, there are three different subgroups of enabling compliance strategies. The so-called 'preventative measures' seek to stop noncompliance from the very beginning by reducing regulations, simplifying compliance procedures, introducing new categories of work, introducing technological innovations (for instance certified cash registers), etc. On the other hand, 'curative measures' are dedicated to providing incentives for those who are already inside the informal realm to legalise their activities. The most common strategies here are formalisation advice services, society-wide amnesties and tax incentives for both purchasers and workers. Finally, there are 'measures fostering commitment', which aim at raising public awareness about importance of paying taxes. This is usually done through various campaigns or normative appeals (Williams & Renooy, 2008).

In spite of calls to put more emphasis on shifting undeclared work to formal realm (European Commission, 2003a, 2003b, 2007), deterrence is still the predominant policy approach in tackling this phenomenon in Europe (Dekker, Oranje, Renooy, Rosing, & Williams, 2010). On the other hand, although there is an increasing tendency to rely on measures enabling compliance, this is mainly limited to preventative measures (Williams & Nadin, 2012). These findings are in line with the survey of key stakeholders in 31 European countries¹⁹ which reveals that repression is still perceived as the most convenient strategy (Williams, Windebank, Baric, & Nadin, 2013). Namely, more than a half of respondents see repressive measures as the most effective in tackling undeclared work, while only 12% perceive them as the least effective (Table 9). On the other hand, 44% of respondents think commitment measures are the least effective, while almost one third think the same for curative measures.

Table 9 Perceived effectiveness of policy measures, % of respondents

	Most effective	2nd most effective	Least effective
Repressive measures	55	13	12
Preventative measures	20	41	13
Curative measures	15	27	31
Measures fostering commitment	10	19	44

Source: Williams et al. (2013)

¹⁹ EU27 plus Norway, Switzerland, Iceland and Liechtenstein.

The results of the survey²⁰ conducted by Baric and Williams (2013) suggest that practices in tackling undeclared work in Croatia are quite similar to those in other member states. As Table 10 suggests, apart from deterrence, which is a predominant approach, a number of preventative measures have also been introduced recently. Yet, curative measures are particularly scarce, with only three strategies adopted in this field. Similarly, despite being used to some extent, measures fostering commitment are still not widely recognised as an effective strategy in tackling undeclared work in Croatia.

Table 10 Policy measures used in Croatia and 31 other European countries to tackle undeclared work

Policy measure	Used in Croatia	% of 31 European nations using measure:
REPRESSION		
<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
ENABLING COMPLIANCE:		
<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

²⁰The survey encompassed 9 respondents including senior representatives of relevant government departments, representatives of social partners and experts.

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
Fostering commitment to declared work:		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

Source: Baric and Williams (2013)

Before moving to the overview of the policy responses applied in Croatia, we should discuss some general features of the fight against undeclared work in this country. The most important one is that the majority of these reforms were conducted without pilot initiatives or public debates. In addition, apart from a few praiseworthy exemptions, there is a general lack of studies evaluating the effectiveness of the introduced strategies. Nonetheless, the most important weakness of the fight against undeclared work are the too frequent and instant changes of legislation which do not leave enough time for adaptation, not only for the target population, but also for the authorities. One such example happened in the beginning of 2014 when inspectors were left without clear guidance on reallocation and responsibilities after the abolition of the State Inspectorate. For instance, the Labour Inspectorate Act and Tourism Inspection Act came into force more than forty days after the Inspectorate was dismissed.

6.1. Repressive measures

One of the most significant reforms in the field of repression is the aforementioned abolition of the State Inspectorate in January 2014. As explained, the vital departments for tackling undeclared work were shifted to the Ministry of Labour and Pension System, Ministry of Finance, and Ministry of Tourism. Namely, the Labour Inspectorate now exists as a part of the Ministry of Labour and Pension System, Supervision department for unregistered activities and Department for supervision of trade of goods and services work as a part of the Ministry of Finance, while the Inspectorate for catering and tourism exists as a part of Ministry of Tourism. Nevertheless, it is questionable whether this reform will indeed improve the effectiveness of surveillance. The main concern expressed by the Trade Union of State and Local Administration Employees is that shifting inspectors under the jurisdiction of

Ministries will significantly reduce their autonomy. In that light, the abolition of the State Inspectorate actually represents one step back in the fight against undeclared activities from the perspective of the Union (Slobodna Dalmacija, 2014, 2 January).

This reorganization also altered the powers of inspectors in Croatia, which now vary according to the area of inspection. For instance, tourism inspectors are allowed to enter and examine all areas where business activities are carried out, including private houses, apartments and vehicles used for providing services in tourism (Official Gazette, 2014b). On the other hand, subjects under surveillance are not obliged to allow entrance in building for labour inspectors without a search warrant (Official Gazette, 2014a).

When it comes to other strategies for improved detection in Croatia, the most common one is focusing on particular sectors where undeclared activities are highly prevalent. For instance, following Amendments of the Act on the Provision of Tourism Services (Official Gazette, 2010a) and Amendments of the Hospitality and Catering Industry Act (Official Gazette, 2010b), the number of controls in tourism was increased, particularly during the summer period. There were 58% more control actions during the tourist season in 2010 compared with the previous year and 67% more discovered violations (State Inspectorate, 2010).

Another reform dedicated to improved detection was the introduction of the personal identification number in 2009. Each individual and company was given a unique 11-digit number, which acts as an identifier in their transactions and interactions with the authorities and other subjects. The main purpose of this innovation was to make a prerequisite for data exchange among ministries and various governmental departments (Ministry of Finance, 2011).

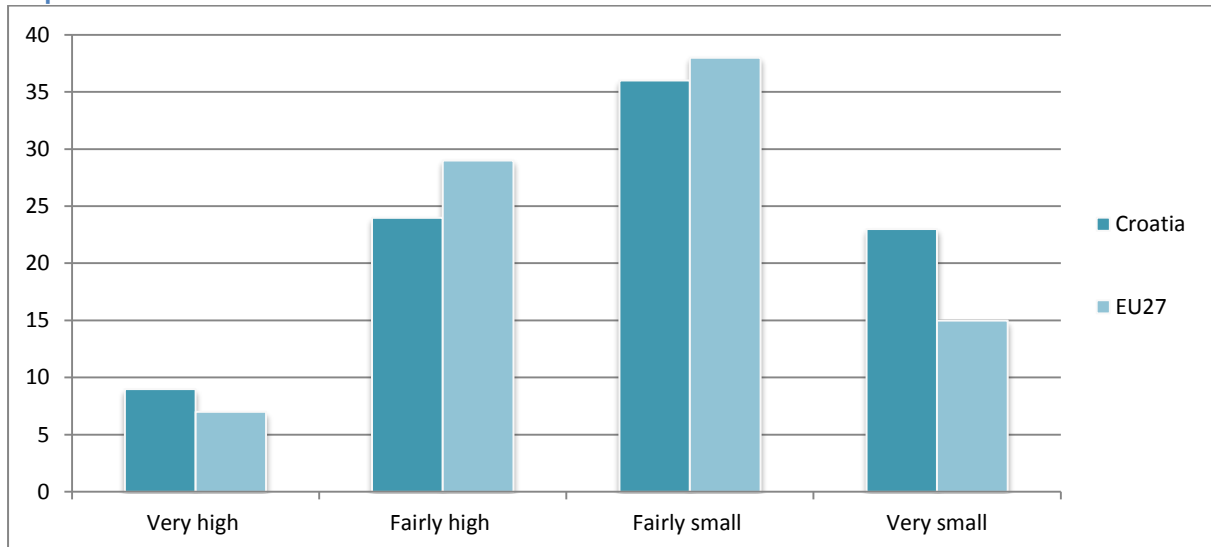
Turning to the surveillance of tax compliance, we should mention recent organisational changes in the Tax Administration that aimed at improving the effectiveness of audits. One of the most important reforms in this field was the introduction of the Office for large taxpayers in 2012 (Official Gazette, 2012c). This office is specialised for supervising all insurance, leasing and telecommunication companies with annual income above HRK 15 million, all banks regarding their income, as well as all other firms with annual revenue above HRK 150 million. In line with that, the Office covers 600 largest taxpayers who jointly pay 46% of all taxes and social contributions and employ one fourth of all workers in Croatia (Tax Administration, 2012). However, there is no any available report on activities and surveillance results of this office.

Financial fines for enterprises caught carrying out undeclared activities range between HRK 10,000 and HRK 50,000, while for responsible individuals in these businesses prescribed fines are from HRK 5,000 to HRK 20,000²¹ (Official Gazette, 2011). Furthermore, penalties for those who enable carrying out these activities in any form range from HRK 10,000 to HRK 20,000 HRK for enterprises and from HRK 5,000 to HRK 15,000 for individuals. The Prohibition and Prevention of Unregistered Activities Act also prescribes confiscation of all equipment used in conducting undeclared activities, as well as deduction of all financial gain and properties earned in these activities (Official Gazette, 2011).

Despite all these substantial endeavours in repression, the perceived risk of being detected and punished among Croatian taxpayers is still quite low. According to the 2013 Eurobarometer survey on undeclared work, 59% of respondents see this risk as small or fairly small (Figure 17). On the other hand, only 9% think the risk is very high, while 24% think it as fairly high. As such, the perceived risk in Croatia is slightly below the EU27 as a composite, where 53% of respondents perceive it as small or fairly small.

²¹ In comparison, the average net wage in January 2014 was HRK 5,553 (Croatian Bureau of Statistics, 2014).

Figure 17 How people perceive the risk of being detected, comparison of Croatia and EU27, % of respondents



Source: European Commission (2014b)

6.2. Measures enabling compliance

6.2.1. Preventative measures

In order to reduce the possibility for tax evasion, the Government introduced certified cash registers on 1 January 2013. The system is quite similar to those in other countries: every receipt for cash transaction is electronically signed and delivered automatically to the Tax Administration by using specialised cash registers (Official Gazette“, No. 133/12). Although this measure applies to the majority of the subjects that are obliged to issue a receipt for delivered goods and services, there are some activities exempted from the law. For instance, activities such as the sale of home-grown agricultural products on a bazaar, sale of travel and lottery tickets or provision of banking and postal services are not included. In order to enhance enforcement of this measure, the Tax Administration launched a specialised website²² where citizens can check whether the receipt they received for purchased goods and services was declared to the authorities. There is also a free phone line for reporting violations concerning issuance of fiscal cash receipts.

Generally, this measure to tackle undeclared work is among the rare ones with a wide public approval. A survey of 1,000 respondents above 15 years of age conducted in September 2013 by GfK - Centre for Market Research reveals that 93% of citizens agree with the introduction of certified cash registers, while only 7% do not recognise it as a good strategy (Tax Administration, 2013b). However, a half of those who support the measure do not think it will be long-term effective due to belief that taxpayers will eventually find a way for cheating. Overall, people with a higher level of education and those with higher income tend to be more optimistic about this reform.

This survey also shows that 32% of respondents changed their behaviour after the introduction of fiscal cashiers, i.e. while they did not have a practice to take receipts in stores, restaurants etc. prior

²² <http://www.provjeri-racun.hr/>

the introduction, now they do. That increase is certainly a result of high media coverage that accompanied this innovation. In that light, the introduction of certified cash registers was certainly the most important measure to tackle undeclared work in Croatia, not only in preventative way, but also from the perspective of awareness rising.

According to the Tax Administration (2014b) there are significant positive results of this measure. Comparison of VAT forms for the sample of SME and self-employed individuals reveals that in 2013 these subjects declared 17.82% more income than in 2012. The greatest growth is recorded in the field of hospitality and catering, accounting for 40%. In the category of wholesale, retail sales, and motor vehicle repairs, this increase was 14%, while lawyers declared 4.8% more taxable services.

Another area where a significant improvement has been achieved during the last few years is a simplification of procedures for starting a business. The first and the most essential step in this field was taken in 2005 by launching an online platform called 'HITRO.HR'. Apart from enabling quick communication of enterprises and citizens with the authorities, this platform also provides all relevant instructions and other important information for starting a business. In order to further simplify procedures in this field, in 2009 the Government launched an online service (e-Company) for quick registration, as a part of the HITRO.HR platform. This service, similar to the one-stop shop services in other European countries, enables online registration for limited liability companies with procedures lasting no more than 24 hours.

Further simplification of procedures for small businesses was introduced by the possibility for the establishment of the 'simple limited liability company' (Official Gazette, 2012a). This allows up to three applicants to establish a company with minimum capital of only HRK 10 (€1.3). The fact that 8,062 new simple limited liability companies were registered in the first eleven months after these changes came into force²³ suggests that entrepreneurs recognised this opportunity. Nevertheless, no detailed analysis on business results and sustainability of these companies is available.

An interesting attempt for improvement of the general business environment was pursued in 2006 when the Government launched the 'HITROREZ' project. The project was dedicated to analysing the effectiveness of existing regulations and suggesting necessary changes. Despite being recognised by United Nations Development Programme as the world's best example of good practice in the area of regulatory reform and institutional capacity building, the project was strongly criticised by domestic experts and entrepreneurs and eventually abandoned, without accomplishing its purpose.

When it comes to employer-employee relations, there are three important measures in this field that aim at preventing undeclared work. Firstly, since May 2012 it is not possible to pay a salary without simultaneous payment of social contributions. In addition, new Pension Insurance Act, which came into force on 1 January 2014, proscribed a registration of new employees to the Pension Insurance Institute no longer than 24 hours after starting the job²⁴ (Official Gazette, 2013c). Finally, there is a plan for publishing the names of employers who hire workers on an undeclared basis, as well as of those who have not paid wages to their employees for more than three months. This should be realised in May 2014.

There were also some efforts to reduce labour costs in Croatia. The most important step in this area was the reform of the personal income tax in 2010, when the number of tax brackets was decreased from four to three (Official Gazette, 2010c). This was accompanied by a reduction of the lowest tax rate from 15% to 12%. With further amendments of the Personal Income Tax Act in 2012, the personal

²³ <http://www.poslovna.hr/>

²⁴ This period was 15 days before the Act came into force.

tax relief was increased from HRK 1,800 to HRK 2,200 (Official Gazette, 2012b). In addition, the health insurance contribution rate was reduced from 15% to 13% in 2012²⁵. This was a part of the broad strategy to shift the tax burden from income to consumption. Namely, the standard VAT rate was first increased from 22% to 23% in 2009 and then additionally to 25% in 2012.

We should add to this a new Minimum Wage Act adopted in March 2013, which reformed the system of determining minimum wages. While previously the minimum wage was calculated by an automatic formula (which heavily relied on the rate of GDP growth), now it will be set once a year directly by the Government. However, the Act prescribes that the minimum wage for each subsequent year cannot be lower than for preceding one, which disables the Government from manipulating labour costs. The gross minimum wage for 2014 is set at HRK 3,017.61 which is about 38% of the average gross wage for January 2014 (54% of the average net wage).

Two key reforms that aim at increasing the effectiveness of the social welfare system were conducted recently. Firstly, a new information system that interconnected databases of Ministry of Social Policy and Youth, Ministry of Interior, Tax Administration, Croatian Employment service and Financial Agency was introduced in January 2014. Apart from data about income, the system also enables insight into the ownership of bank accounts, real estate and stocks. As such, this application enables authorities to check one's eligibility for benefits and easily eliminate from the welfare program all those who were falsely claiming benefits. Until now, there is no official data on results of this innovation.

Further changes in this field were introduced by the new Social Welfare Act (Official Gazette, 2013e). The Act prescribed the 'proprietary census'²⁶ and redefined the award of cash aids/allowances to achieve better targeting, i.e. to direct social aids to those who really need them. The most essential change is the introduction of guaranteed minimal social benefit, which can amount up to the level of the minimum gross wage. Every person or household whose income or opportunity for gaining income (e.g. by renting or selling a property.) is below the prescribed level is entitled to this benefit, regardless of employment status. However, if the beneficiary rejects an offered job or prequalification, or voluntarily quits their current job, they will lose the benefit. In any case, the maximum period for receiving this benefit is two years, which should foster unemployed individuals to search actively for employment.

There has been a substantial effort in promoting employment, particularly in the case of young inexperienced people. So far, the most successful reform in this field is a possibility for professional training without formal employment introduced in 2012 (Official Gazette, 2012c). This is a specific form of internship, which enables young people to gain necessary experience after finishing education. Only individuals with less than one year of professional experience are eligible for this type of work, which is subsidised up to one year for those with a university degree and up to three years for artisans. Employers are exempt from all liabilities concerning wages and social contributions, while apprentices are provided with a public subvention of HRK 1,600. Although widely supported by employers, this measure was strongly criticised by experts, and especially by the target population. The main criticism is that employers are provided with a costless workforce while in return they do not have any obligation concerning employment after the end of the internship. However, faced with the lack of other employment opportunities, many young people eventually accepted this chance. Having in mind that 19,322 young individuals were included in this scheme during 2013 (Croatian Employment Service, 2014), one can conclude that the scheme plays an important role in endeavours of inexperienced people to find their path to formal employment. According to data from the Croatian

²⁵ Nevertheless, in April 2014 it was returned back to 15% in order to alleviate high budget deficit.

²⁶ This means that apart from the income, the assessment of one's eligibility for state benefits will also consider ownership of estates.

Employment Service, 62% of about 35,000 young people who were encompassed by different employment schemes since 2010 managed to find a regular job afterwards, which suggests that these programs have been providing a relatively good chance for future employment despite the crisis.

When it comes to smoothing transition from unemployment to self-employment, there are two different arrangements offered by the Croatian Employment Service. The scheme entitled 'Your initiative, your job' is open for all unemployed people, regardless of age, qualification or duration of unemployment. Specificity of this scheme is that apart from individuals, it provides subventions for a group of unemployed persons with an idea for a joint business. Financial support is restricted to the first year of business, and accounts for HRK 25,000.

The second scheme, named 'Your initiative, your job during the season', provides financial and logistic support only for unemployed women who want to start a seasonal business. In this case, financial support is restricted to the first two years of business, and accounts for HRK 25,000. In addition to individual women, it also entitles a group of unemployed women with joint business ideas to apply for the support.

Apart from the aforementioned schemes, there are 39 other measures to promote employment in Croatia. According to the Croatian Employment Service, 53,656 beneficiaries were included in various employment promoting programs during 2013 (Croatian Employment Service, 2014), which was an increase of 15% in comparison with 2012, accompanied by a 42% increase in the overall budget for this purpose (Seperic, 2014).

In addition, the Ministry of Labour and Pension System has announced a new Act on Job Retention Subsidies. The Act aims at smoothing the process of employment and improving the compliance with workers' rights. Current Act on Job Retention, which came into force in 2009, failed to fulfil its purpose due to over-restrictive eligibility criteria, what resulted in only few employers receiving the subsidy (Eurofound, 2012).

6.2.2. Curative measures

As already discussed, measures dedicated to providing incentives for those inside the undeclared realm to formalise their activities are particularly scarce in Croatia. Although there has been some improvement in this field, these endeavours are mainly restricted to the formalisation of seasonal and occasional work.

In order to reduce undeclared work in agriculture, in 2012 the Government introduced a voucher scheme for seasonal and occasional work in this sector (Official Gazette, 2012c). This scheme entitles unemployed and pensioners to work up to 90 days per year on various jobs in agriculture, for a minimum daily wage of HRK 72.08. Liabilities concerning social contributions for individual employees in this case depend on the number of daily vouchers they receive. This is a significant change in comparison to the previous situation when social contributions had to be paid for the whole month, regardless the number of days the seasonal employee really worked. Still, unlike voucher systems in many other member states, in this case no public subvention on the labour cost is provided. Despite that, 99,741 contracts for the seasonal work in agriculture were sold during 2012 and 2013²⁷. From 18 June to 31 December 2012 a total of 325,295 vouchers were bought by 3,363 business subjects. In 2013, 517,183 vouchers were sold to 3,371 subjects. However, it is hard to say whether the introduction of

²⁷ Data received on request from the Ministry of Labour and Pension System.

service vouchers in agriculture indeed accomplished its purpose without knowing the overall number of people working on this type of jobs in Croatia.

There was also a plan to extend the voucher scheme to all occasional and part-time jobs. However, after strong protests from the trade unions, in December 2013 the Government decided to postpone this scheme. Trade unions argued that this could result in employers shifting a certain part of regular jobs to the scheme.

We should also mention here an attempt to formalise babysitting in Croatia. In March 2013 the Government prescribed terms for the registration of subjects who carry out these activities (Official Gazette, 2013a), which were previously mainly conducted on an undeclared basis. Nevertheless, due to restrictions imposed on eligibility, accompanied by complicated procedures and unclearly defined responsibilities of governmental bodies in the registration process, this innovation resulted in only three registered subjects. Apart from a number of certificates (e.g., a police clearance certificate and a medical certificate) that are needed for babysitters, there are also numerous terms regarding the location of babysitting, which contributed to this failure. For instance, the property has to be bounded by the fence higher than 1.2 meters (with door handle unreachable to children) and must be equipped with its own playground if there is no public one nearby, the distance between balcony railings (if they exist) should be not more than 9 centimetres, interior space must have smoke detectors and fire extinguishers, etc. (Official Gazette, 2013d).

6.2.3. Measures fostering commitment

In parallel with the introduction of certified cash registers, the Tax Administration launched a huge national competition in collaboration with the Croatian Lottery. Every individual who sent 20 fiscal receipts issued after 1 January 2013 could win valuable money prizes in four rounds organised during 2013. The main objective of this contest, named 'It doesn't count without a receipt' was to increase awareness among Croatian citizens about the importance of taking a receipt after each payment. As explained in the description of the competition, "it is not fair that some people pay all their liabilities towards the Government, while the others cheat and actually live at the expense of honest and diligent ones" (Tax Administration, 2013a).

Another interesting measure in the field of fostering commitment is a publication of a tax debtors' list. This measure aims at creating a negative public image of tax debtors, as well as on informing taxpayers why it is important to pay taxes. First published in July 2012, the tax debtors' list is being updated several times per year. It includes all legal entities owing more than HRK 300,000, small businesses with debt above HRK 100,000 and citizens who owe more than HRK 15,000, providing that the debt exceeds 90 days. According to the Tax Administration, when the first list with 102,000 debtors who owed a total of HRK 29.97 billion was released, 2,081 of them settled their debts, paying HRK 152.4 million in total. A further 1,610 debtors paid HRK 107.9 million in total after the second list was released at the end of October 2012. The last list published in January 2014 comprised 18,195 less names than the first one (Tax Administration, 2014a).

We should also add that the Ministry of Labour and Pension System launched the project '2014—the year of the fight against undeclared work' (Ministry of Labour and Pension System, 2014). Apart from campaigns focused on raising public awareness about the consequences of undeclared work, the Ministry also announced greater endeavours in detection, as well as an increase of penalties for carrying out these activities. As a part of this action, in March 2014 the Ministry established a free

phone line for citizens to report (anonymously) employers who hire workers on undeclared basis or in any other way violate employers' rights.

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