



## TACKLING UNDECLARED WORK IN CROATIA: KNOWLEDGE- INFORMED POLICY RESPONSES

### GREY Policy Brief No. 3, 2017

Undeclared work is a well-known phenomenon **in Croatian society**. One in six Croatians acquire goods from the undeclared economy, 20% pay for undeclared services, 9.2% of adults perform undeclared work, 6.6% of registered dependent employees receive envelope wages, 30.8% of Croatians rely on illegitimate help/favours from people to circumvent formal regulations. Almost six out of ten Croatians believe that at least 20% of citizens violates tax and labour laws.<sup>1</sup>

In the initial years of transition, Croatia was not focused on its undeclared economy issues. But the recession led to high fiscal deficits, which combined with EU membership, pushed **the problem of undeclared work to the policy forefront** as the government needed to increase its revenue and the large undeclared economy in Croatia was seen as one of the best potential sources of additional fiscal revenue.

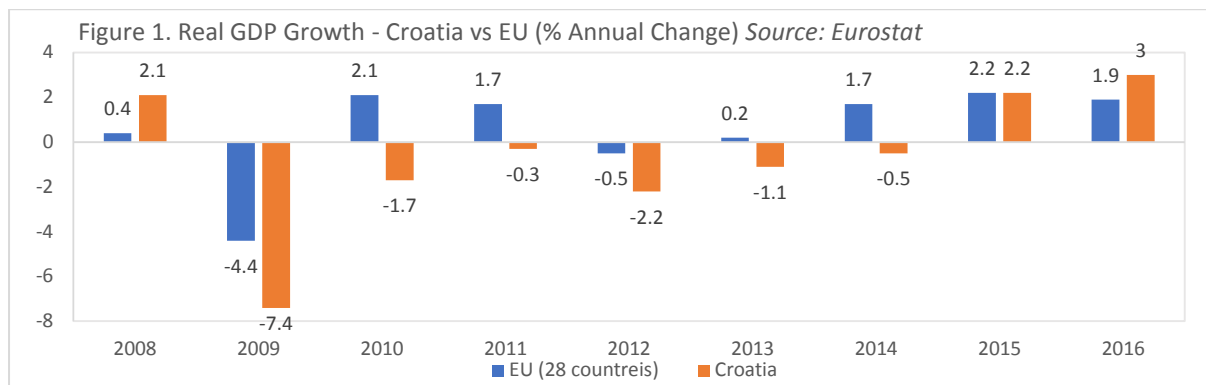
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**Authors: Ruslan Stefanov, Colin C. Williams and Peter Rodgers**

<sup>1</sup> Franic, J. and Williams, C., 2017. *Unregistered Economic Practices in Croatia*, Sheffield University Management School, University of Sheffield, GREY Working Paper No. 9, March 2017

#### KEY POINTS

- Undeclared work has **deep roots** in Croatia. **One in eleven declare to have done some fully undeclared work**. Six out of ten though believe at least 20% of their compatriots violate tax and labour laws.
- **The perception of the widespread nature of undeclared work and the lack of trust in formal institutions** seem to be the main incentives for people to engage in undeclared work. These have been exacerbated by high unemployment and low retirement income.
- **Hence, the conventional rational actor approach to tackling undeclared work** that focuses upon increasing penalties and surveillance has become less effective in Croatia.
- An alternative perspective, called the **social actor approach**, focuses upon the changing values and beliefs, and the modernising of formal institutions. It seems to have stronger empirical support in Croatia.
- The Croatian government should **at the very least supplement penalties and surveillance with more marketing, education, and higher social spending to tackle undeclared work**.



## Macroeconomic overview

**In 2013, Croatia joined the European Union.** Both suffered heavily from the 2008 financial crisis. Croatia registered a negative growth of 7.4% in 2009 (Figure 1). This was 3 percentage points lower than the average EU growth at that time. The crisis showed the structural problems and macro-economic imbalances in its economy.

After six years of negative annual real GDP growth until 2014, **in 2015 the Croatian economy finally recovered**, partly as a result of EU funds and the increase in the export of goods and services to its new partners in the EU. Since 2013, exports of goods and services have increased by nearly € 4 bn. This provided a positive contribution to the growth in GDP. Moreover, in 2013 Croatia registered a positive balance of payments which had not happened in this century.<sup>2</sup> Falling energy prices and rising tourism receipts contributed to growth in 2015 - 2016. Consumption was stimulated also through a tax reform, reducing personal income tax. Macroeconomic conditions are important scene setters for possible policy decisions for tackling the undeclared economy.

**However, growth is not expected to remain as high.** The European Commission's 2017

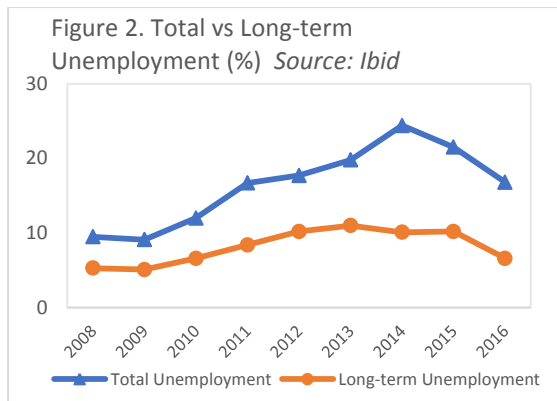
winter forecast concluded that GDP growth will drop to 2.5% in 2018 after increasing to 3.1% in 2017. The conditions that contributed to the recovery, such as a high productivity rate, are expected to diminish. This is further confirmed by an estimated potential growth of only 1%.<sup>3</sup>

The GDP growth is strongly associated with the labour market. Figure 2 illustrates how unemployment has fallen from 11% in 2013 to only 6.6% in 2016. The fall in unemployment was caused not only by the acceleration in output, but also due to the two reform rounds in 2013 and 2014 which **made the labour market more flexible**. However, the job creation that followed relied on temporary contracts<sup>4</sup> mostly. This is evident in the tourist industry, which may suggest some link with the payment of 'envelope' wages. Importantly, however, long-term unemployment has been declining too (Figure 2). Nevertheless, unemployment has fallen partly due to the contraction of the labour force. This is evident in the employment participation rate which has been one of the three lowest in the EU since 2013. In general, unemployment is expected to continue decreasing further this year and decelerate afterwards.

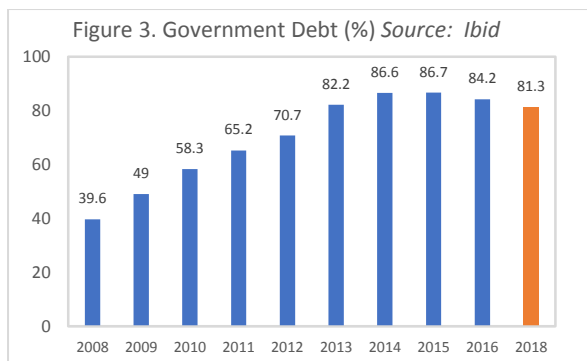
<sup>2</sup> European Commission, Country Report Croatia 2017, 22 February 2017, available at: [https://ec.europa.eu/info/files/2017-european-semester-country-report-croatia\\_en](https://ec.europa.eu/info/files/2017-european-semester-country-report-croatia_en)

<sup>3</sup> Ibid

<sup>4</sup> Ibid.



Another positive development in the Croatian economy is **the declining government debt** (Figure 3). During the global recession, the Croatian government registered large deficits. Consequently, government debt was increased, doubling in the period from 2008 (40%) to 2014 (87%). In 2011, the deficit hit a record high of 7.8% of GDP. However, GDP growth and the budgetary targets triggered by the EU's excessive deficit procedure helped bring it under control. As a result, government debt declined to 84.2% and is projected to decline further to 81.3% in 2018.<sup>5</sup>



### Definitions

**Undeclared work** is usually defined as paid activities that are lawful as regards their nature, but not declared to public authorities, taking into account the differences in their regulatory systems between Member States. This definition implies that if a good or service such as drugs is illegal, it is part of the criminal world not necessarily of the informal economy.

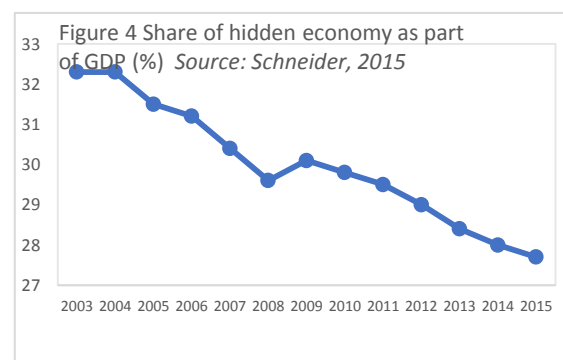
**Envelope wages** is an additional wage paid to a declared employee. It is paid in addition to

the officially declared wage and without declaring the tax and social contributions due to the authorities.

### Policy context

The prevailing policies in Croatia, as well as in the EU, have been orientated towards repressing undeclared work by increasing the **cost/benefit ratio** for engaging in undeclared work or envelope wages. This is based upon *the rational actor approach* which states that people engage in undeclared work **if the benefits from participating are higher than the costs**. By increasing the cost/benefit ratio people are supposed to stop doing so. Policies adopting this approach include increasing the sanctions for working undeclared or increasing the risk of being caught.

Although the share of the undeclared economy as part of GDP in Croatia has declined (Figure 4)<sup>6</sup> with the use of such measures, the effectiveness of those policies has been questioned.<sup>7</sup> GREY research has found correlations between the size of sanctions or the risk of being caught and engagement in undeclared work in Croatia but these have not been as strong as for other variables.



<sup>6</sup> Schneider, Size and Development of Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments, 2015, Available at: <http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf>

<sup>7</sup> Franic, Josip and Colin C Williams, *Illegitimate Practices in Croatia*, Sheffield University Management School and Institute of Public Finance, Zagreb, Working Paper No. 9, March 2017

<sup>5</sup> The 2018 projected value is taken from Ibid, p.8

Another policy alternative would be to **supplement the dominant rational actor approach with the social actor approach**. The latter view states that citizens are more likely to engage in undeclared work when they believe that other people are generally supporting and participating in the informal economy (lack of **horizontal trust**) and/or when they do not feel that formal institutions respect the socially shared norms (lack of **vertical trust**). Policies using this approach are aimed at increasing people’s trust in formal institutions and challenging the idea that it is acceptable to do undeclared work. Such measures include limiting corruption in institutions and raising awareness about the benefits of working in the formal economy via marketing and educational campaigns.

## Undeclared work

**Croatians have come to regard undeclared work as part of their daily life.** According to GREY data, one in five citizens has knowingly purchased a service on an undeclared basis. One in eleven adult Croatians has been engaged in undeclared work. Only 13% of these though were conducted as part of employment for business. As Table 1 illustrates though, nearly half of Croatians believe that between 20% and 50% engage in the undeclared economy and 11% believe that this share is above 50%.

These numbers illustrate that Croatians take undeclared work to be fact of life and that **horizontal trust** in society is low. Doing undeclared work is perceived as acceptable. On the other hand, Table 2 shows that Just 30% consider the risk of being detected as fairly high or very high. **Citizens clearly do not believe that formal institutions will detect all violations**, which points to low **vertical trust**, i.e. between citizens and institutions in Croatia. But before considering the specific policy implications, the nature of the demand

side (i.e. the buyers) and supply side (the suppliers) is analysed.

	Share
<5%	4.4%
5-10%	10.5%
10-20%	19.6%
20-50%	46.7%
>50%	11.2%
Refusal/dk	7.6%

*Table 1. Perceived share of people engaged in undeclared work, Source: Josip and Williams, 2017<sup>8</sup>*

	Share
Very small	28.0%
Fairly small	35.6%
Fairly high	21.2%
Very high	9.4%
Refusal/DK	5.8%

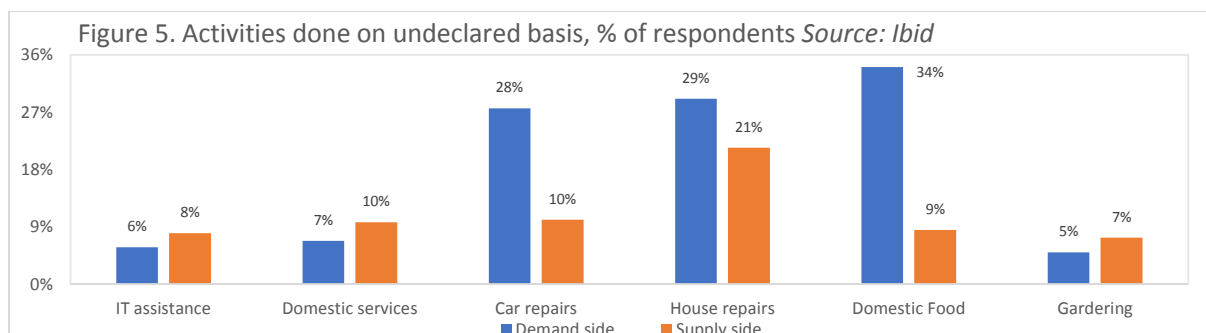
*Table 2. The perceived risk of being detected*

## Demand Side

Figure 5 compares the main sectors in which people purchase undeclared goods or services. **The most common are domestic food such as agricultural products, car and house repairs.** These should be targeted by policy makers.

A closer look at the relationship between the possibility of being caught and participation in the undeclared economy suggests that **a higher perceived risk does not seem to be strongly associated with a lower chance of purchasing undeclared.** (Table 3) People who see the risk as very small (20%) are less likely to purchase an undeclared good than people who perceive it only as fairly small (23%). Thus, even if policy makers increase the risk of detection, it is unlikely that people will stop buying undeclared goods and services. This might also be the result of the lack of trust that such measures can be enforced uniformly.

<sup>8</sup> Source refers to Ibid.



	Share
Very small	20%
Fairly small	23%
Fairly high	16.9%
Very high	17.5%

*Table 3. Relation between the perceived risk of being caught and the share purchasing undeclared services. Source: Ibid*

These findings confirm that continuing the current approach of improving surveillance and increasing sanctions might prove to be ineffective. Simply changing the cost/benefit ratio of engaging in undeclared work cannot fully limit the purchase of undeclared goods. However, increasing sanctions is found to have some positive impact on reducing undeclared work.<sup>9</sup> A reasonable way forward seems to be to complement repressive policies with other instruments. GREY Project findings suggest these instruments should be based on the social actor approach.

**GREY research has found out that the higher citizens' tax morale<sup>10</sup>, the lower the chance of purchasing undeclared services.<sup>11</sup>** People

<sup>9</sup> Ibid.

<sup>10</sup> Tax morale is the intrinsic motivation of citizens to pay taxes. It can also be seen as the extent to which formal rules and institutions correspond to the socially accepted norms. It is measured by the Asymmetry Index. I have marked values <2 as 'Very High', 2-4 as 'Fairly High', 4-6 as 'Average', 6-8 as 'Fairly Low' and 8-10 as 'Very Low'. For a detailed description, see Franic, J. and Williams, C., 2017. *Illegitimate Practices in Croatia*, Sheffield University Management School and Institute of Public Finance, Zagreb, Working Paper No. 9, March 2017

<sup>11</sup> Ibid.

who respect the formal institutions are found to be less likely to engage in the undeclared economy (Table 4). Furthermore, this result is confirmed by a rigorous statistical analysis which finds a strong significant correlation between tax morale and the purchase of undeclared goods.<sup>12</sup> As measured here, tax morale is closely connected to the ideas about the lack of vertical and horizontal trust among citizens in Croatia. Consequently, if policymakers would increase horizontal and vertical trust, less undeclared goods should be purchased.

Tax morale	Share
Very High	17.1%
Fairly high	26.4%
Average	23.4%
Fairly low	30.6%
Very low	11.3%

*Table 4. Tax morale and engagement into the undeclared economy. Source: Ibid*

When Croatians perceive that a higher share of their compatriots engage in undeclared work, they are more likely to buy undeclared goods and services themselves. (Table 5) This indicates that a lack of horizontal trust among citizens is associated with a higher possibility for participation in undeclared work.

<sup>12</sup> The only problem with Table 4 is the group with 'Very Low' tax morale. But researchers conclude that this is not vital. The group is not a representative sample, because it is a very small share of all the respondents. Moreover, there was a large part of answers which were 'Don't know' or a 'Refusal' to answer. (Ibid, 2017: 51)

	Share
<5%	8.6%
5-10%	12.3%
10-20%	11.7%
20-50%	18.9%
>50%	22.9%

Table 5. Relation between estimated share of undeclared economy and actual participation into the undeclared economy. Source: Ibid

## Supply Side

GREY Project research has found that workers in the undeclared economy can be divided into two types, which co-exist, depending on the motivation for doing undeclared work. **There is the “lower tier” who have been involuntarily excluded from the formal market (exclusion-driven) and the “upper tier” who move out of the formal market voluntarily (exit-driven).**<sup>13</sup>

Generally, the lower tier is more likely to be unemployed or/and struggling financially, whereas the latter is not. Between these two groups there is another which shares both motivations. In Croatia, for every exclusion-driven undeclared worker are four exit-driven workers. A quarter of workers are driven by a mixture of both types of reason. Another result confirming even more clearly the existence of a ‘lower tier’ group and an ‘upper tier’ group can be found in Table 6. Even though with every group with rising income which is below 10 000 HRK (~1300 EUR)<sup>14</sup>, the share, which is participating in the undeclared economy, seems to fall, the biggest share (15.2%) participating in undeclared work can be found among the richest people with income between 10 000 HRK and 15 000 HRK. This illustrates how **undeclared work has a**

<sup>13</sup> Williams, Colin and Bezeredi, Slavko, 2017. *Explaining and tackling the informal economy: a dual informal labour market approach*, GREY Project Paper, University of Sheffield, 2017.

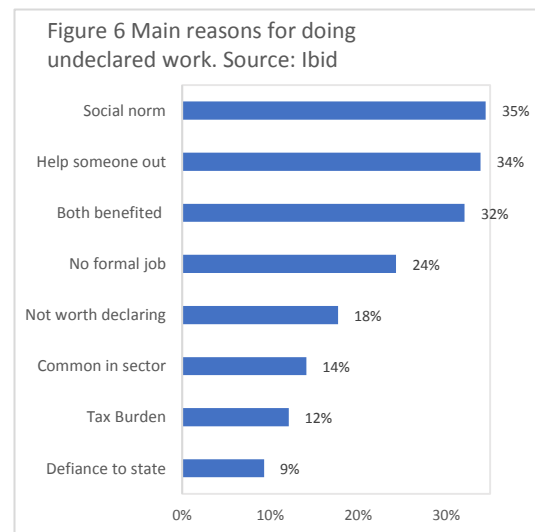
<sup>14</sup> According to ECB exchange rates, the exchange rate in the last decade was stable at around 1EUR= 7.5HRK

**double function** in Croatia. Firstly, it provides the least well off with a coping mechanism. Secondly, it allows the relatively well-off a chance to earn even more money unrestricted of formal regulations<sup>15</sup> But why do people engage into undeclared work?

Wages 000s HRK	Share
0	14.1%
1-2.5	9.5%
2.5-5	7.7%
5-7.5	8.1%
7.5-10	4%
10-15	15.2%
>15	0%

Table 6. Relation between declared wage and engagement in undeclared work. Source: ibid

The two main motives of people for doing so basically state that it is just normal to help out friends or relatives. (Figure 6) This confirms



that undeclared work is an accepted social phenomenon in Croatia just like in the other CEE countries. Yet, one in three people stated that their engagement motive was an economic rationale, namely that both parties benefited. Some people also stated reasons related to the intrusiveness of the state such as the ‘tax burden’ (12%) and ‘defiance to the

<sup>15</sup> Franic, Josip and Williams, C., 2017. *Illegitimate Practices in Croatia*, Sheffield University Management School and Institute of Public Finance, Zagreb, Working Paper No. 9, March 2017, p. 91



state' (9%). **Consequently, it would not be sufficient to tackle undeclared work simply by increasing the costs connected with it.** Moreover, in the case of the exit-driven workers, the GREY Project statistical analysis clearly establishes a significant correlation<sup>16</sup> between tax morale and their participation.

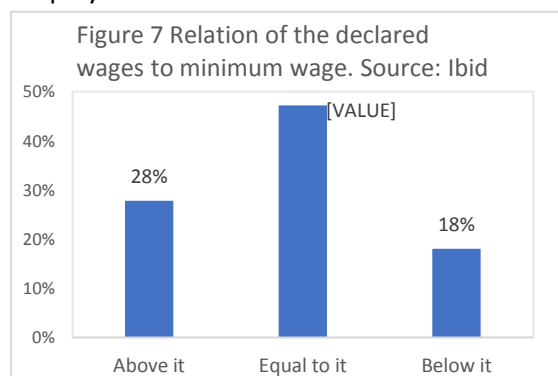
## Envelope wages

In Croatia, at least 6.6% of declared employees receive an additional undeclared envelope wages from their formal employer.<sup>17</sup> Table 7 presents the main sectors in which envelope wages prevail. Agriculture (28.3% of employees receive envelope wages) and household services (15.5%) are some of the most important sources of envelope wages. Wages also tend to be under-declared in construction (16.1% of all employees) and the hospitality sector (9.4%).

Sector	Domestic food	Construction	Household services	Hospitality
Share	28.3%	16.1%	15.5%	9.4%

*Table 7. Sectors where the practice of envelope wages is most widely spread.* Source: Ibid.

**The officially declared wage of nearly half of the workers who receive envelope wages is the minimum wage** (Figure 7).<sup>18</sup> This minimises the taxes paid by employers and employees.

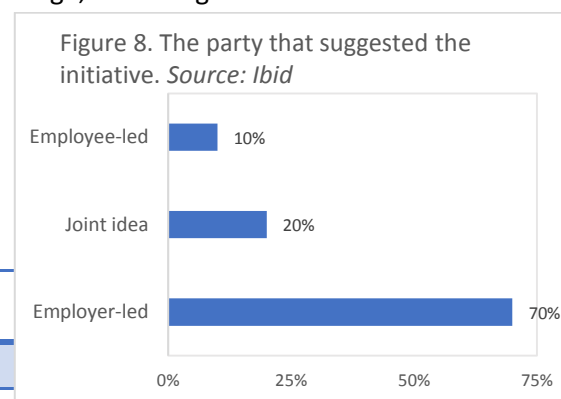


<sup>16</sup> Ibid, p. 8

<sup>17</sup> Ibid, p. 68-70

<sup>18</sup> Croatians who answered 'Do not know' to the respective question in the Survey are excluded

Who instigates the payment of envelope wages? Figure 8 reveals that in nearly 3 out of 4 cases of envelope wages, the initiative was proposed by the employers. Thus, if policy-makers would like to stop this practice, they need to make it less cost efficient for employers to propose envelope wages. However, clearly this will not be sufficient to completely erase the practice. In 30% of cases, the employee had an active role in making the arrangement and their incentives should be addressed as well. Workers seem to be accepting the prevalence of envelope wage, indicating a lack of horizontal trust.



GREY research has concluded that **dealing with envelope wages cannot be done only through increasing the sanctions or the risk of detection as employees are not less likely to accept envelope wages when the two are increased.**<sup>19</sup> However, similar to undeclared work, they found a significant correlation between tax morale and paying envelope wages and the need to suggest policies in line with the social actor approach.

## Policy recommendations

GREY research has confirmed that a **coherent policy against undeclared work primarily requires changes in the institutional framework and the rather positive perception of undeclared work in Croatian society.** In order to initiate any changes, more

<sup>19</sup> Willimas, C., and Bezeredi, S. 2017 *Tackling the illegal practice of under-reporting employees' wages*, GREY Paper, University of Sheffield, 2017.

information should be gathered on the nature and characteristics of undeclared work in Croatia. Resources currently are limited and do not provide the full picture though GREY research has suggested some possible policy actions.

It would be beneficial for a **central organization dedicated to undeclared work to be established to gather such data and do additional analyses**. It would also be able to coordinate the efforts of the different government departments to cooperate towards reducing the negative effects of undeclared work. It will then be able to execute effectively much needed reform, based on big data approaches. To achieve even more effectiveness, changes in the dominant rational actor approach of the Croatian authorities are urgently required. While increased sanctions might be effective and should be pursued in limiting undeclared work, increasing tax morale seems to be more important. Thus, **at the very least, the rational actor perspective should be supplemented with the social actor approach**. The social actor perspective suggests two areas in which changes are necessary:

### Vertical trust

**More expenditure on active labour policies** is required. Such policies will restore the trust in formal institutions and demotivate citizens from exiting the formal market as the costs of doing so become higher. While falling official unemployment has reduced the pressure for engaging in such policies, they should become a key tool for preventing the reappearance of structural inefficiencies in the future.

**In order to create vertical trust in the public administration, corruption should be further limited**. The work of the independent judiciary and the anticorruption agency should be strengthened and independent

investigations of high level corruption encouraged.

**Changes are required in the way citizens are treated by the public administration, and in particular the Tax Office, Labour Inspectorate and other regulatory bodies**. The move in all these agencies from a control to customer service mentality should be further encouraged. The pulling of strings should be limited, which will ensure the fair treatment of citizens and reduce evasion.

Lastly, vertical trust will be hugely increased, if **citizens' approval is sought more intently before reforms are executed**. Surveys and evaluations of the respective policy proposals should be conducted on a more regular basis.

### Horizontal trust

It is vital to further **educate people in Croatia about the value of taxation and government services** such as infrastructure and schools. This could be done through introducing a subject, which includes civic education, into the school curriculum.

Wider awareness should be raised about **the costs associated with envelope wages in particular for the richest, e.g. the detrimental effect this has on solidarity**. In the long-term this will affect things such as people's pensions, but will also limit the responses that are available to the Croatian government in times of crises, due to lower budget revenues.

**Media publicity can also be helpful** as it may potentially have a huge impact on society. However, the media should not make any exaggerated claims about the size of the undeclared economy in order to avoid reinforcing the negative perception that most work in the undeclared economy (i.e. horizontal trust). People should not be exposed to simplistic reporting about the sheer size of the undeclared employment, which would only strengthen their understanding that it would be normal to



engage in such practices. Rather, **the aim should be to inform citizens about the harms of engaging in the undeclared economy and**

**benefits of declared work**, taking into account the interests of the ones participating but also of the wider society.

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