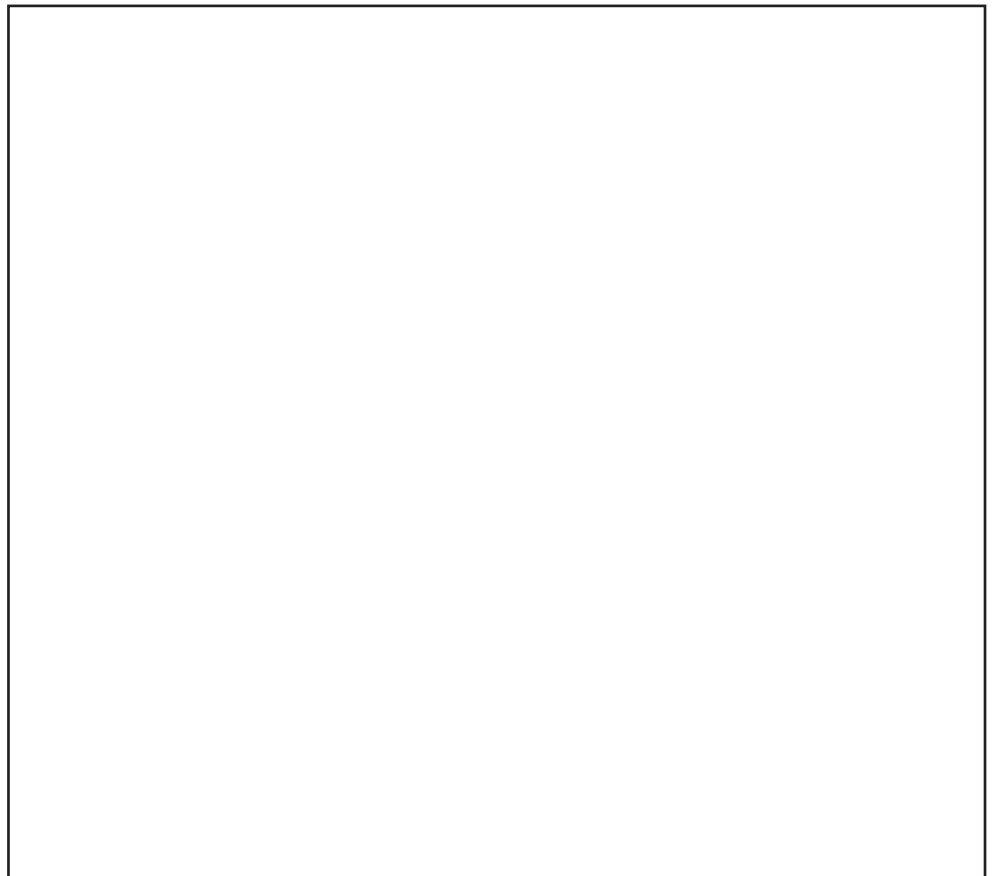




Eurofound

# Tackling undeclared work in Croatia





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# Executive summary

## Introduction

The aim of this report is to provide a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in the EU acceding country of Croatia.<sup>1</sup> Croatia has been classified by the World Bank as a 'high income' country, having a GNI per capita of USD 13,760 in 2012. The objectives of the report are to analyse the prevalence and character of undeclared work in Croatia; to examine how the fight against undeclared work is organised; and to review relevant policy approaches and measures adopted. Throughout the report, the situation in Croatia is compared with the EU27 wherever feasible. This report forms part of a research study into undeclared work in five countries: four candidate countries for EU membership (Iceland, Montenegro, Turkey and the former Yugoslav Republic of Macedonia) and one acceding country, Croatia.

## Policy context

Estimates regarding the size of the undeclared economy in Croatia differ. The common finding is that Croatia has a large undeclared economy relative to the EU27. Using the Multiple Indicators Multiple Causes (MIMIC) method, Schneider (2011) found that the undeclared economy in Croatia was equivalent to 30.4% of GDP in 2007 and therefore was larger than that prevailing in all EU27 Member States with the exception of Bulgaria. As in the EU27, the size of Croatia's undeclared economy is also gradually decreasing over time, from 33.8% of GDP in 1999 to 32.1% in 2003 and to 30.4% in 2007. Responding to the World Bank Enterprise Survey 2007, 31.7% of firms in Croatia reported that they compete against unregistered or informal firms, and 25% said that the practices of informal sector competitors comprised a major constraint on their business. These figures are high compared with the EU27, but lower than those found in the EU candidate countries in the south-east of Europe.

There are few contemporary studies regarding the undeclared economy in Croatia, covering issues such as the sectors in which it is prevalent, who undertakes this work and why it is carried out. The 2007 World Bank Enterprise Survey revealed that businesses in the food sector (agriculture and allied industries) were most likely to experience competition from unregistered or informal firms, followed by manufacturing and retailing. It also found that the activities of informal or unregistered businesses were most widely viewed as a major constraint by formal businesses in the food sector, followed by other services (such as tourism) and then the garment industry. Large firms, and exporting and foreign-owned businesses, are less affected by informal businesses, and less likely to view them as a major constraint, than are small and medium-sized businesses, non-exporting businesses and domestically owned businesses. There are significant regional variations. A total of 53% of businesses in Zagreb stated that they compete against unregistered or informal businesses, as did 41.2% of those in the north and 40.8% in Slavonia. By contrast, this problem was cited by only 25.6% of businesses in Lika and Banovina, 17% in Dalmacija and 12.3% in Istra and Hrvatsko Primorje.

The annual World Bank Doing Business surveys compare how easy or difficult it is for a local entrepreneur to open and run a small-to-medium-sized business that complies with relevant regulations in 183 countries. In terms of ease of doing business, Croatia was ranked 80th out of 183 in 2012 and 79th in 2011, while the EU27 as a composite was ranked 38th. Doing business is therefore less easy in Croatia than it is in the EU27 as a whole.

It is as easy to start a business in Croatia (ranked 67th) as it is in the EU27 as a composite (which was ranked 66th). In Croatia, starting a business involves six procedures, takes seven days, costs 8.6% of income per capita and requires a paid-in minimum capital of 13.8% of income per capita.

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<sup>1</sup> At the time of writing, Croatia was expected to become an EU Member State on 1 July 2013.

It is easier to pay taxes in Croatia (ranked 32nd on this issue) than it is in the EU27 as a composite, which was ranked 71st in this regard. On average in Croatia, companies make 17 tax payments a year, spend 196 hours a year filing, preparing and paying taxes, and pay total taxes amounting to 11.5% of profit.

### Key findings

#### Organisation of efforts against undeclared work

A 2010 study of 31 European countries found that only 8 countries (26%) have either a single agency responsible for the fight against undeclared work or a central coordinating committee responsible for ensuring coordinated action by the multifarious departments involved in tackling undeclared work. In Croatia, there is no single compliance unit or coordinating committee for this purpose. Neither is there a department with main responsibility for this. Instead, responsibility is distributed across a range of government departments, including the Ministry of Finance, the Ministry of Labour and Pension System, the State Inspectorate, the tax administration, the Croatian Employment Service, the Ministry of Tourism, the Ministry of Agriculture and the customs administration. Each is responsible for different facets of tackling undeclared work, and has its own separate targets. The adoption of coordinated strategies, operations or targets is rare.

The social partners are involved through the Economic and Social Council (ESC), established in 1994 to enable tripartite social dialogue between the government, employers and trade unions. The ESC has had a different number of working bodies over the years. Currently, following the signing of the new agreement on establishing the ESC in February 2012, the ESC has five permanent working bodies known as committees. To improve this process, the Office for Social Partnership was introduced in 2001. At the end of 2011, this was abolished by the new government, and the Independent Service for Social Partnership within the Ministry of Labour and Pension System was established.

Despite a well-established formal institutional framework, the culture of social dialogue in Croatia has varied over time and could be perceived as weak. This was exemplified by the trade unions withdrawing from the ESC in 2010 for six months in protest at the weak dialogue. After that, some changes were introduced in the work of the ESC, the most important being the abandonment of the voting system. Instead, each group in the council is allowed to express their 'separate opinion' on the discussed subject; these stated views are then forwarded to the government and published on the webpage of the Independent Service for Social Partnership. Despite these changes, both tripartite and bipartite dialogue structures are still weak, and the social partners consider them to be even weaker since the new government came into power.

#### Policy approaches towards undeclared work

Tackling undeclared work has traditionally been pursued in the EU27 by a repressive approach that seeks to stamp it out. Recently, there has been a call for the EU27 to pursue 'enabling' measures; these aim to pursue more positive interventions to prevent people from entering the undeclared economy and to help those already in the undeclared economy to legitimise their operations. Despite this, most EU27 Member States continue to give prominence to 'deterrence' measures rather than measures that facilitate declared work.

This is also the case in Croatia. As indicated in interviews with government officials and social partners, the focus is on deterrence. Although enabling measures are starting to be used alongside deterrents, 'curative' measures are particularly scarce, and policies aimed at fostering commitment to declared work are quite recent; for this reason, their impact is not yet evident.

## Policy pointers

First, as with other European countries, Croatia needs to conduct empirical research into the nature of undeclared work in a manner that would allow comparative analysis with the EU27. Second, it might give slightly greater prominence to enabling policy measures that encourage work in the formal economy. This particularly concerns the adoption of ‘hard’ supply-side curative measures, but also, to a lesser extent, ‘soft’ commitment measures to improve citizens’ tax morality. This could involve changing the tax, distributive and procedural justice systems, so that they appear fairer, and improving the public’s knowledge of the tax system, in order to engender a culture of commitment to compliance.

This report also provides evidence of a strong correlation between countries with greater labour market intervention, social protection, redistribution and equality, and smaller undeclared economies.





# Introduction

Europe's struggle with economic recession and historically high unemployment levels has put the issue of undeclared work high on the political agenda, not least due to the significant impact it has on public finances and employment participation rates. This report forms part of a research study into undeclared work in five countries: four candidate countries for EU membership (Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey) and one acceding country, Croatia.

## Aims of the report

The aim of this report is to provide a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in the EU acceding country of Croatia. The objectives are to analyse the prevalence and character of undeclared work in Croatia; to examine how the fight against undeclared work is organised; and to review the relevant policy approaches and measures adopted. Throughout this report, the intention is to compare the situation in Croatia with the EU27 wherever feasible. The main questions being addressed are:

- What is the extent and nature of undeclared work in Croatia and how does this compare with the rest of Europe?
- What institutional structures and policy approaches are used to tackle undeclared work and how do these compare with the EU27?
- Which specific policy measures have been adopted that appear to be effective in tackling undeclared work?
- What lessons might be learnt from the EU27 in terms of policy measures when tackling undeclared work in Croatia?
- What lessons can the EU27 learn from the Croatian practice?

## Methodology and data collection

First, a comprehensive literature review was carried out, which included academic sources, literature published by the government and social partners, and statistical research. The completed review comprises three elements, outlined below.

- **A review of surveys of undeclared work in Croatia:** As with the EU candidate countries of Iceland, the former Yugoslav Republic of Macedonia, Macedonia and Turkey, Croatia is included in cross-national databases such as the World Bank Enterprise Surveys, the World Bank Doing Business surveys and cross-national surveys using indirect measurement methods (see Schneider, 2011; European Commission, 2008). National-level surveys and 'grey' literature reporting the extent and nature of undeclared work are also available; where feasible, these are compared with findings in the EU27.
- **A desk-based survey of the institutional approach to fighting undeclared work in Croatia:** This includes both published and 'grey' literature on the organisation of the fight against undeclared work in Croatia. Findings are compared with approaches taken in the EU27, using typologies developed for comparing the Member States (Dekker et al, 2010).
- **A desk-based survey of policy measures:** The range of policy instruments used in Croatia, including those undertaken by social partners and sector-specific organisations, are reported, and compared with the EU27.

Second, to provide up-to-date information and to fill gaps in understanding, an online survey and telephone interviews took place with six key stakeholders, including senior officials in government departments involved in the fight against undeclared work, expert academics, a representative of an employers' association and a World Bank economist. Information was sought on the extent and nature of undeclared work in Croatia, the organisational approach to fighting

undeclared work and the policy approaches and measures used, along with their perceived effectiveness. This survey was based on the method recently applied across the 30 countries of the European Economic Area (EEA) and Switzerland (Dekker et al, 2010), enabling comparative data to be collected. Thirdly, a validation workshop took place in November 2012 in Zagreb with experts and representatives of key stakeholders in Croatia and four EU candidate countries.

The outcome is a wide-ranging review of the extent and nature of undeclared work in Croatia and an analysis of how undeclared work is being tackled there compared with the situation in the EU27.

# Research background

Although there is no official definition of undeclared work in the EU27, the widely accepted definition is that it covers ‘any paid activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems between Member States’ (European Commission, 2007a, p. 2).

There is now a considerable body of research and policy documents on undeclared work in the EU27. These reports aim to understand, conceptualise, measure and tackle undeclared work in these countries. Since the turn of the millennium, important research has been commissioned by the European Commission on both the extent and nature of undeclared work in the EU27, on how it is being tackled and what can be done in the future. The situation in Croatia can be compared to these data.

The studies *Undeclared labour in Europe* (Mateman and Renooy, 2001) and *Undeclared work in an enlarged Europe* (Renooy et al, 2004) provide some of the first estimates of the extent and character of undeclared work in the Member States. The European Employment Observatory (2004) published a further overview, entitled *Fighting the immeasurable? Addressing the phenomenon of undeclared work in the European Union*. More recently, in order to gain a better understanding of the phenomenon, the European Commission instigated both a direct survey (European Commission, 2007b) and a review of indirect survey methods (European Commission, 2009).

During the same period, significant policy shifts occurred. Following the 2003 recommendation in Employment Policy Guideline No. 9 to shift away from a deterrence approach and towards the transformation of undeclared work into regular work (rather than simply eradicating it), and the reiteration of this stance in the Commission’s second Communication on undeclared work, ‘Stepping up the fight against undeclared work’ (European Commission, 2007a), a number of initiatives have taken place. Eurofound commissioned studies in both 2007 and 2009 to identify how this might be achieved (Eurofound 2008, 2009), as well as compiling a knowledge bank of good practice policy measures (see <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>); this was fully updated in 2013 to include cases from Croatia, Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. The Commission evaluated the feasibility of developing a European platform to better coordinate the fight against undeclared work across the EU27 (Dekker et al, 2010). All this research provides a solid evidence base against which the extent of undeclared work in Croatia, and various strategies for tackling it, can be compared.

With a population of 4,430,003, the World Bank defines Croatia as a ‘high income’ country with a GNI per capita of USD 13,760 (World Bank, 2012). In 2012, the monthly minimum wage was HRK 2,814, the average gross monthly earnings per person in paid employment was HRK 7,958,702 and monthly net earnings per person in paid employment was HRK 5,499. The registered unemployment rate from March to October 2012 was 19.61% (Croatian Bureau of Statistics, 2012).



# Extent and nature of undeclared work in Croatia

## Extent of undeclared work

In Croatia, in common with other countries, there are many different estimates of the size of the undeclared economy, each using different measurement methods. It is important, therefore, to be aware of the measurement method underpinning any estimate. Table 1 reports the findings of the World Bank Enterprise Survey 2007, which involved interviews with 633 firm owners, using the same questions across many countries. It found that 98.1% of the firms surveyed reported that they were formally registered when they started operations and the 1.9% of firms that were not registered operated on average for just 1.1 years without formal registration. Nevertheless, evidence that many formal and informal businesses operate on an undeclared basis is provided by the fact that 31.7% of firms reported that they compete against unregistered or informal firms. A further 25% reported that the practices of informal sector competitors are a major constraint on their business.

Table 1: *Prevalence of undeclared work in Croatia*

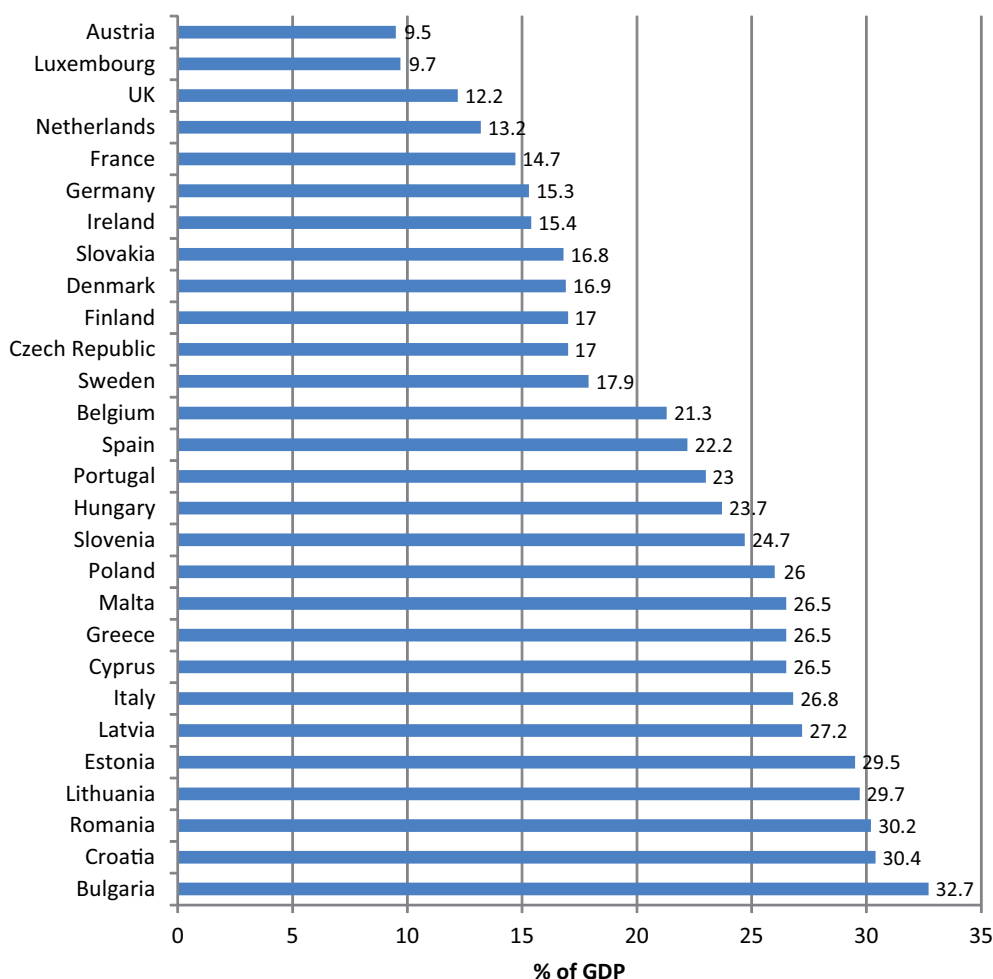
N=633	Croatia	Eastern Europe and Central Asia	World
Firms formally registered when they began operating (%)	1.9	675,614	194,288
Years operated without formal registration (no.)	1.1	296,690	69,189
Firms competing against unregistered or informal firms (%)	31.7	321,229	72,346
Firms identifying practices of competitors in the informal sector as a major constraint (%)	25	816,406	191,414

Source: *World Bank Enterprise Survey 2007*

A further measure of the extent of the undeclared economy is provided by Schneider (2011), who measured its size as a proportion of GDP using his Multiple Indicators Multiple Causes (MIMIC) method. As with the MIMIC estimation procedure, this provides relative values, with the help of the currency demand approach for a few countries (Austria, Germany, Poland and Switzerland). (These values have been calibrated into absolute ones.) Figure 1 compares the size of the undeclared economy in Croatia with its EU27 counterparts. It shows that the undeclared economy in Croatia is equivalent to 30.4% of GDP and, as such, is larger than that found in all EU27 Member States with the exception of Bulgaria.

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

Figure 1: Undeclared economy as % of GDP by country



Source: *Schneider (2011)*

Care needs to be taken with estimated sizes of undeclared economies that result from indirect measurement methods. Such studies use proxy indicators and/or seek statistical traces of undeclared work in data collected for other purposes, and marked variations in estimates often occur. As shown by the Institute for Market Economics (2002), summarised in Table 2, at any one time different methods can produce different estimates of the size of an undeclared economy as well as different views of its trajectory. For example, while the approach that seeks discrepancies in the national accounts (Madžarević-Šujster, 2002 and Mikulić and Madžarević, 2002) reveals a sharp decline in the size of the undeclared economy between 1995 and 2000, monetary methods show a slight increase over the same period, as does the electricity consumption approach (Sosic and Faulend, 2001).

Table 2: *Estimates of the size of the undeclared economy 1990–2000 as % of GDP*

Method	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Discrepancy method	14.37	28.15	29.4	36.8	25.45	18.38	16.31	11.38	9.12	8.41	6.81
Monetary – cash deposits						25.0	24.7	29.2	29.8	34.0	25.3
Monetary – foreign currency in circulation						25.0	22.0	26.1	25.5	24.9	25.8
Electricity consumption method						25.0	24.8	24.0	26.3	29.8	26.8

Source: *Institute for Market Economics (2002)*

In addition to the above indirect measurement studies, a number of direct surveys of undeclared work have been conducted in Croatia (Bejaković, 2004; Bicanic and Ott, 1997; Institute of Public Finance, 2002). As Bejaković (2004) reports, a survey was carried out into additional paid jobs, without asking about the sum earned, on a representative sample of households in Croatia in early 1995. An additional paid job was defined as any job making an income outside the income from a regular economic activity and (permanent) employment, as well as incomes from own-company or regular agricultural activity. Such jobs were surveyed from both the supply side (whether they undertook such jobs) and the demand side (whether they bought services or goods from persons for whom these activities were additional jobs). It found that in 1995, additional jobs were performed by members in 24% of the 1.5 million households in Croatia. Some 15% of households were involved in such work quite regularly (both in the previous month and in the previous year) and 9% were involved on a non-regular basis. Involvement on a non-regular basis was measured as being involved either in the previous month only (1%) or over the previous year, not including the previous month (8%).

The study found that the main reason for purchasing such goods and services was, in 80% of cases, the lower price. In 10% of cases, it was because the goods and services were better quality and in 9% of cases because it was easier or the only way to obtain the particular good or service.

## Nature of undeclared work

### Sector variations

Various surveys highlight how the undeclared economy is concentrated in some sectors of the economy more than others (Bicanic and Ott, 1997; Institute for Market Economics, 2002; Madžarević-Šujster, 2002; Mikulić and Madžarević, 2002). Comparing the undeclared economy in agriculture, industry and trade over the period 1990–1999, Bicanic and Ott (1997) noted that while the undeclared economy in agriculture was somewhere between 6.8% and 16.9% of GDP between 1990 and 1999, in industry it was much lower, ranging from 2.3% in 1996 to 5.2% in 1998. The undeclared economy was far more prevalent in the retail trade although trends over time in its relative size were identical to those in industry. A sudden growth in the undeclared economy in retailing during the 1990–1993 period (to almost 60% of trade as a whole) was followed by a sudden fall in 1993–1994 (to around 35%), followed by a mild decline or stagnation between 1995 and 1999. Overall, from 1990 to 1999, undeclared work decreased in trade, stagnated in agriculture, and rose in industry. Bicanic and Ott (1997) argued that the process of transition into a market economy varied across sectors, with the transition being most rapid in trade and slowest in industry.

To estimate the size of the undeclared economy in the Croatian tourist industry, Stucka (2001) examined data from the Croatian Bureau of Statistics (CBS) on international and registered tourist traffic, and measured the discrepancy between tourist inflows and officially registered flows. He found that the value of the undeclared economy of unregistered bed nights was 0.4%–0.6% of GDP in 1998, 0.5%–0.6% in 1999 and 0.5%–0.8% in 2000. He also analysed water consumption to estimate the size of the undeclared economy in privately owned accommodation. Separating the average

out-of-season consumption of water from the consumption during the tourist season, which he used to estimate the additional number of guests in private accommodation and tourists in country cottages, he found that the monetary value of unregistered bed nights using this water consumption approach was 0.1%–0.12% of GDP in 1998, 0.1%–0.14% in 1999 and 0.05%–0.1% in 2000. An undeclared bed-night economy in the tourist industry amounted to between 0.05% and 0.5% of GDP.

Findings from the World Bank Enterprise Survey can be analysed to assess the distribution of the undeclared economy across sectors in Croatia in a manner that is comparable cross-nationally. In 2007, and as Table 3 shows, businesses in the food sector (agriculture and allied industries) were most likely to experience competition from unregistered or informal firms, followed by manufacturing and retail. The activities of informal or unregistered businesses were more likely to comprise a major constraint on formal businesses in the food sector, followed by other services and then the garment industry. Although retail businesses witnessed competition from undeclared enterprises, they did not perceive these undeclared competitors as a major constraint on their operations.

Table 3: *Prevalence of the undeclared economy in Croatia by sector, firm size, location, exporting status and ownership*

N=633	Firms competing against unregistered firms (%)	Firms identifying practices of competitors in informal sector as a major constraint (%)	Firms formally registered when started operations in country (%)	Years operated without formal registration (no.)
<b>All</b>	<b>31.7</b>	<b>25.0</b>	<b>98.1</b>	<b>0</b>
<b>By sector:</b>				
Food	54.5	42.2	99.8	0
Garments	25.1	24.3	100.0	0
Fabricated metal products	26.1	12.3	100.0	0
Other manufacturing	38.4	14.3	97.8	0
Retail	35.7	13.8	100.0	0
Other services	25.4	30.1	97.1	0
<b>By firm size:</b>				
Small (5-19)	32.5	31.3	99.4	0
Medium (20-99)	33.0	19.8	96.3	0
Large (100+)	20.0	11.8	98.9	0.1
<b>By location:</b>				
Zagreb	53.0	33.1	97.9	0.1
North	41.2	6.5	100.0	0
Slavonia	40.8	40.6	100.0	0
Dalmacija	17.0	29.2	100.0	0
Istra I Hrvatsko Primorje	12.3	4.1	90.0	0.1
Like I Banovina	25.6	33.1	100.0	0
<b>By exporting status:</b>				
Direct exports 10%+ of sales	18.8	7.2	97.8	0
Non-exporter	34.3	28.1	98.1	0
<b>By ownership:</b>				
Domestically owned	32.6	25.9	98.1	0
Foreign owned	10.2	5.2	98.3	0

Source: *World Bank Enterprise Survey 2007*



### Socioeconomic, business and spatial variations

Table 3 also reveals that large firms appear to be less affected by the existence of unregistered or informal businesses than small and medium-sized enterprises (SMEs). While one-third of SMEs assert that they compete against informal or unregistered firms, only one-fifth of large firms assert that this is the case. Indeed, small businesses are far more likely than medium-sized or large businesses to assert that unregistered businesses are a major constraint. Related to this, non-exporting businesses and domestically owned businesses are more likely to face competition from unregistered businesses, and are more likely to state that the undeclared economy constrains their business, than exporting and foreign-owned businesses.

Significant regional variations also occur in the prevalence of the undeclared economy. While 53% of businesses in Zagreb state that they compete against unregistered or informal businesses, as do 41.2% of those in northern Croatia and 40.8% in Slavonjia, this issue was cited by only 25.6% of businesses in Lika and Banovina, 17% in Dalmacija and 12.3% in Istra and Hrvatsko Primorje.

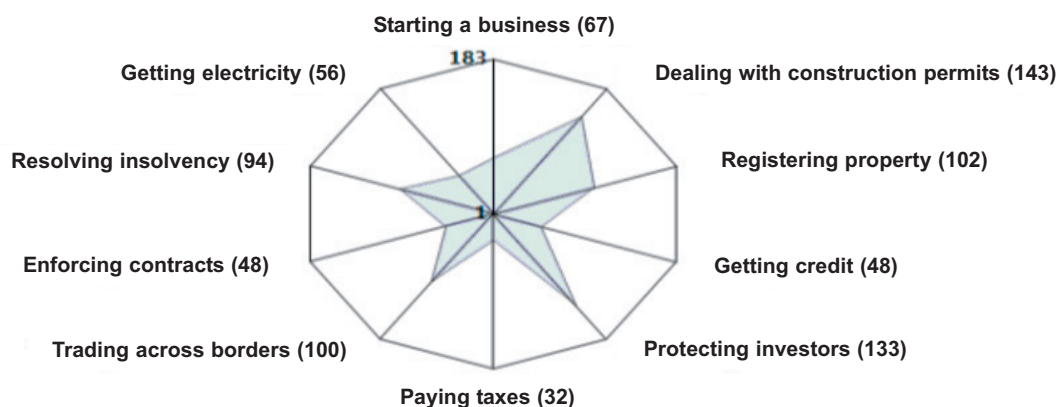
### Types of undeclared work

No known contemporary studies have sought to evaluate the prevalence of different types of undeclared work in Croatia. For example, it is not known what proportion of the undeclared economy is composed of ‘envelope wages’, waged informal employment, informal self-employment or paid favours. This will require investigation in future studies. One way to achieve this would be to replicate the 2007 Eurobarometer survey of the EU27 in Croatia (European Commission, 2007b).

### Barriers to formalisation

The annual World Bank Doing Business surveys provide one of the few data sources on the barriers to formalisation in Croatia. These provide data (which are cross-nationally comparable as the survey is annually conducted in 183 countries) on how easy or difficult it is for a local entrepreneur to open and run a small-to-medium-sized business when complying with relevant regulations. It measures and tracks changes in regulations affecting 10 areas in the lifecycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Croatia was ranked 80th out of 183 countries in 2012 in terms of ease of doing business (the EU27 as a composite was ranked 38th). In 2011, Croatia was ranked 79th. The implication is that it is more difficult to open and run a small business in Croatia than in the EU27 as a composite, although Croatia does perform better on some aspects than others relative to other countries (see Figure 2).

Figure 2: Croatia's ranking on aspects of doing business



Source: World Bank, Doing Business surveys

With regard, for example, to ease of starting a business, Croatia was ranked 67th out of 183 countries, whilst the EU27 as a composite was ranked 66th. Starting a business in Croatia requires six procedures, takes seven days, costs 8.6% of income per capita and requires paid-in minimum capital of 13.8% of income per capita. This is partly because in 2011 Croatia made it easier to start a business by allowing limited liability companies to file their registration application with the court registries electronically through the public notary (World Bank, 2012).

In relation to ease of paying taxes, Croatia stands at 32nd place in the ranking of 183 economies, while the EU27 as a composite is ranked 71st, suggesting that paying taxes is easier in Croatia than it is in the EU27 as a whole. On average, firms in Croatia make 17 tax payments a year, spend 196 hours a year filing, preparing and paying taxes, and pay total taxes amounting to 11.5% of profit. Although the World Bank Doing Business survey states that no regulatory reforms occurred in Croatia between 2010 and 2012, this is not the case. In 2009, the standard VAT rate in Croatia was increased from 22% to 23% and a 'crisis tax' was introduced, levied on the net income of households and involving the abolition of all tax relief in the personal income system. This had a negative impact in citizens' minds on operating formally but by November 2010 the crisis tax was revoked. Furthermore the government changed the law on personal income tax, decreasing the tax brackets from four to three, reducing the lowest tax rate (from 15% to 12%). This was done in order to lower the tax burden for the employed.

Comparing Croatia with the EU27, Grdović Gnip and Tomić (2010) show that Croatia has a higher tax burden and a higher employment protection legislation index. They also point out that the greatest impact of the tax burden occurs among Croatian workers in the lower income brackets. Although the government has taken some action to reduce the tax burden, this is perhaps an area for further improvement in Croatia, despite its apparently higher ranking than the EU27 in the World Bank Doing Business surveys.

# Organisation of efforts against undeclared work

## Cross-government organisation

Analysing how the fight against undeclared work is organised in 31 European countries, Dekker et al (2010) found that 8 countries (26%) had established one body dedicated to the fight against undeclared work. This was either a single agency or a central coordinating committee responsible for ensuring coordinated action by the multifarious departments who have a stake in tackling undeclared work.

In Croatia, there is no single agency or coordinating committee responsible for ensuring joined-up action by the different departments involved in tackling undeclared work. The main responsibility for tackling undeclared work varies from country to country, with labour inspectorates, social security administrations and tax administrations being the main bodies spearheading the campaign (Table 4). In Nordic countries, local tax offices tend to take this role, not least because much of the undeclared work is conducted as self-employment, a type of undeclared work that is of less interest to labour inspectorates. In much of southern and east-central Europe, waged work is a more prominent type of undeclared work and the focus is therefore on employer–employee relations; in these countries, the labour inspectorate has greater responsibility.

Table 4: *Main authority for tackling undeclared work in 31 countries*

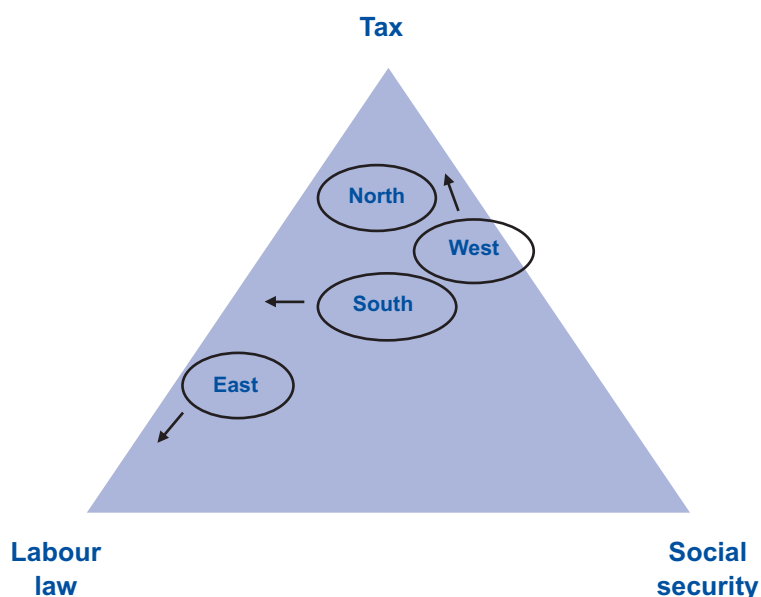
Labour inspectorate	Social security administration	Tax administration
Bulgaria, Cyprus, Czech Republic, Greece, Hungary, Italy, Iceland, Latvia, Lithuania, Malta, Luxembourg, Poland, Portugal, Romania, Slovakia, Slovenia, Spain	Belgium, France, Switzerland/Liechtenstein	Austria, Denmark, Estonia, Germany, Finland, Ireland, Netherlands, Norway, Sweden, United Kingdom

Source: *Dekker et al (2010)*

Figure 3 summarises where the balance of responsibility lies between the various authorities in different European regions. In northern European countries, it is predominantly the tax authorities who take the leading role in formulating policy on undeclared work. In western European countries, while the tax authorities take the leading role, the social security authorities play a bigger role. In southern European countries, a more equal contribution is made by all three bodies whilst in east-central Europe, most responsibility lies with the labour inspectorates.

Figure 3 also shows how the balance of responsibility is shifting over time. Although little if any change has occurred in northern European countries, with the tax authorities remaining predominantly responsible for tackling undeclared work, in western European countries, the dominance of the tax authorities is growing. In southern European countries, a shift is occurring away from an equal role played by all three bodies and towards greater responsibility being taken by the tax and labour authorities.

Figure 3: Responsibility for undeclared work in the regions of Europe



In Croatia, there is no single agency or coordinating committee. Nor is there a leading body in charge of tackling undeclared work. Instead, different governmental organisations are responsible for different aspects of undeclared work, including the Ministry of Finance, the Ministry of Labour and Pension System, the State Inspectorate, the tax administration, the Croatian Employment Service, the Ministry of Tourism, the Ministry of Agriculture and the customs administration. These government departments largely have their own separate targets for undeclared work, although occasionally objectives and projects run across departments, and shared plans and goals are adopted. An example is the goal of informing the public of the pitfalls of undeclared work and the benefits of formalising. However, in general, limited coordinated action occurs across government departments.

Despite this responsibility being distributed across numerous departments and the fact that targets being pursued are largely department-based rather than shared, there are individual examples of operational cooperation and coordination, such as joint inspection visits. Data mining and sharing across departments have also been improved since the introduction of individual identification numbers for citizens.

### Role of social partners

The involvement of social partners occurs through the Economic and Social Council (ESC), established in 1994 to enable tripartite social dialogue between the government, employers and trade unions. In 2001, the Office for Social Partnership was set up to improve this process.

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

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



# Policy approaches to undeclared work

## Typology of policy approaches

In the EU27, tackling undeclared work has been dominated traditionally by a repressive approach that seeks to stamp it out through increasing the costs associated with working undeclared. This is achieved by increasing the penalties and/or the perceived or actual likelihood of being caught. Since the turn of the millennium, however, calls have been made by the European Commission for governments to transform undeclared work into declared work rather than simply repress it and to do so by adopting measures that change the benefits side of the equation, making it more beneficial and easier to engage in declared work (European Commission, 2003a, 2003b, 2003c). At the 2003 Lisbon Summit of the European Council, Employment Policy Guideline No. 9 was published on ‘transforming undeclared work into regular work’, which states:

*Member States should develop and implement broad actions and measures ... which combine simplification of the business environment, removing disincentives and providing appropriate incentives in the tax and benefits system, improved law enforcement and the application of sanctions.*

(European Commission, 2003b, p. 9)

Further encouragement to move in this direction was provided by the European Commission (2007a) in its second Communication on undeclared work, which explicitly called for Member States to transform undeclared work into declared work. As Williams and Renooy (2009) note, there are three approaches: preventative measures that stop from the outset occurrences of non-compliance; curative measures to help those already working in the informal economy to transfer into the declared realm; and ‘softer’ commitment measures that foster an allegiance to tax morality.

## Policy approach in Croatia compared with 31 other European countries

As Table 5 shows, 57% of stakeholders in the EEA and Switzerland state that repressive measures are accorded the most importance in their country when tackling undeclared work, with just 43% saying measures that transform undeclared work into declared employment are given the most importance. When asked to identify policy measures accorded the least importance, some 84% cited those seeking to transform undeclared work into declared employment, with only 16% citing repressive measures. The clear intimation is that despite the call by the European Commission to transform undeclared work into declared employment, most countries remain entrenched in a repressive approach that seeks to stamp out undeclared work. The view that undeclared work needs to be transferred into the declared realm is far from being widely accepted.

Table 5: Stakeholders’ views on the importance of different policy approaches to tackling undeclared work in the EEA and Switzerland compared with four candidate countries and Croatia

Types of measures	Most important (%)	Second most important (%)	Least important (%)
Repressive	57 (80)	17 (20)	16 (0)
Preventative	19 (20)	46 (60)	23 (0)
Curative	14 (0)	19 (20)	32 (60)
Fostering commitment to declared work	10 (0)	18 (0)	29 (40)

Note: Figures for the four candidate countries and Croatia are provided in brackets.

Source: Dekker et al (2010)

In the four EU candidate countries, it is also the case that the widespread view is that repression measures to tackle undeclared work are accorded most importance. Croatia is no exception. Interviews with government officials and social partners strongly confirmed that deterrence remains the dominant policy approach, although it is recognised that a much

wider range of measures are being introduced, even if they are not yet accorded the same importance as deterrence in the fight against undeclared work.

As Table 6 shows, the 30 EEA countries and Switzerland are continuing to use repressive measures aimed at stamping out undeclared work, with all seeking to improve detection and 93% using penalties and/or sanctions. However, they are also pursuing measures to change the ‘benefits’ side of the equation by making it easier and more advantageous to operate in the declared economy, as called for by the European Commission. A total of 90% of these countries have adopted at least one preventative policy measure, although the range of such measures is relatively narrow beyond simplifying compliance. In addition, 64% use one or more curative measures, although again the range used is narrow beyond the use of targeted direct tax incentives (such as income tax relief, tax reduction and subsidy schemes). Moreover, there is recognition of the need to shift away from the hard policy approach, which changes the cost–benefit ratio confronting suppliers and purchasers, and towards a soft approach that seeks to engender a commitment to tax morality; 69% of the 31 countries have adopted some commitment measure.

Table 6: Policy measures used in Croatia and 31 other European countries to tackle undeclared work

Measures	Used in Croatia	% of 31 other European countries using measure
<b>Repressive measures</b>		
<i>Preventative</i>		93
Administrative sanctions for purchasers/companies	✓	87
Administrative sanctions for suppliers/employees	✓	83
Penal sanctions for purchasers/companies	✓	74
Penal sanctions for suppliers/employees	✓	52
<i>Measures to improve detection</i>		100
Data matching and sharing	✓	83
Workplace inspections	✓	100
Registration of workers prior to starting work or on first day of work	✓	74
Coordinating strategy across government	✓	57
Certification of business, certifying payments of social contribution and taxes	✓	65
Use of peer-to-peer surveillance (e.g. telephone hotlines)		39
Coordination of operations across government		61
Coordination of data sharing across government		65
Mandatory ID in the workplace	✓	65
<b>Measures enabling compliance</b>		
<i>Preventative measures</i>		90
Reduce regulations	✓	48
Simplify compliance procedures	✓	87
Technological innovations (e.g. certified cash registers)	✓	43
New categories of work (e.g. for small or mini-jobs)	✓	35
Direct tax incentives (e.g. exemptions, deductions)	✓	61
Social security incentives	✓	35
Ease transition from unemployment into self-employment	✓	65
Ease transition from employment into self-employment	✓	44
Changing minimum wage upwards	✓	48
Changing minimum wage downwards		9
Training and support to business start-ups	✓	61



Measures	Used in Croatia	% of 31 other European countries using measure
<b>Measures enabling compliance</b>		
<i>Preventative measures</i>		90
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 purchasers to buy declared		
Service vouchers	✓	26
Targeted direct tax incentives	✓	61
Targeted indirect taxes		17
Stimulate suppliers to formalise		
Society-wide amnesties		9
Individual-level amnesties for voluntary disclosure		17
Formalisation advice to business		30
Formalisation support services to businesses	✓	30
Targeted VAT reductions		17
Free record-keeping software to businesses		13
Fact sheets on record-keeping		22
Free advice/training on record-keeping		22
Gradual formalisation schemes		13
<i>Fostering commitment to declared work</i>		69
Campaigns to inform undeclared workers of risks and costs of working undeclared	✓	61
Campaigns to inform undeclared workers of benefits of formalising their work	✓	57
Campaigns to inform users of undeclared work of the risks and costs	✓	61
Campaigns to inform users of undeclared work of the benefits of declared work		52
Use of normative appeals to people to declare their activities		52
Measures to change perceived fairness of the system		26
Measures to improve procedural justice of the system (i.e. degree to which people believe government has treated them in a respectful, impartial and responsible manner)	✓	17
Measures to improve knowledge of tax, social security and labour law	✓	65
Adoption of commitment rather than compliance approach (e.g. 'responsive regulation')		30
Campaigns to encourage a culture of commitment to declaration	✓	39

Source: Decker *et al* (2010)

Comparing the range of measures used in Croatia with those used in the EEA and Switzerland, Table 6 shows a great deal of similarity between the two. While both Croatia and other European countries have begun to use enabling measures, up to now the majority of measures have been preventative. Curative measures that seek to transform undeclared work into declared work are particularly scarce in Croatia when compared with the other European countries, while policies aimed at fostering commitment to declared work, although introduced, are quite recent and their impact is not yet known.

Over the past few years, one of the priorities of the Croatian government has been to update the laws and clarify the conditions that businesses and persons must meet to be fully legal. The majority of legal amendments, however, have adopted a deterrence focus, signalling the continued prominence of the repressive approach. For example, the powers of government inspectors have been expanded. State inspectors are now able to enter houses, garages and commercial buildings on the basis of reports of unregistered activities. Previously, they were unable to do so as inspectors were limited to checking the operations of registered businesses only, which prevented them from finding undeclared activity that was fully informal. Inspections are also increasingly carried out on an annual basis, intensified during seasons of increased working (such as summer in the region of Dalmacija) and targeted at small-scale cash-in-hand work, room and apartment renting in the summer period, and chartering boats. Coordination of various inspection bodies in this regard has been introduced to ensure greater efficiency.

Despite this continued focus on deterrence-based measures, the use of enabling measures has also increased in recent years. As is the case in other EU27 Member States, incentives have been introduced to help the unemployed move into self-employment, although certain sectors are excluded here, such as the hospitality industry. Twelve-month grants range from €2,500 for craftspeople to €3,250 for traders.

As with many other European countries, a voucher system has been introduced; in Croatia this has been introduced in the agricultural sector. No evaluations have yet been conducted but, if successful, the intention is to extend it to tourism, household services and other seasonal activities. While under the previous law, social contributions had to be paid for the entire month even if the weather allowed the seasonal employee only five days of working, the new voucher system provides employees with a daily voucher for each recorded day of work and provides employers with incentives for declaring seasonal work. Workers must receive a minimum daily wage of HRK 70.40 (€9.40) and work no longer than 12 hours per day. A seasonal worker can be employed for 90 days per calendar year. The penalties for violating the provisions of the act are up to HRK 50,000 for legal persons and HRK 10,000–30,000 for individuals. The law is simple, clear and involves a straightforward administrative process.

Business registration procedures have been simplified in Croatia, in a model similar to the ‘one-stop shop’ approach taken in many other European countries. A business registration service called ‘HITRO.HR’ was set up to enable citizens and entrepreneurs to have quicker and simpler access to information and services in one location. As part of this initiative, a multifunctional smart card (FINA e-card) has been introduced to encourage electronic business, simplifying and speeding up business processes and eliminating unnecessary paperwork. The e-card clearly saves time and money for businesses willing to operate electronically.

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

Although Croatia gives prominence to deterrence measures, it is also paying greater attention to enabling policy measures. Until now, however, this has been mostly in the realm of preventative measures. The use of supply-side curative measures has been very limited. The adoption of ‘soft’ commitment measures to improve citizens’ tax morality has occurred only recently.

## Relationship between undeclared economies and work and welfare regimes

If the undeclared economy is to be tackled effectively, changes are not only required in the area of direct policy measures. Evidence suggests that broader work and welfare regimes also influence the size of the undeclared economy in a country. Until now, in simple terms, there have been two contrasting perspectives regarding the relationship between the size of an undeclared economy and a work and welfare regime. According to the neo-liberal viewpoint, undeclared economies are the direct result of high taxes, over-regulation and state interference in the free market, and the remedy is therefore for countries to pursue tax reductions, deregulate and minimize state intervention. According to the social democratic viewpoint, undeclared economies are the product of under-regulation; the remedy involves intervention in the economy and higher levels of social protection.

Five indicators can be used to evaluate these competing perspectives. These are the level of implicit tax rates on labour income (Eurostat, 2007, 2011); state expenditure on interventions in the labour market as a proportion of GDP (Eurostat, 2011); the level of state social protection expenditure (excluding old age benefits) as a proportion of GDP (European Commission, 2011); the effectiveness of state redistribution via social transfers (European Commission, 2011); and the level of intra-national equality in the society, as measured by the Gini coefficient (European Commission, 2011). For fuller details on the datasets and methodology used in the studies cited here, see Williams (2012a, 2012b) and Vorley and Williams (2012).

As Table 7 shows, there is no statistically significant correlation between the implicit tax rates on labour (the average effective tax burden on labour income) and the size of undeclared economies. Using Spearman's rank correlation coefficient ( $r_s$ ) due to the non-parametric nature of the data, no statistically significant correlation is found between the size of the undeclared economy across the EU27 and the implicit tax rates on labour ( $r_s=-0.266$ ). Merely 10.2% of the variance in the size of the underground economy is correlated with the variance in implicit tax rates ( $R^2=0.1019$ ). However, a statistically significant correlation is found between the size of undeclared economies and the level of state expenditure on labour market interventions, expenditure levels on social protection, the level of state redistribution via social transfers, and the degree to which societies are equal. Welfare regimes with greater labour market intervention, higher levels of social protection and redistribution via social transfers and greater equality tend to have smaller undeclared economies.

This has clear implications for Croatia. It tentatively suggests that undeclared economies can be reduced both by pursuing targeted policy measures and by modernising the country's work and welfare regime through higher levels of expenditure on state intervention in the labour market and social protection, coupled with redistribution via social transfers so as to promote greater social equality.

Table 7: *Relationship between size of undeclared economy and work and welfare regimes*

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

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



# Conclusions

This report has given a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in Croatia. Throughout the report, the situation in this acceding country has been compared with that in the EU27 wherever feasible. The key finding is that the undeclared economy in Croatia is equivalent to 30.4% of GDP and, as such, is larger than that found in all EU27 Member States with the exception of Bulgaria.

The undeclared economy is not evenly distributed in Croatia. It is most concentrated in agriculture and allied trades, followed by manufacturing and retailing. Large firms and exporting and foreign-owned businesses are less affected by informal businesses than are small and medium-sized, non-exporting and domestically owned businesses, and are less likely to view them as a major constraint. At present, however, it is not possible to compare data on who does undeclared work in Croatia, what types of work they do and for what reasons with that from other EU27 Member States. One way forward might be the implementation of the 2007 Eurobarometer survey and/or the inclusion of Croatia in any future second wave Eurobarometer survey, so as to enable a comparison of the nature of undeclared work in Croatia with the EU27.

There is not one single compliance unit, agency or organisation responsible for tackling undeclared work in Croatia. No government department takes the main responsibility on this issue either. Instead, different governmental organisations take responsibility for different aspects of it, including the Ministry of Finance, the Ministry of Labour and Pension System, the State Inspectorate, the tax administration, the Croatian Employment Service, the Ministry of Tourism, the Ministry of Agriculture and the customs administration. On the whole, these departments do not have common or shared targets with regard to tackling undeclared work, and the pursuit of a joined-up approach is in its infancy so far as strategy is concerned, although there are a few examples of joined-up operations and data sharing on a cross-departmental basis. Furthermore, although formal institutional arrangements exist for the involvement of social partners, including the Economic and Social Council (ESC) and the Independent Service for Social Partnership, the culture of social dialogue remains relatively weak.

Finally, and similar to other European countries, Croatia has so far focused on repressive measures in tackling undeclared work, seeking to stamp it out. Although enabling measures are starting to be used in Croatia, especially preventative ones, little use is made of curative measures, especially incentives to encourage those working undeclared to formalise. Moreover, measures to foster commitment to tax morality are fairly recent. The lesson is that Croatia needs to pay greater attention to curative and commitment policy measures that seek to transform undeclared work into declared work.

This report also provides evidence of a strong correlation between countries in which there is greater labour market intervention, social protection, redistribution and equality, and smaller undeclared economies.



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**Colin C. Williams, Marijana Barić and Piet Renooy**

