Assessing the cross-national transferability of policy measures for tackling undeclared work

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1 Introduction

This working paper is part of a series of deliverables within the project entitled ‘GREY – Out of the shadows: developing capacities and capabilities for tackling undeclared work in Bulgaria, Croatia and FYR Macedonia’ (‘GREY’), funded by the European Commission’s Framework 7 Industry-Academia Partnerships Programme (IAPP) (Figure 1). The objective of this project is to provide concrete policy recommendations about what policies may work better in tackling the undeclared economy in two new EU Member States (Bulgaria and Croatia) and a candidate country (FYR Macedonia). In particular, the objectives of our project are to:

- Conduct a comprehensive review of the policy approaches and measures being used to tackle undeclared work.
- Empirically evaluate the measures for facilitating the shift of undeclared work into the declared economy in the selected target region.
- Based on the results of the first two objectives, to recommend possible new policy approaches and measures (or endorse old ones) that will facilitate the shift of undeclared work into the declared economy.

The project outputs during the first phase of ‘GREY’ include three country reports on assessing the nature and extent of undeclared work in the three target countries (Dzhekova and Williams, 2014; Dzhekova et al., 2014; Franic and Williams, 2014) and a conceptual framework for understanding the policy approaches for tackling undeclared work (Williams, 2014) which is Working Paper No. 4 (see Figure 1).

Figure 1. GREY project on tackling undeclared work in BG, HR and FYROM: research milestones and outputs

The aim of the present Working Paper No. 5 is to provide a preliminary assessment of the appropriateness of possible policy approaches for tackling undeclared work as well as their transferability to three target countries: Bulgaria (BG), Croatia (HR) and FYR Macedonia (FYROM). This assessment will result in highlighting a set of promising policy practices that can be tested empirically in terms of their...
acceptability among the population and stakeholders in the three Southeast European states, to be completed in the second phase of the GREY project.

Successful policy transfer and cross-national policy learning should be informed by prospective policy analysis and testing the features of the specific program against the specifics of the local context and circumstances. In line with the ultimate project objective to provide concrete policy recommendations for more efficient and effective policies towards formalisation of undeclared work, this paper serves an important role, for it aims at establishing criteria and processes through which potential policy adopters can identify promising policies used elsewhere to tackle similar problems and assess their ‘goodness of fit’ prior to adaptation to local realities.

This paper is structured as follows. Chapter 2 provides a conceptual overview of cross-national policy transfer and lesson-drawing, highlighting potential obstacles and factors for success. Chapter 3 reviews the methodological aspects related to prospective evaluations of policies for potential transfer, and develops a practical framework for assessing their applicability and transferability to a target country. Chapter 4 provides an overview of policy developments at EU level and efforts to facilitate cross-national policy learning in the field of undeclared work. It discusses recent advances at EU level in the understanding of what policy strategies are most effective in improving tax compliance and formalising undeclared work. The chapter then turns to discussing some cross-cutting contextual variables likely to influence the transferability of different policy approaches. Chapters 5, 6 and 7 assess in more detail the specific hierarchy of policy intervention priorities in each country against a number of prospective policy measures used elsewhere. Each chapter attempts to scope out for further empirical investigation potentially useful examples of policy strategies applied elsewhere to tackle similar problems as those identified in the target countries. The accent is on outlining how prospective policy examples may interplay with the local context and the problem areas identified.

2 Cross-national policy transfer and lesson-drawing – an overview

The EU in its employment strategy package and recommendations to member countries has emphasised the need to develop an innovative and holistic policy approach towards undeclared work, through sharing information and best practices and learning from the experiences of other Member States. Policy transfer and policy learning through studying the experiences of other countries when tackling a similar problem is increasingly recognised as a crucial dimension of the policy-making process, given the accelerated transnationalisation and mobilisation of knowledge, ideas, policies and practices. The EU’s open method to coordination is one example of an institutionalised framework that encourages such processes.

This project’s overall objective is to facilitate both – cross-national and domestic policy learning in the field of tackling undeclared work by assessing available policy options and experiences across Europe, and providing the necessary evidence for prospective policy transfer decisions. Therefore, the first part of this chapter provides a conceptual overview of the literature on policy transfer and cross-national lesson-drawing. The emphasis is on facilitating better understanding of the processes of policy transfer and policy learning from foreign experience, as well as the obstacles and factors for success. The second part turns to methodological aspects of policy transfer – and more specifically the process of selecting promising practices and evaluating the transferability and feasibility of foreign experience, while recognising that this process can never be completely neutral, systematic and rational.

2.1 Forms of policy transfer

Policy transfer is traditionally defined as “a process in which knowledge about policies, administrative arrangements, institutions etc. in one time and/or place is used in the development of policies, administrative arrangements and institutions in another time and/or place” Dolowitz and Marsh (1996: 344). The subjects of transfer from one political system to another can be “almost anything”, including
“policy goals, structure and content; policy instruments or administrative techniques; institutions; ideology; ideas, attitudes and concepts; and negative lessons” (Dolowitz and Marsh, 1996: 349-350).

Cross-national policy comparisons and drawing lessons from foreign experiences can contribute to innovation and improving the quality and rationality of domestic policy-making. In that sense policy transfer is often associated with rational approaches to policy-making, based on the notion that decisions should be based on evidence of ‘what works’, instead of a particular ideology. Numerous scholars advocate viewing cross-national policy transfer as a form of policy-oriented learning and lesson-drawing, where a lesson is “a detailed cause-and-effect description of a set of actions that government can consider in the light of experience elsewhere” (Rose 1993: 27). However, the extensive literature on policy transfer and lesson-drawing recognises a number of problems associated with the process of extrapolating ‘lessons’ and best practices and applying them to a different context, which are briefly discussed in the following.

Motivations to borrow policies from other settings can be placed on a continuum between ‘want to’ and ‘have to’ (Dolowitz and Marsh, 2000: 9). Voluntary transfer draws on the assumption that policy actors rationally chose to search for solutions abroad for potential utilisation at home, aimed at innovation or optimisation of existing policies (Rose, 1991). This can be catalysed by dissatisfaction with local circumstances, uncertainty about the course of action in crisis or legitimisation needs (Dolowitz and Marsh, 1996). Coercive, conditioned or obligated transfer implies transposing external rules under ‘external inducement’ or compulsion to conform. One typical example is the transposition of EU rules in candidate countries. Randma-Liiv (2005) distinguishes between demand- and supply based policy transfer. In the latter case, the availability/supply of solutions determines what will be transferred upon the initiative of external actors, while the ‘importers’, often under pressure, do not necessarily consider any alternatives and display different degree of participation in co-designing policies. A typical example is the post-communist welfare transformation in Eastern European countries in line with models prescribed by international financial organisations, or obligated transposition of EU rule.

Rose (1991, 1993, 2005) explores the different modes of policy transfer in terms of the extent to which a certain model is adapted during the transfer and how it is used to shape domestic policies. He distinguishes between five broad categories of lesson-drawing, ranging from copying the original programme without much change to using a foreign idea as an inspiration for designing own programmes.

**Figure 2. Forms of lesson-drawing**

<table>
<thead>
<tr>
<th>Copying</th>
<th>• Enacting more or less intact a program already in effect in another jurisdiction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adaptation</td>
<td>• Adjusting for contextual differences a program already in effect in another jurisdiction</td>
</tr>
<tr>
<td>Hybridization</td>
<td>• Combining elements of programs from two different places</td>
</tr>
<tr>
<td>Synthesis</td>
<td>• Combining familiar elements from programs in a number of different places to create a new program</td>
</tr>
<tr>
<td>Inspiration</td>
<td>• Using programs elsewhere as an intellectual stimulus to develop a novel program</td>
</tr>
</tbody>
</table>

*Source: adapted from Rose (1993: 30).*
While some of the earlier research on policy transfer has focused on what motivates policy transfer (i.e., the ‘why’ variable), other scholars have studies in more detail the process of ‘how’ lesson-drawing occurs or should occur in a systematic manner (Rose 1991, 1993, 2005). Rose suggests ten steps policy actors can follow to extrapolate lessons from foreign experience in the process of adjusting beliefs and redefining policy approaches Figure 3). This process may lead not only to transfer in different forms as outlined above, but also to policy termination based on negative lessons learned.

**Figure 3. Ten steps in lesson-drawing**

1. Learn the key concepts: what a program is and what a lesson is (and is not)
2. Catch the attention of policymakers
3. Scan alternatives and decides where to look for lessons
4. Learn by going abroad
5. Abstract a generalized model of how a foreign program works
6. Turn the model into a lesson fitting your own national context
7. Decide whether the lesson should be adopted
8. Decide whether the lesson can be applied
9. Simplify the mean and ends of a lesson for greater chances of success
10. Evaluate a lesson’s outcome prospectively and as it evolves over time

*Source: adapted from Rose (2005: 9)*

Systematic lesson-drawing in Rose’s model entails scanning alternatives, and deciding where to look for lessons, understanding how a foreign programme works, abstracting generalizable models and mechanisms and assess their applicability and transferability in the domestic context. As Robertson (1991: 55) points out: “the degree to which a population of polities adopt a particular lesson will be a function of the program’s economic and political feasibility”. However, as the following section shows, such a systematic prospective evaluation and adaptation is rarely possible in reality due to a number of intellectual and political challenges associated with it.

### 2.2 Obstacles and factors for success of policy transfer

Success and failure of policy transfer have been widely discussed in the literature, although the differentiation, as well as the causal nexus, between transfer outcome and policy outcome is not always clear (Stone, 2012; Evans, 2009). It is argued that transfer involving more complex conceptual forms of learning through deeper understanding of foreign models would produce more successful domestic policy solutions. However, the processes of searching for policies to transfer, identifying promising models and assessing their feasibility pose a number of challenges (Page and Lawson, 2007; Dwyer and Ellison, 2009).

The political and economic resources of the ‘borrowing’ country to implement the policy are crucial for the success of transfer (Robertson, 1991), alongside bureaucratic size and efficiency (Rose, 1993). The borrowing of an idea or model “does not mean it can bypass the complexities of policy making including the need for policy makers to mobilise political support” or “make compromises with affected interests”
This is why patterns of policy borrowing tending to follow (prior) ideological alignments: "policy models that affirm and extend dominant paradigms, and which consolidate powerful interests, are more likely to travel with the following wind of hegemonic compatibility or imprimatur status" (Peck and Theodore, 2010: 170; Robertson, 1991).

The transferability of a particular programme from one setting to another is mainly affected by its complexity (Dolowitz and Marsh, 1996). Rose (1993: 132-4) suggests six hypotheses in this respect:

- programmes with single goals are more transferable than programmes with multiple goals;
- the simpler the problem the more likely transfer will occur;
- the more direct the relationship between the problem and the ‘solution’ is perceived to be the more likely it is to be transferred;
- the fewer the perceived side-effects of a policy the greater the possibility of transfer;
- the more information agents have about how a programme operates in another location the easier it is to transfer;
- the more easily outcomes can be predicted the simpler a programme is to transfer.

According to Dolowitz and Marsh (2000: 17) there are three major factors for policy transfer failure. Uninformed transfer occurs when the borrowing country has insufficient information about how the policy operates in the ‘donor’ country. Another form of potentially unsuccessful outcome is incomplete transfer, when key features of what made the policy successful in the original setting have not been transferred. When there is a limited fit between the social, economic, political and ideological contexts of the transferring and borrowing settings, an inappropriate transfer is likely to occur.

Policy-makers willing to learn and borrow policy models from other countries have at their disposal an ever growing ‘market’ of best practices and benchmarking measures. International organisations such as the EU and OECD have a significant role in the ‘soft’ diffusion of such instruments. While ‘best practice’ research widens the potential range of solutions to problems and provides ‘shortcuts’ to often demanding and time-consuming scanning exercises, it is also the case that best practice studies often contain methodological problems (Bardach, 1994: 260), especially because they tend to blend out contextual variables. Radaelli (2004) views critically the growing popularity of the ‘identifying best practices’ model in EU and OECD circles. He notes that they are highly attractive from a political point of view as they grant legitimacy and are expected to address a need to deal with uncertainty, yet at the costs of efficiency and genuine policy learning. As such, Radaelli (2004: 726) warns of the risks and limitation of the method of benchmarking based on a synthesis of the experiences of several countries and the ‘labelling’ of certain models as ‘best practices’ or success-recipes with total ‘fungibility’ potential. This can have the negative effect of ‘de-contextualising’ the problem to be solved, and inhibit “a real forum for learning from different, context-sensitive national experiences”. Institutional legacies, state traditions and dominant legal cultures are easily neglected in this way (Radaelli, 2004: 726). He concludes that policy success is a holistic phenomenon with a complex explanation, depending on the particular ‘alchemy’ of a wide range of factors. From this perspective, the lesson-drawing approach should be preferred over the ‘best practices’ (or success-oriented) model, as the former recognises the obstacles and limitations of cross-national learning and emphasises the importance of contextualised learning.

Evans (2009: 247-8) develops a framework of factors that constrain policy transfer, distinguishing between cognitive and environmental factors. Cognitive obstacles refer to “the process by which public policy problems are recognized and defined in the pre-decision phase, the breadth and detail of the search conducted for ideas, the receptivity of existing policy actors and systems to policy alternatives and the complexity of choosing an alternative” (ibid.). Environmental obstacles, on the other hand, can be structural (socio-economic, political, institutional) and technical, as well as the ability to mobilise elites and public support. Technical constraints in implementation include: “the incorporation of an adequate causal theory of policy development; the sensible allocation of financial resources; hierarchical integration...
within and among implementing organizations; clear decision rules underpinning the operation of implementing agencies; the recruitment of programme officers with adequate skills/training; sufficient technical support; and the use of effective monitoring and evaluation systems including formal access by outsiders” (Evans, 2009: 248).

The process of systematically drawing lessons in practice is often limited to the availability of information and existing awareness of examples/countries to consider, while finding out how policies work elsewhere is time-consuming and intellectually challenging. The main difficulties with the first phase of searching for prospective policies used elsewhere include lack of information about how foreign programmes work and how they achieve their objectives, absence of formal impact evaluations that allow an assessment of their success, lack of time and resources to engage in systematic analysis of alternatives, a high degree of uncertainty about desired policy outcomes in the borrowing setting and imprecise problem definition. Furthermore, the political ‘window of opportunity’ to place an idea on the agenda presents additional constraints (Page and Mark-Lawson, 2007). Policy-makers and analysts therefore often apply ‘shortcuts’ and ‘heuristics’ when using foreign evidence/experiences to react to local contingencies at the expense of deeper cognitive learning that would trigger a change in perspective. Some commonly applied strategies are to consider ‘smart ideas’, basic and loosely defined concepts as inspiration for developing or complementing their own programmes (Page and Mark-Lawson, 2007). Some common messages from the literature regarding the success factors of policy transfer have been synthesized by Stead et al, 2009, as follows:

- Inspiration from several examples is better than from just one. Looking across several examples can help to identify the useful and constructive elements of each of them and allow the various policy actors to enter into a process of negotiation regarding appropriate policy options.

- Making a literal copy of one example is unlikely to succeed. Such an approach is not generally conducive to generating locally suitable solutions or implementation mechanisms.

- Strong domestic champions and change agents (or ‘policy entrepreneurs’) are often necessary to achieve policy change. Their creativity and agility in dealing with other (sometimes more powerful) policy actors can make a big difference to policy outcomes.

- Transferring policies from legally and culturally kindred nations should in principle be easier to achieve than from countries that are very different. However, even similar countries have subtly different preferences, circumstances and institutional arrangements, which are often not well anticipated.

- Policy ideas, solutions, models, programmes or instruments invariably have to be incorporated in the existing institutional structure of the recipient constituency. Adopting generic ideas or instruments provides leeway for making refinements that are appropriate to the formal and informal institutional environment.


2.3 Policy learning in transition settings

Policy transfer between settings with different levels of economic, political and social development presents specific challenges. Borrowing from more developed countries is a particularly attractive option for transitional countries, as a means of finding the quickest solution when uncertainty about the course of action is high (Tavits, 2003; Randma-Liiv, 2005). The most comprehensive endeavour of transferring external policies and rules to the countries of Central and Eastern Europe (CEE) has been undertaken within the EU accession process, which provides rich empirical evidence of the factors that lead to different forms of convergence or resistance. CEE countries see policy transfer within EU accession
aspirations as a means of catching up politically and economically with more developed economies (Rose, 2003). However, while most of the change that has occurred in new EU member states has been as a result of similar external incentives and pressures (conditional/obligated/supply-based transfer), the varying levels of motivations to engage in deep-reaching reforms and lesson-drawing point to different paths of policy and institutional transformation. While the EU acquis is not negotiable, candidate countries have developed different coping strategies to respond to the challenges posed by external EU rules transfer to the domestic context. The outcome of transfer of EU rules and policies to the East has been both convergence and resistance. Resistance against transfers may derive from domestic veto players that have an embedded interest in existing institutions (Steffens, 2006: 109). In most cases, indigenous versions of the policy mechanisms have been developed, depending on a number of local factors. To explain different modes of EU rules transfer as well as the variations of its effectiveness in candidate countries from CEE, Schimmelfenning and Sedelmeier (2004) suggest the following models:

- **External incentives model**: a state adopts EU rule based on a rationalist bargaining model (possible variables influencing different levels of convergence – determinacy and credibility of the conditionality imposed by the EU, the size and speed of rewards, veto players and adoption costs).
- **Social learning model**: a state adopts EU rule if it is persuaded of its appropriateness (variables – legitimacy EU of rules, identification of the target state with the EU community, resonance with domestic rules).
- **Lesson-drawing model**: a state adopts EU rule if expects these rules to solve domestic policy problems effectively (variables – policy dissatisfaction, EU-centred epistemic communities, transferability of rules, veto players).

However, it is ultimately the domestic situation of candidate countries that will influence the actual outcomes of externally induced reforms, especially in the institutional realm, “where the density of rules is generally low” (Jacoby 2004: 34ff). Domestic obstacles, motivational and contextual factors shaping transfer of external policies, norms and rules to transitional contexts include (see also Steffens, 2006: 107; Randma-Liv and Kruusenberg, 2012; Rose, 1993):

**Motivational factors**:
- Lack of previous experience and expertise
- Uncertainty over outcomes, course of action, policy options
- Perceived urgency of reform needs
- Administrative capacity, immaturity of institutional infrastructure

**Transfer outcomes**:
- Indigenous factors influencing transfer success include the density of domestic veto players (including embeddedness of rent-seeking elites), adoption costs and the existing political equilibrium (Steffens, 2006; Schimmelfenning and Sedelmeier, 2004).
- These may lead to incentive-oriented (“box-ticking”) rather than social learning-based transfers (Tavits, 2003; Noucheva and Belchev, 2008; Vachudova, 2005).

In general, while countries from the first wave of Eastern enlargement in 2004 have demonstrated greater ‘institutional engineering’ and creativity in designing their own indigenous versions of the transferred institutional models, in newer member states (Bulgaria and Romania) the case seems to be more of incentives-motivated transposition of rules rather than transfer based on persuasion, lesson-drawing and social learning models. In Bulgaria and Romania in particular, ‘lagging behind’ the rest of the Eastern Member States is the result of endogenous factors such as difficult institutional legacies, initial socioeconomic conditions, but also “choices made during the early stages of democratization, and the
2.4 The process of prospective policy evaluation

Mossberger and Wolman (2003) suggest a framework of rational criteria for assessing the process of policy transfer as a form of “prospective policy evaluation”, identifying common problems and potentially useful strategies. The first stage is information gathering or awareness, whereas the scope and accuracy of the information are variables impacting the ability to assess its utility. Study visits and consultations with local experts are a common way of gathering first-hand information. Case studies of transfer of more complex programs (such as the transfer of the US welfare-to-work programs by the UK Thatcher Government) show that borrowers disposed of very detailed information from a wide range of sources (Dolowitz, 1998). Information diffusion is facilitated by expert communities and networks and can contribute to broader awareness of policy options from several countries. A ‘heuristic’ approach to searching and selecting prospective policy measures can be applied through ‘mixed scanning’ (Mossberger and Wolman, 2003; Etzoni, 1967). This entails first conducting a broader scoping / scanning of the environment and subsequently narrowing down the selection to one or a few models for reasons that are important to the potential borrower. Filtering criteria may include the similarity in problems, policy performance, or the proximity in socio-economic and political development. This selectivity is a necessary ‘heuristic’ to quickly narrow down the scope of options available, as opposed to systematic scanning. This is also the approach adopted by our project team. We want to further suggest that this selection should be ideally guided by a theoretical policy approach, a conceptualisation of possible policy instruments and their intended effects. Such a conceptual framework for ‘judging’ the feasibility of possible policy choices is provided by Williams (2014a) for the purposes of this project.

The second phase of policy transfer is policy assessment, where the following need to be considered (Mossberger and Wolman, 2003):

- Similarity in problems and goals
- Policy performance (including lessons from ‘failure’)
- Differences in settings

Mossberger and Wolman note that that even if differences in problems and goals exist with respect to certain policies, a transfer may still be considered. Case studies show that even if this type of transfer does not reduce uncertainty over outcomes, the policy in question may bear innovation potential even if considerable adaptation is required. Indeed, it is often the case that what is transferred are a few general similarities or ideas rather than specific policy designs. However, vague policy labels “invite application to a number of different problems” and can be fitted to numerous purposes which in turn presents difficulties to make a precise judgement about the policy’s feasibility. When looking at how such vague concepts have been applied in practice in different settings, one can discover a wide range of policy designs, which makes it difficult to generalise how the core mechanism works. One example is the ‘voucher scheme’ in the field of formalising undeclared work, which has been applied in a number of EU member states with large disparities in terms of concrete implementation features, target groups, types of work covered, objectives and outcomes. In fact, evaluating policy performance is the most challenging feature of the prospective evaluation, especially when programme goals are unclear and there are a number of designs operating under the same label (Mossberger and Wolman, 2003: 433). It may prove difficult to assess the objectivity of different types of evidence and testimonies, especially (but not only) in the absence of formal systematic performance audits.

The last category of factors to be examined – differences in settings – captures a variety of contextual variables, such as political, social, and economic institutions, political culture, public opinion, available resources, and the existence of other policies that affect efficacy. The crucial role of these factors cannot be overemphasised as they may potentially affect the effectiveness and the political viability of the
prospective policy. A common criticism in case studies of policy transfer is the lack of sufficient understanding of how the policy interacts with the domestic policy infrastructure, culture, belief systems and norms (Dolowitz, 2000; Mossberger and Wolman, 2003). Based on a review of previous case studies of policy transfer, Mossberger and Wolman offer a number of practical recommendations for practitioners engaging in policy transfer and evaluation, acknowledging that bounded-rationality heuristics are more likely to be used than systematic methods. For example, seeking expert consultations in the absence of formal evaluations may be a viable option when evaluating the prospective policy, or identifying criticism and evidence of implementation problems when quantitative impact data is lacking.

In the following we look closer at conceptual approaches that discuss in more detail how the numerous variables related to the policy’s characteristics and its context, as outlined above, can be operationalised to evaluating the transferability and applicability of prospective policies after an initial scan and selection of candidates for transfer has been made. Based on the lessons from the literature, we suggest a practical framework of analytical questions which we apply to appraise policy measures to tackling undeclared work and their transferability to the three target contexts.

### 3 Approaches to assessing policy transferability and applicability

One of the key problems with extrapolating (transferable) lessons from foreign experience appears to be to **strike a balance between de-contextualisation and over-contextualisation** of potential foreign policies. This tension is also recognised in policy evaluation research, where the trend is to increasingly use mixed approaches of summative and formative evaluations of complex policy interventions. The first tends to focus too much on outputs, results and impacts – blending out the contextual variables, while the second over-emphasises the narrative, the ‘how’ of the success or failure of a certain intervention (Pawson, 2002). If we consider interventions to be too contingent upon the context in which they are put into practice, we could never make any generalisation about their potential utility in another context. If we, however, fail to understand the variables that make it unique to the context in which it operates, we risk adapting a policy that is unsuitable for our local context.

In order to assess how successful or not a policy is, one needs to ask not only is it working (what are the outcomes), but also “what works for whom, in what circumstances, in what respects and how” (Pawson et al, 2005, 21). The same rationale applies to the question of ‘best practices’ cross-nationally: asking “How does this system manage to work at all?” should be replaced with “Given that it works in thus-and-such a way, how can we make it work better and/or prevent it from breaking down, backfiring, or falling victim to distortion and abuse?” (Bardach, 2004: 263). This is well-rehearsed within the policy evaluation literature, where these two sets of questions are at the core of the two major evaluation types: summative (focused on outputs) and formative (focused on processes) (Table 1).

**Table 1. Summative vs formative policy evaluation**

<table>
<thead>
<tr>
<th>Evaluation question</th>
<th>Type of evaluation</th>
<th>Methods</th>
</tr>
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<tbody>
<tr>
<td>Does it work?</td>
<td>Summative (impact- and outcome-focussed)</td>
<td>Quantitative methods (meta-analysis, systematic review and synthesis, micro-simulation, experiments, piloting, impact assessments, statistical controls)</td>
</tr>
<tr>
<td>How does it work? (in what respect, for whom and under what circumstances)</td>
<td>Formative (process-focussed)</td>
<td>Qualitative methods (narrative review, interviews, focus-groups, case studies, observation, Delphi consultations, etc.)</td>
</tr>
</tbody>
</table>

*Source: adapted from Walker and Duncan (2007) and Walker (2004).*

The policy evaluation literature suggests that policy programmes should be viewed and analysed as the product of how core mechanisms interact with context (Pawson et al. 2005):

\[
\text{Mechanism (M)} \iff \text{Context (C)} = \text{Outcome (O)}
\]

Pawson et al (2005) advocate a synthesis of systematic reviews that tell us something about outputs, impact, results, and formative analysis of the processes (causal mechanisms) through which the policy works and how it interacts with the context. According to Pawson et al (2005), realist evaluations of complex policies need to make a synthesis of these two questions, by first making “explicit the programme theory (or theories) - the underlying assumptions about how an intervention is meant to work and what impacts it is expected to have”. This theoretical understanding is then combined or juxtaposed with the empirical evidence, in order to explain “the relationship between the context in which the intervention is applied, the mechanisms by which it works and the outcomes which are produced”. This way, the evaluation accounts for the programme’s theory (causal mechanism) and its embeddedness in the social system.

This formula (Mechanism + Context = Outcome) can be rendered useful when we consider foreign programmes for potential adoption in another setting. Since we need to de-contextualise the policy in order to render it feasible for our context, it is crucial to understand the core mechanism through which it works, and then to analyse what context-specific factors lead to particular outcomes, since if we only look at outcomes, we miss the main factors for its success that can be made transferable. Mechanisms are not the same as policy measures or programmes, one programme can have several mechanisms (Pawson and Tilley, 2004). Mechanisms are “the triggers of the change in (the motivation of) actors’ behaviour derived from some sort of reflection about the new situation they find themselves in” (Busetti et al, 2013: 4). Hence, when assessing programme transferability and feasibility within efforts to replicate their success elsewhere, Pawson and Tilley (2004) suggest looking at a number of indicators, starting from the salient features of the innovation in the original setting, and then working through a number of contextualising factors such as recourses, people, institutional and environmental factors, procedures, and finally outcomes, identifying observed and prospective mismatches between donor and target settings.

Tizot (2010) has explored the problem of over-contextualisation with respect to transfer of social policies, which often are deemed barely transferable as they are considered too ‘idiosyncratic’, ideological and context-dependent to be adequately described and sufficiently understood by foreign observers, let alone adapted to another setting. He argues that one needs to “distinguish between the context-specific elements and the more adaptable ones within each policy programme“ (2010: 316)” by “looking for ‘contextualization effects’, and then comparing them between countries. The transfer of more adaptable, less context-specific variables and parameters in the compared policies may be supposed to be easier than whole policies”. This entails identifying ‘functional areas’ of the policies, or mechanisms through which they operate (Tizot, 2010). Bardach (2004), in a similar vein, suggests that the foreign policy intervention evaluated should be broken down into two types of elements: basic causal mechanisms and contingent features (Table 2).
Table 2. Examining how programmes work – key elements

<table>
<thead>
<tr>
<th>Causal mechanisms</th>
<th>Contingent features</th>
<th>Effects, vulnerabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic mechanism</td>
<td>Support or directly implement the basic mechanism: Implementing features Optional features (no essential functional role) Supportive features (budget, infrastructure, etc.)</td>
<td>Intended effects (effectiveness and cost-effectiveness) Secondary benefits and costs</td>
</tr>
</tbody>
</table>

*Source: adapted from Bardach (2004).*

The idea is that what is referred to by different authors as basic causal mechanisms (Bardach, 2004; Pawson and Tilley, 2004), functional areas (Tizot, 2010), generic concepts (Rose, 1993) or ‘smart practices’ (Ongoro, 2009) are those elements of a policy that are generally more transferable, as opposed to contingent features. Ongoro (2009: 7) concludes that “the analysis of the process context factors allows the identification of the ‘domain of applicability’ of the practices: smart practices are generalizable (in the sense that they apply beyond the specific case from which they are extracted to a wide range of situations), but at the same time they work under specified conditions, which we call context factors of the change process (process context factors) - and enables the development of research on categories of smart practices”. In that sense, policy learning is not about assessing effectiveness and cost-effectiveness, but about understanding “the ‘basic mechanisms’ underlying effectiveness and cost-effectiveness of what a source site has done – assuming, of course, that what they have done is indeed effective and cost-effective” (Bardach, 2004: 218.). The hypothesis is that such basic mechanisms would work in a similar way in different settings, although they can be triggered by “different institutional contrivances” (Busetti et al, 2013: 4).

Towards a practical framework

Considering the above, for the purposes of this report we suggest a practical framework for rapid appraisal of prospective policy measures incorporating to a great extent the concepts of causal mechanisms and contingent/contextualising factors outlined above. These are translated into two sets of indicators: transferability and applicability. The approach of the rapid appraisal is not intended to entail a full-blown evaluation of policy effects, outcomes and processes due to the absence of proper impact assessments that would tell us how programmes have performed in the original settings. Instead, the goal is to focus on appraising the core ideas behind policy measures and how these fit with current needs in the three countries, as well as the possible implementation and enforcement obstacles and opportunities. In that sense what we attempt to extrapolate are more general ideas and inspirations for innovation and improvement, instead of comprehensive policy designs. The two main categories here: transferability and applicability capture well the above discussed notions of causal mechanisms and contextualising factors. Transferability questions assess the generalisability of the hypothetical policy goal and intended effects in the original context and asks if its ‘core mechanisms’ are suitable for solving identified problems in the target setting. Applicability controls for the contextualising factors of a prospective policy in the local setting, assessing factors such as political and social climate and acceptance, resources, administrative and institutional capacities, other structural constraints. In other words, the fit between policy objectives/goals and the fit between contexts, can be operationalised for assessment in this way.

Buffet et al (2007), who explored methods to assess the transferability of evidence and interventions in the field of public health policy, noted that there is no empirical evidence to support the definition and selection of particular criteria for such an appraisal. Based on a comprehensive literature review, they
developed a framework of criteria/questions to be asked when assessing applicability and transferability. Most studies reviewed by Buffet et al (2007) highlight the following broader concepts that need to be considered within such an evaluation:

1) **Transferability (generalisability)** criteria (see also Wang et al, 2006) refer to whether the intervention can achieve the same outcomes in the local setting (goal/objective vs. need). Attributes of transferability include the magnitude of issues in the local setting, magnitude of the reach or coverage and cost-effectiveness of the intervention, target population characteristics, among others.

2) **Applicability (feasibility)** assessment (see also Wang et al, 2006) refers to whether it is possible to provide the intervention in the local setting (contextualising factors). Attributes of feasibility include political climate/leverage, political barriers, social acceptability, locally tailored intervention, available essential resources, and identified organization(s) to provide intervention, organizational expertise, and capacity.

We adapt this framework to the purpose of evaluating prospectively policy measures used in the EU to tackle undeclared work. The framework, derived from Buffet et al (2011), provides a set of relevant questions to be asked when selecting prospective policies from elsewhere and assessing their applicability and transferability to the local context. The factors can be given different weight and priority, and ideally discussed in consultation with a broad range of stakeholders, before a final judgment is given to each criterion. Our goal is to consider as many of these questions as possible, although we are aware that at this stage our judgments would be only preliminary and informal, based on expert and analogical appraisal and available secondary evidence. We therefore can only identify ‘smart ideas’, map possible variables and hypothesize potential scenarios for more rigorous empirical testing.

**Table 3. Framework for evaluating transferability and applicability of policy initiatives**

<table>
<thead>
<tr>
<th>Construct</th>
<th>Factors / criteria (may be given different relevance / weight)</th>
<th>Questions to ask</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transferability and adequacy</strong> (“generalisability”) Can we expect similar results?</td>
<td>Magnitude of issue in target context</td>
<td>Does the need exist? Is it already addressed by other policies?</td>
</tr>
<tr>
<td></td>
<td>Objective of the intervention</td>
<td>What is the prevalence of the issue in the local context?</td>
</tr>
<tr>
<td></td>
<td>Magnitude of “reach” vs. cost effectiveness of the measure</td>
<td>What is the difference in the risk status/issue prevalence between the donor and target setting?</td>
</tr>
<tr>
<td></td>
<td>Target group characteristics</td>
<td>Is the measure targeting the same priority objective in the donor and target context?</td>
</tr>
<tr>
<td><strong>Applicability and enforceability in local context</strong></td>
<td>Political acceptability</td>
<td>Does the objective of the measure match with political priorities?</td>
</tr>
<tr>
<td></td>
<td></td>
<td>What are the government’s indicators for success of the measure?</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Is there political opposition in the current climate?</td>
</tr>
</tbody>
</table>
Can it work for us?

- **Social acceptability**: Will the target population be interested in the intervention?
- **Impact on other affected interest groups / stakeholders**: Does the measure contradict the interests of any important stakeholders / interest groups? (trade unions, etc.)
- **Existing institutional / policy infrastructure**: Is the measure’s potential impact contradicting / cancelling out / overlapping with other existing policies? Is the institutional and legislative infrastructure in place? It may be that the measure is premature, as certain preconditions are not satisfied (undeveloped legislation; weak trade unions, etc.).
- **Available resources**: Financial, human resources, training required? Administrative / enforcement capacity in place?
- **Other local barriers and implementation risks (structural constrains)**: The risk of corruption / deformation of the measure in its implementation due to other structural/cultural constraining factors, inefficient enforcement bodies, immaturity of the economic/financial system, political volatility.

*Source: adapted from Buffet et al. (2011).*

## 4 Policy strategies towards undeclared work and their transferability to BG, HR and FYROM

### 4.1 EU policy perspectives on tackling undeclared work

Although tackling undeclared work is the responsibility of member states, this phenomenon has been increasingly recognised as a common concern across the EU and thus important at the EU level. There is no coherent EU policy strategy in this respect. However, there are a number of EU guidelines on economic and employment policies more broadly, and on moving undeclared work into the declared realm more specifically, that aim at facilitating the development of more effective instruments at the national level, including through mutual learning and cross-national policy transfer.

Combating undeclared work, and tax evasion more broadly, are recognised as important priorities contributing to the fulfilment of the EU Employment Strategy and growth targets. Since 2003, employment guidelines have been adopted calling for Member States to implement broad measures to transform undeclared work into regular employment, through combining 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 (Council of the European Union, 2003). More recently, in its Communication *Towards a job-rich recovery* (2012c), the Commission stressed once again the importance of employment policies that generate favourable conditions for job creation, and that the transformation of undeclared work into regular employment could have a positive impact on labour demand (European Commission, EC, 2014f). Within the *Europe 2020* growth strategy, the *Employment Guideline Nr 7* on “Increasing labour market participation of women and men, reducing structural unemployment and promoting job quality”, recommends stepping up social dialogue and tackling labour market segmentation with measures addressing precarious employment, underemployment and undeclared work (European Commission, 2010b). In the 2012 and 2013 Country Specific
Recommendations, several Member States received recommendations concerning fighting undeclared work, the shadow economy, tax evasion and/or tax compliance (European Commission, 2014f: 3).

An annual cycle of economic policy coordination now takes places within the European Semester towards achieving the Europe 2020 growth and employment targets. This process entails specific recommendations made by the European Commission to Member States on their national reform programmes, including on budgetary and taxation issues, labour market and structural reforms, towards achieving common EU-level targets. These recommendations can serve as important pointers when discussing prospective measures towards tackling the undeclared economy in the three target countries, especially when it comes to strategies for modernising the public administration, improving tax governance and the business environment, as well as specific labour-market interventions that can contribute to reducing undeclared work and ensuring greater protection of vulnerable groups. These recommendations have been taken into account in the country-specific policy chapters on Bulgaria and Croatia.

Despite this, so far there has been no comprehensive targeted approach involving all relevant authorities of all Member States to tackle undeclared work at EU level (EC, 2014f). However, mutual learning has been recognised by the EU as an effective way of sharing experiences and lessons cross-nationally towards the development of more successful policy measures. A number of EU initiatives have facilitated better understanding of what policies might work best in different contexts. A comprehensive review of policy approaches used across Europe was initiated by Eurofound in 2007 (and updated in 2013: Williams and Renooy, 2013), followed by a Communication by the EC on undeclared work, recommending the use of mutually reinforcing negative (deterrence through control and penalties) and positive measures (prevention, enabling compliance, fostering tax morality) (European Commission, 2007). Two rounds of Eurobarometer surveys on undeclared work in the EU have been conducted in 2007 and 2013 to provide the evidence base for cross-national comparisons and the development of effective policy approaches.

To help countries learn about what works and what does not, a knowledge-bank has been created by Eurofound. This now contains over 180 examples of policy measures from 36 European countries and was most recently updated in early 2013.

Undeclared work has received special attention within the framework of the PROGRESS Mutual Learning Programme under the European Employment Strategy (European Commission, 2012d). In 2012, a peer review process on “Tackling undeclared work: developing an effective system for inspection and prevention” was initiated by the Czech Ministry of Labour and Social Affairs, inviting ministry officials and experts from other Member States to compare their national experience with recent policy reforms introduced in the Czech Republic. The potential for cross-national transferability of promising policy measures received special attention. The peer review provided a synthesis of several horizontal policy pointers:

**Mutual Learning Programme on tackling undeclared work: key lessons**

- Political willingness to tackle undeclared work is paramount. Without it, the capacity and credibility of any measure can be severely undermined.
- A clear and robust legal framework is needed that clearly defines undeclared work, gives authority to inspectorates and helps to enforce penalties.
- The role of labour inspectorates is central to monitor, control and penalise undeclared work.
- There is a need for a strong cooperation between the different state authorities, and labour market actors.

A balanced combination of activation measures, monitoring and sanctions can be effective in dissuading or preventing individuals from engaging in undeclared work.

National authorities will have to encourage a legal and economic incentives' framework to make 'declared work pay' in order to engage employers and individuals in the fight against undeclared work.


Nevertheless, there is a persisting need for more in-depth evaluations of what policy measures are most effective in various contexts, and in what combinations, as well as the need to assess their potential transferability based on common criteria. In 2014, the European Commission proposed the establishment of a European Platform to enhance cooperation and exchange good policy practices in the prevention and deterrence of undeclared work (European Commission, 2014f), building upon consultations with stakeholders and a feasibility study (Dekker et al, 2010). The initiative is expected to contribute to the creation of employment and to social inclusion, within the strategy for smart, sustainable and socially inclusive growth (European Commission, 2014f: 21).

Furthermore, there are a number of more specific policy guidelines and potentially effective instruments highlighted at the EU level in various documents and studies. Policy actions recommended by the European Commission within the Action Plan to strengthen the fight against tax fraud and tax evasion (2012b) that are highly relevant to the fight against the undeclared economy refer to measures to enhance tax governance and tax compliance, including through:

- Improving the relationship between taxpayers and tax administrations. The preparation of a European taxpayer’s code is envisioned, which will set out best practices for enhancing cooperation, trust and confidence between tax administrations and taxpayers, for ensuring greater transparency on the rights and obligations of taxpayers and encouraging a service-oriented approach.
- Creating a one-stop-shop approach in all Member States, as well providing single tax web portals to ease compliance.
- Developing motivational incentives including voluntary disclosure programmes.
- Strengthening cooperation and information exchange between law enforcement bodies
- Stronger compliance risk management tools.

In the field of tax governance the concept of ‘responsive regulation’ has gained traction as potentially highly effective, where risk-based segmentation of taxpayers into compliance categories (co-players or opponents) is used to differentiate the approach towards the taxpayer between service and control (Jensen and Wöhlbier, 2012: 18; also Williams, 2014b). Studies on the criteria for successful policies in tax governance conclude that there are a number of factors that make tax administrations successful:

Criteria that characterise efficient tax administrations

- They successfully implement an overall compliance strategy and focus audit efforts on the largest revenue risks.
- They divide taxpayers into co-players and opponents and distinguish between providing a service and education to those who voluntarily comply and control for those who don’t.
- They use third-party information comprehensively, provide pre-filled tax returns to taxpayers and use IT systems as far as possible to both make it easy to pay taxes and at the same time limit the taxpayers’ ability to evade.
- As regards their organisational structure, they often apply a function-based organisational approach.
- Moreover, it is important that tax systems are simple and stable and that tax arrears are efficiently collected.
All these measures underpin tax morale and contribute to achieving a high share of voluntary compliance among taxpayers which allows the tax administration to concentrate its efforts on those taxpayers who try to evade taxes.

To successfully fight the shadow economy it has proven important to increase the tax morale in a country and to benefit from electronic means of payments, with tracking possibilities for audit purposes. On the contrary, the success of deterrence through punishment and the provision of monetary incentives to declare work are rather limited.

Criminalising the purchaser of shadow economy activities appears to be fruitful.

Tax amnesties should certainly be avoided despite the temporary and short run increase in revenues.

A particular focus should be put on fighting VAT evasion, both at the national level and EU level, with large amount of revenue being at stake. Tax evasion by placing financial wealth in tax havens also remains a major concern in the EU.

Source: Jensen and Wöhlbier (2012: 5).

Overall, extending the use of e-services and electronic payments, as well as shifting from a control to a service approach of tax administrations and other enforcement bodies have also been recognised as potentially fruitful approaches in the fight against the undeclared economy (Jensen and Wöhlbier, 2012; Vanderseypen et al, 2013; Williams, 2014a,b). Efficient procedural justice mechanisms are also regarded central to increasing voluntary compliance, where an independent complaint and dispute resolution procedure is considered beneficial (Jensen and Wöhlbier, 2012).

As indicated in the above recommendations, it has been increasingly recognised at EU level that there is a need to pay greater attention to “indirect” measures aimed at improving tax morale and a culture of voluntary commitment, as the success of deterrence through punishment and the provision of monetary incentives to declare work, have proved insufficient (Jensen and Wöhlbier, 2012: 5; Vanderseypen et al, 2013; Williams, 2014a,b,c; Williams and Nadin, 2012a,b,c; Williams et al., 2013b,c).

These developments and shifts in perspective are best captured by Williams (2014a), who provides a comprehensive conceptual framework of policy approaches and suggests an institutional approach for understanding how indirect controls can be applied alongside direct measures to tackle the undeclared economy. This institutional perspective emphasises the need to bridge the gap between formal institutions (official laws, rules and norms) and informal ones (the norms, values and beliefs of the population), in order to strengthen the psychological contract between the state and citizens. This can be done in several ways – formal institutions can pursue wider social and economic developments and improve procedural and distributive justice and fairness. At the same time, informal institutions can be changed towards eliciting a culture of commitment among taxpayers through awareness raising campaigns, normative appeals and better tax education. The applicability of this approach in the target settings is now explored.

4.2 Transferability of policy approaches to the target settings – key issues

The conceptual framework of possible policy approaches to tackling undeclared work, as provided by Working Paper 4 (Williams, 2014a), serves as the starting point for our assessment of the appropriateness of policy options through considering potential problems which might affect the transferability and applicability of policy measures in the target countries (Figure 5). Potential transferability obstacles stem from: (a) the specific structural characteristics of the policy and institutional environment in transition settings, and (b) the way the causal assumptions behind theoretical policy options in the field of undeclared work are likely to interplay with these contextual factors. An overview of some general
variables influencing policy learning and change in a transitional context has been provided earlier, highlighting the role of the administrative capacity, the level of maturity of the policy environment and institutions, as well as prevailing socio-cultural norms and the embeddedness of powerful veto players.

The baseline assessments conducted on the nature and drivers for undeclared work in the three target countries have highlighted common contextual factors that are likely to alter expected outcomes of theoretical policy options. There is a need to further interrogate these contextual features from the perspective of the fight against undeclared work, because they are likely to impact not only on policies borrowed from abroad but also the effectiveness of locally developed ones. These include most notably the low trust in public institutions and low tax morale, but also institutional obstacles such as the inefficient control of corruption, low administrative capacity and government effectiveness and weak rule of law (see Figure 4). In the following, we assess how these contextual variables are likely to influence the potential outcomes of each of the theoretical policy options to tackle undeclared work, and how the approach should be adapted and tailored to reflect this.

Figure 4. Contextual factors constraining options for policy transfer in transition settings (BG, HR and FYROM)

<table>
<thead>
<tr>
<th>Institutional obstacles</th>
<th>Socio-cultural factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Government effectiveness / administrative capacity</td>
<td>• Tax morale</td>
</tr>
<tr>
<td>• Rule of law and judicial independence</td>
<td>• Trust in public institutions</td>
</tr>
<tr>
<td>• Control of corruption</td>
<td>• Social legitimacy of undeclared work</td>
</tr>
<tr>
<td>• Procedural fairness and justice</td>
<td></td>
</tr>
<tr>
<td>• Quality of public services/goods</td>
<td></td>
</tr>
</tbody>
</table>

The conceptual framework of policy approaches towards undeclared work shows that in order to achieve a holistic strategy for tackling informality both direct and indirect measures should be incorporated. Although the latter are less commonly used it is emphasized that they are equally important in the quest for formalisation as they seek to narrow the gap between formal and informal institutions by targeting both sides. In doing this, the options lie with changing the norms and values of the citizens regarding the acceptability of undeclared work and changing the formal institutions to better align with the norms and values of the population.

Whilst analysing where the needs for intervention lie in the target countries, it is useful to evaluate potential problems with each of the steps outlined in the framework. In doing this it becomes more evident as to what the most immediate needs are for the target countries.
Figure 5. Typologies of measures to tackling undeclared work


Direct Controls

The main factor influencing the direct controls sphere at the most basic level is a cost-benefit analysis of operating formally or informally. Here, an individual rationally weighs up all of the costs as well as all of the benefits of the two options and chooses the most optimal route. Therefore, a clear policy strategy in this instance might be to increase the benefits of operating formally whilst increasing the costs of operating informally. However, the levels of perceived corruption are a particularly important element in this scenario. For simplicity sake, increased penalties for those carrying out undeclared work are a useful example of a deterrence policy. However, this might not have the desired effect in countries with high levels of perceived corruption and might instead foster further bribing of government officials. In fact, the bigger the penalty the more worthwhile it is for the individual to offer a bribe therefore creating the opposite of the desired effect. This therefore casts doubt over the appropriateness and applicability of deterrence measures in the target countries unless government corruption, efficiency as well as fairness are improved alongside it.

The use of incentives in the context of transitional countries also poses problems. Bulgaria, Croatia and FYR Macedonia, much like other countries in similar transitional settings, suffer from low levels of trust in government (Franic and Williams, 2014; Dzhekova and Williams, 2014). Therefore, the actions undertaken by formal institutions will be considered by individuals in a very critical and doubtful light, regardless of them being packaged in a very positive manner. This has the potential of diminishing levels of citizen buy-in with regard to the use of incentive measures, with individuals either avoiding them due to skepticism or being open to exploiting them for personal or business benefits.
Indirect controls

The indirect controls approach is equally complex. Transition economies suffer from a large incongruence between formal and informal institutions (Williams, 2014a,b). Furthermore, because of the aforementioned low levels of trust in government, the norms of informality are deeply rooted. These issues are likely to cause difficulties with policies that aim at raising awareness of the benefits of declared work as well as normative appeals. This is because the idea that the benefits are scant is deeply embedded in citizens’ minds. The lack of trust in formal institutions is thus likely to dilute the effectiveness of any such attempts to change social norms and values unless it is coupled with visibly real attempts to change formal institutions by reducing corruption and improving government effectiveness.

The above conceptual framework emphasises the application of the ‘responsive regulation’ approach, where state institutions adapts their response according to the taxpayer behaviour, to pursue voluntary or enforced compliance (indirect or direct control measures depending on the attitude to compliance of taxpayers). Using this approach successfully requires as a precondition the existence of well-established, efficient and accountable bureaucracies that enjoy a certain level of public trust. This is not entirely the case in transitional settings, as the baseline assessment of the effectiveness of the policy response towards the shadow economy in BG, HR and FYROM has shown (Franic and Williams, 2014; Dzhekova and Williams, 2014). Previous research has recognised administrative capacity as a key concern when it comes to implementing reforms through the transfer of policies and rules from abroad, especially in the context of EU accession countries (Randma-Liiv and Kruusenberg, 2012; Verheijen, 2007). In fact, the immaturity of the policy and institutional environments creates a vicious circle – increasing the power of the state and its control functions creates an even greater mistrust by citizens prompting further non-compliant behaviour, as institutions are unable to guarantee procedural justice and fairness.

Therefore, when juxtaposing the characteristics of the contextualising factors likely to affect transferability of policies against the theoretical framework of possible policy measures towards undeclared work as suggested by Williams (2014a), several implementation obstacles emerge in at least three policy spheres (deterrence, incentives and changing informal institutions). This shows the need to focus on changing formal institutions in order to gain stability and provide a sound foundation for measures aimed at changing attitudes to take root. As outlined by Williams (2014a), this can involve changing processes of formal institutions as well as changing their products. However, to make the approach to tackling undeclared work holistic, it is still important to consider and use other available measures whilst bearing in mind what the priorities are by referring to the hierarchy of needs (Figure 6).

This analysis focuses the approach in the fight against undeclared work substantially. However, further evaluation of each particular country is necessary to ensure that each individual chosen measure fits each of the country contexts as well as possible.

Figure 6. Hierarchy of needs
In the following country-specific sections, we derive a set of more particular priority areas requiring intervention for each country, building upon an assessment of the nature and scope of the undeclared economy, the specific drivers and causes of informality, but also the nature of the institutional and policy environment in place. These intervention needs are largely in the spirit of the overall approach discussed above, yet tailored to the specific situation in each country, accounting for structural constraints and barriers to formalisation.

For each intervention area we discuss examples of policy approaches used within Europe and beyond to address similar problems. The goal of the analysis presented in the following is to narrow down the scope of possible policy choices and filter out those options that have the potential to 'match' best the identified needs and their specific hierarchy for each country, thus preparing the ground for more rigorous empirical testing of prospective policy choices. Furthermore, the potential interplay of the discussed foreign examples with the local contexts is hypothesised in a preliminary manner, using where appropriate the above introduced indicators of transferability and applicability of policy measures.

**Knowledge bank of measures to tackle undeclared work**

For the purpose of this analysis, this working paper mainly consults the Eurofound knowledge bank of policy initiatives addressing the issues of undeclared work across Europe. Additional sources of prospective good practices were also used where appropriate. The Eurofound database features 186 policy initiatives against undeclared work, including deterrence and prevention measures, as well as instruments aimed at legitimising undeclared work, enabling compliance and changing attitudes towards a culture of commitment (see Appendix for further details).

## 5 BULGARIA

### 5.1 Overview

In this section we provide a brief synthesis of problem areas identified in the field of tackling undeclared work in Bulgaria (for further details see Dzhekova and Williams, 2014), including the scope and nature of undeclared work, vulnerable groups and economics sectors, as well as the characteristics of the institutional infrastructure and the policy response applied so far. Based on this, five broader clusters of intervention needs have been extrapolated to guide the search for prospective policy measures. The priority hierarchy of these needs is discussed from the viewpoint of an institutional approach towards tackling undeclared work, as already indicated (see Williams, 2014a). A more comprehensive identification of needs and possible solutions would ideally involve a broad consultation with relevant stakeholders and interest groups. Such a consultation is envisioned later in the project, once an initial scanning of a wide range of policy options has been conducted. This stage of the analysis aims at narrowing down the scope of prospective policy options and assessing their transferability to the local context in a preliminary manner, in order to prepare the ground for a more rigorous empirical investigation.

#### 5.1.1 Undeclared work: state of play

**Extent and forms of undeclared work**

The size of the undeclared economy in Bulgaria is larger than in any other EU Member State and there is a broad political consensus that this problem needs immediate policy attention. Although the overall trend is declining, some forms of undeclared work have expanded during the economic crisis. Underreporting
the actual remuneration in dependent employment is the most prevalent form of undeclared work. Work without formal contract occurs to a higher degree within secondary employment. Other forms of undeclared work have emerged, such as false reporting of the contract’s duration or the actual activity performed. Overall, non-compliance by employers is a more serious problem than non-reporting by households or the self-employed. Micro-, small- and medium-size enterprises as well as domestic firms are to a greater extent involved in the undeclared economy. The most vulnerable sectors include construction, tourism, agriculture, real estate, food processing, textile and garments, as well as some services. Different forms of tax evasion and avoidance (corporate income, VAT, excises) through underreporting of turnover/profit are equally widespread, with significant involvement of large (legitimate) economic actors, as well as criminal networks in such practices.

Based on the analysis conducted so far, Figure 7 provides a basic overview of the most prevalent types of undeclared work, including the most affected or potentially vulnerable sectors, business types and population groups.

**Figure 7. Types of undeclared work and vulnerable sectors, business types and population groups**

<table>
<thead>
<tr>
<th>Types of violating activities</th>
<th>Vulnerable sectors / economic activities</th>
<th>Vulnerable business types</th>
<th>Vulnerable population groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underreporting remuneration (incl. fake contract clauses)</td>
<td>Construction, real estate sales</td>
<td>Small and medium-size enterprises</td>
<td>Long-term / temporary unemployed / discouraged</td>
</tr>
<tr>
<td>Non-declaration of second job</td>
<td>Tourism, hotels and restaurants</td>
<td>Domestic firms</td>
<td>Low-qualified, low earners, manual workers</td>
</tr>
<tr>
<td>Social security evasion</td>
<td>Wholesale trade and retail (food, garments, textiles)</td>
<td>Micro-firms and sole traders</td>
<td>Self-employed</td>
</tr>
<tr>
<td>Tax evasion / mass underreporting of turnover and profit</td>
<td>Agriculture, food processing</td>
<td>Start-ups</td>
<td>Young people</td>
</tr>
<tr>
<td>Excise duties avoidance and evasion</td>
<td>Services (repairs, advertising, accounting, hydroisolation, funerals, taxis, security...)</td>
<td>Firms in small/medium towns and in rural areas</td>
<td></td>
</tr>
<tr>
<td>Food commodities trade (grain, sugar, etc)</td>
<td>Production and distribution of excise goods (cigarettes, fuels, alcohol)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Barriers to formalisation**

For businesses the most important disincentives to operate in the formal economy are: a) the cost of compliance with formal rules and the complexity of frequently changing and at times contradictory regulations, and b) the perceived low level of fairness of the system in general (including stricter control over small firms and harsher penalties for violations with small financial impact compared to more lenient treatment of large tax sinners). Ensuring a level-playing field for businesses, fighting corruption more effectively and strengthening judicial independence, coupled with enhanced e-services coverage are recognized by the European Commission (2014a) as key challenges that remain to be addressed in a more effective manner. Businesses would also benefit from “improved tax administration, insolvency procedures and contract enforcement. Shortcomings in public procurement and the independence, efficiency and quality of the justice system also persist” (European Commission, 2014b: 4).
Given the lack of formal jobs and the income shortages of households in the present economic climate, the disincentives for low earners to go formal (i.e. regressive taxation on low-paid workers) should be addressed. The existing system of Minimum Social Insurance Thresholds needs to be revised, as their increase during the economic downturn, coupled with the strong minimum wage growth, have put low-skilled and the lowest-paid workers at risk of being priced out and pushed into unemployment and undeclared work. Policy-makers should aim at ensuring greater flexibility of the labour market through enabling formalisation of non-standard forms of work.

The psychological contract between the state and citizens should be strengthened not only through efforts to change citizens’ informal norms, beliefs and attitudes (tax morale and compliance with formal norms), but also through increasing the fairness, transparency and accountability of the formal institutional framework from within, in order to restore public trust. There is high level of public tolerance towards non-compliance and increased readiness to participate in the undeclared economy in the current economic climate.

**Policy response and key actors**

Enforcement bodies have in recent years improved their accountability, strengthened their inspection capacity and started to implement a more targeted risk assessment approach. The areas requiring continuous efforts include:

- improving operational and investigative capacity in relation to large-scale/more complex tax fraud and evasion;
- increasing coordination, data matching and joint actions;
- developing a customer-oriented approach and improving communication with citizens through e-services and simplification of compliance; and
- strengthening political independence, improving professional standards and an internal anti-corruption system.

The key role of social partners in the fight against undeclared work should be taken into account when discussing the potential transfer of policy options. Trade unions and employers’ organisations have implemented a number of targeted projects in this field, although some efficiency problems exist, such as overlapping activities, insufficient coordination between similar initiatives implemented by different consortiums, and sustainability potential. These initiatives need stronger involvement from state institutions. Moreover, the voice of small- and medium-size enterprises should be strengthened.

Repressive measures tend to have a temporary effect, at the same time placing a large administrative burden on compliant companies, as well as on small- and medium-sized businesses which are the main targets of inspections. Previous efforts to simplify compliance for businesses through streamlining the regulatory framework have been unsuccessful despite the adoption of comprehensive legislation. In fact, the positive effects of measures for stimulating voluntary compliance have often been neutralised by an increase in the administrative burden. The fairness of the penalty structure should be reconsidered since large tax sinners are commonly spared from harsh treatment (CSD, 2011).

The sustainability of the effect of control and inspection efforts conducted in a “campaign-like” manner is questionable, considering that measures aimed at changing attitudes and fostering voluntary compliance remain limited in scope, while the customer-oriented approach of government institutions needs further improvement (CSD, 2011). Supply-side incentives such as amnesties, voluntary disclosure schemes or formalisation services, or demand-side incentives such as tax reliefs, have not been sufficiently used, if at all. However, incentives should be used carefully since the institutional inability to ensure procedural justice and fairness may open the door for rent-seeking behaviour. The effectiveness of tax amnesties is
Measures fostering commitment have focused mainly on awareness raising and education campaigns. The main initiators for such (often overlapping) campaigns have been the social partners, while the government needs to intensify its involvement in such measures. However, for these initiatives to bear fruit and increase tax compliance, social solidarity and a culture of corporate responsibility, they need to be matched with an equally genuine effort to change formal institutions towards procedural justice and fairness and restore public trust in formal institutions.

5.1.2 Contextual features – implications for policy transferability
The policy response of the Bulgarian authorities to tackle the undeclared economy has been mainly focused on tightened control for both firms and individual taxpayers, although some preventative and curative measures have also been introduced, with mixed results. Overall, the national policy approach towards the undeclared economy is characterised by the following deficiencies (CSD, 2011):

i) lack of systematic evaluations and cost-benefit analysis of measures (both, prior to and after adoption);
ii) insufficient tailoring of measures to the features of the national economy, as well as fitting those into the existing policy infrastructure; and
iii) economic and administrative measures neutralise their respective effects.

In more general terms, the difficulties with implementing successful policies to tackle the undeclared economy resonate to some extent with the challenges posed by the economic and political transformation in the post-socialist period, and more particularly with how domestic policy making has responded to the process of EU accession (Pashev et al, 2007). This process has been characterised by dissonance between policies/regulations imported from outside (EU acquis) and limited capacity of national institutions to enforce and apply those policies. Furthermore, the need for impact assessments prior and after adopting regulations in the process of harmonisation with EU norms and rules has been neglected. This has resulted in the low level of willingness/readiness of economic and social actors to adapt to these new regulations and use them to their benefit. This is not least due to the fact that new rules (or frequently changing old ones) do not take sufficiently into consideration the needs and adaptation costs of these actors. Overall there has been insufficient adaptation of transposed external rules and policies, and lack of political will to bear the responsibility for policy decisions, placing it instead onto external factors. These trends point to a type of transfer of external rules without the necessary ‘internalisation’ and policy learning process, which could have contributed to greater maturity of the policy and decision-making environment.

In consequence, although Bulgaria has effectively adopted EU legislation, the governance regime, as well as the way formal institutions function in practice has not changed accordingly (Stoyanov et al., 2014: 6), thus creating a large gap between official norms and rules and their practical enforcement. Superficial and imitative change instead of deep structural transformation in favour of greater transparency and accountability in policy making has had advantages for rent-seeking elites that managed to consolidate themselves and effectively block reforms undermining the sources of their domestic power (Noutcheva and Bechev, 2008: 115; Vachudova, 2005). These structural factors need to be taken into account when considering the borrowing of promising policy models with innovation potential. The consequences of reform resistance have had serious implications for the institutional set-up and the immaturity of the policy environment.

Context also matters in terms of analysing the domestic motivations for resorting to undeclared practices, with important implications for potential policy responses. Market entry barriers and the costs
for operating in the formal market could be sufficient explanations for the existence of the undeclared economy, but only if administrative controls and law enforcement operate in accordance with legal regulations. However, in Bulgaria the rules of the game are highly unpredictable. Entrenched corruption remains a fact of life\(^2\). Inadequate structure and poor functioning of the administration, accompanied by the lack of customer-oriented approach in delivering public services to citizens and businesses allow the extraction of bribes (CSD, 2011). Networks of local vested business interests intersect with political parties and are able to influence both local and central government decisions (CSD, 2013). Law-enforcement agencies, on the other hand, remain prone to political influence (Dzhekova, Gounev and Bezlov, 2013).

The most significant progress in corruption control and good governance has been made in the period 1998-2004 with respect to administrative corruption. Since the country’s EU accession, however, progress has been uneven and driven mainly by pressure from civil society. Power distribution, although open for competition, is still centred on a few political party leaders and powerful business conglomerates, “interlinked in a complex web of dependencies with former secret service and communist party elites, which still have privileged access to state resources” (Stoyanov, Stefanov and Velcheva, 2014: 2).

### 5.1.3 Rationale for prospective policy interventions

Following the analysis presented so far, it becomes apparent that the success of concrete measures (incentive and deterrents) designed for suppliers and consumers of undeclared work both at the individual and firm level would depend on broader structural and institutional reforms with crucial albeit indirect impact on all other targeted efforts towards the undeclared economy. These reforms are the necessary fundament for more targeted policies to take root, and include the following key pillars (Figure 8):

- Reducing corruption pressure, strengthening the rule of law and enhancing the accountability and transparency of state authorities and institutions;
- Improving the conditions for doing business and the quality of public services, as well as raising the effectiveness of public resource management, e.g. in public procurement, property swaps, etc.;
- Reinforcing the culture of accountability, good governance and corporate responsibility among businesses.

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\(^2\) Eurobarometer surveys shows over 96% of citizens consider corruption and organised crime to be a serious issue. European Commission, 2012a.
With respect to the targeted policy response towards undeclared work, instead of proposing small-scale improvements and ‘best practices’, the approach should be towards analysing where existing legislation has failed, how existing measures interact with and contradict one another, and how enforcement of existing policies can be strengthened. Adding new measures to the mix poses the risk of even further confusion and complication. The focus instead should be on consolidation and simplification of policies. This would require a thorough analysis and impact evaluation of the existing policy infrastructure. Therefore, the following principles for improving the policy-making and delivery process should be integrated within all targeted policy responses towards the undeclared economy:

*Policy development and design:* Introduction of impact assessments of new measures and monitoring evaluations of already applied legislation and regulations, which take into account the costs/effects on all affected parties and contribute to reducing red-tape overall. Aim at consolidation and simplification of existing formal rules, as well as better enforcement of a few measures which proved effective.

*Policy delivery and implementation:* Improving government communication efforts to inform the public and affected groups about policy reforms and changes in legislation. Developing the service character and customer orientation of public administration bodies is crucial in this realm.

Based on the needs assessment and the discussion of the potential applicability of theoretical policy approaches towards undeclared work from an institutional perspective (Williams, 2014a), we identify five broader thematic areas for potential intervention, and discuss a number of examples of policy measures used elsewhere to tackle similar problems. These prospective interventions address mainly the middle and upper segments of the policy pyramid presented above.

- **Stimulating formalisation of vulnerable employment.** Within this cluster we assess measures aimed at creating opportunities for formalisation of non-standard forms of work, simplifying procedures for the employment of low earners and irregular workers, as well as measures aimed
at encouraging self-regulation in sectors prone to high levels of undeclared work. The protection of low-earning jobs also requires further attention.

- **Creating an enabling environment for businesses.** The focus of discussed measures with respect to businesses is on combining incentives and rewards for compliant firms used in a wise manner, as well as reducing administrative barriers, especially for micro and small businesses. At the same time, we highlight the need to consider measures aimed at restricting unfair competition and increasing the visibility of compliant behaviour. We acknowledge that unless there is a working mechanism to ensure transparent, just and fair distribution of resources and corresponding criteria for defining who qualifies for certain benefits, incentives can open up venues for rent-seeking behaviour and deteriorate trust in institutions even more.

- **Overall government strategy and coordinated policy response:** We consider effective foreign examples for a coordinated government approach towards undeclared work at both, the strategic and operational levels, suggesting that a combination of mechanisms may work best, including: legal definition of undeclared work, clearly defined national priorities, targets and action plan, as well as a coordinating structures to monitor and evaluate policy implementation, or streamline operational actions. However, we also note that the success of the discussed mechanisms would ultimately depend on the existence of genuine political will to declare the field of tackling undeclared work a national priority.

- **More efficient, fair and responsive control system:** We depart from the assumption that deterrence and control measures should become more responsive to the behaviour of taxpayers. We assess measures for stimulating voluntary correction of tax behaviour of high-risk economic actors, which also ensures that control bodies are seen as cooperative service providers and less as repressors. This can be fruitfully complemented by a more efficient and objective risk assessment system, and the greater use of e-government services. These measures are likely to be most effective if embedded within a comprehensive tax compliance strategy.

- **Strengthening tax morale and a culture of commitment:** Social partners in Bulgaria have been strongly engaged in varied efforts aimed at facilitating better understanding of the undeclared economy, increasing public awareness and creating a culture of intolerance towards undeclared work, including through providing formalisation advice to citizens and firms. We suggest that these efforts should ensure a much stronger involvement of state actors, and become an integral part of an integrated national approach to ensure sustainability and effectiveness. We further suggest that innovation is possible and highly needed with respect to self-regulation and joint action on the part of businesses and civil society as a means of leading by example. Bridging the gap between formal and informal institutions is linked to interdependent processes and should be pursued in parallel. A bottom-up approach to increased collective sensibility and intolerance of businesses and civil society towards issues of non-compliance would contribute to voicing stronger collective demands for change in formal rules towards more transparency and accountability.

The prospective policy mechanisms discussed in the following cannot cover all intervention needs discussed previously. Furthermore, designing a strategic approach to undeclared work is primarily a political process that requires inputs from a number of relevant stakeholders and gathering better, more specific and objective evidence. Therefore, our goal is to draw attention to potentially useful policy instruments, point to lessons learned from foreign experience, and prepare the ground for more rigorous prospective evaluation of applicability of different policy choices. When discussing transferability and applicability of foreign policy measures, we were guided by the effort to focus on identifying basic mechanisms and more general ideas behind interventions instead of discussing in detail the complexity of
the original policy design. Contextualising features in the original and target settings have also been discussed whenever possible.

The general rationale applied by the project team for selecting promising policy measures used in European countries is based on the following criteria:

- A theoretical framework for understanding policy approaches towards undeclared work from an institutional perspective, which emphasises the need to address the incongruence between formal institutions and society’s norms, values and beliefs (Williams, 2014a).
- Identification of a context-specific hierarchy of needs, derived from identified high-risk activities, economic actors and sectors.
- Measures with innovation potential, but also those that complement or improve others already applied or attempted, yet unsuccessful.
- Mechanisms already proposed by social partners in Bulgaria, where a favourable public discourse has been previously generated (CSD, 2011; BCCI, 2011, 2012).
- ‘Good practices’ already appraised as transferable and applicable in Bulgaria by the Bulgarian Chamber of Commerce and Industry within an independent comprehensive analysis of policy measures applied in 6 EU Member States (BCCI, 2013).

Table 4 provides an overview of the intervention clusters derived from the needs assessment, possible policy goals and approaches, as well as a selection of corresponding mechanisms applied in other European countries. The following section discusses each of these separately and provides a rapid appraisal of transferability and applicability of selected instruments.

Table 4. Intervention clusters, policy goals and assessed foreign practices

<table>
<thead>
<tr>
<th>Intervention cluster</th>
<th>Potential policy goals</th>
<th>Examples of possible policy instruments</th>
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| Stimulating formalisation of vulnerable employment | Simplifying registration and reporting of non-standard work | Promoting external work contracts (SK)  
Simplified Employment Act (HU)  
Special regime for temporary employment contracts (PT)  
Regulation of occasional work act (RO) |
|                                      | Encouraging self-regulation in high-risk sectors and restoring social solidarity        | Builders’ Social Fund (RO)                                                    |
|                                      | Protecting low-waged employees                                                        | Minijob initiative for marginal employment (DE)                               |
| Creating an enabling environment for business | Simplifying company registration and compliance                                        | ‘On the Spot’ company set-up (PT)                                             |
|                                      | Simplifying tax compliance for micro-businesses                                        | Micro-enterprise tax (LV)                                                     |
|                                      | Creating a level-playing field and restricting unfair competition                     | Certification of labour compliance (IT)                                       |
|                                      | Rewarding compliant behaviour and increasing its visibility                            | Register of compliant taxpayers (LV)                                          |
| Overall government                   | Legal definition of undeclared work                                                   | Employment Act (CZ)                                                          |
### 5.2 Stimulating formalisation of vulnerable employment

The baseline assessment of undeclared work in Bulgaria (Dzhekova and Williams, 2014) showed that policy-makers should aim at ensuring greater flexibility of the labour market through enabling formalisation of non-standard forms of work, which are affected by high levels of undeclared work. Furthermore, given the lack of formal jobs and the income shortages of households in the present economic climate, the disincentives for low earners to go formal should be addressed (in particular regressive taxation on low-paid workers). Long-term / temporary unemployed, the low-qualified, low earners, manual workers, self-employed and young people are the most vulnerable groups when it comes to engagement in undeclared work (Dzhekova and Williams, 2014). At the same time, more innovative measures for high-risk sectors should be developed beyond sectorial inspection campaigns with short-term effect.

Although these needs and objectives are complex, we examine a number of mechanisms that contain promising aspects, as they address partially overlapping problems of non-declaration of non-standard and low-waged employment, as well as undeclared work in vulnerable sectors. The accent here should be on extending the possibilities for formal work, through making it easier for firms to hire employees in particular cases and stimulating sustainable formal employment in high-risk sectors and at the same time lowering the motivations of workers to remain undeclared. A variety of objectives can be achieved through these mechanisms, including (see also the figure below):

- Simplify the procedure for registering and reporting non-standard employment

<table>
<thead>
<tr>
<th>strategy and coordination</th>
<th>Coordinated approach at strategic and operational level</th>
<th>Mechanism to monitor, control, and reduce the rate of illegal work (RO) Coordinated strategy against undeclared work (FR) Hidden Economy Monitoring Group (IE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>More efficient, fair and responsive control system</td>
<td>Stimulating voluntary correction of tax behaviour – from repression to responsiveness</td>
<td>Notification letters from Tax and Customs Board (EE)</td>
</tr>
<tr>
<td></td>
<td>More efficient and objective risk assessment capabilities</td>
<td>OASIS (BE) Risk Evaluation Analysis and Profiling (IE)</td>
</tr>
<tr>
<td></td>
<td>Improving the service-character of public bodies</td>
<td>E-government in social security sector (BE)</td>
</tr>
<tr>
<td>Strengthening tax morale and a culture of commitment</td>
<td>Ensuring the sustainability of public campaigns as integral part of the government strategic response</td>
<td>National Center ‘Rules for Business’ (BG) Virtual Social Academy (BG)</td>
</tr>
<tr>
<td></td>
<td>Increasing the role of state institutions in formalisation services</td>
<td>Highlighting the link between public revenues and expenditures (tax awareness)</td>
</tr>
<tr>
<td></td>
<td>Stimulating self-regulation and corporate responsibility</td>
<td>Clear Wave initiative (LT)</td>
</tr>
</tbody>
</table>
• Extend the possibilities for formal work for vulnerable (low paid) employees, non-standard types of work and work in high-risk sectors
• Reduce the repressive nature of taxation for low-earners
• Decrease labour costs of employers
• Ensure social protection of non-standard workers and low earners

5.2.1 Simplifying declaration and reporting of non-standard work

Prospective measures:
- Promoting external work contracts – Slovakia
- Simplified Employment Act – Hungary
- Special regime for temporary employment contracts – Portugal
- Regulation of occasional work act - Romania

Existing labour regulations in Bulgaria allow for the employment of workers on a temporary contract, but this form of employment is suitable for more predictable and long-term work, albeit for a fixed period of time – for example the entire summer season in tourism, for the completion of a construction project etc. (BCCI, 2013). All other non-standard, more spontaneous types of jobs such as occasional, intermittent, short-term, seasonal, hourly, daily or other irregular work are not sufficiently regulated, which creates a stimulus for undeclared work. The existing temporary contract rules are not much different than the standard labour contract except for the duration for which the employee can be hired. The result is that many forms of non-standard work remain unregistered or employers use the so-called 'civil contract', which is designed for the delivery of specific tasks or services. However, the administrative requirements and obligations of employers for signing a contract, registering and reporting the employment under the temporary and civil contracts are identical with the standard procedures for regular (permanent contract) employment (BCCI, 2013).

An example of a policy measure aimed at easing the employment of workers outside standard employment is the initiative *Promoting external work contracts* in Slovakia (Bednarik, 2013), adopted in 2004. It introduced a new legal form of employment outside standard contract procedures, where
employers wishing to hire workers for irregular types of jobs are exempted from paying the full amount of social security contributions (instead of 35.2% only 1.05% of the amount of the gross wage is paid to the insurance funds). In that sense, the main mechanism of this measure was to reduce labour costs for non-standard employment, resulting in the formalisation of undeclared jobs and reduced unemployment. The benefits for employees are that they are not levied 13.4% of their gross wage for social insurance and only pay taxes from their gross wage. In 2013, an increase of the levy burden on employers was considered to balance out the deteriorating resources of the compulsory insurance funds, yet this was met by negative reactions from employers. The lesson learned is that the initial positive effect of reducing undeclared work and extending the forms of legal work have been slowly outweighed by the growing negative impact on the social security system during the economic crisis. This shows that more flexibility is needed to address the challenges of the changing economic cycle.

A similar measure was introduced in Hungary in 2010 through the adoption of the Simplified Employment Act (Rindt and Kren, 2013). The core mechanism here is to simplify the registration, reporting and remuneration of seasonal and casual employment, and hence to remove administrative burdens for both, the employer and the employee. All reporting obligations of employers to the authorities (declaration, reporting, tax payment) can be settled through a simple notification submitted electronically (via sms or online via a dedicated client gate system), after an initial system registration. The act specified a limit of maximum working hours per year to distinguish it from other types of employment. The employees are not covered by social insurance and are entitled only to accidental health care and job seeking allowances, which in the long term is likely to have negative consequences for workers’ pensions. The simplified employment scheme can be used for seasonal tourism services and other casual/temporary work (i.e. domestic work).

It should be noted that there are a number of similar measures implemented across several EU member states, such as the Special regime for temporary employment contracts in Portugal (BCCI, 2013), where the accent is once again on abolishing the requirement for a written contract and simplifying registration and reporting procedures or the Regulation of occasional work act in Romania, which also makes it easier for households to hire unqualified workers for occasional jobs (BCCI, 2013). In the second case the employer pays wages on a daily basis (a minimum hourly wage has been set, as well as a limit of 12 working hours per day and 90 days within one year), with a due tax of 16% of the gross wage. Employees do not pay compulsory social insurance contributions, but have the option to join an insurance scheme. Since the introduction of the scheme in 2011 until 2012, there have been over 6 million newly registered occasional workers (BCCI, 2013).

Transferability (generalizability)

These examples include several mechanisms that are transferable and are expected to trigger a positive effect:

- Legalising new forms of non-standard work
- Removing the requirement to sign a written contract for non-standard forms of work
- Simple registration, reporting and payment through electronic notification of the authorities
- Reduced labour cost for employers / reduced social security contributions of employees
- Guaranteeing social protection of vulnerable workers

While the first three elements are core mechanisms of a prospective measure in this field, the last aspect should be viewed as an optional feature, as its beneficial effect would depend heavily on the results of a cost-benefit analysis and an assessment of the potential impact on the social security system.

Opting for the incentive mechanism of lowering the labour costs for employers under this non-standard employment form can have negative consequences, depending on how the measure is structured: 1) for
the employee who may be insufficiently covered by social insurance; or 2) for the state budget / social insurance funds. One has to balance carefully between conflicting objectives: increasing the levy burden for labour under these special contracts would discourage employers to make use of the mechanism, but it would ensure better social protection for workers and stability of social security system. At the same time, as long as the levy burden on non-regular contracts remains lower compared to standard employment contracts, the incentive to use this form of employment for irregular jobs may still be maintained, although with a weaker effect.

The measures examined would potentially target a large number of workers engaged in low-qualified jobs of very short-term or occasional character such as in tourism and catering, seasonal work in construction and agriculture. However, while this incentive is stronger than just relieving the administrative burden, and is likely to ensure greater use of the mechanism, the cost (especially financial ones) have to be weighed against the benefits. Furthermore, as shown from the experience of the initiative in Slovakia, the negative effects of the mechanism should be considered. The major drawbacks of the measure are decreased revenues for the social insurance funds, and the risk to be rendered as unattractive – and hence ineffective if no labour cost reduction is offered. One should also consider that if micro and small firms would potentially benefit, their social function for creating and maintaining employment may outweigh the direct budget implications.

The second mechanism – simplifying the registration procedure and reporting requirements for non-standard employment is much less controversial and in general transferable, yet without the incentive of lower labour costs and social contributions of employers and employees, it is unclear to what extent it will be used and will contribute to formalising undeclared work. As the Hungarian example indicates: "employers who normally notify the authorities anyway are the most likely to use the simplified employment".

It should be also noted that these mechanisms are suitable for registered companies that are employing undeclared workers to avoid bureaucratic procedures or are under-reporting salaries to reduce labour costs. The instruments are unsuitable for firms operating entirely in the shadow, who are off the radar of inspections all-together. The effect of potentially applying any of the above measures could be strengthened by reducing the burden on small registered firms posed by frequent control checks.

**Applicability (enforceability)**

The core mechanisms described above are in general applicable, yet a more in-depth analysis is required to define the potential target groups and the costs and benefits for employers, as well as the potential effect on the social insurance funds. According to data from the BCCI, the number of permanent contracts in sectors such as construction and tourism are significantly lower than the number of all registered employees in these sectors, and the target group is relatively large due to the different forms of non-standard employment in labour-intensive sectors. The measure would affect mainly the low-qualified, low-paid and seasonal workers, and is likely to be received positively by vulnerable groups of workers and employees alike: however, this would depend largely on the size of the social security contributions due. The measure may include an option for employees to opt out of pension / health insurance coverage, which in turn has long-term negative effects for them. In any case the exact design of the mechanisms to be employed should be consulted in depth with social partners.

Changes in the Labour Code, or adoption of a separate legislation would be required in the case of introducing new forms of employment contracts or a voucher system, while the simplified registration procedure would require additional technical capabilities (adaptation of the IT systems of the NRA, NSI and GLI). The lack of access to the internet by small rural firms should be considered. Centralisation of data provides opportunities for data sharing and matching, but also poses problems of data protection and technical maintenance.
The potential risks are mainly for the stability of the social security system, as well as of employers switching regular forms of employment to non-regular contracts in order to benefit from the reduced labour costs and simplified compliance procedures. In that sense the measure should be linked to an efficient control mechanism to prevent abusive practices.

We note that the BCCI reviewed the transferability of the Regulation of occasional work act in Romania, and appraised it as difficult to apply mainly due to legislative changes required, as well as the required costs to inform and familiarise potential users with the measure, but included it in its final Strategy for Implementation of Good Practices in the Field of Undeclared Work (2013).

5.2.2 Encouraging self-regulation in high-risk sectors and restoring social solidarity

Prospective measure:
- Builders' Social Fund – Romania

The efforts of the Bulgarian authorities so far towards addressing informality in economic sectors prone to high levels of undeclared work have been focused on sectorial inspection campaigns and controls. This approach can be complemented with stimulating measures to ensure voluntary commitment, and foster a sense of self-responsibility and social solidarity on the part of employers and workers. On the other hand, the legitimacy of the social security system in the country is low, and the inadequate quality of public services puts off potential contributors. While improving public services is a long-term goal that would require complex structural reforms, in the short term it may be more realistic to focus on measures that would encourage joint actions and self-support by social partners, businesses and employees.

The Builders' Social Fund in Romania\(^3\) (Casa Socială a Constructorilor - CSC) is an example of a promising policy initiative with a multi-dimensional approach to undeclared work that incorporates several of the above objectives (Ciutacu, 2009). The Fund was established in 1998 by social partners and operates as a private welfare organisation with co-contributions from trade unions and employers’ organisations in the construction and building materials. The main goal is to provide welfare services to workers during the winter period when construction activity slows down and unemployment rises. The Funds’ members are companies from the construction and building materials sector, who contribute 1.5% of their turnover to the welfare fund, while employees contribute 1% of their gross salary, where personal contributions cannot be transferred to another member. Firms’ contributions to the fund are recognised as operational expenditure – thus reducing the taxable income of employers. At the same time, the precondition for participating in the fund is certifying that employers have registered their workers in line with all legal requirements and that social security contributions have been paid.

Since its establishment, the CSC has developed as a Secretariat for Self-regulation in the entire sector, which carries out a number of tasks: vocational training, migrant services, monitoring and combating undeclared work, holiday fund, etc. In the long term, the experience with the social Fund shows that the initiative has the potential to become a central venue for self-regulation in the construction sector. The positive impact of this initiative is manifold:

- Stimulates sustainable formal employment in the construction sector
- Provides basic welfare coverage to workers during low seasons and allows them to retain their jobs
- Strengthens social solidarity through joint action and support
- Stimulates voluntary compliance and self-regulation

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Transferability (generalizability)

The mechanism is transferable to Bulgaria, as it would address a number of intervention needs outlined above. Voluntary unemployment insurance funds do exist in Bulgaria, and allow for individual contributions, co-contribution by the employer or on the basis of collective labour agreement (BCCI, 2013). However, the described mechanism has clear advantages over the standard form of voluntary insurance funds, especially for the purposes of reducing undeclared work and ensuring sustainable legal employment in high-risk sectors, while providing social protection to workers.

The voluntary character of the initiative means that participants will have strong commitment to contribute. Contributions are proportional to firms’ turnover. The potential beneficiaries are all construction and building material companies. The functioning of the fund would depend on the buy-in from a sufficient number of firms. A more detailed analysis of potential beneficiaries and an assessment of the readiness for participation on the part of employers would be required. It is possible to consider this mechanism also in other sectors with seasonal work.

Applicability (enforceability)

The mechanism would require mobilisation on the part of trade unions and employers’ organisations. However, given their active engagement in numerous initiatives aimed at tackling undeclared work in Bulgaria, they can be expected to support such an initiative. Employees are also likely to respond positively to the prospective measure. The state is relieved from any costs and additional expenditures and hence should be expected to provide political support and facilitate implementation where possible. Enforcing a voluntary social fund would require some changes in the Social Insurance Code, possible the Labour Code or the adoption of new legislation.

5.2.3 Protecting low-wage jobs

The sector-specific Minimum Social Insurance Thresholds (MSIT) introduced in Bulgaria were aimed at protecting employees’ rights, support the incomes of low paid, low productivity workers and stimulate employers to pay social insurance on salaries close to the actual pay levels in each sector and occupation group (Dzhekova and Williams, 2014; European Commission, 2014d). However, this measure has not sufficiently deterred the practice of hiring workers on part-time contracts or registering employees in a different occupational category with lower MSIT. In other cases, employers comply with the MSIT, but deduct the incurred higher expenses for social security contributions from workers’ salaries. The strong growth of the minimum wage during the economic downturn (by about 40% since 2011) has pushed upwards the MSIT for the unskilled and low-skilled at a higher rate than the average minimum thresholds growth, "adding to the risk of pricing these vulnerable groups out of the labour market” (European Commission, 2014e: 15; 2014d). This shows that even if their initial goal was to protect workers’ rights the MSIT thresholds have not sufficiently deterred undeclared work practices on the part of employers who are struggling in the stagnating economic climate. A reconsideration of the current system would be in the interest of both, employers and employees. However, there is a strong disagreement at the moment between trade unions and employers’ organisations on the effects and usefulness of obligatory social security thresholds on different affected groups (employers vs. employees). Therefore, any adjustment in the current system would depend upon the ability of social partners to agree upon (partially) contradicting objectives. The MSIT system appeared to be less adequate in times of economic crisis, as their constant increase has pushed employers into reducing their workforce, non-declaration or false declaration of employment in order to comply with the thresholds which were perceived as too high by the employers.

The German Minijob initiative for the reduction of social security contributions and taxes on employment of marginal / low-wage workers is a policy measure aimed at creating new jobs and reducing undeclared
work amongst marginal employees. Although it is tailored to the German tax and social security system, its basic mechanism has some potential to simplify and incentivise formal employment in the low-wage segment and hence address some of the problems in this area in Bulgaria.

5.3 Creating an enabling environment for businesses

The baseline assessment for Bulgaria (Dzhekov and Williams, 2014) indicates that the most important disincentives for businesses to operate in the declared economy include:

- the cost of compliance with formal rules and the complexity of frequently changing and at times contradictory regulations
- the perceived low level of fairness of the system overall (including stricter control over small firms and harsher penalties for violations with small financial impact compared to more lenient treatment of large tax sinners).

These problems have been accumulated over a prolonged period of time and would require a combination of continuous highly effective interventions. The following priority areas can be emphasised as particularly important (see figure below). Besides measures improving the overall business environment, a special focus should be placed on micro and small businesses due to their vital social role for the Bulgarian economy.

Previous efforts to simplify compliance for businesses through streamlining the legislative and regulative framework have been unsuccessful despite the adoption of comprehensive legislation. In fact, the positive effects of measures for stimulating voluntary compliance have often been neutralised by an increase in the administrative burden. The Bulgarian government identified that there is a substantial administrative burden on economic activities and in 2003 developed the Act on Limiting Administrative Regulation and Administrative Control on Economic Activity (LARACEAA) (Bulgarian National Assembly, 2013). The
The ultimate objective of this law was to "ease and encourage economic activities while it restricts to socially justifiable limits the administrative regulations and controls exercised over any economic activities by the state bodies and local governments." The initial draft was prepared by a number of business associations, lawyers and economic experts (Dzhekova and Williams, 2014: 72). It aimed at clearly defining the main regulatory regimes, introducing obligatory justification of new regulations, as well as mandatory ex-ante impact assessments, the principle of ‘silent consent’ by administrative bodies when issuing permits and certificates, among other mechanisms (Dzhekova and Williams, 2014: 71). The Act was amended several times since its adoption, yet it remains at an extremely low level of utilisation mainly due to its limited legal scope and the undeveloped institutional framework for enforcement. There have been several evaluations of the Act’s implementation and the lessons learned should be considered when introducing further measures aimed at creating a more enabling environment for businesses.

The World Bank Doing Business survey of firms (2013a) shows that since 2005, no progress has been achieved in terms of simplifying procedures for getting permits and licenses, getting electricity, resolving insolvency, among others. The EC has highlighted the persisting lack of a fully functioning Point of Single Contact (PSC) in Bulgaria, which is a legal requirement of the EU Service Directive along with a number of other measures aimed at simplifying compliance in the service sector (European Commission, 2014b). The PSC is e-government portals allowing entrepreneurs active in the service sector to complete a number of administrative procedures online. Overall, the introduction of e-government services in Bulgaria has been fragmented and inefficient (European Commission, 2014b).

Several practices to simplify compliance costs of businesses were examined, identifying a number of promising mechanisms, but no single clear-cut measure. This is mainly due to the existing level of development of business regulation in Bulgaria, which to some extent constrains the potential options for innovation. Instead, the focus should be placed on improving enforcement and transparency, and reconsidering previously adopted yet largely unsuccessful legislation on simplifying administrative control and regulation of the business environment.

5.3.1 Simplifying company registration and reporting

Prospective measures:
- ‘On the Spot’ company set-up – Portugal
- One-stop shop business registration – Croatia

In the past several years some progress has been achieved in Bulgaria with respect to simplifying registration of limited liability companies and sole traders, mainly in relation to a significant decrease of the required starting capital to BGN 2 (EUR 1). Furthermore, in 2009 a centralised electronic database for commercial registration has been launched, which led to some consolidation and reduction in the number of procedures and other requirements (World Bank, 2013a). The existing registration process is based on a paper or electronic applications, which however still require the preparation of a package of various documents and declarations for which companies often use external legal services. Furthermore, there are several separate procedures that companies need to complete: preparing the articles of incorporation, opening a bank account and paying the initial capital deposit, registering with the commercial register, VAT registration. Simplifying company registration and reporting can remove to some extent disincentives for new firms to enter the undeclared realm.

There are a number of potential examples for ‘one stop shop’ models of company registration and reporting across Europe (MK, PT, HR, among others). As part of a broader programme for administrative and legislative simplification, the Portuguese Ministry of Justice in 2005 introduced the ‘On the Spot’ company set-up system (Perista and Cabrita, 2009). The measure was identified as a good practice by the World Bank. A number of countries expressed transferability interest since its introduction. The
registration of a company is possible with a single day, takes less than an hour and requires the completion of a single form (World Bank, 2014). The costs are about EUR 360. Besides the significant bureaucratic relief for companies, the measure also simplifies the relationship between firms and the public administration.

Transferability
In general, the idea has simplification potential for the state administration and for the business as well, especially after fulfilling the initial requirements for its inter-institutional implementation. It could be expected that such a policy initiative would contribute to reducing corruption levels in the area of business administration. On-the-spot company set-up could be used to generate a new layer of companies with compliant behaviour especially if the measure is potentially linked to a system for rewarding tax compliance.

In Portugal there have been some concerns that the simplified procedure would facilitate VAT fraud, which indicates that the procedures and requirements for establishing an enterprise should be carefully designed to incorporate robust security guarantees. The Portuguese Ministry of Finance confirmed that the conditions for on-the-spot company establishment are even stricter than before, for example with respect to bank account validation and the requirement to appoint official accounts technicians (Perista and Cabrita, 2009). While this signals that it is not impossible to achieve a secure and efficient system, it also raises the question of the ultimate cost for businesses and the public administration.

Applicability
Introduction of “On the Spot company set-up” will require changes in several legislative acts as well as an initial investment in terms of providing the necessary electronic platform, registration templates, reorganisation of the communication between several public registries and information systems. This is likely to prove difficult and costly. A preliminary version of the mechanism could be applied on a pilot-basis in parallel to the continued functioning of the standard procedure in order to assess its feasibility. The limited technical capabilities and internet access of micro firms in rural areas should also be considered, as well as the need to popularize the measure among businesses altogether. While Bulgarian entrepreneurs would be highly interested in such a policy initiative having in mind their high level of frustration related to consumption of administrative services, the potential costs would be decisive.

5.3.2 Simplifying tax compliance for micro businesses

Prospective measures:
- Micro-enterprise tax – Latvia

Further changes in the tax legislation should be carefully considered, as taxpayers are already overwhelmed by the need to keep up and comply with frequently changing and ever more complicated tax rules. The accent should be put on consolidating existing rules and simplification, especially with the micro and small businesses in mind. The experience of Latvia can be further explored in this respect. In 2010, based on a thorough analysis of the existing system and recommendations of a high-level working group, the Latvian government undertook a comprehensive simplification of the tax regime for micro-enterprises by consolidation of several tax liabilities into one, the so called micro-enterprise tax (Karnite, 2013). It includes personal income tax, social contribution and risk fee regarding employees of micro-enterprises, corporate tax (if the company meets requirements) or personal income tax payments due from the owner of the micro-enterprise (Karnite, 2013; BCCI, 2013). The consolidated micro-enterprise tax applies to those firms that are inactive or generate profits lower than the taxable minimum. This tax level is retained even in the case of subsequent profit increases, and thus the measure stimulates business growth. The effect of the measure has not been evaluated yet, but no substantial implementation
difficulties have been reported. The reform is only one aspect of a broader Action plan for combating the shadow economy and ensuring fair competition for 2010–2013.

Transferability and applicability

Taxpayers are likely at first to react negatively to any new tax changes due to potential additional compliance costs. However, in the long term, the potential benefits are significant not only for taxpayers, but also for the state budget and the work of control bodies. A similar measure exists in Bulgaria within the fixed ‘patent tax’ for physical persons / sole traders that are not VAT-registered and carry out paid activities with annual income below BGN 50,000 (hairdressers, cosmetic services, car and other small repairs, tailoring, shoe repairs, small restaurants and cafes, food kiosks, small hotels/guest houses with up to 20 rooms, etc.). The transferable mechanism from the Latvian example is retaining that fixed tax in the case of growing income, which will keep small businesses in the formal realm and ‘whitening’ of the actual size of turnover which small firms tend to partially or entirely hide at the moment. On the other hand, inactive firms would be forced to choose between closing down or paying the tax. In any case, the measure may require several legislative changes and should be considered only after a detailed analysis of the existing system and needs.

However, given that overall tax levels are relatively low in Bulgaria (which does not mean that hiding turnover is not widespread), it is a less serious burden for companies compared to the social security burden, and especially the complicated system for calculating contribution levels. Therefore, it may be useful to consider applying the mechanism of such a fixed payment with respect to social security contributions.

5.3.3 Creating a level-playing field and restricting unfair competition

Prospective measures:
- Certification of labour compliance – Italy

The needs assessment indicates that micro-, small- and medium-size enterprises as well as domestic firms face to a greater extent unfair competition from informal actors. Until there are effective mechanisms in place ensuring fair competition and reduced corruption pressure on the business, most firms, especially small ones, and such operating in vulnerable sectors where informality is widespread, would have little motivation in playing by the rules, as their informal peers would continue extracting considerable benefits. To send a stronger message and demonstrate to taxpayers that compliance ‘pays off’, while non-compliance brings serious disadvantages, the government can making compliant behaviour a precondition for access to public tenders, subsidies, concessions and financing. Since 2006, Italy applied nationwide Certification of labour compliance (Documento Unico di Regolarità Contributiva – DURC). DURC is a document certifying that construction companies are regularly paying social security contributions for their workers and comply with other labour law requirements (Baculo and Gaudino, 2009). The application procedure is simple due to a cooperation agreement and data sharing between the National Security Institute, Italian Workers’ Compensation Authority and social partners, although there have been some delays in checking companies’ status and issuing the document. Companies are not allowed to receive contracts for public or private works without the certificate, including:

- public works, services and supplies;
- services and activities in covenant or concession;
- private building works;
- facilities, financing and subsidies.
The positive effects of the measure include:

- Creating a level-playing field in business and reducing unfair competition
- Better monitoring of labour compliance
- Increasing visibility of and rewarding the behaviour of compliant taxpayers

**Transferability**

In Bulgaria such mechanisms are partially applied through restricting the access of companies with unpaid public liabilities (taxes and social contributions) to participating in public tenders and applying for EU financing. The restriction can be extended to also apply to companies employing undeclared workers or underreporting salaries. This, however, may require a legal definition of undeclared work to be specified in Bulgarian law, which at the moment is lacking. This indicates that a literal transfer of the Italian measure would not be possible, but even without introducing a legal definition of undeclared work, the existing restrictions of unfair competition can be adapted and extended.

Further analysis is necessary to assess in what sectors and public services/grants the rule can be applied, although in the long term a more universal application of the mechanisms would ensure a level-playing field for all economic actors. The aim should be also to create sectorial registers of non-compliant firms restricted from access to public tenders, grants and other types of financing and public benefits.

**Applicability**

Business associations are expected to support this measure as they will benefit greatly from the restriction of unfair competition and redistributional justice. Applying the above mechanism would require adaptation of the Bulgarian legislation, although no substantial additional administrative capacities would be required. However, some serious improvements in public procurement procedures and law would be highly necessary to reduce widespread corrupt practices and lack of transparency in awarding funding. The BCCI (2013) assessed as applicable a similar mechanism used in Luxembourg for restricting access to public financial assistance of companies involved in undeclared work in any form.

### 5.3.4 Rewarding compliant behaviour and increasing its visibility

**Prospective measures:**

- Golden Register’ of exemplary tax-payers – Bulgaria
- Register of compliant taxpayers – Latvia

Compliant taxpayers are insufficiently encouraged in Bulgaria. In fact, micro and mall firms bear a large administrative burden of compliance with regulative procedures, as well as frequent control checks. The visibility of companies and taxpayers complying with the rules should be increased in order to highlight their positive example. In Bulgaria the ‘naming and shaming’ approach has been already used by making public lists of companies with unpaid taxes and social security contributions. The NRA in 2013 considered establishing a ‘Golden Register’ of exemplary tax-payers in Bulgaria, a measure suggested by business associations. The potential incentives attached to being featured on the ‘white list’ are faster VAT refunds, as well as reputational gains. The envisioned criteria for being ‘exemplary included: lack of violations detected during audits, lack of outstanding tax payments, regular reporting to the NRA, as well as to have never displayed high-risk behaviour. However the indicators for high-risk tax behaviour applied by the NRA are partially confidential, which led to concerns that the objectivity of the selection procedure cannot be fully guaranteed. In 2012 the Commission for the Protection of the Competition issued a statement that the register is potentially discriminatory, and the measure was not introduced. The NRA indeed
reconsidered its plan and announced that the ultimate goal should be to bring everyone in the 'golden register' and speed up VAT refunds whenever possible.

The measure could be reconsidered based on more transparent and clear criteria for selecting compliant companies who will benefit from such incentives. This could send a clear message by the authorities on the boundaries of accepted behaviour. A similar approach has been used, for example, in Latvia, where the government in 2011 established a similar **Register of compliant taxpayers**, who are entitled to preferential administrative services (BCCI, 2013). Beyond faster VAT refunds, companies have access to an individual tax consultant from the tax authorities, shorter response time by the tax office upon requests by companies, lowered administrative requirements for customs operations, regular information, etc. The communication and level of trust between tax-payers and tax office can improve significantly in this way. The requirements for including companies in the register are also more comprehensive compared to the Bulgarian plan, and are made public. The average salary paid by the respective company has to be higher than the average for the sector. The measure targets large taxpayers with significant contribution to the state budget, where even minimal formalisation rates are expected to significantly improve public revenues. During the first year of the scheme, over 1,000 applied for the register, but only a few hundreds were approved, which demonstrates that the criteria are indeed strict.

**Transferability and applicability**

Given that the measure has been already considered in detail and some preparations have been made before the proposal was dropped, this mechanism could be reconsidered by learning some important lessons from countries already using preferential registers as a means of rewarding and encouraging compliance. The measure in Latvia does not require companies to demonstrate growth to be able to benefit from the incentives. Its application in Bulgaria would require several legislative and procedural changes, but no significant changes in administrative structures or reorganisation of recourses is expected. The voluntary character of the measure means it needs to be sufficiently popularised amongst businesses. Furthermore, as long as the costs for initial registration are kept to a minimum and do not outweigh the expected benefits from better administrative services and faster VAT refunds, the measure is likely to receive broad support from the business sector. BCCI appraised the measure as applicable.

### 5.4 Overall government strategy and coordinated policy response

The policy approach towards undeclared work in Bulgaria is characterised by too many measures, often overlapping or even cancelling out their respective effects, but no overall systemic approach (CSD, 2011). In order to streamline the numerous and fragmented policy efforts that directly or indirectly target undeclared work, a more coordinated approach should be considered at strategic, as well as operational level (see figure below). Ideally, such an approach should build upon a legal definition of the phenomenon, an integrated national strategy accompanied by a practical action plan with short-, mid- and long-term targets, and a coordinating body that monitors and evaluates its implementation. This would ensure better planning and analysis to prevent adopting contradicting and ineffective measures that cancel out their respective effects, or impose large administrative burdens on the affected population.
5.4.1 Legal definition of undeclared work

Prospective measures:
- Legal definitions of undeclared work (CZ, RO, DE)

One of the relevant policy mechanisms expected to be beneficial for Bulgaria is to introduce a legal definition of undeclared work in national legislation, which is lacking at the moment. Legally defining the types and forms of punishable behaviour and corresponding sanctions on both, employers and employees, can streamline and unify the efforts of all control bodies, sending a clear message regarding the boundaries of tolerated behaviour and removing any room for subjective interpretation in legal disputes. Introducing a legal definition of undeclared work in Bulgaria could only position the existing framework of measures in a more effective mode of existence. Most importantly however, it would enable the development of coordinated tackling approaches united around phenomena, which are clearly defined.

A number of EU member states have incorporated such definitions in their legislation under different modes: in stand-alone laws or within existing ones, mainly in the labour code, in combination with definition of the nature and scope of sanctions (Luxembourg, Lithuania, Germany, Croatia, among many others). One example is the Czech Employment Act (Dolezelova, 2009). In parallel to defining illegal labour, further provisions were included extending the powers of control bodies, as well as defining the liabilities of employers, employees and jobseekers in case of violations. The Czech experience shows that prohibiting illegal labour by law was not sufficient itself, as its enforcement was marked by difficulties to detect and prove the defined phenomenon. This shows that both, the exact formulation of the definition, as well as the accompanying enforcement infrastructure should be carefully considered.

In Romania, legislative amendments introduced in 2011 provide for “criminal liability for employers found to keep in illicit employment five or more persons” (Ciutacu, 2013), revoking employers’ right to enjoy public services or subsidies, including European funds, to ban violators from bidding for public tenders for a period of up to five years. The most severe punishments in Romania include shutting down businesses, or temporary or permanent withdrawal of the operation licence for the working sites where the breach of law was committed (Ciutacu, 2013).

Transferability
There are several mechanisms that can be applied to incorporate a legal definition of undeclared work in national legislation (BCCI, 2013):
The meaning of the term undeclared work can be defined within a National strategy for combating undeclared work.

- Amendment or upgrade of the Labour Code to incorporate a legal definition including penalties, accounting for the already existing provisions on the sanctioning powers of the Bulgarian control bodies.
- Introducing a new, stand-alone Act on limiting and preventing the undeclared economy.

The second option will be the most feasible, while it would be ideally followed by a more streamlined national strategy and action plan for combating undeclared work that would set clear common targets and goals. Further in-depth analysis is necessary to review the experience of other countries with introducing different legislative designs, as well as to identify what combinations of the legal definition with other measures have been most effective.

**Applicability**

To ensure synergies with other effective mechanisms, the legal definition would best fit within the Bulgarian Labour Code (BCCI, 2013), where there is already legislative readiness. The Labour Inspection Act would also require amendments. The measure would not contradict any stakeholder interests, but it is important that there are preliminary consultations with trade unions and relevant controlling bodies. Introducing liability for workers has been previously challenged in Constitutional Court and abandoned (Daskalova, 2013), which shows that some resistance on the part of trade unions against harsher sanctions for undeclared workers is to be expected. The measure is expected to have a strong deterrence effect, to simplify the work of control bodies and impose a more predictable character of penalties. There are already sufficiently functioning administration and enforcement bodies in order to utilise the benefits of a legal definition. However, it should be noted that the exact formulation of the definition and the types of undeclared work to be included should be carefully considered and adapted to the local context, as well as its interaction with the existing legislative and administrative framework. For example, BCCI notes that regulating some forms of domestic work (babysitting, elderly care) may face public resistance (BCCI, 2013) and hence prove premature, given the vital importance of informal social networks to compensate for insufficient public welfare services.

### 5.4.2 Coordinated approach at strategic and operational level

**Prospective measures:**

- Mechanism to monitor, control, and reduce the rate of illegal work – Romania
- Coordinated strategy against undeclared work – France
- Hidden Economy Monitoring Group – Ireland
- Joint Shadow Economy Teams – UK

Undeclared work is a multi-faceted phenomenon and as such requires a multi-dimensional approach that draws upon the efforts and competences of a number of public bodies. So far, there has been no official national strategy in Bulgaria to focus these efforts and provide policy direction. This would require also a constant monitoring and evaluation mechanism to ensure better planning and feasibility of policy measures. Ideally, the functions of such a coordination body, regardless of its particular institutional set-up, should integrate data gathering and assessment, designing preventative and control policies, as well as monitoring and evaluating their implementation.

Between 2009 and 2013 social partners in Bulgaria implemented a large-scale project on “Restriction and Prevention of the Informal Economy”, which led to the establishment of a national centre to streamline the efforts to tackle the problem. In addition, a public council for the restriction and prevention of the
undeclared economy was set up in 2009, comprising representatives of government control institutions, ministries, social partners and other stakeholders (Daskalova, 2013). Its main objective is improved coordination and cooperation at national level in tackling the undeclared economy. However, the council meets only twice a year and cannot be an effective instrument to providing monitoring, analysis and policy direction in a continuous and sustainable manner. Furthermore, such an initiative must come from the government, and it should be clearly demonstrated that it stands firmly behind such a structure. Within EU member states, there are several different successful models for coordinating a national approach to tackling undeclared work, including at:

- **strategic level**: national strategies and action plans, inter-ministerial committees, special working groups or single coordination bodies;
- **operational level**: inter-institutional monitoring groups and joint task forces

In France there is a single agency responsible for tackling all aspects of the undeclared economy, and in that sense the institutional set-up is cohesive and integrated at both, strategic and operational level (Dekker et al, 2010: 14), supported by clearly defined priorities and regularly updated action plans. It has an *Inter-ministerial Committee for Combating Illegal Work*, which provides general guidance and strategic direction (Williams and Windebank, 2009). At the next level, there is a *National Commission for Combating Illegal Work* composed of the main control bodies and public officials from central government departments and social partners. This national body is supported by a coordination secretariat *Inter-ministerial Delegation for Combating Illegal Work - DILTI*, composed of 40 civil servants of different ministries). It is responsible to communicating policy decisions to regional and local level structures and to social partners. At the same time, DILTI has local coordination units chaired by the local mayors, which are much closer to operational actions on the ground. The French integrated approach is one of the most comprehensive models of a coordination system in the fight against undeclared work, encompassing different levels of government and enforcement bodies.

Attempting emulation of such a comprehensive institutional set-up is likely to prove premature in Bulgaria. Instead, the government should focus on integrating existing efforts and streamlining the deployment of available recourses through minimal investment in more complex institutional structures. Furthermore, the focus should be on improving monitoring, analysis and evaluation of the effect of existing measures and better understanding of the domestic manifestations of the undeclared economy. In Ireland, for example, the *Hidden Economy Monitoring Group* is an advisory body for developing more effective policies as the result of “monitoring developments and reviewing the effectiveness of measures to combat tax evasion and social welfare fraud” (Dobbins, 2009).

Romania is a good example of how several mechanisms ensuring coordinated policy response can be applied in combination through streamlining existing administrative structures. Upon recommendations from the European Commission, the Romanian government in 2009 signed a Memorandum of Understanding for the purpose of creating a ‘Mechanism to monitor, control, and reduce the rate of illegal work in Romania’ (Ciutacu, 2013). As part of this measure the following action were taken:

- establishing an Inter-ministerial Committee against Undeclared Work (CIMND)
- adopting a National Strategy to reduce the rate of undeclared work, and a related Plan of Action to implement the strategy
- strengthening the legislative framework to introduce stricter penalties.

The CIMND is composed of members of the Government’s General Secretariat, the ministries of labour, finance and interior, as well as the national security institute. While the CIMND is giving the overall strategic direction of the policy response, there is a Group of Technical Experts attached to it, which has
the task to monitor and evaluate progress, gather data and support decision-making and operational activities with evidence, preparing performance reports, etc. This is a crucial element of the mechanism which should be considered for potential transfer to Bulgaria. Although it is difficult to measure the success of this comprehensive policy initiative fully, during the first three months after the legislative amendments were introduced, there have been 587,000 new individual employment contracts (Ciutacu, 2013). This is attributed mainly to the harsher penalties and tightened control, however, it can be assumed that this systematic and integrative approach has had a favourable effect on reducing undeclared work.

**Transferability**
The examined practices point to a number of transferable mechanisms and possible models, whereas some sort of combination of key elements is likely to be the most effective option, as it would provide a comprehensive coverage of vital function such as data gathering, monitoring, analysis, setting policy priorities and developing concrete action plans, monitoring and coordinating their implementation. The basic instruments of coordination include, but are not limited to the following:

- High-level strategic committees providing overall guidance and policy direction. This can be an inter-ministerial commission (FR) with supporting coordination / technical secretariats.
- Analytical and advisory bodies or working groups tasked with gathering and reviewing data on undeclared work, assessment of problems and needs and policy impact evaluations, on which future policy proposals to be based (IE).
- National strategy and action plan (RO, FR, etc.).
- Operational coordination body (UK).

Drafting a national strategy and action plan is probably the least problematic measure, however, its effective implementation and progress monitoring would largely depend upon having in place some of the other institutional instruments. The government priorities in the field of preventing and countering the undeclared economy (broadly referred to as the grey economy) are usually set out in broader strategic plans for social and economic development. The Romanian experience shows that making these more explicit and focussed within a separate strategic document can increase the visibility of government’s efforts in this field. In addition, a coordination body can contribute to raising the sensibility of other government departments and administrative bodies towards the need to consider the phenomenon when addressing economic, fiscal and social problems. On the other hand, the particular design and institutional set-up of a coordinating structure is likely to be highly country-specific and should be undertaken only following a careful situation analysis.

**Applicability**
A national strategy to counteract undeclared work will need to become a political priority as Bulgaria has the highest share of informal economy in the EU. However, it appears that successive governments have not made this one of the top political priorities due to the unpopular actions required in implementing such a strategy. A coordinated national approach against undeclared work would be in the interest of the trade unions, but it may however encounter some difficulties with big businesses that are currently benefiting from certain forms of undeclared work (playing by the letter of the law).

An external encouragement at EU level may accelerate this process. However, as previous experience in the field of anti-corruption policy shows, even if these instruments are put in place (following external pressure), their success depends largely on whether they are underpinned by genuine political will and resolve to action on the part of the government. Establishing multifunctional agencies with broad mandates in the field of anti-corruption has not been as effective as expected, due to political resistance towards granting them sufficient autonomy and powers.
At operational level there is already cooperation between the labour inspectorate and the tax office in terms of joint inspections and exchange of information, but these efforts could become much more intelligence-led. For example, the Joint Shadow Economy Teams in the UK applied “area-based cross-departmental intelligence and data sharing” to specific sectors to detect different occurrences of undeclared work (Williams, 2009). This model can be applied as a compromise in the absence of a central coordinating body, which is corresponding to the current situation in Bulgaria. Nevertheless, enforcement bodies in Bulgaria have found it difficult to establish lasting and effective cooperation due to different organisational cultures and operational autonomy.

5.5 More efficient, fair and responsive control system

The three main state institutions responsible for developing and implementing control functions in regards with undeclared work in Bulgaria are the National Revenue Agency (NRA), the General Labour Inspectorate (GLI) and National Social Security Institute (NSSI). Dzhekova and Williams (2014: 64-67) provided detailed discussion about their role, functions and main performance indicators. What becomes evident is the fact that NRA has implemented a huge amount of operational checks during 2011, 2012 for which data is already publicly available. Even though the high amount of imposed sanctions, the overall efficiency remains questionable – if it is accounted for the collected income and expense per check for that period. The sustainability of the effect of control and inspection efforts conducted in a “campaign-like” manner is questionable, considering that measures aimed at changing attitudes and fostering voluntary compliance remain limited in scope, while the customer-oriented approach of government institutions needs further improvement.

According to a recent EC assessment of the national reform programme within Europe 2020, Bulgaria still lacks “a fully-fledged tax compliance strategy, which would include estimates of tax gaps, analysis of the underlying causes, impact assessment of the measures already in place and new policy measures” (European Commission, 2014e: 13). Nevertheless, enforcement bodies have in recent years improved their accountability, strengthened their inspection capacity and started to implement more targeted risk assessment approach. However, there are areas requiring further improvement:

- More targeted and balanced approach to inspections and sanctions (including risk assessment optimisation)
- Enhancing the efficiency and operational capacity of control bodies, including capabilities to conduct complex financial investigations, data matching;
- Develop a customer-oriented approach and improve communication with citizens (incl. through e-services)
- Ensure greater political independence and transparency of the control system.

These components cannot be addressed by a single measure, but by combination of working mechanisms found in a number of approaches.

5.5.1 Towards more efficient risk assessment and investigation capabilities

Prospective measures:
- OASIS – Belgium
- E-government in social security sector – Belgium

Over the past few years, the Bulgarian tax authority (NRA) has become more sensitive to enhancing its efficiency and operational capacity, including the development of a more strategic approach to tax governance. Its current inspection and auditing decisions are based upon a ‘selection process’ (risk assessment and profiling) incorporating a number of risk indicators. Furthermore, it has started
implementing a contemporary software solution based on the same platform used by HMRC, UK (Oracle Business Intelligence Enterprise). The system should be implemented by September 2014 and amongst its diverse features it would enable:

- Actionable tax intelligence and real time responses.
- Tax non-compliance diagnostics – calculation of cost.
- Tax compliance enforcement – calculation of cost.
- Ad hoc Analysis and Interactive Reporting.
- Proactive Detection and Alerts.
- Lesser subjectivity in enforcement of checks and audits.
- Scorecard and Strategy Management.

With the implementation of the new system, it is expected the NRA to become the leading coordinating body in investigating undeclared economic activity in Bulgaria due to its potentially advantageous position in terms of its actionable business intelligence. However, it should be also noted that despite these innovations, NRA experiences shortages of qualified and well-trained analysts, which may compromise the potential effectiveness of the system. Especially when it comes to financial investigations of complex cases of tax evasion, there is a lot of room for improvement in terms of operational and analytical capacity, while political interference with high-profile investigations remains a serious problem. At the same time, the NRA has become much more service-oriented towards taxpayers. Recently it has released a number of new e-services for companies, including access of companies to documentation with regards to ongoing control and audit procedures, as well as electronic submission of relevant documents within audit procedures. This enables better communication between taxpayers and the NRA and greater transparency and accountability in relation to its control function. These ongoing efforts should be reinforced through learning from successful similar experiences of other countries, in order to improve objectivity of control activities, greater use of e-services by taxpayers in the communication with the tax office, as well as more targeted investigations and risk assessment. Such examples include:

- OASIS, Belgium
- E-government in social security sector – Belgium

Procedural fairness (Williams, 2014, p. 26) refers to the extent to which people believe that they are paying their fair share compared with others and receive fair treatment by institutions. It is worthwhile noting, that he appreciation of procedural fairness amongst Bulgarian individual and small business tax payers is below the acceptable social minimum. For instance, big tax payers often receive much more favourable treatment by the tax authorities and that they could even avoid situations (not paying the lawful amount of tax) while the smaller tax payer would be treated to the letter of the law and exposed to much more institutional scrutiny. The reasons behind these phenomena lie in the domains of high level of corruption and doubtful political protection for specific tax payers. That is why it is highly desirable and applicable for Bulgaria to achieve greater level of automation and objectivity in its intuitional control and enforcement measures, starting from more efficient risk assessment system.

In this context, one of the promising policy initiatives, which could be beneficial to the intervention needs, is an anti-fraud warehouse OASIS implemented in Belgium. The project joins a number of data sources and public databases and allows several control bodies to conduct “objective-oriented inspections and perform analyses on related data from different social security sectors with the overall objective of detecting and analysing cases of fraud. (Horlings, 2009).” At the same time, the precondition for the proper functioning of the system is a sound infrastructure of e-government services. Therefore, another
highly relevant initiative is the E-government system in the social security sector, Belgium, allowing for electronic collection and of social security data:

"Over the last 10 years, Belgium has developed and pioneered a policy of electronic collection and exchange of administrative data in its social security system. It is believed that specific measures seeking to spread electronic government processes (e-government) throughout all bodies involved in the social security system could strengthen measures seeking to combat social and fiscal fraud...Belgium appears to be the first European country to have implemented a system of generalised electronic declaration in the social security sector (Tilly, 2009)."

Transferability
It important to note that potential transfer of OASIS policy initiative would tightly address two of the top 5 identified risks by NRA and in particular:

- Concealment of part of the wages of employees.
- Lack of payment of declared mandatory social contributions by self-employed.

The need for objective detection and automated analysis of fraud (as with OASIS) in such a systematic inter-institutional context is not addressed by a specific policy at this moment of time. The prevalence of the target risk is much more expressed in Bulgaria compared with Belgium, which signifies the adequacy of this policy measure to the Bulgarian context.

At the same time, the Bulgarian tax administration can draw upon a wide range of EU good practices in the field of compliance risk management and tax governance. For example, within a benchmarking exercise of 11 leading tax administrations, the Irish REAP- Risk Evaluation Analysis and Profiling has been rated by the EU as one of the most effective risk assessment systems (European Commission, 2010a). BCCI (2013) appraised this measure as easily transferable and applicable in Bulgaria, given the already substantial efforts of the NRA in this respect.

A potential transferability of e-government in social security sector will need to overcome some implicit political resistance. It is going to significantly moderate some grey re-distributive political powers over public revenues. However, it is expected that e-government in the in social security sector will receive wide public support by the individual and business tax payers in the perspective of perceived benefits. Most importantly such a policy implementation will contribute to build capacity for a responsive regulation approach. Williams (2014, p. 28-30) discuss the shift from deterrents to fair and respectful treatment of tax payers and that would be possible through much higher level of electronic governance in the Bulgarian environment.

Applicability
Successful implementation of OASIS requires a functioning e-government, which has been a political priority in Bulgaria for several years. Bulgaria has only partially functioning e-government at this moment of time with unknown perspectives when it would be completed. However, it appears that the main institutions which would be involved in OASIS in terms of data exchange will be equipped with the relevant data management systems – so that such a policy programme will be technically possible providing there is a political will.

A potential implementation of measures similar to OASIS would not contradict the interests of any important stakeholders. Because it relates to inter-institutional data exchange and mutual action capacity, it would not impose any additional requirements either upon the individual or business tax payer. However, the considerable costs of such measures should be carefully considered. So far the NRA has
been drawing upon support from EU funds for development of administrative capacity and technical capabilities. Furthermore, the implementation of such a complex system requires much better analytical capacity and appropriate staffing of the NRA. There could be some political unwillingness to implement such a policy initiative since it will allow for automatic fraud detections which once escalated by the system could not be easily resolved unnoticeably.

The application of an e-government framework would be probably the most desirable measure/functionality amongst the population and local businesses that are very keen to enjoy this level of administrative service and fair treatment. There is unarguably great need for efficient electronic bureaucracy and at the same time widely advertised political willingness, which however remains empty in terms of appropriate actions towards more comprehensive e-government reform. The Belgian experience indicates that their e-government system is associated with a very small administrative burden thanks to the extensive use of modern technologies. The potential achievements of policy objectives are highly promising – the efforts to combat fraud through more integrated and targeted actions, and data mining are well rewarded.

5.5.2 Stimulating voluntary correction of tax behaviour – from repression to responsiveness

Assessed measures:
- Notification letters from Tax and Customs Board – Estonia

When it comes to monitoring potential violations, inspections in Bulgaria still predominantly rely on inspections and visits. A number of recently conducted reforms mainly aimed at increasing effectiveness of detection and raising penalties for violators. On the other hand, not much is done to enhance voluntary cooperation, which could save resources. By using ‘sticks’, inspection bodies therefore additionally amplify the gap between the authorities and taxpayers. Such punitive approach can generate defiance among taxpayers and thus potentially result in even greater evasion. For that reason, if eradication of undeclared work is to be effective, it is necessary to alter the way control bodies treat citizens, i.e. to modify their approach from pure repressive to more cooperative one. The business, especially micro and small firms should see the administration not as a purely sanctioning authority, but as a service one. This opens up new venues for cooperation and could stimulate voluntary correction of non-compliance. Such a strategy is in line with the concept of the ‘responsive regulation’ approach described by Williams (2014), where taxpayers are openly engaged to “think about their obligations and accept responsibility for regulating themselves (p. 29).

Notification letters sent by the authorities to potential tax violators are a potentially useful instrument towards these objectives. This mechanism was applied in 2008 by the Estonian Tax and Customs Board (Lill and Nurmela, 2009). Upon detecting companies at high risk of under-declaring salaries due to the low average levels paid in comparison with their market peers, the authorities sent those firms letters informing them of their low wage competitiveness and clarifying the risks associated with this. In this way they were given the opportunity to correct their behaviour voluntarily. Those who failed to adjust their employment declarations were targeted for inspections and strict control measures. Around 1,000 companies and 2,000 employees were targeted within the campaign in 2008, and 1,000 companies were previously notified in 2005. The measure is considered successful, since 46% of companies adjusted their wage levels (43% ignored the letters and 8% worsened their behaviour). This resulted in additional tax payments of EEK 10 million.

Transferability
The measure addresses the problem of ‘envelope wages’ – a widespread phenomenon in Bulgaria (estimated at over 13% of the population; CSD, 2013), which is also particularly difficult to detect through inspections and standard punitive actions. In that sense, the targeted problems and population are very similar to the country of origin, while the multi-dimensional potential effects make the mechanism attractive for potential transfer. The instrument is transferable without much alteration of the original design. The Estonian experience shows that the most effective way was to send letters to both, employers and employees. The number of letters and the target population can be adjusted accordingly to detected needs.

**Applicability**

Due to the low expected additional investment in terms of technical capability and human resources, the measure is likely to face broad support by control bodies. Since the labour inspectorate and the tax authority already use a joint electronic register of employment contracts and have data-sharing agreements, the additional investment is only in terms of reorganising staff that would monitor wage levels and identify companies to which the letters are to be sent. The measure would potentially reduce the administrative burden on compliant companies, as well as the number of inspections based on better targeting. While the potential of letters to change tax behaviour long-term is uncertain, the optimisation of resources through fewer but better targeted inspections is sufficient justification for considering the measure.

It should be noted that in 2014 a variation of this mechanism has been attempted by the NRA with unsatisfactory results. Further analysis is necessary to assess the exact parameters and design of the measure applied and the potential for improving its impact in the Bulgarian context.

**5.6 Strengthening tax morale and a culture of commitment**

There is a high level of public tolerance towards non-compliance in Bulgaria and increased readiness to participate in the undeclared economy in the current economic climate. Furthermore, the decision not to declare economic activities is not always associated with a low level of knowledge and awareness about the consequences. Especially large-scale tax evaders and non-compliant economic actors rely upon the low risk of being detected or on bribing control bodies.

Nevertheless, the general public awareness of the issue has been increasing in the past years due to a number of initiatives and engagement of various social actors with this problem area, including more proactive civil society. Social partners in Bulgaria have been strongly engaged in varied efforts aimed at facilitating better understanding of the informal economy, increasing public awareness and creating a culture of intolerance towards undeclared work, as well as providing advice to citizens and firms. There have been several public campaigns by state institutions and social partners (“Come into the light”, “Work legally”), large-scale EU-funded projects launched by trade unions and business associations (“Rules for Business Center” and “Virtual Social Academy”), as well as continuous civil society efforts (CSD *Hidden Economy Monitoring System*). These initiatives, although often fragmented, have largely applied a multi-dimensional approach to pursue various objectives, including:

- Providing more detailed knowledge and analysis of the nature, causes and spread of informal economy in the country through a number of national representative surveys, focus groups, interviews and sectorial company audits (BICA, 2011; 2012; BCCI, 2013; CSD, 2011)
- Introducing a monitoring system and indexes of the dynamics of the hidden economy and its many forms (CSD, 2013; BICA; 2012);
- Improving public awareness of manifestations and consequences of undeclared work;
- Improving citizens’ and employers knowledge of tax and labour legislation and compliance requirements;
• Encouraging anonymous reporting of labour violations through hotlines and websites;
• Assessing ‘good practices’ from other counties and their transferability (BCCI, 2013)
• Developing national action plans and strategies, as well as coordination committees (BCCI, 2013; BICA, 2012)
• Providing education and training;
• Providing advice and information to citizens and businesses (including formalisation advice, start-up support, career training, etc.);
• Fostering a wide public debate on ways to tackle the problem, through engaging the media and all relevant stakeholders;
• Improving social dialogue.

Given the wide range of activities and mechanisms applied already by social partners in Bulgaria, one would think that the possibilities for innovation have been exhausted. Indeed, unlike many other countries in the region, awareness rising campaigns and other ‘soft’ measures to stimulate intolerance towards informality and increase commitment have been applied extensively in Bulgaria. However, they have similar shortcomings, such as their short-term/campaign character and lack of long-term sustainability, insufficient participation and support by the state, as well as the lack of credible enforcement mechanisms. Nevertheless, these efforts should not be abandoned but aim at becoming an integral part of the state’s overall, long-term policy strategy towards undeclared work. For example, projects such as the National Rules for Business Centre established by BICA\(^5\) or the Virtual Social Academy\(^6\) initiated by BCCI provide a wide range of consultation and information services for businesses and employees at local level or via the internet, including formalisation advice. The multi-dimensional activities of the National Rules for Business Centre have undergone already preliminary evaluation showing that knowledge of this complex phenomenon has improved and employees are now more critical of different informal practices (Daskalova, 2013; BICA, 2012). There has been an increase in the reported violations via anonymous hotlines. These initiatives have already laid down some foundations for broad public discourse and organised social partner efforts to support national policies, as well as an infrastructure of local and national advice offices, data gathering tools and channels for communication and knowledge exchange. However, without strong involvement and commitment on the part of state institutions in these efforts, their sustainability and long-term effects are at risk. Furthermore, in order for efforts to change social attitudes to bear fruits and increase tax compliance, social solidarity and a culture of corporate responsibility, they need to be matched with equally genuine effort to change formal institutions towards procedural justice and fairness, and commitment to the values of transparency and accountability on the part of public bodies.

**Addressing the asymmetry between formal and informal institutions**

Bridging the asymmetry between societal norms and official rules (Williams, 2014) in Bulgaria would require both, a top-down, as well as a bottom-up approach. Change processes in formal and informal institutions are in fact two interdependent and constantly interacting realms (see Figure below). Therefore, we believe that along with efforts of formal institutions to provide a greater level of procedural justice and fairness, innovative approaches should be pursued in the field of encouraging and reinforcing self-regulation and an attitude of corporate and collective responsibility and solidarity.

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\(^5\) [http://www.ikonomikanasvetlo.bg](http://www.ikonomikanasvetlo.bg)

\(^6\) [http://www.vsa.bcci.bg/?cid=33](http://www.vsa.bcci.bg/?cid=33)
Given the analysis so far, in order to increase the credibility of efforts aimed at fostering a culture of commitment, the state needs to become more involved and visible in ensuring a persistent and sustainable flow of communication with the citizens in the following priority areas:

- Highlighting the benefits of paying taxes through making more explicit and transparent what taxes pay for, including through fostering better understanding of the link between public revenues and expenditures.

- Raising awareness among citizens (and youth in particular) about the negative consequences of undeclared work, including educating taxpayers and workers about their rights and obligations. This would also entail increasing the population’s tax knowledge, coupled with better information and administrative services. Such efforts have already been implemented in Bulgaria by the authorities, yet they need to become an integral part of public institutions’ service-oriented approach to taxpayers.

Finally, a bottom-up approach to developing a culture of commitment entails action to be taken on the part of non-state actors (civil society, businesses, social partners), such as:

- Self-regulation in the private sector with respect to business integrity, civil and corporate responsibility.
- More pro-active and vocal civil society to serve as a watchdog, monitor and scrutinize public spending and channel collective demands for change in formal institutions.
5.6.1 Stimulating self-regulation and corporate responsibility

Assessed measures:

- Clear Wave, Lithuania

Broad public awareness raising strategies tend to be conducted in a campaign-like manner and their effect is not sustainable in the long run. Considering the time required to lastingly change public attitudes, as well as the need to combine public awareness efforts with notable improvements in public services, the approach should be reconsidered. This is not least because too little attention is paid to the corporate behaviour of companies, given that non-compliance by firms is a much more serious problem in Bulgaria than non-reporting by households or individual taxpayers. The shortcomings of formal institutions, the spread of high-level political corruption and state capture by oligarchic interests are constantly overemphasised in the public domain, cementing an atmosphere of desperation and hopelessness among society that change is possible. Yet businesses, as well as civil society, can start acting more proactively and responsively themselves to become drivers for change and put pressure on the government. Bulgarian firms have low level of sensitivity towards issues of business integrity and internal compliance procedures. Despite the strong involvement of business associations in public campaigns against undeclared work, there are too few examples of genuine efforts to self-regulate. Trade unions and business associations are not immune from accusations of serving private and party-political interests (Stoyanov et al., 2014: 21). There have been no attempts to attach membership rights to more strict requirements for transparency and compliance (CSD, 2011).

Furthermore, what is lacking at the moment is a bottom-up approach and collective action to promoting compliant behaviour and setting a positive example for others. The Clear Wave\(^7\) initiative in Lithuania is, for example, a business campaign for strengthening public intolerance towards the informal economy. It

\(^7\) [http://www.baltojibanga.lt](http://www.baltojibanga.lt)
envisions awarding a business transparency label to companies that publically declare their commitment to integrity and responsible corporate practices, including: (OECD, 2013a; BCCI, 2013):

- transparent and fair participation in public procurement – commitment not to bribe tender organisers and members of the jury, or resort to illegal financial and non-financial measures to gain advantage against other participants;
- compliance with national laws and commitment to paying all taxes and fees due;
- maintaining transparency and accountability with respect to employees’ remuneration.

Business with the label of transparency can earn higher customer reliance, a trustworthy name in the society, and encourage companies to act responsibly. Similar initiatives have been launched by businesses in the field of anti-corruption and corporate responsibility around the world, including in Bulgaria (e.g. UN Global Compact). Such initiatives are transferable and applicable without much additional cost, provided that there is sufficient motivation and commitment on the part of the business and its associations. Although they are largely lacking effective monitoring and enforcement mechanisms, such projects could gradually prepare the ground for more sophisticated self-control and self-regulation measures in the business community. Furthermore, the increased sensibility and intolerance of businesses and civil society towards issues of non-compliance would contribute to voicing stronger collective demands for change in formal rules towards more transparency and accountability.

6 CROATIA

6.1 Undeclared work in Croatia: problem areas and intervention needs

The current section is introduced with a brief baseline assessment of the undeclared economy in Croatia including the extent of undeclared work, nature and types of undeclared work, barriers to formalisation as well as the current policy response (for further details see Franic and Williams, 2014). Informed by this, and in combination with the priority hierarchy discussed in Chapter 4, a possible strategy for a more holistic and needs-based approach is developed. Within this, the recommendations focus on reducing the incongruence between formal and informal institutions. However, it is important to bear in mind that this is a preliminary step in the overall development of policy recommendations. This is because, in order to build a more informed and empirically grounded framework, further action will need to be taken in terms of consultation with relevant stakeholders and interest groups.

Extent of undeclared work

The undeclared economy in Croatia is estimated at 28.4% of the official GDP in 2013, which is among the highest rates in the EU (Schneider, 2013). There is a general decreasing trend in the share of illegitimate economic activities during the last decade, which was only temporarily interrupted in the initial phase of the economic crisis (Schneider, 2012, 2013). Yet, this decline does not necessarily imply the eradication of undeclared activities. For instance, in their analysis of the non-exhaustiveness of national accounts for the period 2000-2008, Lovrinčević and Nagyszombaty (2011) found that both the declared and undeclared economies in Croatia were increasing during the given period. Thus, it seems that the drop in the relative size of undeclared work in the pre-recession period was a result of the faster growth of the declared economy, not a result of a diminution of undeclared work.

According to the 2007 World Bank Enterprise Survey, almost one third of the surveyed firms in Croatia recognised the existence of informal competitors, while one in four identified informal practices of others as a major constraint in the running of their business (World Bank, 2008). When it comes to the individual level, the Special Eurobarometer on undeclared work conducted in 2013 reveals that some 17% of the
population is buying undeclared products and services (European Commission, 2014c). On the other hand, only 7.3% of respondents in the same study admitted personal engagement in undeclared activities from the labour supply side.

Nature and types of undeclared work

A significant part of small-scale undeclared activities in Croatia is based on close social relations. According to the Special Eurobarometer Survey on undeclared work, some 57% of the respondents who were carrying out unregistered work did so for their friends, colleagues or acquaintances (European Commission, 2014c). The survey further reveals how manual workers, unemployed people and the retired conduct about 70% of all undeclared work in Croatia. More precisely, nearly one third of people engaged in undeclared work are manual workers, almost every fourth person is unemployed, while about every seventh undeclared worker is retired.

Turning to the firm level, companies in agriculture and related industries are the most likely to face competition from unregistered firms (World Bank, 2008). Illegitimate economic practices occur more often among small firms, and particularly among domestic owned and non-exporting ones. According to the State Inspectorate, although violations in employment relations were present in almost all industries, they were the most prevalent in construction, the catering sector, and the trade sectors (State Inspectorate, 2013).

The most common recorded violations in 2012 were employment without a contract and employment on a piece work agreement in situations where a standard work contract should be applied. This was followed by non-declaring to pension or health insurance authorities, employing foreign workers illegally or without informing the relevant authorities and hiring workers for seasonal jobs in agriculture on an undeclared basis (State Inspectorate, 2013).

We should also highlight the 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 the surrounding area are far more likely to carry out undeclared activities in comparison with their counterparts from other regions (European Commission, 2014c). There are also differences according to the type of community. 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 (European Commission, 2014c).

Barriers to formalisation

Unemployment is certainly the central issue that requires consideration when combating undeclared work in Croatia. At 17.2% in 2013, the unemployment rate in Croatia is one of the highest in the EU, with Spain and Greece the only member states facing more prevalent unemployment (Eurostat, 2014b). A particularly concerning fact is the long-term unemployment and pervasive unemployment among young people. Almost two thirds of unemployed persons in this new member state are without a job for more than 12 months (Eurostat, 2014a), while 43.1% of active people between 15 and 24 years of age face the lack of formal employment opportunities (Croatian Bureau of Statistics, 2013). Such a pervasive unemployment among the young population is not solely a consequence of the economic downturn; it is also partially a result of disproportion between labour demand and supply.

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 (war veterans, former political prisoners etc.), who took early retirement, are often motivated by a surplus of time.
Turning to the disincentives for formal employment, a high tax burden and benefit traps seem to be the most salient. The issue of the tax burden is particularly pronounced in the case of workers with a lower income (67% of the average gross wage) whose personal average tax rate in 2009 accounted for 27.5% of the gross wage⁸ (Grdović Gnip and Tomić, 2010). On the other hand, as formal earnings very often exceed low-income thresholds imposed on eligibility for social benefits in Croatia, some low-income earners can potentially lose more than they earn by accepting a formal job (European Commission, 2013). An additional rationale for noncompliance can be found in a broadly accepted perception of a mismatch between current liabilities concerning social security contributions and future benefits from the pension and welfare system (Bejaković, 2012). Making formal employment pay is therefore important if the undeclared economy is to be tackled.

From the perspective of businesses, the main obstacle in running a business is the instability of the tax system, followed by complexity of administrative procedures. Another factor which fosters undeclared work in Croatia is the inflexibility of the labour market. In the assessment of the 2013 economic programme for Croatia, the European Commission (2013) concludes that apart from disincentives caused by the procedural complexity of hiring employees, probably even more problematic are costly and complex dismissals which can run for several years in court. By hiring workers on an off-the-books basis, some employers circumvent the rules concerning the protection of workers and therefore avoid the problems in the case of dismissals, as well as all other liabilities regarding taxes and social contributions.

Nevertheless, one of the key factors fostering informality in Croatia, so far neglected in endeavours to tackle this phenomenon, is the gap between the state and citizens. The inability of the state to secure procedural fairness (i.e. fair distribution of liabilities between taxpayers) and redistributive justice (i.e. to establish a clear link between tax liabilities and goods and services received in return) on the one hand, and the weak rule of the law accompanied by prevalent corruption on the other, have deteriorated the psychological contract between the authorities and taxpayers (Bejaković, 2012). In the country where only 13.8% of the population have confidence in the government, it is not surprising that every third citizen tends to tolerate tax evasion (EVS, 2011). These findings clearly highlight the low level of tax morale as an important factor behind undeclared work in Croatia. There is a wide social approval of undeclared work which has become a common way of operating, on both the business and individual level. Although unregistered practices are widespread and inherent for every part of society, young people are those who are the most prone to opportunistic non-compliant behaviour, which indicates a possible long-term trend in such a high share of undeclared work in Croatia (Štulhofer and Rimac, 2002).

Organisational structure of the fight against undeclared work

There is no single agency responsible for tackling the undeclared economy, nor a committee in charge of coordinating actions in this field in Croatia. Instead, the 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.

Until January 2014, the central body responsible for enforcement of regulation in Croatia was the State Inspectorate. Alongside its own responsibilities, this surveillance institution maintained good cooperation with other government departments. 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

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⁸ In comparison, this rate for the EU27 as a composite was 23.4%.
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. However, the State Inspectorate was abolished from 1 January 2014, while its responsibilities 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. It is not completely clear what was the rationale for this decision, which was brought without any systematic analysis or public debate. 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).

The culture of social dialogue in Croatia is quite weak, thus presenting a significant obstacle for a more successful fight against illegitimate practices. 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). Following this, importance of improving cooperation of social partners is clear.

Policy approach used in Croatia

The fight against undeclared work in Croatia is characterised by 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 (Franic and Williams, 2014). These measures are usually introduced 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.

Although a number of preventative measures have also been introduced recently, repression is still the most prevalent approach in combating undeclared work in Croatia. However, despite substantial endeavours in deterrence, the perceived risk of being detected and punished among Croatian taxpayers is still quite low. Some 59% of taxpayers see this risk as small or fairly small, while only 9% think it is very high (European Commission, 2014c). Generally, there is a need to put greater emphasis on enabling compliance, especially on fostering voluntary commitment and providing incentives for undeclared businesses and individuals to formalise their activities, which do not appear to be fully recognised as effective strategies in a Croatian context (Franic and Williams, 2014).

6.2 Explanation and justification of measures chosen for Croatia

The following section outlines the relevant policies that address the needs described previously. As discussed, repression as a dominant approach in tackling undeclared economic activities in Croatia has been supplemented during the last few years with a number of preventative measures. However, these two strategies, which are guided by the assumption that taxpayers are rational economic actors who make their decision about (non)compliance after assessing costs and benefits, has had limited success in reducing undeclared work so far. The main reason for this can be found in a weak psychological contract between citizens and the authorities. By practicing repression and prevention, without offering tangible benefits of formal work, the authorities in Croatia seem to additionally reduce the willingness of citizens to comply (Franic and Williams, 2014).

Given this, more attention should be placed on indirect measures, which seek to reduce the disparity between formal institutions (official laws, regulations and codes) and informal institutions (values, norms and beliefs of citizens). The idea behind the indirect approach is “to engender willing or voluntary commitment to compliant behaviour rather than force citizens to comply” (Williams, 2014, p. 20). This is
to be done by increasing the legitimacy of the state and raising awareness about the role of taxation and benefits of the declared realm\textsuperscript{9}.

From the earlier presented overview of undeclared work in transitional settings more broadly\textsuperscript{10} as well as in Croatia specifically, it becomes evident that policies cannot be chosen in isolation but as part of an overall plan. This is because although the identified problems of certain measures can be detrimental to the success of that particular instrument, such problems can be compensated for by the introduction of other measures. The following section therefore describes the set of recommended reforms and policy measures to tackle undeclared work in Croatia, which will be theoretically and empirically evaluated in a later phase of the research project.

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<td>Combatting Corruption</td>
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<td>Increasing transparency</td>
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<td>Citizen Involvement</td>
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<td>Improving coordination of agencies responsible for the fight against undeclared work</td>
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<td>Promoting formalisation</td>
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<td>Fostering tax morale</td>
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<td>Increasing knowledge about tax payers and the undeclared realm</td>
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<tr>
<th>Improving informal institutions</th>
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<tr>
<td>Reducing acceptance of UDW</td>
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<tr>
<td>Fostering formalization</td>
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<td>Educating citizens about taxes</td>
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As can be seen, the proposed set of measures includes a number of general recommendations for improving government legitimacy (e.g. combatting corruption, increasing transparency, citizen involvement etc.). As those measures are a part of wider institutional reforms fundamental for a more successful fight against undeclared work, they fall outside the scope of discussing transferability issues and therefore will be considered from a theoretical perspective. However, good practices in other European (and some non-European) states are identified and discussed where possible for all other measures.

\textsuperscript{9} This does not mean that deterrence should be abandoned, but rather used as a last resort. For more detailed discussion on this issue see Williams (2014a,b).

\textsuperscript{10} See section 4.1.
Government inadequacies and the subsequent low trust in institutions represent vital obstacles for a more successful fight against undeclared work in Croatia. As according to the developed hierarchy of needs this should then be the key area to focus on. Ott (2013) argues that much of the persistence of economic problems in Croatia is due to institutional and administrative weaknesses. She argues that implemented reforms are superficial in nature and lack substantial content. Whilst bureaucratic and corruption issues dominate, there is a lack of a long-term strategy and coordination of policy. Therefore, the main focus of improving formal institutions lies with increasing government legitimacy and appropriate to the context of Croatia, this can be done by improving procedural, distributive and retributive justice. In order to effectively do this, due attention should be given to improving administrative efficiency as well as combatting corruption and increasing transparency. With regards the latter, real involvement of citizens in the decision making process can not only help with increasing transparency but also serves as a useful tool for informing citizens of the positive changes being made to change formal institutions.

### 6.3.1 Increasing Government Legitimacy

Researchers have continuously demonstrated that greater confidence in the government has a positive impact on the level of public policy acceptance whilst cutting down administrative costs and encouraging agreement with laws and regulations (Ayres and Braithwaite 1992; Tyler 1998, 1990). Thus, fostering public trust in government has increasingly become a vital objective as this enables central and local governments to implement their policy measures effectively and with greater ease. Further to this, Scholz & Lubell (1998) state that trust in government is more than a “rough measure of the net benefits from governing institutions” (1998:411). It also involves the effectiveness and fairness of the government whilst delivering policies and programs to citizens. This highlights a need to not only focus on the provision of goods and services but also on justice.

Government inadequacies and the subsequent low trust in government by the citizens seem a vital issue. According to the developed hierarchy of needs, this should then be the key area to focus on. Ott (2010) argues that much of the persistence of economic problems in Croatia is due to institutional and
administrative weaknesses. She argues that implemented reforms are superficial in nature and lack substantial content. Whilst bureaucratic and corruption issues dominate there is a lack of long-term strategy and coordination of policy.

The literature generally differentiates three types of justice: distributive justice, procedural justice and retributive justice. Distributive justice refers to the exchange of resources, both benefits and costs. Equity theories draw attention to the fair distribution of the results of exchanges between partners (Adams, 1965; Homans, 1961; Walster, Berscheid and Walster, 1976). Procedural justice refers to the process of resource distribution. In other words, if people perceive the formula used to distribute resources (benefits and costs) as fair then procedural fairness will be high. Procedures of allocation of resources are regarded as fair if the partners involved are treated in a way they think is appropriate (Thibaut and Walker, 1978; Tyler, 1990; Tyler and Degoey, 1996). According to Leventhal (1980), treatments are considered fair if decisions about resource allocation are perceived as being consistent, accurate and free of errors, representative and ethical, and correctable in case of errors. In discussing public trust and confidence in institutions, Tyler (2001) has argued that the key issue that shapes public views is a process-based evaluation of the fairness of procedures that are used to exercise authority. Central to this process is the communication of respect for the individual. This will therefore be the basis for the policy recommendations for Croatia.

Pervasive corruption is a major driver hampering justice in Croatia. Akin to other transition countries, it is an important factor behind undeclared work. According to the Special Eurobarometer Survey on corruption conducted in 2013, 94% of citizens in Croatia see corruption as highly prevalent phenomenon in all aspect of society (European Commission, 2014b). In addition, 89% think bribery and nepotism are the easiest ways to acquire public services. In comparison, these shares for the EU as a composite are 76% and 73% respectively, which is significantly lower than in Croatia. When it comes to the business level, six out of ten firms in Croatia recognise prevalent corruption as an important obstacle in their business, while the average share at the EU level is 43% (European Commission, 2014a). Although the foundations for entrenched corruption in this new member state can be found in the period of socialism, one should not neglect the role of the privatisation process during the 1990s (Čučković, 2002). The problem arose with the abolition of old institutions after gaining independence, which created a vacuum that has not been filled quickly enough with new and adequate democratic institutional and legislative infrastructure. Due to undeveloped legislation and weak enforcement bodies in the initial phase of transformation, illicit practices have become deeply ingrained in the business transactions, public administration and consequently the whole society.

Arguably a substantial amount of attention should be given to fairness amongst interactions between public servants and citizens. Given that this is the personal and most direct contact that citizens receive in terms of their interactions with the state, it is likely that it is a major factor in shaping their opinions of the government. Public officials are faced with an ever-changing environment in their pursuit of providing services to individuals and collectives. Some such issues include firmer limits on resources, increased demands from citizens as well as greater public inspection. In turn, the increased complexity of aims requires public officials to carry out state business in new ways. The likely inadvertent effects of these reforms have been the prevalence of traditional public service values and standards (OECD, 2000). Croatia, since its independence, has undergone many structural, administrative and legislative changes adding further difficulties. This creates a need for updating accountability mechanisms and ensuring public servants are equipped with appropriate frameworks and skills that they need to ensure quality in public service.
6.3.1.1 Creating a direct link between revenue and expenditure

Although the issues described above go hand in hand with combatting corruption and increasing transparency it is noteworthy to mention some more specific instruments. In order to more directly affect tax morale it is important to make explicit links to revenue and expenditure. Making this connection more apparent is likely to positively affect perceptions of the government in the eyes of its citizens. This is in turn likely to increase tax compliance and revenues. The following example thus describes a specific contribution to the overall aim of transparency.

Hypothecation and earmarking are terms referring to the process of assigning tax revenues to a specific end. Through increasing transparency, hypothecating is thought to have positive effects on citizen trust. This is because rather than individuals viewing their contribution of taxes to be going towards a 'black hole', they are provided with 'in-built accountability for public spending' (Doetinchem, 2010, p. 1). One of the benefits of increasing visibility in this way is that it may reduce resistance to taxation (Commission on Taxation and Citizenship, 2000). An example of hypothecation already exists in Croatia within the healthcare system (Voncina et al, 2012).

6.3.1.2 Participatory Public Expenditure Management

Corruption is a collective problem of the nation. Citizen involvement relates to the fight against corruption on a number of different levels. Firstly, it is the citizens that bear the main consequences of corruption, in terms of misused funds and lessened goods and services. Secondly, they can be actively involved with regards fighting corruption by reporting irregularities and expressing collective intolerance for such activities (OECD, 2005).

Citizen involvement is however also important for the building of a sense of collective identity amongst citizens as well as the government. Citizens being involved in the decision making process is more likely to reduce the formal/informal incongruence through improving communication between the institutions, but also through providing citizens with a sense of responsibility for decision-making.

A useful tool in participatory public expenditure management is set out by Wagle and Shah (2002, p. 4-5). They identify four phases of participatory budgeting, operating in a cyclic manner.
Stage 1 — Formulation: As part of the formulation process, civic participation is used as a mechanism within the ‘budget making’ process which involves the estimation of expenditure and revenue. It can also affect crucial choices about the distribution of spending within sectors, geographical areas and among social groups. The process is generally steered by the finance ministries at a state level where as for developing countries at a local level it might be less formalised.

Stage 2 — Analysis: This phase occurs subsequent to the budget being presented in the legislature. It encompasses an evaluation of the impact and implication of the relevant policy proposals and allocations at the hands of the public. The involvement of civil society organisations is vital at this point as it serves to conduct a budget analysis and in doing this pursues to clarify the seemingly technical aspects of the budget to the general public and the legislators. Here the implications of the budget for overall objectives such as pro-poor changes are considered and general awareness created. If necessary, training of parliamentarians is also undertaken at this stage.

Stage 3 — Tracking: This stage is ready for commencement once legislative improvement is received for the budget and the allocations are distributed to ministries and lower-tiered agencies such as local governments. Difficulties occur here due to issues such opportunities for rent seeking and leakages. In many developing countries the consequence of this is that the correct amounts may not reach the relevant beneficiaries and thus will not be used for the intended purposes (Wagle and Shah, 2002, p. 4). The necessary action to be taken here is therefore for civic groups to highlight the systematic deficiencies, either independently or in cooperation with the governments. As part of this they can track the flow of funds through the relevant channels to ensure that the correct amounts reach the intended beneficiaries. This section therefore, in part, relies on the capabilities of CSO’s to carry out detailed analytical work as well as work closely with relevant communities to assess the appropriateness of the funds. The Public Expenditure Tracking System (PETS) serves as a useful example of this (World Bank, 2001).

Stage 4- Performance Evaluation: The concluding phase of the Public Expenditure Management Cycle comprises of an assessment of the performance of publicly funded agencies that are funded by the
budget. As part of a process where ‘report cards’ are assembled, feedback from citizens is sought with regards the quality of, access to and satisfaction with the relevant services. The medium used is a survey that then provides in-depth information on where and how basic public services are letting down the poor.

**Applicability (feasibility) and enforcement in local context**

The European Commission (2011) reported progress within the public administration reform in Croatia stating however that further efforts are needed. Although the initial costs of implementing such wide reaching measures as those discussed above may be a disadvantage, the long-term benefits are vast and such measures are highly desirable to improve the situation. This is because although progress has been made, substantial improvements are necessary to capture the attention of society in order to change their perceptions and in turn, norms and values. In light of this, it is generally argued that an ‘integrated approach’ is required with regards ‘embedding’ public service values into agency culture (APSC 2003, p. 26). As part of this, the formal high-level commitment of governments to values of transparency and integrity should be also reflected in a substantive commitment to integrating ethics into the operational values of agencies. This is necessary because individuals feel that ‘the words stayed on paper and were not always translated into action’ with regards good policy words (APSC, 2003:31). Therefore, alongside implementing the measures, it is necessary for the government to undertake a full commitment to ensure that the integration of frameworks, as part of the development of a national integrity system, results in real actions.

Lack of transparency and accountability with regards to the operation of public funds diminishes the trust of citizens not only towards the tax system but also the government more generally. This, in turn, increases the motivation of non-compliance (Kirchler, 2007). Therefore the above policies are appropriate to meet the overall need of improving tax morale through increasing public governance.

As aforementioned, corruption is a substantial problem for Croatia. Given that this affects the perception of justice, it is necessary to see the above measures as integral to the development of a holistic approach. Although creating direct links between revenue and expenditure is a constructive approach in promoting transparency, its effects are limited in isolation. As Croatian citizens have such negative and untrusting perceptions of government, it might not achieve its full potential due to an overly critical view of government actions. However, participatory actions of citizens would water down this effect, as it would achieve more involvement in the actual processes, having more power to resolve any uncertainties the citizens may have. This would also further improve the communication between the state and the public. Embedding the correct ethical values in the minds of public officials is a significant need in Croatia, as reducing public-level instances of corrupt behaviour will aid in decreasing overall perceptions of corruption in the country. Improving the efficiency of the service provided to citizens is likely to positively impact on their perception development.

It should be stressed however, that some notable steps to combat corruption in Croatia have been undertaken recently. For instance, in 2008 the Government adopted the Anti-Corruption Strategy (Official Gazette, 2008a) and accompanying Action Plan of the Anti-Corruption Strategy (Official Gazette, 2008b), set clear foundations for a more efficient fight against the phenomenon. Following this, the Bureau for Combating Corruption and Organised Crime (Croatian: Ured za suzbijanje korupcije i organiziranog kriminaliteta - USKOK), a central prosecution service that was established in 2001, was accompanied by specialised police for the fight against corruption and organised crime (PNUSKOK) in 2009. These changes resulted not only in a significant increase in the number of detected corruption affairs, but also in the number of those involving the highest positioned politicians and business people. Among others, some of the most exposed cases of corruption detected during the last several years include the ex-prime minister, several ministers, regional leaders, local mayors and directors of state-owned companies.
However, despite these praiseworthy improvements at the level of detection, more should be done in order to achieve desirable results in this area. For instance, the problem still remains at the judicial level, as those accused of corruption often remain unpunished or get short prison sentences (in some instances only conditional sentences) (European Commission, 2014). Yet, the biggest drawback of the policy response towards corruption in Croatia is its reliance solely on detection, while not much, if anything, is done on prevention (European Commission, 2014c). Such an approach can have detrimental effects on the already low trust in institutions, because new cases of corruption at the highest political level continue to reduce citizens’ willingness to pay taxes. For that reason, it is necessary to supplement the existing repressive approach with preventative strategies in order to reduce possibilities for corruption in the first place. Therefore the persistent low levels of trust in government, low perception of government effectiveness and high levels of perceived corruption point to an urgent need to improve procedural, distributive and retributive justice systems thus explicating the need for an improvements in transparency (measure 1) and citizen involvement (measure 2).

Discussing earmarking, it is necessary to note that the specific measure of hypothecating revenues from specific sources to specific areas is controversial. This is because of the potential economic efficiencies caused by the implementation of the measures. However, some states have determined that the political benefits outweigh such issues. An effective example of this lies with the government of Ghana, whose citizens are happy to pay taxes (OECD), where a navigation of VAT revenue is directed specifically to health services. Although a direct link cannot be drawn, Ghana comes first in the Tax Effort Index (OECD) which is an index measure of how well a country is doing in terms of tax collection, relative to what could be reasonably expected given its economic potential. This emphasizes the potential benefits of such an approach. Furthermore, it can be argued that hypothecation can create public support for increases in tax, especially in the education and health sectors (Hoffmeyes, 1994; Glennnerster, 1997; Le Grand, 2006).

### 6.3.1.3 Further notes on increasing government legitimacy

The OECD also recommends the development of an infrastructure for internet-based technologies and applications such as e-Government. It is argued that this is a vital element in achieving an accessible, transparent and open government. However, as improvements are being made in these areas in Croatia (see Franic and Williams, 2014), the recommendations for this set of policies are not necessary at this point in time.

As part of the transparency quest, the OECD also emphasizes the necessity of governments ensuring the availability of public sector information. Croatia has taken steps to encompass some of these core concepts but it is useful to refer to OECD Recommendation on Public Sector Information (see Appendix) which OECD governments have adopted. These include policy procedures designed to improve access and increase use of public sector information through greater transparency, enhanced competition and more competitive pricing. Additionally, it is noteworthy to mention that the above issues should be integrated into the later mentioned measures of raising awareness as the OECD (2013a) argues that direct public education campaigns can also serve as a platform for reinforcing revenue and expenditure links.

### 6.3.2 Improving Administrative Capacities

As outlined in the needs section, there is no single agency responsible for tackling undeclared work and no single committee in charge of coordinating action (Baric and Williams, 2013). This is a key priority. The lack of coordination among the ministries and departments responsible for tackling undeclared work has serious implications for procedural justice and fairness issues. It is important that processes as well as
outcomes are well coordinated, consistent and fair in order for the system to be perceived as legitimate. It is difficult to do this if there is no overall plan or body to take responsibility for action. If citizens do not perceive the system of enabling formalisation and punishing undeclared work (retributive justice) as fair and adequately developed, then this will substantially impact on their tax morale. In light of this, the following measure is recommended.

6.3.2.1 Coordinated response at strategic and operational level

A contributing factor to the quite modest success in tackling undeclared work in Croatia so far has been poor coordination between numerous government bodies (Baric & Williams, 2013). As responsibility is shared between a substantial number of ministries and departments, which each define own separate strategies, overlapping or awkward divisions of responsibilities are a common occurrence. In that light, the partition of the State Inspectorate in five independent inspection services (incorporated into five ministries), which came into force in January 2014, seems a step backwards. Although the rationale for such reform was an increase in efficiency, a number of problems on both the organisational and strategic level so far may suggest a different outcome. Given this, we advocate the improvement in coordination as another key step towards more successful fight against undeclared work in Croatia.

As already discussed in the section on Bulgaria, there are several different successful models for coordinating a national approach to tackling undeclared work deployed in EU member states, depending on the level of governance and the preferred functions:

- **strategic level**: inter-ministerial committees (RO) or single coordination agencies with hierarchical structures (FR);

- **operational level** (surveillance and inspections): inter-departmental monitoring bodies (IE), ad-hoc / standing control groups (LT) and joint task forces (UK)

As aforementioned in France for instance, there is a single multi-functional agency responsible for tackling all aspects of the informal economy, and in that sense, the institutional set-up is cohesive and integrated at both the strategic and operational level (Dekker et al, 2010, p. 14), supported by clearly defined priorities and regularly updated action plans. This integrated approach is one of the most comprehensive models of a coordination system in the fight against undeclared work, encompassing different levels of government and enforcement bodies, enabling it also to deploy a localised and sectorial approach to specific preventative and control actions. However, attempting emulation of such a comprehensive institutional set-up may be too ambitious and resource-demanding given the present state of affairs in Croatia.

When it comes to the operational level, a successful example of coordinated control actions can be found in Latvia. The Latvian Ministry of Welfare initiated a mechanism for improved cooperation between inspection authorities, endorsed via a government regulation act (Karnite, 2009). It covered improved information exchange, clearer division of responsibilities and better planning of common or parallel actions of a wide range of institutions. The labour inspectorate appears to be the lead body, while

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11 For more detailed discussion on the State Inspectorate and its abolition, see Franic and Williams (2014).
12 State Labour Inspectorate (Valsts Darba Inspekcija, VID), the State Revenue Service (Valsts iešūmumu dienests, VID), the State Employment Agency, the State Social Insurance Agency, the Office of Citizenship and Migration Affairs (Pilsnības un migrācijas lietu pārvalde, PMLP), the State Border Guard, the Republic of Latvia’s Register of Enterprises, the State Construction Inspectorate, the State Control, the Union of Local and Regional Governments of Latvia (Latvijas Pašvaldību savienība, LPS), institutions issuing licences for commercial activities and the Free Trade Union Confederation of Latvia (Latvijas Brivo arodbiedrību savienība, LBAS).
inspections are conducted jointly with the participation of State Labour Inspectorate and the State Revenue Service. Information campaigns are organised jointly with the participation of several from the above mentioned bodies.

An example of a locally-based cooperation on the operational level are Joint Shadow Economy Teams established in 2000 in the UK (Williams, 2009), composed of operational officers from the Department for Work and Pensions (DWP), Her Majesty's Revenue and Customs (HMRC) and the employment agency Jobcentre Plus. HMRC appears to have been the lead body in these task forces, providing 200 civil servants out of the 257 staff that worked on the teams during 2004.

The UK example shows that effective joint inspections can be conducted without specific legislative framework and without being organised by and subordinated to a formal coordination body. In Bulgaria for instance, joint inspections of the General Labour Inspectorate and the National Revenue Agency are conducted on the basis of signing formal annual cooperation agreement, which also allows for participation of trade unions in control activities (Daskalova, 2013).

Transferability and Applicability

The particular design and institutional set-up of a coordinating structure is likely to be highly country specific and should be considered following a careful situation analysis. It appears that in Croatia the most pressing need is to better coordinate surveillance and inspections across government departments, given the recent abolition of the State Inspectorate and splitting up of its functions into the realms of the five ministries. The need for such cooperation is particularly important when it comes to information exchange, clearer division of responsibilities and better planning. However, in the case of joint inspection, sustainability of cooperation within joint task forces could be an issue. This is not only because such audits are composed of officers from various departments with different organisational cultures, separate targets and performance measurement systems, but also due to possible inter-departmental rivalry, which could impede cooperation and effectiveness. However, joint actions during specific time periods (e.g. summer season inspections for tourism) can be a viable alternative.

A further key question to be addressed is which body should be leading a potential effort to streamline inspection activities that are now under the realm of several departments. In the vast majority of examples of coordinated operational approaches across East-Central and Southern Europe, labour inspectorates have taken the lead in organising joint task forces and inspection teams with officers from several departments.

Establishing a coordination body at central/inter-departmental level is another desirable option in Croatia. However, for any operational coordination body to function effectively there are some minimal conditions that have to be fulfilled, the most important ones being autonomy, sufficient powers, and access to resources. Data sharing and the existence of joint registers (or sufficient level of access to separate relevant registers/databases) is also a critical area that may endanger the effectiveness of a coordination body altogether.

As these criteria are not likely to be met in Croatia, the more appropriate option is to endorse cooperation mechanisms/coordination agreements between various departments with a cooperation agreement or government regulation act, without establishing a separate coordination body. Joint task forces can be also formed in a more informal manner. Yet, the same applies as in the case of the operational level, as a dominant department must be appointed. The decision under which institution/level of government to subordinate such a joint task force should be carefully considered, yet the labour ministry appears to be the most obvious choice.
6.3.2.2 Developing a friendly relationship between the state and taxpayers

Although previously recommended measures can significantly increase commitment, it is important for them to be integrated into a broader approach for tackling undeclared work. It is not sufficient solely to seek changes in the behaviour of citizens; as aforementioned, the way that the authorities treat taxpayers should be also altered. If this does not happen, a weak psychological contract between the state and citizens can alleviate the effectiveness of awareness campaigns. For that reason, we recommend an initiative that seeks to develop a friendly relationship between the state and its citizens. This is considered as an important next step towards a successful fight against the undeclared economy.

Fruitful projects aiming to reconcile the authorities and taxpayers were introduced in Italy during the early 2000s. The pioneering scheme, which was later adopted by other municipalities all around Italy, was established in Naples in collaboration between the local Labour Office and the University of Naples. The central idea of the project entitled “Centri Urbani Operativi per la Riqualificazione Economica” (eng. The Urban Operational Centres for Economic Renewal) was to provide an advisory service for all stakeholders (workers, unemployed people and employers) on all relevant issues, with particular attention on consultancy for unregistered entrepreneurs who want to formalise themselves (Bâculo and Gaudino, 2009). In addition to four specialised advisory offices established in different parts of the city, the project also included door-to-door campaigns, public actions, conferences, seminars and training for target groups, as well as organisation of various fair trades. The goal of these supplementing actions was to maintain direct and continuous communication between the state and citizens, thus establishing high levels of trust and a friendly relationship.

After initial resistance due to scepticism and fear of exposure, taxpayers eventually recognised the initiative as beneficial and valuable. Overall, some 1,280 undeclared entrepreneurs were advised on their position, more than 3,500 new entrants were helped to start their businesses, and some 4,000 contacts with target individuals and companies were established. In spite of substantial financial costs, the project proved to be quite successful having long-term gains.

Applicability (feasibility) and enforcement in local context

Adequately designed advisory centres can have multiple roles in the fight against undeclared work. On the one hand, they can help in prevention by easing the registration process for start-ups. On the other hand, such centres are valuable in efforts to increase tax morale as they send a message to citizens that the authorities are willing to pursue cooperation rather than coercion. Finally, one should not neglect their “curative” role as they advise informal businesses and individuals who want to formalise their activities. Having said this, it is reasonable to expect that the authorities in Croatia might find this measure as highly beneficial. In addition, trade unions and the Employers’ Association could provide important support in such an initiative as both of these groups of stakeholders have long-term interests in improving the psychological contract between the state and its citizens.

A potential obstacle is the high cost requirement for the project, which can elicit resistance among citizens and political opposition. In addition, one should bear in mind that the key of success in the case of Naples was in well-educated staff, professional approach and well-planned strategies. The initial phase of the scheme, for instance, included a detailed analysis of the causes and nature of undeclared work for each of the city-areas in order to decide which businesses and individuals should be particularly targeted. However, having in mind previous experience with failures of various government offices in Croatia caused by rashness and poor planning, there is a reasonable possibility for failure of this project. Although the idea itself perfectly matches the need in Croatia, only careful and professional planning would yield desirable results. This foremost includes education of personnel for work in such offices and a local-
based approach grounded on a comprehensive study of undeclared activities for each administrative unit. Unfortunately, such analyses are non-existent and thus the next proposed measure will address that issue.

**Transferability and adequacy (“Goodness of fit”)**

In terms of target population and the strategic approach, the measure applied in Naples can be with some minor changes easily transferred to Croatia. For instance, the involvement of trade unions and the Employers’ Association would be highly beneficial for the project, particularly in alleviating issues of low trust and the fear of exposure. Similarly, as financial cost is potentially quite high, it might be more appropriate to focus primarily on advice service, accompanied with occasionally organised seminars and conferences.

Further important issue to discuss is geographical coverage. Although it would be ideal to establish such offices in each of the twenty regional units, this approach might be financially unprofitable. For that reason, perhaps the better idea is to organise five or six large regional offices and several smaller local ones. In any case, the most important accent should be on direct and continuous contact between the authorities and citizens.

6.3.2.3 Establishing a data gathering service

The OECD (2013b) outlines the building of taxpayer profiles and better understanding of the undeclared economy as an integral part of efforts to improve tax morale and tax compliance. In light of this, it is argued that further and more in-depth analysis of attitudes and perceptions of individuals towards tax issues allow countries to develop their own taxpayer profiles. Given that these are then country specific, they provide a better understanding of how the decision-making process of the decision to formalise or be undeclared can be influenced by targeting tax morale. More information is needed about the development of tax morale and the factors that influence this before adequate policies can be designed. Once it is known which groups are most resistant to working formally and which have the potential of being easily convinced of the benefits of formality, effective targeting of policies such as awareness campaigns can be achieved. Understanding the various contextual, socioeconomic and institutional factors influencing tax morale and the social contract can moreover be used to inform the work of the revenue authority, business and civil society, to build on and target taxpayer literacy and education campaigns therefore linking to the other recommended measures. In establishing a data gathering service, even more focus can then be given to building profiles for different regions, sectors, types of undeclared work or personality types. This is important because of the heterogeneous nature of the undeclared realm even within one country.

Other than building tax profiles, the data gathering service can also be committed to better understanding undeclared work as a whole. Taxing the undeclared economy is a challenge not only for countries in transition such as Croatia but also for most developing countries and a better understanding of the phenomenon is crucial in the fight against undeclared work.

**Applicability (feasibility) and enforcement in local context**

Given that this is a general suggestion, rather than a policy identified within another country, the transferability issue is rendered non-applicable. The adequacy of the suggestion is confirmed in its simplicity yet importance in terms of building of capacities for understanding the causes and consequences of undeclared work. Once the relevant data is collected then the body itself can be involved in developing policies that more specifically target the root causes of the problem in Croatia. However, a potential difficulty may be unwillingness of the different organizations involved to cooperate,
which would hamper the potential progress. On the other hand, the implementation of a coordinated response at strategic and operational level will ensure that there is a relevant body to take responsibility for coordination of any necessary inter-departmental cooperation.

Controversies surrounding the use of an evidence-based approach to decision making should also be noted due to potential problems of resistance. In order to overcome this, it might be useful for the service to work within a government structure as this would increase the likelihood of taking the data into account when devising policies. This however raises issues of independence and impartiality and is a problem that should be more comprehensively evaluated once specific recommendations are made on the basis of more empirically grounded conclusions.

As the importance of this measure is tied to the subsequent effectiveness of other measures, and there is no similar body responsible for such actions in Croatia, it is considered as a vital tool in terms of developing a long-term strategy in the fight against undeclared work. A more in-depth calculation of the costs and benefits should be undertaken before a decision of the scale of the implementation is made as the potential costs might be a large obstacle for Croatia.

This instrument has the potential to better inform policy design. Many of the issues with tackling undeclared work often lie with political ideologies carrying interpretations of the causes of undeclared work. For example, the political right view is quick to blame tax burdens and bureaucracy caused by the state whereas the political left is more likely to look to issues such as labour exploitation. Having more empirical data specific to Croatia can ensure the correct issues are focused on.

6.3.2.4 Changing the surveillance approach—repression only as a last resort

When it comes to surveillance activities, inspections in Croatia still predominantly rely on deterrence. A number of recently conducted reforms mainly aim at increasing effectiveness of detection and raising penalties for violators. On the other hand, not much is done to enhance voluntary cooperation. By using ‘sticks’, inspection bodies additionally amplify the gap between the authorities and citizens. Such a punitive approach can generate defiance among taxpayers and thus potentially result in even greater evasion. For that reason, if eradication of undeclared work in Croatia is to be effective, it is necessary to alter the way in which surveillance institutions treat citizens, i.e. to modify their approach from pure repressive to one of a more cooperative nature.

An interesting example of such a shift can be found in Estonia. Faced with pervasive problems with under-declaration of total remuneration for formal jobs, the Estonian Tax and Customs Board developed a successful pilot program for tackling those activities (Lill and Nurmela, 2009). After detecting companies with wage levels significantly below the average for that sector, type of organisation and region, the Board decided in 2005 to send notification letters to 1,000 of those businesses. Employers were informed about the suspicion of under-declaration and advised to make adjustments if this really was the case. They were also informed about future actions against them if no change was accomplished. After a few months, inspections were sent to those firms that did not alter their behaviour. The initiative was repeated in 2008, but with a slight modification. While in 2005 letters were sent only to employers, in the second wave three different options were applied: in some companies both employers and employees were informed, and in some only one of them (either the employer or employee). In total, the second wave encompassed 1,000 companies and 2,000 workers.

According to the evaluation for 2008, the action can be deemed as quite successful. Almost one half of firms increased their payments, which resulted in a tax payment increase accounting for 10 million EEK. On the other hand, 43% of business did not alter their behaviour, and 8% even worsened. Analysing the results for three different groups, the biggest improvement was noticeable in cases when both an employer and employee received a notification, with positive changes in 56% of such cases.
Generally speaking, the notification letters approach had a three-fold effect. First, the tax authorities softened their approach by marking repression only as the last resort. At the same time, the letters certainly raised the perception of the probability of being audited and thus curtailed readiness for future noncompliance for those who received the letter. Finally, the strategy managed to yield a noticeable increase in tax revenues, while keeping the cost at a minimum possible level.

**Applicability (feasibility) and enforcement in local context**

According to the Special Eurobarometer Survey on undeclared work, 8% of workers in Croatia are working on under-declared basis, i.e. only a part of their total remuneration is declared. This places Croatia among the countries with highest rates in the EU. In line with the general approach towards illicit activities, so far only punitive actions have been applied to tackle under-declaration of income in this new member state. However, given the successfullness of notification letters and their multi-fold role in endeavours to eradicate this type of disobedience, such action could be highly beneficial for the authorities in Croatia.

Due to the low cost of implementation and no significant human and technical capacities needed, this initiative should not face any particular opposition. It does not contradict interests of any stakeholders and does not overlap with other existing policies. On the other hand, it can help in changing taxpayers' perception about the way the tax authorities treat them. However, there is a concern of long-term effects of notification letters. If this scheme to promote cooperation is applied in isolation, its effectiveness could vanish rapidly. For that reason, it should be incorporated in a broader strategy to improve the general relationship between tax authorities and citizens.

**Transferability and adequacy (“Goodness of fit”)**

Due to similarity in the nature and extent of under-declared employment with the donor state, the measure could be transferred directly into Croatia. However, some minor changes to achieve better targeting could increase the effectiveness of such letters. For instance, only businesses in susceptible sectors (e.g. construction, agriculture and tourism) could be targeted. On the other hand, the initiative can be focused on certain regions or solely on businesses from large cities where these practices are most prevalent.

The next important aspect that should be addressed, if a more successful fight against undeclared is to be accomplished, is improving the cooperation among social partners, on both a national and sector level.

6.3.2.5 **Social partnership on sector level – joint actions, data and knowledge exchange**

Due to considerable discrepancies in the interests and values between social partners and overall lack of mutual confidence (Milicevic-Pezelj, 2013; Eurofound, 2012; Šokčević, 2009), the tripartite dialogue on the national level has so far had a quite modest achievement in combating undeclared work (Franic and Williams, 2014). The most recent dispute on the new Labour Act for instance prolonged its preparation and adoption (Franic and Williams, 2014), which in consequence resulted only in minor changes in comparison to the previous Act. Given the similar disagreements on a few other occasions during the last four years, there is an impression that the relationship between social partners has become even more strained (Nestić, Rubil, Stubbs, and Tomić, 2013). Therefore, we highlight the importance of developing an open and fair dialogue between the state on the one side, and trade unions and employers on the other as an essential step for a more successful fight against undeclared work.

Still, it is not only vital to recognise the benefits of cooperation on a national level, but also on lower levels (regional, local and/or sector). Indeed, the collaboration of social partners on lower levels can be quite fruitful as it enables a more local-specific approach in addressing the issue. Such tripartite bodies may be
focused on data and knowledge exchange or joint actions (or both in parallel), thus promoting social partners into important players in combating undeclared activities.

A good example of cooperation on lower levels can be found in Germany, where the importance of sectorial tripartite bodies has been recognised. The first such cooperation activity was established in 2004 between the Federal Ministry of Finance and the social partners in the construction sector (Vogel, 2013) and later extended to several other sectors (the transport sector, meat processing industry, textile industry, painting services, etc.). Alongside exchange of information and experience, these tripartite bodies jointly launch public awareness campaigns about the pitfalls of undeclared work. In addition, social partners organise working groups, which seek to develop appropriate sector-specific measures to tackle the phenomenon, conduct joint field controls and monitor compliance with the minimum wage law.

Given this, such sectorial tripartite bodies have manifold roles in tackling undeclared work. While on the one hand the cooperation of partners on sectorial level helps in improving enforcement through deterrence, it can also be a valuable tool in fostering voluntary compliance through educative campaigns, targeting both employers and workers. Achievement of the tripartite body in the construction sector in Germany suggests that such collaboration can yield significant results in combating undeclared work. For instance, according to the Association of Small and Medium-sized Employers in the Construction and Related Industries in Berlin and Brandenburg, which monitors compliance with regulation on construction sites, 76% of all cases they reported to the local authorities due to suspicions of a violation indeed turned out to include undeclared work (Vogel, 2013).

**Applicability (feasibility) and enforcement in local context**

Most attempts to tackle undeclared work in Croatia have been thus far conducted on the part of the authorities, thus leaving the partners outside the process. Trade unions and the Employers’ Organisation, on the other hand, have not expressed a particular interest in launching campaigns and schemes that would aim at fostering voluntary compliance. Following this, proposed cooperation on the sector level can be a first step towards recognising the importance of the cooperation between social partners in Croatia in combating the phenomenon.

Given the predominance of undeclared work in certain sectors in Croatia (foremost in construction, agriculture and manufacturing), the German example can prove to be a valuable strategy if applied in Croatia. Yet, the effectiveness of such bodies would depend on the quality of cooperation on the national level and thus it is crucial to promote the culture of dialogue among the partners on both levels. If there is no will for the dialogue at the national level, it is hard to expect that collaboration at the sector level would function.

Alongside high financial cost, another potential obstacle for the introduction of this measure can be the lack of human resources and a weak infrastructural capacity. Still, although one can argue that this measure is still premature, the possible benefits of such an approach towards combating undeclared work should foster all three stakeholders to put its introduction high on the agenda in the near future.

**Transferability and adequacy (“Goodness of fit”)**

No similar attempts to tackle undeclared work at the sector level have been pursued in Croatia. Although the need for such joint strategies exists in most sectors, they could be particularly valuable if applied in construction and agriculture for instance. As these are among the sectors with the highest number of unregistered firms and individuals, the two can serve as foundations for pilot strategies. This could

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13 Successful examples of such schemes and campaigns launched unilaterally or jointly by trade unions and employers' organisation can be found in Romania (Ciutacu, 2009) and Bulgaria (Dzhokova and Williams, 2014).
provide insight into the viability of tripartite cooperation; and if prove to be fruitful, such cooperation can be transformed into other sectors.

When it comes to the range of activities, there are different options possible. Even if the lack of human resources, weak infrastructural capacity and/or high costs are indeed insuperable obstacles for joint inspections, benefits of data and knowledge exchange seem a reasonable motivation for involved parties to embark in the collaboration. This can be accompanied by the occasional awareness campaigns, which could yield better outcome if all three stakeholders are involved.\(^{14}\)

This measure is the final tool recommended in the aim of changing formal institutions. However this is one that can be used within a number of the recommended instruments. In doing this a more rounded and legitimate approach to tackling undeclared work is achieved.

### 6.3.3 Overall conclusion for development of formal institutions

One of the key issues that arose early in the identification of relevant measures is that of improving the interaction of the government with its citizens. Although it was noted that this need is met by the development of an ethics infrastructure, the interconnecting nature of the plan is shown by the number of other policies that also target this need (Figure below).

The general discussion points to a lack of sufficiently functioning administration bodies in order to fully utilise the benefits of some recommended measures. Emphasis should therefore be placed on building necessary infrastructure. Alongside this, the government should aim to increase a sense of collectiveness through better communication and more citizen involvement. Sending the message that political interests are aligned with the interests of society (coupled with serious implementation of measures) is more likely to create a sense of obligation to the government and thus increase tax morale rather than further fostering norms that approve the engagement in the undeclared realm. Some recommendations of measures have been kept quite broad, such as the citizen participation schemes. This is so as to not

\(^{14}\) Further discussion on awareness raising strategies is provided in the next section.
narrow the focus so much that the implementation becomes about the specific instrument. Rather, alongside specific tools, efforts should lie with genuinely incorporating the concepts as part of a more general state strategy.

### 6.4 Changing Informal Institutions

In this section, the focus is placed on changing informal institutions as a means of subsidising the formal/informal incongruence.

Castro and Batel (2008), amongst others, discuss the difficulties of instilling new norms and practices. There are many factors that shape the developments of norms. As context and history are amongst these, it is clear that the desired change will take a substantial amount of time and that there is no quick fix.

Therefore, importance lies in considering this a second stage of the overall plan. It is crucial that changes to formal institutions are implemented because, as the section on Issues of Transferability and Applicability in Transitional Contexts suggests, the inadequacies of formal institutions will hamper the success of changing informal ones. This becomes even further evident when specific measures are looked at and potential problems considered.

In order to better align social norms and values with formal institutions there are two types of education about compliance at disposal (Williams, 2014a,b). Whereas the first focuses on educating citizens about the value of paying taxes the second fulfils a need to educate citizens about their requirements of the current tax system. In order to achieve the latter, easily consumable information on taxpayers’ responsibilities should be provided.

#### 6.4.1 Raising Awareness

The following set of measures focus on awareness raising as a tool with the overarching aim of developing tax morale. Having examined the vast body of literature about measures dedicated to fostering commitment it became evident that in order to effectively fulfil the target of raising awareness, it is necessary to focus on a number of different issues. In doing this, a more holistic approach arises that considers the problem from multiple angles. Two separate, but interlinking, policies are therefore chosen to reach this target. The first encompasses collective issues of not paying taxes whereas the second set of strategies aims at raising awareness about the benefits of the declared realm.

##### 6.4.1.1 Raising awareness about the consequences of undeclared work

Several countries have conducted successful national campaigns focused on clarifying the link between paid taxes and the public goods and services received in return. The main idea of such campaigns is to
illustrate a picture of a situation in which everyone ceases paying taxes. This is done in a simple and direct manner that commonly includes advertising on national media and/or on various public facilities (vehicles, buildings etc.) in order to reach a wide population. The message is usually placed within remarkable photographs that can be accompanied by short captions, or simply by provocative acclamations on billboards and radio stations.

For instance, as a part of the campaign ‘Unpaid Taxes Will Leave a Mark’ launched by the Estonian Tax and Customs Board in 2010, buses in eight cities in Estonia carried a photo of rescue service workers with the accompanying text: “Should we take the trolley bus to an emergency call-out? This can happen if you do not pay your taxes” (Nurmela, 2013). In addition, ambulance and rescue cars in several cities had a clearly visible and short text stating that the vehicles were bought with taxpayers’ money. In 2011 the initiative was repeated, but redesigned to address cultural and social aspects of tax evasion. For instance, advertisements provided information about how many kindergartens could have been built or how many computers for public schools could have been bought if tax debtors and evaders did not fail to comply.

A similar action was launched in Denmark in 2005, focusing principally on the younger generations, as they are most prone to noncompliance (Pedersen, 2009). Although being also present in newspapers and public surfaces, the campaign predominantly relies on TV advertising during peak periods. Short commercials, which contain images (without text) relevant for the young population (e.g. rusty playground or injured skateboarders in front of a closed accident and emergency service), seek to make young people think of why it is important to pay taxes and how that money is spent.

It is also worthwhile mentioning a quite similar information campaign conducted during October 2011 in Latvia. This action named “I spit on it”, which aimed at showing negative consequences of undeclared work on social provision, was a first stage of a wider scheme initiated by the Latvian Employers’ Confederation15 (Karnite, 2013b). However, unlike the two aforementioned strategies, a more sophisticated approach was employed. Initially, television advertisements and street billboards began appearing with only the text “I spit on it” showing. This generated curiosity among citizens and elicited discussions about what the adverts could mean. In the second stage, the white background was replaced by three different images, portraying a child, women in pregnancy and grandparents. Finally, in the last phase each of the pictures was supplemented by a short text (“Happy childhood?” next to the photo of a child, “Young families?” accompanying the pregnant women, and “Well provided old days?” alongside the image of grandparents). After having people prepared in this way, the key idea of the scheme was revealed. Although this ‘psychological game’ served as an introduction of a broader initiative, such strategy of gradual messaging can be a quite useful tool in increase the effectiveness of awareness raising even if applied as an independent measure.

Potential issues with raising awareness about the consequences of undeclared work

Although this measure seems desirable for Croatia, it is important to consider some issues that might impede its success. Thurman et al (1984) describe issues such as denial of responsibility with regards the negative effects of undeclared work, which campaigns such as this seek to portray. They argue that individuals construct themselves as minor players in the undeclared economy and rationalise their activity by thinking that the undeclared work of other actors is much more substantial than theirs. As part of their justification this diminishes their own activity to not being important and thus not having an overall effect on the outcome. In such a case, campaigns such as this one would be of little value. This is because upon receiving the message of the campaign blame for the consequences would be shifted to those that evade bigger amounts.

15 Apart from this advertisement campaign, the scheme entitled “Against the shadow economy – for fair competition” included several other strategies (online testing, focus groups, public discussions, awareness actions in city squares etc.)
This potential problem can be resolved in a number of ways. One such option is to minimise the opportunity of denial of responsibility for the issue through normative appeals. This can be done by designing the campaign to present the average level of non-compliance so that people no longer see their own activity as ‘minor’ compared to others but instead get a more realistic outlook. However, framing and phrasing this information are key issues that can influence the reception of the message. Phrasing the information negatively (percentage of those that engage in undeclared work) might lead individuals to reconsider their personal norms by questioning the strength of the social norm of compliance. Many examples of this are found in literature. An interesting instance is found with the Petrified Forest National Park where when a sign was placed showing three people to be stealing wood, theft actually increased. However, when the sign showed only one person to be stealing as opposed to three, thefts decreased (Cialdini, 2007). In the instance of undeclared work, it is desirable to present the figure of non-compliance in terms of the majority that pay taxes rather than those that do not. Once an individual operating in the undeclared realm realizes that they are not in the majority, it is more difficult for them to deny responsibility. The establishment of the aforementioned data gathering service would also aid in targeting specific types of evaders. Furthermore, the provision of wide ranges of empirical data is likely to instil more trust in the presented figures.

Another possibility is coupling this type of awareness raising campaign with another that seeks to present the benefits of declared work to the individual, as the two applied together, might have a more powerful effect. It is for this reason that the following measure is suggested.

### 6.4.1.2 Raising awareness about positives of formality

Strategies that aim at expounding positive effects of declared work for personal welfare represent an indirect tactic to foster commitment. They provide an inverted view of reasons to comply by putting private rather than social interests in the focus of the attention. In turn, such schemes are usually more effective than those focused on broad social consequences of tax evasion. This is because noncompliant individuals sometimes tend to relativize their responsibility in the overall evasion, as already discussed previously. On the other hand, when confronted with tangible, personal benefits of declared work, they much easier realise the disadvantages of informality and are thus more likely to change their behaviour. Yet, the two approaches are not mutually exclusive, in reality, because both commonly rely on use of same tools (TV and radio advertising, posters, actions on city squares etc.) the authorities usually apply them in tandem. Following this, the same is advocated for the case of Croatia.

Several countries recently ran raising awareness campaigns to illuminate the negative consequences of undeclared work on personal well-being. Although slightly different in terms of the approach and the target population, no significant discrepancies exist between these measures and thus we first briefly describe the idea of such initiatives, before turning to the issue of transferability and applicability in Croatia.

Two similar strategies were applied during the pre-crisis period in Estonia, both targeting employees. However, while the first wave in 2005 was focused solely on young workers (who are the most susceptible for opportunistic behaviour in Estonia), the second wave in 2008 was dedicated to the whole working population (Nurmela and Lill, 2009). Those actions, initiated by the Estonian Tax and Customs Board, relied mainly on advertising in public media and posters all over the country, accompanied by hand-outs in Estonian and Russian. The main idea was to clearly elucidate the most salient pitfalls of work on undeclared basis, such as uncertainty, poor working conditions, non-existence of insurance in the case of accident on the workplace, lack of social protection, lower pension, constrained access to loans and credits etc.
Although the initiative “Let’s stop undeclared work” launched in 2010 in Slovenia had the same objective, it was adjusted to cover all stakeholders involved in undeclared activities (Rajgelj, 2013). Apart from workers, the campaign thus also targeted firms and consumers of undeclared products and services. While in the case of businesses the focus was on unfair competition caused by informal activities, consumers were primarily educated about the lack of the legal protection when the quality of acquired goods and services is unsatisfactory.

Probably the most advanced attempts to distract people from undeclared work were undertaken in Latvia during 2007 and 2008 (Karnite, 2013b). In the first stage, some 100,000 black envelopes with the heading “All that is under the table is not gold” were sent to citizens all around the country. Each envelope contained a card with a short explanation of why people should avoid undeclared work. The action was continued in 2008 by depicting personal experience of undeclared workers in an intensive advertising campaign, which aimed at distracting people from such activities.

**Applicability (feasibility) and enforcement in local context**

No similar measures have been applied in Croatia thus far. However, given the recent initiatives launched by the Tax Administration and the Ministry of Labour, it can be concluded that such a strategy matches appropriately with the political priorities in this new member state. Although intensive advertising entails substantial expenditure, the potential benefits (not only in the short run, but also in the longer period) are large and thus no political opposition is envisaged. Indeed, the measure perfectly fits with current initiatives to tackle undeclared work.

A further question that should be looked at is one of institution involvement with the design and implementation of campaigns. It is not imperative that government agencies lead such events and involvement of social partners is an especially interesting option for Croatia because of the low engagement thus far. Therefore, it is not only that such attempts to combat illicit activities do not oppose the interests of trade unions and the Employer Association, but rather that these two groups of stakeholders could be valuable partners in the process. There are, in fact, many instances of trade associations being involved in countries such as Sweden, Germany, France and Bulgaria. The case of Bulgaria is particularly interesting as the Bulgarian Industrial Association run an ‘In the Light’ campaign ([www.nasvetlo.net](http://www.nasvetlo.net)). As part of this, the aim was to elicit a public discussion as a means of overcoming existing problems. This might be especially appropriate for improving tax morale as it encourages citizen participation in the fight against undeclared work therefore instilling more involvement.

Considering the target population, the absence of potential risk or danger for them diminishes the existence of any such obstacle for introducing the measure. Similarly, there is no any reason for resistance of trade unions and employers, as this initiative does not contradict their interests.

The most important advantages of this strategy to reduce tax evasion lie in its simplicity, broad-reaching character and the low level of institutional and administrative infrastructure required. The main drawback surrounding the implementation of the measure is the difficulty of predicting its reception and effectiveness, as well as the constrained possibility of assessing the impact after the campaign is finished. However, the European Commission (2007) acknowledged noteworthy opportunities for Member States to make greater use of advertising campaigns as instruments in tackling undeclared work. Although the collected evidence is limited it shows positive impacts in terms of effectiveness and cost efficiency. One such example lies with the HMRC who predict that, as a result of their UK based advertising campaign,
around 8,300 additional individuals registered to pay tax (National Audit Office, 2008). Although there are issues with measurement, this is a good indicator of the potentially positive outcome.

A further drawback is that as these initiatives are of restricted duration, their initial effect might fade after a certain period. However, this can be outweighed by a long-term, sustainable, commitment to changing and reinforcing social norms.

As explained before, strategies to raise awareness about the positives of declared work are usually more effective than the measures focused on the negative consequences of tax evasion. However, there is little doubt that better results are achieved by a combination of the measures.

**Transferability and adequacy (“Goodness of fit”)**

No particular obstacles with transferability are envisaged. Because target group characteristics are similar to those in the four donor countries\(^\text{17}\), such an approach could easily fit in the local context. However, we propose a mixture of these donor strategies in order to achieve better effects.

As part of the design process, it is necessary to determine whether the whole population should be targeted or just certain groups of interest. Because tax morale is generally low in Croatia the scheme might be appropriate for everyone. However, specific targeting might have a more powerful effect because it can be better tailored to have a substantial psychological impact where certain individuals can recognise themselves in the particular situation that is being portrayed. Furthermore, this means that sectors or groups that have particular issues with undeclared work in Croatia can be targeted. For instance, a high level of opportunism among the young population in Croatia implies that the strategy applied in Denmark would be of particular value. On the other hand, the scheme could also be adjusted to target solely individuals employed in certain sectors that are particularly problematic (e.g. agriculture, construction, the trade sector). Similarly, it is also important to decide if only certain geographic areas should be covered (e.g. large cities) or if it is more appropriate to apply it to the whole country. Answers to these questions will determine which advertising services are the most appropriate medium (national TV, local TV stations, the internet, public transport vehicles in large cities or perhaps only working areas of certain employees if sector-targeted strategy is applied) as well as the design of the campaign itself.

**6.4.1.3 Conclusion**

Due to substantial acceptance or normalisation of certain types of undeclared work a campaign targeting the negatives is important in terms of creating awareness of the concept as a problem. This is the first step in creating a social climate in which undeclared work is stigmatised and might help in supporting a broader culture of tax compliance rather than social enforcement of evasion. The use of shocking images would be particularly effective here because they get individuals to think about the phenomenon in an alternative manner whilst considering the dire consequences. Coupled with the measure that points to the positives of formality, the awareness campaign approach is expected to have good results in Croatia.

As per the evaluation of the typology of policy measures in the context of transition countries, this type of measure will only work in combination with the aforementioned measures that seek to improve the social contract between citizens and the state, thus increasing trust in government and reducing levels of corruption. Otherwise, because of personal experiences and word of mouth information, messages that seek to describe the positives of declared work and negatives of undeclared work would not be taken seriously. The current low trust in government would cause such campaigns to be viewed in an overly critical manner.

\(^\text{17}\) All donor countries are economies in transition, akin to Croatia.
Having outlined the relevant awareness raising measures the following section recommends the improving of citizens' tax knowledge as a means of influencing the formation of social norms and values.

6.4.2 Improving Tax Knowledge

Improving citizen tax knowledge is a widely recognised measure for tackling undeclared work. Eriksen and Fallan (1996, p. 399) state that ‘a successful means of preventing tax evasion is to provide more tax knowledge to larger segments of society in order to improve tax ethics and people’s conception of the fairness of the tax system’.

The intricate importance of taxes for the performance of the state is not always clearly evident to its citizens. Likewise, the complexities of the system may cause individual tax liabilities as well as obligations to comply, difficult to comprehend. Taxpayer education and service can function as a valuable means for informing and educating citizens about the tax system as well as assisting them in their attempts to comply. Efforts in this direction have been described in the below outlined measure.

6.4.2.1 Taxpayer education and taxpayer service

Good examples of taxpayer education and a taxpayer service were implemented in Rwanda and Peru (GIZ Sector Programme Public Finance, Administrative Reform, 2010) The rationale of the measure came from recognizing the need for taxpayers to understand the importance of contributing to the tax system, as well as for them to better comprehend the specific intricacies of tax systems. In this sense, the measures perfectly align as an extension of the previously mentioned instruments of raising awareness. Furthermore, it was acknowledged that individuals also need to develop a deeper understanding of the tax systems and the taxing procedures. One of the Rwanda Revenue Authority’s key goals is to alter the public’s opinion about the revenue authority to that of a benevolent attitude and to stimulate a “tax-paying citizen” culture, they have hoped to achieve this through incorporating its external environment into the capacity development process. This involves the creation of an annual “taxpayer’s week” including parades and the bestowing of certificates and various prizes. Moreover, influential people and political figures are educated as to how they can promote conformity amongst their constituents. Furthermore, the Rwanda Revenue Authority is working with partner organisations to help supplement their efforts to circulate information about paying tax (Land, 2004). This highlights the value of incorporating a wide array of stakeholders into the education process. Important tax payers, donors and NGO’s can assist in bolstering the tax morale or act as exemplars for a responsible or sensitive citizen; two examples of endeavours that go above and beyond the regular efforts of politicians and tax officers.

The Peruvian Revenue Authority (SUNAT) has the function of teaching its citizens about the capacity of taxation. Its goal is to educate and inform not only current taxpayers but the future taxpayers as well. SUNAT provides, although is not only limited to: E-learning, education programs at schools and universities, education courses, video lessons, a virtual library and a range of publications. By using comics and videos they hope to reach illiterates, children and ultimately a vast proportion of their citizens. Their wish is to cultivate a type of tax morale, tax culture and, in the long term, an understanding of the tax system that is more than just a vague superficial knowledge.

Applicability (feasibility) and enforcement in local context

It is evident that the costs of instruments for setting up an infrastructure for changing formal institutions are vast but this is justified by the long term benefits of increasing tax morale which would result in
reduced costs in deterrence and incentive schemes. Once the desirable environment for the implementation of this measure is created no political barriers or social unacceptability are envisaged. However, without the advancement of the correct enabling institutions there are also issues with structural constraints. This is because it is important for the education element to be developed adequately and to be far reaching in terms of its audience. It should especially be capable of targeting youth as Mazar and Ariely (2006) argue that there is a likely possibility that this is the critical period for developing norms.

There is much common sense in arguing that well educated taxpayers that know more about the fiscal connections are aware of the benefits the state provides for the citizens from its revenues. In turn, these taxpayers are then in a superior position with regards assessing the degree of compliance (Lewis, 1982). Looking at this in the context of long-term changes education has the ability to enhance and strengthen norms. Due to the fact that norms and morality are attained through the process of socialisation, education can strengthen norms that are beneficially related to tax compliance for example honesty, morality, national pride, concern for others and fairness (Mazar and Ariely, 2006). Rather than focusing merely on tax education policy makers can devise strategies that see to underline the idea of the tax system being fair amongst ordinary taxpaying citizens; and construct programs that increase and engage with a taxpayer’s moral conscience whilst still enlarging social cohesion (ibid).

There is a significant amount of research that is highly critical of the convolution of tax systems and the issues this creates for reaching high levels of compliance (Andreoni et al., 1998; Natrah, 2013; Tanzi and Shome, 1994). A reasonably large amount of what some might call tax evasion is actually not deliberate; fairly often it actually occurs due to either people lacking certain knowledge, misunderstandings or ambiguous interpretations of tax law (Hasseldine and Li, 1999; Natrah, 2013). Consequently, one potential way of moving past this problem is to increase the provision of information to taxpayers (Internal Revenue Service, 2007; Vossler et al., 2011).

However, depending on the context, this might have the opposite of the desired effect. In the current situation in Croatia, although confusion about compliance is existent, it is combined with the root cause of undeclared work being low trust in governments and deeply embedded social norms. If individuals become highly educated they are better able to evaluate tax systems and fiscal policies making the inefficiencies and government wastes more visible to them. Furthermore if there is a lack of transparency, this sends the wrong message to citizens, who are likely to become more critical as a result of being better educated and can thus further damage the social contract. This can then have a cascading effect of causing a reduction in tax morale, which causes an increase in undeclared work. This is because the educated individuals are better equipped to recognise opportunities for evasion and avoidance.

This measure, just as the awareness raising one, therefore goes hand in hand with the policies recommended in the previous part. For this particular instrument to be effective, efforts to combat corruption and increase transparency are vital.

**6.4.3 Changing Informal Institutions: Conclusions**

As can be seen, the above measures are examples of appropriate policies that can aid in the change of social norms and values with regards to undeclared work. Although the change of formal institutions was placed as the key priority, the targeting of informal institutions carries with it equal importance. This is because even though government might be changing, the citizen’s may choose to ignore this or be overly critical of it in order to keep justifying their undeclared activities.

A potential way of diminishing this effect is narrowing and tailoring the focus of the message better. The described measures of awareness raising and education can thus be better incorporated into the overall
plan for tackling undeclared work in Croatia. Alongside implementing the more general information dissemination (information about taxes, benefits of declared work and disadvantages of the undeclared realm) that is outlined above, the state can also use the instruments as a forum for improving communication efforts of on-going changes to citizens. As part of this, they can inform the citizens of the specific reforms and steps taken by the government in efforts to improve formal institutions. In this light, the attempts to change formal institutions should be better received by the citizens having a better likelihood of affecting the development of norms and values.

6.5 Overall Conclusions

The intertwining nature of policies has been signposted throughout showing the dangers of implementing measures on an ad-hoc basis.

The low levels of optimism in Croatia (EVS, 2011), combined with the low trust in government (EVS, 2011; Sekulić & Šporer, 2010) and deep social embeddedness of undeclared activities (Bejaković, 2009; Rubić, 2013) make reducing the undeclared economy a particular problem in this context. It is vital to be aware that the success of the suggested strategies seeks to change opinions, attitudes, values and norms. In this sense, it depends on primary changes in the way of thinking and the perception of undeclared work on a collective, societal level. The aims and objectives will therefore take time to materialise as they require sustainable, long-term transformations and commitment.

Nonetheless, evidence from other countries shows that even once citizen trust is established and the government is seen as fair and legitimate, undeclared work will persist. This is due to the free-rider problem where certain individuals have a utilitarian rather than collective behaviour propensity (Long & Swingen, 1991). Therefore, once improvements are seen in the alignment of formal and informal institutions, the incorporation of direct controls will better fit part of the overall plan of tackling undeclared work in Croatia. Alongside improving tax morale, the focus can then also be placed on increasing the costs of informality and benefits of formality. Whilst the former involves deterrence
measures of improving detection and increasing penalties the latter comprises of incentive measures for both businesses and individuals (Williams, 2014a,b).

In doing this, the synthesis of direct and indirect control approaches, outlined in WP4 (Williams, 2014a), should be incorporated. However, once this stage is reached, it is important to deliberate which combination as well as sequence of measures should be taken on. Williams (2014a) outlines the responsive regulation and slippery slope frameworks as particularly interesting structures. In spite of the logical appeal of these however, there has been no concrete evidence of their effectiveness or appropriateness for various contexts.

The responsive regulation model, which is gaining increasing popularity, is especially useful in terms of its flexibility in dealing with taxpayers. Although this is generally a great advantage it might cause problems in the context of Croatia because it may lead to an inconsistency in administrative responses. Because Croatia already has low levels of trust in government such inconsistency has the potential of worsening perceptions of procedural fairness. This might in turn cause further damage to tax morale. This therefore, once again, points to the urgency of improving formal and informal institutions in Croatia.

7 FYR MACEDONIA

7.1 Undeclared work in FYR Macedonia: an overview

In this section we provide a brief synthesis of problem areas identified in the field of tackling undeclared work in FYROM (for further details see Dzhekova et al, 2014). Following this, the goal is to extrapolate broader clusters of intervention needs and prospective policy approaches for more rigorous empirical testing.

Extent and nature of undeclared work

The undeclared economy in FYR Macedonia is estimated at some 35% of the official GDP (Schneider et al, 2010), with almost one fourth of the total workforce working on an undeclared basis (SSO, 2013). In spite of a decreasing trend during the last decade, undeclared work in this EU-candidate country is still far more prevalent than in any member state18.

Accounting for over 85%, the share of the undeclared workforce is the highest for the population above 65 years of age, followed by young people aged 15-24 (with 40% of them working on an undeclared basis). Although no significant difference in the prevalence of such activities among men and women exists, gender discrepancies can be found in the occupational structure. Whereas men who work undeclared are mostly self-employed, women are to a larger extent involved in unregistered agricultural activities (SSO, 2013).

In general, labour-intensive, low-earning jobs in construction, transport, catering, the textile industry, domestic services, agriculture and trade are most prone to undeclared work (ILO, 2011; Jackman and Corbanese, 2007; Stankovic and Stankovic, 2012; Tevdoski, 2011). Informal activities in agriculture are particularly prevalent, as some 82-86% of all agricultural employment remains unreported to the authorities (Novkovska, 2013). It is not therefore surprising that the most common informal practice from the demand side is purchasing agricultural goods from undeclared merchants at markets.

18 Currently, Bulgaria and Croatia are the two member states with the highest shares of undeclared work (Schenider, 2013).
Barriers to formalisation

Unemployment is among the main drivers of undeclared practices in FYR Macedonia from the labour supply side (Stankovic and Stankovic, 2012; Jackman and Corbanese, 2007; Risteski, 2009; Nenovski, 2012). A progressive reduction of formal employment during the transition period resulted in extremely high unemployment rates, which have remained above 30% throughout the last two decades. Some particularly concerning features of the labour market are high long-term unemployment and youth unemployment, which indicate “deep-rooted structural impediments in the labour market” (European Commission 2013c, p. 18).

Although the business environment in FYR Macedonia can be assessed as satisfying (World Bank, 2013b), weak performance in certain areas still provides a significant rationale for informality. This principally applies to the limited ability of the state to enforce contracts and resolve insolvency (World Bank, 2013b), as well as to lengthy and expensive market exit procedures (European Commission, 2013c).

The frequent changes in the tax system, as well as the lack of transparency and impartiality within state institutions also represent important barriers to formalisation from the perspective of businesses (Stojkov, Nikolov and Smilevski, 2008). These are followed by the weak capacity of the Public Revenue Office: both the insufficient number of tax officers and the unsatisfactory level of skills of existing personnel often cause undesirable complications in the process of paying taxes. This certainly directs a proportion of firms into the informal realm, as the most attractive strategy to avoid hassle with the administration.

Another issue is the weak performance of inspections, which are prone to political influence (Stojkov, Nikolov and Smilevski, 2008). This provides a secure shield for some privileged companies engaged in informal operations. However, even those who are detected often manage to remain unpunished due to inefficient and corrupt judicial system (Garvanlieva, Andonov and Nikolov, 2012). With court trials lasting for several years and rarely producing a fair verdict, the system contributes to the low perception of risk for those who operate in the undeclared economy.

In general, corruption and bribery transactions are deeply entrenched in each segment of public life in FYR Macedonia. As revealed by a representative survey of 3,500 citizens conducted in 2010 (UNODC, 2011), one in ten Macedonians had an experience with bribery in interaction with public officials during the twelve months preceding the survey. There is also a broad belief among respondents that skills play only a minor role in getting a job in public institutions, while corruption, nepotism and cronyism dominate.

In consequence, low trust in public institutions and the perceived unfairness of official rules and norms has significantly deteriorated tax morale and reduced voluntary compliance. As a substantial proportion of taxpayers do not see a clear link between paid taxes and received benefits, there is a wide approval of disobedience with official rules. Therefore, all imminent efforts to eradicate undeclared work should put the improvement of the psychological contract between the state and its citizens high on the agenda. This particularly applies to minority ethnicities19, who do not identify themselves with the state and therefore have a weaker sentiment towards the importance of tax compliance (Klekovski, Nuredinoska, and Stojanova, 2010).

Organisational structure of the fight against undeclared work

There is no single body in FYR Macedonia responsible for tackling undeclared economic activities. Instead, several ministries are involved in this policy area through specialised agencies, with cooperation and joint

19 Ethnic Macedonians comprise approximately 64% of population, one quarter of citizens identify themselves as ethnic Albanians, while the remaining 11% are mainly Turks, Roma, Serbs and Bosnians (State Statistical Office, 2005).
actions taking place with respect to certain control tasks. The Ministry of Labour and Social Policy has a leading role: it implements state policy through its specialized units, namely the Employment Agency, State Labour Inspectorate, Social Assistance Agency and their regional structures. It also regulates the activity of labour market institutions at national and regional level and participates in the development of the main parameters of social security and payments related to it.

The State Labour Inspectorate within the Ministry of Labour and Social Policy is the main enforcement body exercising control over the observance of labour laws under the Labour Code, including the area of undeclared work. The coordination between the State Labour Inspectorate and other enforcement agencies remains limited, judging by the lack of formal coordination procedures and joined-up strategies, as well as the lack of common targets for different departments (Williams, Baric and Renooy, 2013).

Bipartite and tripartite social dialogue occurs through the Economic and Social Council (ESC), a consultative body established in 1996. The ESC failed to play a significant role in the past due to a lack of interest or conflict between its members, which resulted in limited activity taking place within the council. For example, no single meeting was held between May 2008 and September 2011.

In general, there is a lack of public trust in trade unions and the employers’ organisation, which are not seen as important social actors. Trade unions are, for instance, seen as close to the political elites and unable to promote and protect the interests of employees. Problems are similar when it comes to the employers’ organisation, whose density was also below 24% in 2010 (Eurofound, 2012b).

Policy approach used in FYR Macedonia

Akin to other European states, the fight against undeclared work in FYR Macedonia still predominantly relies on repression. Several reforms to increase perception of risk and costs of noncompliance have been conducted since the onset of the crisis (Williams, Baric and Renooy, 2013). However, there is a noticeable intention on the part of the authorities to supplement such deterrence strategies with enabling compliance measures, which are focused on increasing the benefits of declared work (Dzhekova et al, 2014). This is done mainly through reducing administrative and tax burdens for both businesses and workers, eased access to finance for certain categories of businesses and increased protection of the workers. In that way, the authorities seek to change the cost/benefits ratio by acting on both sides of the equation. However, it should be stressed that enabling compliance measures tend to target the workforce which is about to enter the labour market, while paying less attention to the formalisation of those already operating in the informal sector.

7.2 Rationale for policy interventions

From the presented findings it is clear that a significant discrepancy between formal institutions (laws, regulations and codes) and informal institutions (values, norms and beliefs) in FYR Macedonia represents a key barrier in creating a more successful fight against unregistered activities. Furthermore, the complexity of the situation is evident in that there are numerous areas that require improvement.

In light of this, a four-part approach is suggested for changing formal institutions. The first stage focuses on broad functional changes that are not specific in targeting undeclared work but instead seek to improve formal institutions more generally. Such policies seek to improve public governance across all levels and it is argued that this acts as an enabling step for the following actions. Following this, attention lies with policies that seek to improve the economic situation of FYR Macedonia on the one hand, and a

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20 Establishment of a Misdemeanour Body, Centre for debt collection, Centre for seized goods, Tax Academy for training and a forensic laboratory are some of the most important examples (see Dzhekova et al, 2014).
specific change of formal institutions with regards undeclared work on the other hand. Finally, a set of measures that also seeks to change formal institutions but in doing so narrows the emphasis on affecting informal institutions are chosen. These policies mainly surround a change of attitude towards taxpayers and change of interaction with the public and are crucial in terms of improving the psychological contract between state and its citizens.

Furthermore, it is also suggested that informal institutions should be more specifically targeted through equipping the citizens with knowledge and information of improvements being made more generally as well the tax system more specifically so that they can be better informed throughout their decision making processes.

### 7.2.1 Changing Formal Institutions

Akin to other transition states, the problem with formal institutions in this candidate country is not in the legislation itself, but rather in its (non)enforcement (European Commission, 2013c). The rules of the ‘game’ are clear and straightforward, but difficulties arise when it comes to their realisation and the control of compliance. This is not solely because of the weak institutional and administrative capacities, but also as a result of the low level of the rule of law, accompanied by prevalent corruption. As discussed above, many of those who are prosecuted for illicit activities often manage to remain unpunished due to the inefficient and corrupt judicial system (Garvanlieva, Andonov and Nikolov, 2012). On the other hand, surveillance bodies are prone to political influence, which provides a secure shield for some powerful companies in pursuing illegitimate practices. Due to a significant mismatch between formal rules and their integrity in practice, introduced measures to tackle undeclared work usually fail to change the perception of the cost/benefit ratio among taxpayers.

As a response to weak formal institutions, a significant gap between citizens and the state inherited from the period of communism has been additionally amplified during the last two decades. Due to the incapability of the state to enable economic development and adequate social protection for vulnerable groups, there is a permissive attitude towards undeclared work among citizens. As revealed by a national survey of 1,200 respondents, 25% of Macedonians do not feel a moral obligation to report violators nor to stop buying goods or services upon realisation that those products are made informally (Stankovic and Stankovic, 2012). Citizens believe that the state is not giving enough in return for paid taxes, and thus they prefer to keep the money for themselves. This would suggest that a low level of vertical trust (trust in the authorities) is certainly an important contributor to such a low level of tax morale. In consequence, such pervasive evasion sends a message to compliant firms and individuals that it is not worth to comply further fostering them to informalise their activities.
Given this, it is necessary to adjust the existing policy approach for tackling undeclared work in FYR Macedonia, i.e. to supplement existing direct controls (deterrence and enabling compliance) with indirect ones. Primarily, this implies the importance of improving redistributive justice (by establishing a clear link between tax liabilities and public goods and services received in return) and procedural justice (fairness with regards to the formula used to distribute resources). Secondly, it is essential to modify the way the authorities treat citizens, i.e. to shift from coercion to collaboration. However, this does not mean that repression should be abandoned, only that it should be used as a last resort.

7.2.1.1 Targeting Public Governance

Efficient public governance is paramount to achieving the target of boosting attractiveness of the business environment (The Regional Cooperation Council, 2013). Much like in the recent South East Europe 2020 strategy for jobs and prosperity, public governance is presented here as a cross-cutting issue due to being crucial in encouraging ‘sustainable and environmentally friendly patterns of growth’ (Regional Cooperation Council, 2018, p. 15). Combatting corruption is particularly imperative in terms of creating a well-educated society as well as encouraging innovation. Therefore the following areas are highlighted as key in terms of improving public governance:

- Increasing the competence and effectiveness of public administration
- Combating corruption
- Improving procedural, distributive and retributive justice
- Strengthening the rule of law
- Improving transparency
- Improving social dialogue

7.2.1.2 Stimulation of economic growth and incentives for formal work

The stimulation of economic growth as a tool for eradicating undeclared work is advocated for largely in proponents of the modernization thesis. According to this, the shadow economy a temporary substitute to unemployment and poverty disappearing as formality increases its ability of absorbing surplus labour (Marcelli, Pastor and Joassart, 1999). Nonetheless, even though the applicability of the modernization thesis is widely criticized it is likely that it has some relevance. Even though increasing economic growth is unlikely to fully eradicate the undeclared economy, there is logic in the claim that certain manifestations of undeclared work will diminish. Williams (2014b) finds some support for this in that larger undeclared economies are associated with under-development. However, this is in terms of it being measured by lower levels of GNI per capita in PPS and average wages. Williams (2014b) also describes other factors such as institutional strength and quality of the bureaucracy whose importance has been previously discussed.

The ‘political economy’ thesis, on the other hand, contends that the pervasive nature of the undeclared economy occurs as a consequence of unsatisfactory government intervention in work and welfare issues therefore leaving individuals unprotected. Proponents of this thesis argue that emphasis should be placed on introducing social protection, promoting equality and pursuing labour market interventions to help vulnerable groups. This seems quite an appropriate direction for FYR Macedonia as Angel-Urdinola (2008) find that approximately 83% of the gender gap in salary is inexplicable. This points to the issue of discrimination against female workers. Furthermore, they find that workers in rural areas or those with

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21 This issue was already discussed earlier in the report.
education of primary or lower level are more disadvantaged due to high gender wage gaps. Therefore measures seeking to correct this as well as the promotion of employment for vulnerable groups (particularly for youth) are highly desirable in the context of FYR Macedonia.

7.2.1.3 Improving institutional capabilities that specifically deal with undeclared work

Although FYR Macedonia has made good progress in this regard, there is room for improvement. Further investing in the reform of institutions and agencies dealing with undeclared work activities would help to strengthen the Hidden Economy Action Plan and the activities that go alongside this. There is a need for a strong cooperation between the different state authorities and labour market actors. This is important because although FYR Macedonia seems to meet the paramount need of political willingness, the long-term lack of political consensus can undermine the effectiveness of any action taken.

7.2.1.4 Targeting Informal institutions through changing formal ones

With regards informal institutions, it is crucial to put efforts in changing public perception about the acceptability of undeclared work and the general attitude towards taxation. However, the key precondition for all these changes is improvement in enforcement of adopted laws and regulations. If the state is not able to protect the rule of law, it is hard to expect from taxpayers to alter their behaviour. Therefore, as a primary focus for changing the perceptions of citizens, fundamental changes in formal institutions are recommended (explained above). Before moving onto policies that seek to specifically target the development of values and norms amongst citizens (such as awareness raising activities) it is recommended that FYR Macedonia adopts another set of measures that target formal institutions. The following set of measures differs slightly in that it takes a step away from internal changes to more directly target informal institutions:

- Developing a friendly relationship between the state and taxpayers
- Improving interaction with citizens
- Changing the attitude towards taxpayers: from ‘sticks’ towards ‘carrots’ (repression only as a last resort)

More broadly, national authorities should support a legal and economic incentives’ framework to make declared work more appealing in order to better engage employers and individuals in the fight against informality (European Commission, 2012d).

7.2.2 Changing Informal Institutions

Finally, in order to fully reduce the institutional incongruence a set of policies that focus most narrowly on changing informal institutions is recommended. In doing this, the aim is to change the norms, values and beliefs the public in terms of formal and informal work practices, promoting the former as desirable and informing of the dangers of the latter.

- providing education and training for citizens (i.e. improving tax knowledge)
- improving public awareness of manifestations and consequences of undeclared work through public awareness campaigns and normative appeals

8 Conclusion

In recent years, there has been a considerable refinement and advancement in the understanding of various policy strategies to tackle undeclared work across Europe, and moving the undeclared economy into the declared realm is now recognised as a common goal at EU level. A shift in policy approaches has started to emerge from the dominant focus on punitive and deterrent measures towards ‘soft’ and
'indirect' policies aimed at enabling and fostering voluntary compliance and increasing the tax morality of the population.

A number of tools and forums for cross-national policy learning are available now at EU level, facilitating the exchange of experiences and lessons and the identification of 'best practices'. Despite this, there is a persisting need to better understand which policy measures are most effective in various contexts, why and under what circumstances, as well as to what degree they are transferable to other contexts. Therefore, the objective of this Working Paper has been at least threefold:

(i) To highlight obstacles and processes of cross-national policy transfer and learning, as well as the importance of prospective policy analysis.

(ii) To identify a number of basic criteria for assessing the transferability and applicability of policy instruments from one setting to another.

(iii) To interrogate in a preliminary manner the potential application of an institutional policy approach towards undeclared work in three target settings (BG, HR and FYROM).

In order to move towards achieving these objectives, a number of contextualising factors have been identified in the target countries which are likely to present obstacles to successful implementation of prospective measures. These contextual variables, at the same time, guide the prioritisation of policy intervention needs in the three countries. What is common for all three countries is that in order for more targeted measures towards undeclared work to be successful, there is a need to strengthen the broader institutional foundation, by increasing government efficiency, confronting corruption, strengthening the rule of law and increasing the legitimacy and transparency of public institutions overall. At the same time, improving the quality of public goods and services, as well as broader economic developments, should be pursued in order to restore social solidarity and reduce inequality. Low trust in public institutions, and hence low tax morale and a weak psychological contract are identified as crucial variables at the core of the gap between citizens and the state and as driving the persistence of undeclared work. Therefore, in all three countries more attention should be placed on indirect measures, which seek to reduce the disparity between formal institutions (official laws, regulations and codes) and informal institutions (values, norms and beliefs of citizens).

Seeking opinions of the public and relevant stakeholders with regards to their perceptions of the appropriateness and potential effectiveness of policies is paramount in devising a strategy that targets a change in informal institutions. This is because choosing policies that have a better citizen approval and 'buy-in' is more likely to foster the development of a positive psychological contract. Therefore, the next phase of the project envisions testing prospective policy measures in terms of their acceptability and feasibility, through conducting national household and business surveys, focus groups with potential beneficiaries, as well as stakeholder interviews.
Appendix

EUROFOUND database on policy measures for tackling undeclared work

The EUROFOUND database of policy measures to tackle undeclared work has been used within this paper to search for prospective policy measures that could be potentially useful for the three target countries. The database allows browsing of the policy initiatives by country, sector and type of measure. The majority of the policy measures are classified to more than one type. For instance a policy measure could be assigned to types: awareness raising, commitment to tax morality and prevention. Some of the policy initiatives do not have an assigned type. The purpose of this preliminary analysis is to build an overall picture for distribution of policy initiatives by type and country.

- Relevant "nodes" were assigned to each measure strictly mirroring the EUROFOUND classification. For instance a policy initiative could be assigned various different combinations of nodes: awareness raising, business services, Austria, employers, purchasers.

- The following figures are representation of several different queries, which were executed in NVivo 10 from within the re-created database of 186 policy initiatives. For every different query there is a corresponding set – one figure and one table to meet different viewing preferences. The figure precedes the table, but both of them represent the very same data for each particular query.

- The countries are represented on the X-axis of each figure. The Y-axis indicates number of policy initiatives of any given type per country.

- The first figure (No. 2 below) represents how many policy initiatives (commitment to tax morality) are available in each country.

Figure 10. Distribution of policy initiatives (type = commitment to tax morality) per country.

Figure 11. Distribution of policy initiatives (type = awareness raising) per country.
Figure 12. Distribution of policy initiatives (type = prevention) per country.

Figure 13. Distribution of policy initiatives (type = legitimising undeclared work) per country.

Figure 14. Distribution of policy initiatives (type = improve detection) per country.
Figure 15. Distribution of policy initiatives (type = increase penalties) per country.

Figure 16. Distribution of policy initiatives (type = unclassified) per country.
Table 5. All types of policy initiatives per country using data from EUROFOUND.

<table>
<thead>
<tr>
<th>Country</th>
<th>Commitment to tax morality</th>
<th>Awareness raising</th>
<th>Prevention</th>
<th>Legitimising undeclared work</th>
<th>Improve detection</th>
<th>Increase penalties</th>
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➢ Policy initiatives which encourage commitment to tax morality are only 16 in total from within 186. Estonia and Italy are the countries, which have implemented more than 2 measures – 3 and 4 accordingly. Fifteen out of thirty three countries do not have any commitment to tax morality measures.

➢ Policy initiatives raising awareness are 27 in total and it is only Estonia where there more than 2 of this type.

➢ Policy measures of preventative type are 64. In comparison with the other countries, Poland, Estonia and Italy are those with most of these measures available.

➢ Policy initiatives towards legitimising undeclared work are 45 in total and it is only Finland which has more that 3 – 7 measures in place. There 11 countries without any of this type.

➢ Policy measures, which improve detection, are 56. Ireland, Germany, Sweden and Belgium have the highest number in comparison with the other countries.

➢ Policy initiatives, orientated towards increased penalties are 23. Sixteen countries are lacking this type at all and the highest number per country is 2.

➢ This is how the different types of measures are represented. It is obvious that most of them are of deterrence type.

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References


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